Introduction:

The City of Atascadero has worked hard to maintain fiscal stability in these times of economic flux. The effects of the local, state, national, and worldwide financial environments have been felt by virtually all governmental agencies, companies, and individuals. The severity of the impact is often times directly related to the planning and preparation that was done in advance. Fortunately, through Atascadero’s visionary leadership, appropriate policies and strategies have been put in place and continue to be used to help navigate the City as the economy recovers. The many tough decisions and sacrifices have worked to keep the organization strong and resilient.

The City of Atascadero has experienced its share of financial challenges over the last few decades. In the early 1990s, a sharp slow-down of the economy devastated the City’s budget and brought the staff to a skeleton crew. In more recent years, the state budget crisis brought more challenges as the State sought to balance their budget on the backs of local government. The loss of redevelopment in 2012 exacerbated this situation. The importance of a well-defined financial strategy to anticipate and conquer difficult issues cannot be understated. The responsibility to maintain a strong organization is shared community wide, but as the City Council and City employees, we agree to be the leaders in this effort. The Council has shown great leadership in its forward-thinking members and continues to look toward ensuring a sustainable future.

As with all successful organizations, the City needs to continue to revisit and update the long-term plan. A current yet fluid Fiscal Strategy is a key element of building a solid foundation upon which to move into the future. The City first adopted a Financial Strategy in 1998 and by focusing its resources, its financial condition has improved dramatically since that time.

The financial plan should outline general strategies and guidelines to mold the City’s decisions. The plan should identify actions and describe the current belief of the organizational needs. However, it should also be flexible as the economy or situations change, direction and efforts can be modified to best suit the needs of the City and community. The plan requires periodic updates to ensure the City’s financial strategy remains current and reflects the priorities of the citizenry.

The overall strategy has consistently been to maintain a conservative outlook by putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. By employing this conservative strategy, the City can avoid the undesirable peaks and valleys in services due to revenue fluctuations and can better maintain its long-term financial vitality.
Comprehensive Financial Strategy:

The first section of this plan highlights some of the actions that Council and staff have taken in response to the recent economic downtown and as the City heads into economic recovery.

The second section reviews some of the major revenues for the City. This section includes a description of these sources, how they’ve changed over the years, and what that means to the City now and into the future.

The third section analyzes ongoing operating costs. This includes employee and benefits costs, trends and assumptions. Additionally, this section reviews operating service costs, supplies, and capital expenditures.

The fourth section discusses long-term costs. These include discussions on long-term funding for maintenance and replacement of streets and bridges, storm drains, buildings, technology, vehicles, and equipment. Additionally, employee leave accruals are reviewed and analyzed.

The fifth section discusses reserves. The City has several different types of reserves to serve different purposes. The organization must retain some reserves to deal with cash flow issues, personnel, equipment, liabilities, and other unexpected expenses. Having a prudent plan to deal with ongoing operating costs and reserves will allow the Council and community to understand levels of risk in the City’s financial operation.

The sixth and last section reviews the City’s fiscal policies. These policies guide our budget process, projects, purchases and general City business. The City has taken a variety of steps over the years to maximize limited resources including economic development, strengthening of reserves, short- and long-term budget reductions, Strategic Planning, and revenue enhancement solutions. Staff continues to search for ideas to better the financial condition of the organization.

As we noted, all organizations must have a plan to succeed. This plan keeps the City’s focus on the top priorities. The plan is dynamic and change is always expected. Improvements will occur and good ideas are invited from all sources. The underlying belief is that through our collective knowledge and teamwork, the City will continue to have a strong financial foundation that will withstand adversity.
Section 1 - Key Actions
Highlights of Key Actions

Council and employees have worked as a powerful team to maintain the organization as fiscally nimble as possible. Critical indicators and influences are continuously monitored and analyzed so adjustments and modifications can be made as new information is available. Detailed below are highlights of some of the key actions in the last several years that have been accomplished to not only get the City through the economic downturn, but also position the City for success moving forward.

Economic Downturn
During the economic downturn, Council endorsed staff budget actions taken such as the reduction in operating expenses, emphasis on economic development, hiring chills, and operations monitoring. Additionally, Council adopted budget policies that enhanced the City’s fiscal position such as budget adjustments, no new or expanded programs, and pursuit of new and/or improved revenue sources. A workgroup was initiated to discuss budget strategies and come up with new ideas for cost reductions and revenue enhancements. The group was comprised of staff from the different departments and representatives from all of the employee associations.

Also during this time, Council approved special and capital project deferrals or eliminations and suspension of specific reserve funding among other gap-closing solutions. Employee groups and the City worked together to agree to additional employee contributions to CalPERS, voluntary salary reductions for the Executive Management Team, and a two-tier CalPERS pension system.

Economic Development
Council has been steadily focused on economic recovery for some years now, and is poised to take advantage of opportunities. Council has prioritized identifying commercial hotspots, reducing the number of vacant store fronts, building partnerships and alliances with local business interests, investing in infrastructure that improves business in Atascadero, and increasing traffic to local businesses through a promotions program.

On-going commercial projects include Walmart, the Del Rio Marketplace, Colony Square, Staples restaurant outpad, and the Hoff Property. Completed projects include West Front Village restaurant and Marriott Springhill Suites.

Council approved the Signage Clean-up Strategy to improve the appearance of the City’s Commercial District along El Camino Real and Morro Road. The Signage Clean-up Strategy included reducing building permit fees for commercial sign permits, creating an online submittal process for commercial signage, and creating a partnership between the City, the Chamber of Commerce and the community.

Council adopted the City’s Marketing Plan to focus on events and promoting the City and its businesses to local and county residents, as well as visitors to the area. Staff began implementing promotions with upcoming events, including television and radio
commercials, outdoor billboard ads, print ads in magazines and newspapers, ongoing social media posts, and digital display ads.

Council and City staff hired a strategic planning company to establish a vision and plan for tourism and promotions. Staff has worked on implementing new events as part of the City's event plan. The City teamed up with the Atascadero Tourism Business Improvement District (ATBID) to introduce the Central Coast Cider Festival. The City also works with non-profits to assist with new events.

Council has also focused on creating a program that provides an advocate to businesses working through the development process. Staff offers intake and pre-proposal meeting meetings, engages applicants and the public to create a collaborative effort in providing creativity, reasonably and logically apply codes to each and every project, look for ways to streamline permitting for businesses, and continue to prioritize business development permits.

Building partnerships and alliances with local business interests is another Council focus. Staff meets with commercial brokers on a regular basis to discuss development opportunities. Staff also meets with Chamber of Commerce leadership for common goal partnerships and to share information about what is going well and what is not going well. The City also remains active in the Economic Vitality Corporation (EVC).

Investing in infrastructure that improves business in Atascadero is an important part of economic development. Constructing the Del Rio/U.S. 101 interchange project will stimulate growth in the area. The City has completed a pavement evaluation study to help identify critical roads to repair using a pavement management software system. Sales Tax Measure F-14 was passed in November 2014 to fund the repair of roads. A five-year capital improvement plan is in place for both Measure F-14 funds and other road funding. Construction plans are currently being finalized to construct a foot bridge linking Colony Square and Sunken Gardens. Final design plans are being completed for the rehabilitation of the Via Avenue Bridge, which provides access to a commercial/industrial area. The Highway 41 Multi-purpose Pathway has been completed. The City continues to work with San Luis Obispo Council of Governments (SLOCOG) for funding opportunities and grants to improve Atascadero's infrastructure.

**Connection between the City and the Community**

Council continues to foster transparency in City Council business by providing City Council meetings on AM radio and by broadcasting live video on cable television. Professional staff reports are prepared and published at least six days in advance of Council meetings. A public information officer coordinates the City’s response to inquiries from the media.

Staff continues to develop and implement innovative ways to celebrate Atascadero with positive outreach and public relations activities. These types of events generate a great amount of positive comments and feedback from the community. Council and staff continuously look for ways to improve relationships with local community groups to maximize the flow of information and assist in positive community activities. Council celebrates each City success with a public ribbon cutting and press releases.
Staff pushes out news to the media by contacting reporters, sending out press releases and posting on social media in a timely manner to be informative and useful in an effort to provide correct information and details for the public.

Staff prepares an Annual Road Report and Community Road Report that summarizes fiscal year activities related to Sales Tax Measure F-14. The Annual Road Report includes detailed revenue and expenditure information, while the Community Road Report is a brochure that provides a summary of roadway work performed during the reporting period, upcoming roadway projects for the following year, and pavement management strategy summary. The Community Road Report is mailed to each property in Atascadero and both reports are published on the City’s website after Council approval in January of each year.

**Common Sense Regulations and Reforms**
Council actions for common sense regulations and reforms include encouraging County, State, and Federal governments to reduce regulations, monitoring and mitigating the effects of potential legislative actions, and implementing common sense updates to City codes.

Council Members and City staff serve on several committees and actively participate in local, regional, and state professional organizations that assist the City with advocacy support.

Staff has completed edits to the Land Use Definitions Section of the Zoning Code. This amendment is the catalyst for minimizing land use barriers and attracting new business to the City. Clarifying and updating the land use definitions will help make it easy to understand what one can do on their property, thereby reducing interpretations. The land use definition update is accompanied by a comprehensive reorganization to the format of the zoning code. This reorganization is intended to make the code easier to read and understand.

As required by the State of California and the Regional Water Quality Control Board (RWQCB), the City adopted new storm water regulations and Post Construction Storm Water Design Standards in early 2014. These new Design Standards require public and private projects to address and maintain historical storm water infiltration, runoff, and water quality as part of new or redevelopment projects. City staff has strived to implement the newly mandated regulations while maintaining a local, common-sense and business friendly atmosphere by working closely with our local builders and developers to help answer and work through their questions and concerns.

**High Quality Public Safety Services**
Council goals to provide high quality public safety services include investing in public safety equipment and infrastructure, collaborating with community groups and partner agencies, participating in regional activities, involving the community in public safety issues, and focusing on core services.
The Police and Fire Departments provide training to school officials and participate in high profile incidents with District Officials and Staff. The Police Department has partnered with the school district to hire a School Resource Officer. The Fire Department has active participants assigned to the SLO County Incident Management Team. Both the Police Chief and the City Manager participate in discussions regarding County animal shelter facility decisions. The City will remain active in regional and State associations.

The Police Department has successfully implemented the Motor Officer Program and two motorcycle officers are now patrolling. The Police Department will maintain two Street Crimes Detective positions to address safety concerns in the community such as narcotics related issues and juvenile crimes including gangs, graffiti and other associated issues. This program saw early successes and large narcotics investigations that resulted in removing dangerous drugs and drug dealers off of our streets.

The Body Worn Camera system was selected and implemented department wide. At this point, the system has proven highly effective in resolving officer complaints and in the collection of evidence. Digital storage of the data is still a concern and the storage is being monitored to determine any long term concerns.

The Fire Department has set up systems that encourage customer feedback. The Police Department is working toward a similar goal and is in the development phase of the project. The Police Department has eliminated the previous Mission and Vision statements in favor of our Purpose, Goal, and Methods motto. The primary focus of this effort is to continue to increase professionalism while serving the public.

Staff continues to work closely with the County Probation Department, Mental Health services and the Veterans Services Office to help address the needs as well as the conduct of our local transient population, and with other local area law enforcement partners to address issues throughout the entire county.

**Staffing**
The City strives to retain current employees. Employees are a priority, and while funds are tight, the City and the employees work together toward solutions. Council also looks for other opportunities to recognize employees for significant accomplishments and awards.

Recruitments are developed and performed in such a way as to attract the best candidates for the job. Applicants are evaluated to determine if the potential employee is the right fit for the job based on experience, personality, and expectations.

City staff completed a salary survey to determine how far positions were out from the county-wide average. The need to work toward the county-wide average in order to attract and retain employees was balanced against other needs of the City. Staff continues to balance the need for realistic fiscal projections with Council’s desire to use potential funds for staffing needs as soon as possible. In September 2015, an
ordinance was adopted that made changes to Council salaries and health benefits effective January 1, 2017.

Staff continues to look for all funding opportunities for additional personnel, including grants, increased revenues and cooperative agreements. Staffing levels continue to be a priority of the City.

**Conclusion**
These actions are but a small sampling of the work that has been done, and continues to be done, to successfully position the City to respond to the ebbs and flows of the uncertain economy and to make the community a great place to live and visit. There has been some terrific progress made in the last several years.

**Seven Year Projections**

In preparation of the two-year budget process, staff prepared a seven-year projection to more fully understand the long-term impacts of the two-year budget. The seven-year projection is an excellent planning tool to get a broader perspective of how the organization will fare and to ensure that the level of reserves currently available will last through any downturn. Similar to the planning horizon for Strategic Planning purposes, the seven-year view is generally believed to be a reasonable time frame for projecting the future. Growth is expected to be slow and steady. Staff has updated the projection’s key revenues and expenses and extended them out to seven years.

A twelve-year history and a seven-year forecast are displayed on the following pages and will be referenced throughout the document.
## General Fund

### Taxes
- Property Tax (Current Secured & VLF) **$3,208,666**
- RDA Dissolution Distributions **-**
- Other Property Taxes **$337,300**
- Sales Tax **$3,646,009**
- Franchise Fees **$766,769**
- Transient Occupancy Tax **$386,164**
- Other Taxes **$373,472**
- Permits **$816,853**
- Intergovernmental **$1,774,933**
- Grants **$689,241**
- Service Fees **$181,399**
- Mutual Aid **$73,470**
- Development Fees **$1,255,604**
- Recreation Fees **$184,219**
- Administrative Fees **$68,841**
- Pavilion & Other Rental Fees **$96,418**
- Parks Fees **$15,399**
- Zoo Fees **$204,838**
- Fines **$90,558**
- Interest Income **$251,040**
- Other **$563,968**
- Interfund Charges **$651,989**
- Donations **$91,419**
- Other **$326,358**
- Transfers **-**

### Revenues
- Total Revenues **$15,493,839**
- Employee Services **(8,705,412)**
- Operations **(4,368,782)**
- Special Projects & Community Funding **(420,886)**
- Capital Outlay **(496,141)**
- Other Uses **-**
- Total Expenses **(14,032,490)**
- NET INCOME / LOSS **1,461,349**
- Fund Balance Beginning of Year **7,960,866**
- FUND BALANCE END OF YEAR **$9,422,215**

### Fund Balance as % of Expenses
- Total **67.1%**
- General **64.8%**
- Capital Outlay **59.4%**
- Special Projects & Community Funding **50.8%**
- Employee Services **43.8%**
- Franchise Fees **46.0%**
- Transient Occupancy Tax **41.7%**
- Other Taxes **38.6%**
- Permits **43.2%**
- Intergovernmental **48.5%**

### Historical and Projections
- Fiscal Years 2004/2005 through 2013/2014
- Actual 2004/2005: $10,522,943
- Actual 2005/2006: $11,034,512
- Actual 2006/2007: $9,887,132
- Actual 2007/2008: $8,233,348
- Actual 2009/2010: $6,920,444
- Actual 2010/2011: $6,466,562
- Actual 2011/2012: $8,007,068
- Actual 2012/2013: $8,620,512

### Notes
- Actual 2004/2005: $18,817,303
- Actual 2005/2006: $18,379,289
- Actual 2006/2007: $18,322,105
- Actual 2007/2008: $17,163,519
- Actual 2008/2009: $15,615,095
- Actual 2009/2010: $16,014,816
- Actual 2010/2011: $16,290,637
- Actual 2011/2012: $20,075,064
- Actual 2012/2013: $18,379,289
- Actual 2013/2014: $18,379,289
## General Fund

### Taxes
- **Property Tax (Current Secured & VLF):** $7,462,645
- **RDA Dissolution Distributions:** $131,077
- **Other Property Taxes:** $278,887
- **Sales Tax:** $3,428,732
- **Franchise Fees:** $1,041,577
- **Transient Occupancy Tax:** $852,154
- **Other Taxes:** $318,825
- **Permits:** $619,182
- **Intergovernmental:** $203,137
- **Grants:** $166,837

### Service Fees
- **Safety Fees:** $220,910
- **Mutual Aid:** $511,899
- **Development Fees:** $644,835
- **Recreation Fees:** $311,578
- **Administrative Fees:** $50,842
- **Pavilion & Other Rental Fees:** $108,699
- **Parks Fees:** $35,191
- **Zoo Fees:** $352,673
- **Fines:** $108,839
- **Interest Income:** $46,308
- **Interfund Charges:** $922,117
- **Donations:** $701,834
- **Other:** $124,602
- **Transfers:** $374,090

### General Fund History and Projections

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</thead>
<tbody>
<tr>
<td><strong>Total Revenues</strong></td>
<td>$19,107,476</td>
<td>$20,155,995</td>
<td>$18,822,660</td>
<td>$19,404,170</td>
<td>$19,909,390</td>
<td>$20,260,821</td>
<td>$21,133,460</td>
<td>$22,396,326</td>
<td>$22,924,288</td>
<td>$23,374,290</td>
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<td><strong>Employee Services</strong></td>
<td>($13,254,966)</td>
<td>($13,429,637)</td>
<td>($14,215,660)</td>
<td>($14,437,600)</td>
<td>($14,891,530)</td>
<td>($15,449,300)</td>
<td>($16,001,470)</td>
<td>($16,634,990)</td>
<td>($17,073,600)</td>
<td>($17,187,750)</td>
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<td><strong>Special Projects &amp; Community</strong></td>
<td>($789,322)</td>
<td>($370,934)</td>
<td>($203,190)</td>
<td>($203,190)</td>
<td>($203,190)</td>
<td>($203,190)</td>
<td>($203,190)</td>
<td>($203,190)</td>
<td>($203,190)</td>
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<tr>
<td><strong>Capital Outlay</strong></td>
<td>($732,777)</td>
<td>($42,589)</td>
<td>-</td>
<td>-</td>
<td>($90,000)</td>
<td>($90,000)</td>
<td>($90,000)</td>
<td>($90,000)</td>
<td>($90,000)</td>
<td>($90,000)</td>
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<tr>
<td><strong>Other Uses</strong></td>
<td>($1,020)</td>
<td>($672,584)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
<td>($1,400)</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>($19,268,802)</td>
<td>($19,350,338)</td>
<td>($19,572,660)</td>
<td>($19,794,600)</td>
<td>($20,467,340)</td>
<td>($21,025,110)</td>
<td>($21,709,310)</td>
<td>($22,342,830)</td>
<td>($22,916,770)</td>
<td>($23,030,920)</td>
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<tr>
<td><strong>NET INCOME / LOSS</strong></td>
<td>($161,326)</td>
<td>$805,621</td>
<td>($750,000)</td>
<td>($390,430)</td>
<td>($557,950)</td>
<td>($764,289)</td>
<td>($575,850)</td>
<td>$53,496</td>
<td>$7,518</td>
<td>$343,370</td>
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<td><strong>Fund Balance Beginning of Year</strong></td>
<td>$8,620,512</td>
<td>$8,459,186</td>
<td>$7,745,510</td>
<td>$9,264,807</td>
<td>$8,874,377</td>
<td>$8,316,427</td>
<td>$7,552,138</td>
<td>$6,976,288</td>
<td>$7,029,784</td>
<td>$7,037,302</td>
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<tr>
<td><strong>FUND BALANCE END OF YEAR</strong></td>
<td><strong>$8,459,186</strong></td>
<td><strong>$9,264,807</strong></td>
<td><strong>$6,995,510</strong></td>
<td><strong>$8,874,377</strong></td>
<td><strong>$8,316,427</strong></td>
<td><strong>$7,552,138</strong></td>
<td><strong>$6,976,288</strong></td>
<td><strong>$7,029,784</strong></td>
<td><strong>$7,037,302</strong></td>
<td><strong>$7,380,672</strong></td>
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<tr>
<td><strong>Fund Balance as % of Expenses</strong></td>
<td>43.9%</td>
<td>47.9%</td>
<td>35.7%</td>
<td>44.8%</td>
<td>40.6%</td>
<td>35.9%</td>
<td>32.1%</td>
<td>31.5%</td>
<td>30.7%</td>
<td>32.0%</td>
</tr>
</tbody>
</table>
Significant Revenues

The General Fund is the City’s primary operating fund, providing resources for most of the City’s ongoing activities including police, fire, parks, recreation and general government. It is this fund that the Council has the most discretion in directing expenditures and accomplishing Council priorities. For many years, the City’s top three General Fund revenues were 1) Property Tax revenue, 2) Sales Tax revenue, and 3) Development Fee revenue, in that order. Property Tax and Sales Tax, while they have evolved over the years, still maintain the top two positions for percentage of General Fund revenue. Transient Occupancy Tax revenue (TOT) is challenging Development Fee revenue for third place, and as is described in this section, TOT exceeded Development Fees for the first time in fiscal year 2015-2016. Following will be a review of all these key income sources in detail, as well as other important, but smaller, revenue sources.

Property Tax Revenue

The City of Atascadero currently receives 40% - 45% of its General Fund revenues from property tax revenues.

WHAT ARE PROPERTY TAX REVENUES?

Property tax revenues are taxes imposed on real property (land and permanently attached improvements) and tangible personal property (movable property). The tax is based on the value of the property rather than on a fixed amount or benefit to the property or person. Proposition 13 (Article XIIIA of the State Constitution) limits the real property tax rate to 1% of a property’s assessed value, plus rates approved by the voters. The amount of the tax is based on an annually determined assessed valuation. The property tax is paid to the county tax collector and allocated to local taxing agencies pursuant to a statutory allocation formula. The property tax is guaranteed by placing a lien on the real property.

The City of Atascadero participates in the Teeter Plan. This means that the City of Atascadero receives its entire amount of the property tax levy regardless of whether or not the tax has been paid to the County. In exchange, the County is entitled to all future penalties and interest collected on the levy.

In order to understand property taxes, it is important to understand assessed value. Proposition 13 calls for a base year assessed value to be established when the property undergoes a change of ownership (typically a sale) or when new construction occurs.
After the base year value is established, the value is factored annually for inflation, which is the lesser of the change in cost of living or 2%. The assessed value may also be adjusted by a Proposition 8 factor. Proposition 8 allows a property to be temporarily reassessed at a lower value. It requires that the lower of either the adjusted base year value or the current market value determine a property’s annual assessment. A significant number of property values were written down to market value during this last recession. As the housing market continues to recover, the assessed value is adjusted back up to the lower of the new fair market value or the original base value adjusted annually for inflation. The table below illustrates how assessed value would be calculated for a fictional property.

### EXAMPLE OF ASSESSED VALUE FOR FICTIONAL HOME

<table>
<thead>
<tr>
<th>Date</th>
<th>Description of Changes in Assessed Value</th>
<th>CCPI Factor</th>
<th>Inflation Factor</th>
<th>Base Value</th>
<th>Fair Market Value (FMV)</th>
<th>Assessed Value</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>Market Value when Purchased</td>
<td>N/A</td>
<td>N/A</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>N/A</td>
</tr>
<tr>
<td>1/1/X2</td>
<td>Annual 2% inflation applied</td>
<td>2.46%</td>
<td>2.00%</td>
<td>306,000</td>
<td>335,000</td>
<td>306,000</td>
<td>2.00%</td>
</tr>
<tr>
<td>1/1/X3</td>
<td>CCPI inflation rate applied</td>
<td>1.85%</td>
<td>2.00%</td>
<td>311,670</td>
<td>375,000</td>
<td>311,670</td>
<td>1.85%</td>
</tr>
<tr>
<td>1/1/X4</td>
<td>Declining Real Estate Market</td>
<td>2.10%</td>
<td>2.00%</td>
<td>317,904</td>
<td>290,000</td>
<td>290,000</td>
<td>-6.95%</td>
</tr>
<tr>
<td>1/1/X5</td>
<td>Slight Improvement in RE Market</td>
<td>4.37%</td>
<td>2.00%</td>
<td>324,262</td>
<td>300,000</td>
<td>300,000</td>
<td>3.45%</td>
</tr>
<tr>
<td>1/1/X6</td>
<td>Drastic Improvement in RE Market</td>
<td>2.08%</td>
<td>2.00%</td>
<td>330,747</td>
<td>350,000</td>
<td>330,747</td>
<td>10.25%</td>
</tr>
<tr>
<td>1/1/X7</td>
<td>Annual 2% inflation applied</td>
<td>2.08%</td>
<td>2.00%</td>
<td>337,362</td>
<td>360,000</td>
<td>337,362</td>
<td>2.00%</td>
</tr>
<tr>
<td>1/1/X8</td>
<td>Home addition adds $50,000 to base value</td>
<td>N/A</td>
<td>N/A</td>
<td>380,747</td>
<td>410,000</td>
<td>380,747</td>
<td>12.86%</td>
</tr>
<tr>
<td>1/1/X9</td>
<td>CCPI inflation rate applied</td>
<td>1.01%</td>
<td>2.00%</td>
<td>384,592</td>
<td>437,000</td>
<td>384,592</td>
<td>1.01%</td>
</tr>
</tbody>
</table>

1 Base Value is calculated on lessor of CCPI or Inflation Factor
2 Amount of Change from prior year assessment

The City receives various forms of property tax revenues each with its own distinct issues and trends as follows:

**Current Year Secured** - Current secured revenues make up 65% of the City’s property tax revenues and are what most people think of when discussing property taxes. Assessed values are established as of January 1 of each year and taxes are paid to the Tax Collector in two installments, due on December 10 and April 10. As the Tax Collector receives the funds, they are then allocated and distributed to the various agencies, including the City. Amounts levied but not collected by the County are distributed to the City under the Teeter Plan at the end of the fiscal year.

**Property Tax in Lieu of Vehicle License Fees** - This revenue source grew out of a state-local budget agreement as part of the State 2004 budget package. Under this arrangement, the Vehicle License Fee (VLF) was reduced to Californians and the reduction in city and county revenues was replaced with a like amount of property taxes. Subsequent to the fiscal year 2004-2005 base year, the property tax in lieu of VLF fluctuates in proportion to the gross assessed valuation in the City.
Current Year Unsecured - Unsecured property tax is collected on items such as mobile homes that are not on a permanent foundation, machinery and equipment owned by businesses, and personal property such as airplanes and watercraft. Unsecured roll taxes are due on August 31.

Current Year Supplemental - This property tax is an extra assessment that occurs when new construction is completed on real property or when a property changes ownership. The assessed value of the property is then increased to the current market value as of the date of the title transfer or completion of construction. Supplemental property tax is the amount due on the difference between the pre-event assessed value and the new market value of the property. Because there is a time lag between the change of ownership or completion of construction and the actual change of assessed value to the tax roll, supplemental property taxes are generally collected six months to a year or more after the event.

Redevelopment Property Tax Trust Fund (RPTTF) Distributions - This new revenue category was created as a result of the dissolution of Redevelopment. As part of the dissolution of redevelopment agencies, all revenues and assets of the former redevelopment agency that are not needed to pay to the required obligations of the former agency must be distributed to the taxing agencies. The City of Atascadero is a taxing agency within the former Atascadero Community Redevelopment Agency and thus is entitled to approximately 18% of the "excess" revenues and assets.

WHAT IS THE CURRENT STATUS OF PROPERTY TAXES?

Property taxes are a function of assessed value and assessed value is a function of the base year adjusted for inflation and/or the fair market value. At the end of 2007, the County Assessor began to review properties throughout the county for Proposition 8 assessed valuation reductions. As the recession continued, the Assessor’s office was eventually reviewing the value on over 56,000 properties annually countywide. This resulted in a cumulative reduction in assessed value by more than $4.5 billion. To date, about $2.5 billion of this value has been restored throughout the county.

According to the San Luis Obispo Auditor Controller’s data, assessed value of adjusted secured and unsecured property has increased more than 5% over the prior year, in each of the last three fiscal years.

The median home price is the midpoint price of homes being sold and is therefore a function of both the value of real estate and number of high end versus low end properties being sold. In its November 2016 Central

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Atascadero</th>
<th>% Change in Assessed Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-04</td>
<td>1,964,719,525</td>
<td>9.58</td>
</tr>
<tr>
<td>2004-05</td>
<td>2,166,790,995</td>
<td>10.30</td>
</tr>
<tr>
<td>2005-06</td>
<td>2,424,564,670</td>
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<tr>
<td>2006-07</td>
<td>2,796,694,310</td>
<td>15.35</td>
</tr>
<tr>
<td>2007-08</td>
<td>3,090,464,606</td>
<td>10.50</td>
</tr>
<tr>
<td>2008-09</td>
<td>3,153,920,008</td>
<td>2.05</td>
</tr>
<tr>
<td>2009-10</td>
<td>3,048,359,883</td>
<td>(3.35)</td>
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<tr>
<td>2010-11</td>
<td>2,974,274,420</td>
<td>(2.43)</td>
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<tr>
<td>2011-12</td>
<td>2,905,011,491</td>
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<td>2012-13</td>
<td>2,911,262,172</td>
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<td>2013-14</td>
<td>3,016,930,596</td>
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<td>2014-15</td>
<td>3,194,259,931</td>
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<td>2015-16</td>
<td>3,378,519,547</td>
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</tr>
<tr>
<td>2016-17</td>
<td>3,578,934,583</td>
<td>5.93</td>
</tr>
</tbody>
</table>

* San Luis Obispo Auditor Controller's Office, "2016-17 Property Tax Rates, Allocations, and Assessed Values"
Coast Economic Forecast, Beacon Economics reported a 13.4% increase in single-family median home prices from the second quarter in 2015 to the second quarter in 2016. While that quarterly increase was particularly exceptional, it is reflective of the overall positive trend in the marketplace. In discussions with local professionals, the consensus seems to be that residential values continue to gradually rise and the number of days homes are on the market is shrinking.

As stated before, assessed values are also a function of the inflation factor. The inflation factor for the 2016-2017 assessments has been released by the State Board of Equalization. The California Consumer Price Index (CCPI) increased by 1.525%.

**WHAT ARE PROPERTY TAX REVENUES EXPECTED TO BE FOR THE NEXT 7 YEARS?**

**Current Secured Property Tax**

When projecting out future property tax revenues, staff tried to consider the factors that go into assessed value: What will annual inflation factors look like? How much new construction can be expected? What will the real estate market look like? What is the housing demand?

While the inflationary factor has been published for 2016-2017, we are trying to predict what the next seven years will look like. It is not easy to predict the end of an expansion period so far in advance. History provides few instructive lessons to foreshadow the demise of the current expansion. Economists seem to generally agree that the slow and steady growth pattern is likely in the short-term. The U.S. unemployment rate has been at or below 5% - a commonly estimated level of full employment - since last October. If the experience of the past few expansions repeated itself, the current expansion would continue over the next couple of years. Some economists, however, believe that full employment requires an even lower unemployment rate. That reasoning would be consistent with an expansion that continued for an even longer period going forward.

The State Legislative Analyst’s Office’s (LAO’s) California Fiscal Outlook (Attachment A) assumes growth for the next two years, and projects increased personal

<table>
<thead>
<tr>
<th>Date</th>
<th>Atascadero SFR Median Home Price</th>
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</thead>
<tbody>
<tr>
<td>2002</td>
<td>$320,000</td>
</tr>
<tr>
<td>2003</td>
<td>359,000</td>
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<td>2005</td>
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<tr>
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<td>2014</td>
<td>430,000</td>
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<tr>
<td>2015</td>
<td>469,900</td>
</tr>
<tr>
<td>2016</td>
<td>475,000</td>
</tr>
</tbody>
</table>

* slocountyhomes.com
income, a continued decrease in unemployment, and a state CPI above 2%. This is consistent with a long, slow climb out of the recession.

Construction valuation is a good indicator of the level of private investment in building and construction. This is particularly of value when home owners elect to invest in upgrades to their homes including additions, alterations, and new structures.

There are currently over 1,400 housing units in some phase of development as shown in the following graph:

A portion of the City’s solid increase in assessed valuation is due to this significant construction activity. Atascadero’s assessed valuation will continue to reflect this added value. For every $1 million that is added in new construction, $10,000 a year is paid to the County in property tax, and about $1,600-$1,800 of that comes back to Atascadero’s General Fund.
Housing trends are often difficult to predict because they are influenced by many factors including income and employment growth, mortgage interest rates, affordability, savings rates, tax policy and consumer confidence. That being said, the demand for housing across the State has picked up and statewide rental rates continue to increase. While some of the factors determining housing values and trends conflict, there continues to be an overriding growth in real estate market values.

In its November 2016 California’s Fiscal Outlook publication, the LAO predicts that statewide assessed valuation will increase about 5.5% per year through 2020-2021. In talking with San Luis Obispo County representatives, they indicate that they are expecting assessed values in the San Luis Obispo County to grow 4% for 2017-2018 over the prior year, but indicated Atascadero may grow at a rate slight higher due to the volume of new construction in progress.

When refining property tax for the budget and projecting what the real estate market may hold, staff will continue to consult with experts including real estate professionals, mortgage banks, economists, and the Community Development Department.

Assumptions

Assumptions that went into the projected property tax revenues were as follows:

- **2016/2017-** Assumed that Current Secured, Redevelopment Agency Pass-Through, and Property Tax in Lieu of Vehicle License Fees are equal to the amounts estimated by the County Auditor’s Office in correspondence dated February 1, 2017. Current Year Supplemental revenues are expected to come in at budgeted levels and Current Unsecured revenues are expected to dip slightly. Redevelopment Property Tax Trust Fund (RPTTF) Distributions are expected to come in slightly higher than budgeted.

- **2017/2018-** Assumes that all current secured property tax increases by 4.25% as new construction comes online and Proposition 8 reductions are recovered. Current Year Supplemental revenue is expected to increase slightly as homeowners turn to renovations in lieu of purchasing new homes, and Current Unsecured revenues are expected to see minimal increases. RPTTF will grow slightly with the tax base in the former RDA area.

- **2018/2019-** Assumes that all current secured property tax increases by 4.0% as new construction comes online and Proposition 8 reductions are recovered. Current Year Supplemental revenue is expected to increase slightly as homeowners turn to renovations in lieu of purchasing new homes, and Current Unsecured revenues are expected to see minimal increases. RPTTF will grow slightly with the tax base in the former RDA area.

- **2019/2020-** Assumes a positive inflation factor. Assumes some continued growth due to new construction. Overall, current secured rolls are increased by 3.5% and supplemental rolls continue to recover.
- **2020/2021**- Assumes a slower overall inflation factor, but assumes some new commercial construction will add to the City’s assessed value. Assumed inflation factor of 3.5%. As homes sell, supplemental rolls continue to increase.
- **2021/2022**- Similar assumptions of prior year, including positive inflation factor of 2.75% and assumes new commercial construction will slightly increase the assessed value.
- **2022/2023**- Assumes a 2.5% inflation factor with adjustment for additional construction and increases in fair market value.

**Sales Tax Revenue**

The City of Atascadero currently receives 15% - 20% of its General Fund revenues from sales and use tax based revenues.

**WHAT ARE SALES AND USE TAXES?**

Under the California Sales and Use Tax Law, the sale of tangible personal property is subject to sales or use tax unless exempt or otherwise excluded. Sales tax is imposed on all retailers for the privilege of selling tangible personal property and is measured by the retailer’s gross receipts. Use tax is imposed on the purchaser of tangible personal property from any retailer for storage, use or other consumption in California. Effective January 1, 2017 the base sales tax rate in California is 7.25%, and in Atascadero, also includes the Measure F-14 0.5%, for a breakdown as seen on the next chart:
Sales Tax is distributed to the City by the State in monthly installments which lag significantly behind the period in which the sales occur. The monthly payments are beneficial to cash flow, but until the end of the payment period (in this case late September), the payments are a reflection of statewide formulas and not necessarily a reflection of the City’s actual sales.

**HOW IS SALES TAX HANDLED ON INTERNET PURCHASES?**

Under federal law, states cannot require businesses without an in-state physical presence to collect taxes on behalf of the consumers. This means that the State can require internet retailers with sales offices, stores or warehouses in the state of California to collect taxes on your internet purchase. The tax from those purchases are
then allocated to the jurisdiction where the sales office, store or warehouse is located, not to the jurisdiction where the product was purchased or delivered (your home).

Internet retailers without a physical presence in the State are not required to collect sales tax; however the consumer is required to pay a use tax on the purchase. California state law requires that consumers that purchase personal tangible property (anything from shoes to boats) from out of state are liable for use tax on that purchase at a rate equivalent to the sales tax. So if last year you purchased a book from Amazon and did not pay taxes at the time of purchase, state law requires that you report that purchase on your income tax return and remit the use tax to the State at that time. The use tax is then allocated to the State or County pools as appropriate.

The State is currently cracking down on use tax reporting and there have been multiple proposals to close internet sales loopholes; however both the State and City continue to lose much needed sales tax to internet purchases.

WHAT IS THE CURRENT STATUS OF SALES TAX REVENUES?

The City’s sales tax consulting firm, The HDL Companies, provides information to the City’s staff periodically to track sales tax revenues. Attachment B is a copy of one such update, the 2016 second quarter report. Overall, the state experienced an increase of 1.9% in sales tax revenues on an adjusted basis compared to the same quarter in 2015. HDL commented that:

“Statewide local sales and use tax receipts were up 1.9% over last year’s spring quarter after adjusting for payment aberrations. The largest gains were for building supplies, restaurants, utility/energy projects and countywide use tax pool allocations. Tax revenues from general consumer goods and business investment categories rose slightly while auto sales leveled off.”

For the third quarter in 2016, the City’s revenues were up 2.4% over the same quarter in the prior year. If the State and County Pools were removed from chart below, the City’s overall revenues are flat. As indicated in the chart and graph below, the City’s revenues from fuel were down significantly in the third quarter this year compared to the prior year.
Fuel and service stations are the largest sector of Atascadero sales tax. Sales tax from fuel prices has been very volatile in California for the last few years. HDL is predicting an overall increase of the price per gallon in 2017-2018. As shown in Attachment C-HDL’s California Forecast: Sales Tax Trends and Economic Drivers, sales tax from fuel and service stations is predicted to increase statewide by 9.7% in 2017-2018.
The building and construction industry continues to be a large contributor to the sales tax base for the City as well. Statewide, HDL is predicting a 3.5% growth in this sector. After many years of decline in this industry with the slow-down in construction, the City is beginning to see upticks in the overall Building and Construction sales tax base.

Sales tax from restaurants and hotels continue to show healthy growth, coming in at 9% over the same quarter last year with continued predicted growth in 2017-2018.

Atascadero’s revenue per capita are one of the lowest in the County. As shown on the following graph, the amount that the City earns in sales tax per capita is indicative of some of the reasons why the community can’t sustain the same level of services and amenities as some of our neighbors. Atascadero receives less than $115 per resident compared with the receipts of Pismo Beach at almost $560 per resident. This is a significant difference and is important to understand as we continue to address concerns for expansion of City services.
**WHAT ARE SALES TAX REVENUES EXPECTED TO BE FOR THE NEXT 7 YEARS?**

Sales tax is arguably the most volatile of the major revenues and is therefore the hardest to project in the seven-year revenue projection. When looked at as a whole, sales tax is closely tied to state and national indicators such as consumer confidence, availability of money, savings rates and other trend projections. It can be assumed that a portion of the City’s sales tax may follow State projected trends. The LAO’s forecast is generally positive, but is projecting a minimal increase sales tax revenue for California at a growth rate of 1% for fiscal year 2017-2018. The LAO cited the quarter-cent rate reduction associated with Proposition 30 as a large portion of why the growth rate was so modest. This Proposition 30 decrease does not have an effect on the City’s sales tax revenue, so we can expect slightly higher growth.

In its November 2016 Central Coast Economic Forecast, Beacon Economics projected sales tax in San Luis Obispo County would grow between 3.9% and 5.8% over the next few years.

If the City of Atascadero had the same mix of business as the county as a whole, the county projections could simply be used. The City of Atascadero, however, is unique and does not have the varied tax base that the county has as a whole. The past may be looked at to predict what our recovery may look like. Unfortunately, there is one thing that most economists agree on - that is that this economic expansion is unlike any other. Therefore, looking to the past to predict what this economy may do is not going...
to work. However, that doesn’t mean there is no value in reviewing past sales tax figures to understand what the City has experienced in the last several years.

The most critical component of the projections must be: what is the unique business mix here in Atascadero and the Central Coast? Which businesses are building? Which are closing? Which sectors are strong in Atascadero? Where are competitors opening? What are local businesses expecting? What are the trends in businesses here in Atascadero?

In order to update the sales tax projections for the next few years, staff met with HDL sales tax experts, looked at projections from the LAOs office, discussed building trends, and looked at the expected effects of Council’s current economic development policies and strategies. Over the next few months, staff will continue to meet with experts and refine sales tax revenue projections.

Current assumptions that went into the projected sales tax revenues were as follows:

- **2016/2017**- Estimated a slight decrease overall to account for the one-time bump in the close-out of the Triple Flip in 2015/2016.
- **2017/2018**- Assumes continuing underlying growth between 2.0% and 2.5%, spurred by Atascadero’s economic development efforts, consumer confidence and projected increases to personal income.
- **2018/2019**- Assumes continuing underlying growth between 2.0% and 2.5%, spurred by Atascadero’s economic development efforts, consumer confidence and projected increases to personal income.
- **2019/2020**- Assumes continuing underlying growth between 2.0% and 2.5%, spurred by Atascadero’s economic development efforts, consumer confidence and projected increases to personal income. Also includes positive additions for 3 quarters of WalMart.
- **2020/2021**- Assumes overall growth of 3%, with positive additions for a full year of WalMart and 3 quarters of Del Rio area marketplace.
- **2021/2022**- Assumes slowing of overall growth of 2.25%.
- **2022/2023**- Assumes further slowing of growth of 1.5%.

As with all projections, these assumptions are based on the information, policies and actions that are in place today. Changes in Council or State policies and/or additional information could and should adjust these projections. Staff will continue to monitor and update projections as things evolve.

**Other Revenue**

Property tax and sales tax account for about 60% of the City’s General Fund revenues, however there are a couple of other significant revenues that should be discussed.
Franchise Fees
The City receives around $1.2 million a year from franchise fees. These are a tax charged on cable, electric, garbage disposal, gas, wastewater, recycling and Chicago Grade Landfill. These fees are based on the revenues collected by each of the entities charged. These revenues have remained fairly flat over the years and are expected to remain flat. Predicted increases in garbage disposal and electricity franchise fees are expected to be mostly offset by decreases in cable franchise fees and gas franchise fees. It is unclear at this time what affect, if any, the closure of Pacific Gas & Electric's Diablo Nuclear Power Plant will have on Franchise Fees.

Transient Occupancy Tax (TOT)
TOT is collected from guests staying at hotels within the City. The City has recently seen significant increases in TOT revenues, with the Council’s emphasis on promotion and economic growth. With help from the Atascadero Tourism Business Improvement District (ATBID), these increases are expected to continue. TOT came in at $1.2 million in fiscal year 2015-2016. For the first time, TOT was the third highest General Fund revenue source. Included within the Seven Year Projection are continued increases as the promotions and tourism focus of the Council continues to build momentum. The City agreement with the Chamber of Commerce pledges 6.5% of the TOT collected to the Chamber and 10% of the TOT collected is pledged to tourism promotions. The related costs are also included in the projections.

Building Permit Activity
Atascadero has seen significant building activity over recent years and this looks to continue into the future. In 2016, the Community Development Department received 1,295 building permit applications and issued 1,103 building permits. This is a 22% increase in permit application activities and a 32% increase in permit issuance when compared to 2015. This is coming close to the level of activity experienced in 2005.
Over the past decade, building permit activity in Atascadero has been rather volatile, reflecting the real estate boom and bust that occurred nationally. In 2005, the City received 1,335 building permit applications and issued permits for 330 housing units. By 2009, overall permit activity dropped to 467 permits with only 12 housing permits issued. Since the bottom in 2009, permit activity has been steadily increasing. Staff is currently working with applicants on over 1,400 housing units that are currently in the development or entitlement process.

**Other Fees for Service**

The City also receives over $1.8 million a year in various fees for other services (including mutual aid). These fees include many items, including items such as zoo admissions, pavilion rentals, softball field rental fees, park rental charges, weed abatement charges, and vehicle release fees. These fees generally increase gradually over time, however, individually, they can increase or decrease over the prior period based on the activity for each revenue source. Development Fees are included in this total and are expected to increase during the current fiscal year as certain larger development projects are expected to occur. The City’s last Service Fee Study was completed in 2014 and Service Fees have been adjusted annually to keep pace with inflation.

**Interfund Revenues**

The 2015-2016 audit included over $800,000 in interfund revenues. These are typically charges to other funds and departments within the city for services provided by the General Fund (such as legal, finance, capital project management, grant administration, affordable housing services, etc.). Staff has found it more efficient to allocate these charges out as Administrative Fees rather than charging a small portion of each support employee’s time or a portion of each invoice to each fund directly.

**Overall**

The overall revenue projections show a slow but steady climb in revenues over the next seven years. In 2006-2007, the City received $19.0 million in General Fund Revenues. The City was back to that level as of 2014-2015, and is projected to grow to $23.4 million by 2022-2023. Revenues are scheduled to outpace expenditures by fiscal year 2020-2021.
Operating Costs

A healthy organization needs to review inflows (revenues) and outflows (expenses) on a regular basis in order to achieve balance over the long-run. Certainly, the Council has successfully navigated this balanced path over the years by holding to the fiscal strategy of saving up a little extra in the good years to use in the down years. The effect of the Great Recession has impacted the City’s ability to bring in revenues, and therefore, expense reductions to temporary but unsustainable levels have been made over the last several budget cycles to better balance the inflow and outflow equation. As the revenues recover, the demand for larger operating budgets will be a key component to consider as the 2017-2019 budget is developed.

Operating costs are typically the bulk of the outflow side of the equation. Given the City’s relative lack of control of the inflow side of the equation (property tax, sales tax, TOT, development revenue), operating costs are an area where the City has more control to determine its own fate.

Operating costs are typically broken into four different categories in the budget document:

- Employee Services
- Operations
- Special Programs & Projects
- Capital Projects

Each of these categories will be defined in this section, and assumptions of the projected costs of each of these will be reviewed. The effective growth management of these categories is what helps the City to influence the bottom line. For the last 15 years or so, cost growth has been reasonable minimized.

Each year as the budget is being prepared, a target is established to limit operations category. Even with some expenses increasing at rapid rates, departments were targeting minimal increases of 2% and 2.5% for the budget cycles 2003-2005 through 2007-2009. For budget cycle 2009-2011, departments were asked to cut operating expenses by 5% in order to keep the deficit gap at a minimum. In addition, departments were asked to cut operating budgets an additional 5% for budget cycle 2011-2013. These decreases in operations were effective in closing the deficit gaps to an amount that was consistent with Council’s strategic plan. Certainly these cuts were not easy, but on the short term were achievable.

As the economy began to recover, operating budgets were increased 4% in budget cycle 2013-2015 (2% in each fiscal year), and increased 6% in budget cycle 2015-2017 (4% in 2015-2016 and another 2% in 2016-2017.) As the cost of doing business continues to rise, additional increases will be needed to sustain service levels in the long-run.
EMPLOYEE SERVICES

WHAT ARE EMPLOYEE SERVICES COSTS?

Employee services are the backbone of the community. The City is a service organization, so the largest portion of General Fund expenditures is dedicated to employee services. In fact, an average of 72% of General Fund expenditures for the budget cycle 2015-2017 were allocated directly toward the cost of employee services. It is critical that the significance of this component to the budget is well understood since it plays such a major role.

Employees are grouped into 6 different categories or bargaining units. (Atascadero Police Association, Atascadero Firefighters Bargaining Unit, Local 620 Service Employees International Union, Mid Management / Professional Employees, Non-Represented Professional and Management Workers and Confidential Employees, Non-Represented Part-time employees.) Salaries and benefits for each of the four represented bargaining units are set forth in Memorandums of Understanding (MOUs). Pay and benefits for Management and Confidential employees are governed by a resolution of the Council and pay for part-time employees are governed by administrative policy.

The following are the general categories of labor costs that are found in the City’s budget:

- **Salaries** - This base pay figure for full-time City employees represents 57% of the City’s total General Fund labor costs.
- **Wages** - This is the pay for part-time or hourly employees such as scorekeepers, lifeguards and fire reserves. (3%)
- **Overtime** - This represents the amount paid in overtime to both full-time and part-time personnel. (5%)
- **Other Pay** - This category includes amounts paid to employees for items other than base pay. Items charged to this category include stand-by pay, holiday pay-off, uniform allowance, pay-off of vacation upon leaving the City and other similar pay types. (2%)
- **Benefits, Taxes and Insurance** - This category is made up of the following:
- **Health Benefits** - Each full-time employee receives health benefits upon employment. The City contributes varying amounts towards medical insurance, dental insurance, vision insurance and life insurance. The amounts vary between bargaining units and whether coverage is for the employee only, the employee plus one dependent or for the employee and his/her family. Employees who were hired prior to September 1, 2000 are entitled to a "medical payback" stipend if they elect employee only coverage. The stipends range from $240.56 - $319.53 per month. Current MOUs require the City to pick up 100% of the increased health benefits cost for the employee and 50% of the increased cost for dependents annually. (11%)

- **Retirement** - The City and City employees do not contribute to Social Security and are therefore required to participate in another retirement program. For part-time employees who work less than 1,000 hours per year, the City contributes 5% to a FICA Substitute / Defined Contribution plan. For full-time employees and part-time employees who work more than 1,000 hours a year, the City participates in CalPERS. The City is now on a three-tiered system for both sworn safety personnel and miscellaneous (non-sworn personnel) as discussed later in this Section. This is a defined benefit plan which means that the City is guaranteeing the benefit that the employee will receive upon retirement (in the case of tier 1 sworn personnel, 3% of the highest year’s salary for each year of service the employee has upon retirement at age 50 or older). Contribution rates for this benefit change annually based on actuarial studies performed by CalPERS. (16%)

- **Medicare** - The City contributes 1.45% of pay to Medicare. (1%)

- **Workers Compensation** - The City participates in California Joint Powers Insurance Agency (CJPIA) for workers compensation coverage. Cost of workers’ compensation coverage is a formula based on payroll, the City’s loss experience and the overall loss experience of CJPIA. (3%)

- **Unemployment** - The City is self-insured for unemployment through the Employment Development Department (EDD). The EDD bills the City quarterly for actual unemployment benefits paid to former employees. (1%)

- **Other Benefits** - There are other minor benefits afforded to employees such as the education reimbursement program and long-term disability. (1%)

Payroll is not just a function of salary and benefit amounts, but is also a function of the number of employees. The current budget includes funding for 122 full-time employees. With a few exceptions, part-time employees are budgeted with a lump sum dollar amount, rather than the number of employees. In fiscal year 2015-2016, 93 part-time employees worked over 39,400 hours or the equivalent of about 17.5 full-time employees.
WHAT IS THE CURRENT STATUS OF EMPLOYEE SERVICES?

Labor is one of the issues that will be of particular interest with the upcoming budget cycle and as the economy begins to turn around. There is no group of people that can do more with less than the City staff here in Atascadero. Of course budgets have always been lean, but starting with the 2009-2011 budget cycle, lean took on a whole new meaning. With the loss of fifteen laid off positions (seven of which were vacant at the time), staff did their best to carry the load. During the 2011-2013 and 2013-2015 budget cycles, a continuing policy of “hiring chills” was also in place. This was a process where management evaluated each position that became empty due to attrition to determine if that position was a priority in the short run.

While this staffing policy kept costs to a minimum, it also caused staffing levels to be deficient in all departments. With the improvement in the economy, however, the City was able to add six full-time staff members during the 2015-2017 budget cycle. This certainly provided some needed relief, and although this is movement in the right direction, the nature of the City’s resources cause the City to continue to lag behind other local jurisdictions when it comes to staffing level metrics.

This leaves many departments frustrated as coverage becomes an issue. Per capita staffing for both police officers and fire fighters is low compared to surrounding cities, making it difficult to effectively staff these 24/7 operations without using excessive overtime. This situation becomes even more difficult when employees are out on vacation, are sick, or have been injured on the job.

The two charts below show the staffing levels for police officers and fire fighters per capita as of June 30, 2015, in Atascadero compared to other local cities:
Employee retention and attracting the best and the brightest of the labor pool to fill vacant positions is much more problematic than might be expected. Now that the economy is beginning to pick up, other agencies whom are recovering more quickly than Atascadero are offering more generous salaries than Atascadero is able to. The market for labor is tight and employers are competing. As discussed later in Section 5, Atascadero has a lower per capita revenue than most cities in the county, making it more difficult to match salaries to other agencies.

Additionally, the nationwide negative attitude toward law enforcement has sharply reduced the number of people interested in a career in law enforcement. Agencies across the nation are having difficulties filling vacancies due to a lack of qualified candidates. In order to attract recruits, police departments are hiring candidates and paying a portion, or all, of the costs to put the recruits through the police academy. This shifts more of the costs onto the City and extends the period between hiring and getting the officer on the street. Atascadero recently hired two police recruits and the City is paying the costs of the police academy, certain uniform and equipment needs, and the salaries of these two employees while they complete the police academy training. As the competition for qualified candidates becomes steeper, this trend is likely to become the norm in law enforcement.

California’s minimum wage is scheduled to increase to $15 per hour beginning January 1, 2022. The increases are scheduled on an annual basis and will increase by $1 per hour every year beginning in 2018 through 2022. This will have a significant impact on City operations. The beginning rate on the City’s part-time employee salary schedule is currently at $10.21 per hour. The State minimum is higher than that at $10.50, and therefore all City employees are being paid at a rate higher than minimum wage. However, each increase to the hourly rate will affect the City’s ability to hire part-time staff to provide City services. Many of the part-time employees work in recreation-related activities where additional recovery of costs may not be an option.

It is important to understand this will not only affect the City’s part-time staff and certain programs. It will also have an impact on staffing salaries in general. As the hourly rate increases annually, there is wage disparity between the entry-level position wages and the full-time salary schedule. For example in 2018, full-time Employee A earns $18 per hour and entry-level Employee B earns $11 per hour. If the City increases only those wages necessary to comply with the minimum wage requirements, in 2022, Employee A would continue to make $18 and Employee B would make $15 per hour. While Employee A earned $7 per hour more than Employee B in 2018, Employee A only
earns $3 more than Employee B in 2022. This very well may affect the City’s ability to continue to provide all the existing programs, and may have far-reaching effects. This will be an important discussion item going into the 2017-2019 budget process.

The City is enrolled in CalPERS to provide employees fixed benefit retirement plans. The calculation of these pension costs is a complicated actuarial process and involves a number of different assumptions and strategies. CalPERS Board of Administration (Board) authorizes changes to the assumptions and structural changes to risk pooling as they see appropriate to ensure the program remains properly funded. A number of changes have occurred lately that affect the City’s pension costs including a change in the smoothing policy, changes to the risk pools, changes to the method of allocating the pool’s unfunded liability, retiree life expectancy assumptions, and actual investment rates differing from assumed earnings rates. The most dramatic change came in December 2016, when the Board voted to change the discount rate from 7.5% to 7.0% over three years. The discount rate is the assumed rate of return on investments, or essentially, interest earnings. Decreasing the rate means the Board assumes that CalPERS will earn less interest income on its investments each year. As the discount rate is decreased, employers will see increases in the costs required to fund the City’s retirement plan.

Currently, the City has two components to the CalPERS annual contributions. The first is the “normal rate”, or the cost of pension benefits for one year. CalPERS' actuaries determine what the normal cost percentage is for each employer, and the employer pays an amount throughout the year equal to the percentage multiplied by the applicable payroll. The second component is a flat dollar amount known as the Unfunded Accrued Liability, or UAL. The UAL is also determined by CalPERS actuaries and the City pays it as a flat dollar amount at the beginning of the fiscal year.

The decrease of the discount rate is being phased in over a three-year period, beginning in fiscal year 2018-2019. CalPERS estimates that the normal cost percentage for most Miscellaneous plans will increase 1%-3% and 2%-5% for Safety Plans. The bigger change is the impact of the UAL. CalPERS estimates that UAL payments might increase 30%-40%. If this is accurate, this will be a large increase to the City’s contributions. The impact of the lowered discount rate is included in the employee services line item in the seven-year projection beginning fiscal year 2018-2019.

In 2012, the Council adopted pension reform that separates the City’s retirement benefits into three different tiers: 1) existing employees, 2) employees hired after 7/14/12, but already part of CalPERS, and 3) employees hired after 1/1/13 not previously part of CalPERS. Each tier has a related formula that is used to calculate future benefits. These changes to retirement are consistent with the California Public Employees’ Pension Reform Act (PEPRA).
Details of each of the tiers for Safety and Miscellaneous are in the following tables:

<table>
<thead>
<tr>
<th>Employees Affected</th>
<th>Tier 1</th>
<th>Tier 2</th>
<th>Tier 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing employees</td>
<td></td>
<td>PERS members hired after 7/14/12</td>
<td>Non-PERS members hired after 1/1/13</td>
</tr>
<tr>
<td>Formula</td>
<td>3% @ 50</td>
<td>3% @ 55</td>
<td>2.7% @ 57</td>
</tr>
<tr>
<td>Employee Contribution</td>
<td>4.7% of employee contribution rate</td>
<td>4.7% of employee contribution rate</td>
<td>11.5% of employee contribution rate</td>
</tr>
<tr>
<td>Salary Factor</td>
<td>single highest year compensation</td>
<td>3 year average compensation</td>
<td>3 year average compensation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Employees Affected</th>
<th>Tier 1</th>
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<th>Tier 3</th>
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<td>Existing employees</td>
<td></td>
<td>PERS members hired after 7/14/12</td>
<td>Non-PERS members hired after 1/1/13</td>
</tr>
<tr>
<td>Formula</td>
<td>2.5% @ 55</td>
<td>2.0% @ 55</td>
<td>2% @ 62</td>
</tr>
<tr>
<td>Employee Contribution</td>
<td>4.7% of employee contribution rate</td>
<td>4.7% of employee contribution rate</td>
<td>6.5% of employee contribution rate</td>
</tr>
<tr>
<td>Salary Factor</td>
<td>single highest year compensation</td>
<td>3 year average compensation</td>
<td>3 year average compensation</td>
</tr>
</tbody>
</table>

Vacation accruals are another issue to consider. Details on vacation and other leave accruals are discussed at length in Section 4 of this document. At this point, it is critical to simply understand that as employees utilize more of their vacation time, there are less people to accomplish the tasks for the vacationing employees. While in some cases the work could be delayed, in most cases, the work still has to get done on schedule and/or works shifts have to be covered. At the end of the day, what this really translates into is additional overtime costs. Overtime is an unavoidable component of spending down the vacation accrual.

The City has been on the offense regarding health care costs. Health care benefits are important to the well-being of the employee group. As health care costs continue to be on the rise, the City continues to search for efficient options to meet the employees’ health care needs. On January 1, 2015, the City switched from a traditional PPO Policy to a high-deductible policy. The City offers employees a choice of either the new high-deductible PPO (HD PPO) or a traditional HMO policy. Anthem Blue Cross is the provider for both. By switching to the HD PPO, overall savings were achieved for employees and they are pleased with the new option.
WHAT ARE EMPLOYEE SERVICE COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

In order to project labor costs, a spreadsheet was developed which details salary and benefits for each employee. Every employee’s expected labor costs were developed for each of the 7 years. Step increases and other expected pay changes as an employee moves through his/her career were built into the projections.

However, the projections do not include a cost of living salary increase in any of the fiscal years. As the chart on the right shows, a one percent cost of living salary increase for the current employees would amount to about $117,000 of additional ongoing costs annually. This is not to say that staff is recommending a policy of no salary increases for the next 7 years. Instead, these projections are intended to illustrate that labor costs will continue to need to be a function of available funding and the market.

Assumptions that went into the projected employee service costs were as follows:

- **2017/2018**- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates continue to increase slightly, CalPERS rates are 6.9%-14.2% for non-sworn employees and 12%-19.7% for sworn safety employees, and UAL payment of $1.5 million (CalPERS actuarially determined rates). CalPERS rates for vacant positions are assumed to be Tier 2 for most positions.

- **2018/2019**- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates slightly increase, CalPERS rates are 7.7%-14.9% for non-sworn employees and 13.3%-20.9% for sworn safety employees, and UAL payment of $1.7 million.

- **2019/2020**- Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 6%, workers compensation remains flat, unemployment rates slightly increase, CalPERS rates are 7.7%-14.9% for non-sworn employees and 13.3%-20.9% for sworn safety employees, and UAL payment of $1.7 million.

### Annual Cost of 1% Salary Increase
Fiscal Year 2016/2017

<table>
<thead>
<tr>
<th>Department</th>
<th>Cost of 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Police</td>
<td>$37,500</td>
</tr>
<tr>
<td>Fire</td>
<td>24,800</td>
</tr>
<tr>
<td>SEIU</td>
<td>25,800</td>
</tr>
<tr>
<td>Mid Management</td>
<td>5,000</td>
</tr>
<tr>
<td>Management and Confidential</td>
<td>23,800</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$116,900</strong></td>
</tr>
</tbody>
</table>
increase, CalPERS rates are 8.4%-15.6% for non-sworn employees and 14.5%-22.2% for sworn safety employees, and UAL payment of $2 million.

- **2020/2021** - Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 4%, workers compensation remains flat, unemployment rates slightly increase, CalPERS rates are 9.9%-17.1% for non-sworn employees and 17%-24.7% for sworn safety employees, and UAL payment of $2.2 million.

- **2021/2022** - Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 4%, workers compensation remains flat, unemployment rates slightly increase, CalPERS normal rates remain flat, and UAL payment of $2.4 million.

- **2022/2023** - Assumes that current employees remain in place, step increases are given to eligible employees, and there are no cost of living salary increases. No increase for minimum wage escalation. Assumes medical insurance costs increase by 4%, workers compensation remains flat, unemployment rates increase slightly, CalPERS normal rates remain flat, and UAL payment of $2.6 million.

![Employee Services (excludes Wastewater and Transit) History & Projection](chart.png)
OPERATIONS COSTS

WHAT ARE OPERATIONS COSTS?

Operations costs are expenditures related to the regular ongoing operation of the department, including supplies, tools, utilities, insurance, contract services, and other similar expenditures.

Overall, the City has been able to keep these costs at a modest level. These operating budgets have been exceptionally tight during the recession, with the understanding that the reductions were a temporary solution until the economy began to turn around. The employees continue to work hard at keeping costs down and are always looking for better and more cost effective ways to get things done. There are, however, a few areas of particular concern as the 2017-2019 budget cycle approaches:

- Regulations – While state and federal regulating agencies have good intentions with their various programs, compliance is becoming more burdensome and costly. The Air Pollution Control District, the Regional Water Quality Control Board, the National Fire Protection Association, Occupational Safety and Health Administration and other similar agencies have specific requirements that the City must meet. Programs such as the Storm Water Management Plan, Groundwater Monitoring, and the National Pollutant Discharge Elimination System are just a few of the many that affect the City. The trend is toward greater regulation in a number of different areas which increases City costs for permits, monitoring, equipment replacement, training, and compliance.

- Voter approved Propositions – Propositions such as Proposition 47, the Reduced Penalties for Some Crimes Initiative, and Proposition 57, the Public Safety and Rehabilitation Act of 2016, will have an impact on the City’s public safety costs. Proposition 47 was passed in 2014 and Proposition 57 was passed in 2016. Both have the effect of reducing and/or eliminating jail time for certain crimes. The City’s police department works hard to keep the community safe, but when repeat offenders are not incarcerated and continue to engage in criminal activity in our community, the costs to the City and to the community will continue to grow. Additionally, other Propositions like Proposition 64, the legalization of adult-use marijuana, will inevitably impact the City’s operational costs. This is new territory for California, and agencies across the state are working to determine what affect, positive or negative, this new Proposition will have on the budget.

- Water – Water will play a big part in operating costs going forward. This has become a topic of high concern as the state has been in a drought and the Governor has required mandatory reductions state-wide. Both the cost of water the City needs to use to provide services and any costs related to control over
local water rights or regulations enforced upon the City by other entities will affect the operating budget going forward.

- Animal Control – The City contracts with the County of San Luis Obispo for animal care and control services. Services provided include emergency and non-emergency response for injured and stray animals, investigative services for animal bites, abuse and neglect, sheltering and quarantine services, dog licensing, animal adoption, and other services as required either by State law or City Municipal Code. All of the incorporated cities in the county contract with SLO County for these services. The cost of the services have been growing over the years and is about $225,000 in fiscal year 2016-2017. Additionally, County Animal Control will be building a new facility for which, if Atascadero decides to participate, will contribute an estimated $120,000 - $160,000 per year for the next 25 years. Atascadero, along with the other contracting cities, have been in collective negotiations with the County over the issue. Many of the services provided by the Animal Control Department are required by law and the City doesn’t have the infrastructure or the staff time to effectively provide these services directly. The costs will be negotiated down as low as possible, but to a great extent, these costs are required and largely out of the control of the City.

WHAT ARE OPERATIONS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?

The projections assume mild growth in operating budgets to keep up/catch up with real costs. Reduced or flat operations budget are a feasible option over a short course of years, but are no longer sustainable. After cutting operations costs by 5% for each of the budget cycles 2009-2011 and 2011-2013, the City was able to gain 4% for the 2013-2015 budget cycle, and 6% for the 2015-2017 budget cycle (4% in 2015-2016 and 2% in 2016-2017.)

The seven-year projection assumes 2.5% increase in operations costs in the first year of each biennial budget cycle, and continued focus on keeping costs lean, smart, and effective.

SPECIAL PROJECTS AND PROGRAMS COSTS

WHAT ARE SPECIAL PROJECTS AND PROGRAMS COSTS?

Special Projects and Programs are costs that are either atypical expenses or other projects or programs that are not part of the City’s regular operations. Included in this category are items such as community promotions, minor equipment, studies, intangible assets, community programs, and infrequent repairs or maintenance. Council increased the budget commitment for community promotions in fiscal year 2014/2015 to
stimulate the local economy. This is anticipated to create a healthier economy and increase City revenues and is assumed to remain at a consistent rate.

**WHAT ARE SPECIAL PROJECTS AND PROGRAMS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?**

The seven-year projection assumes special project costs remain flat across the period.

**CAPITAL PROJECTS COSTS**

**WHAT ARE CAPITAL PROJECTS COSTS?**

Capital Projects Costs are expenditures for new capital equipment with a life in excess of one year and costing over $2,500, and capital improvement projects. Capital purchases are included in the budget only after supplemental budget requests effectively identify and justify the need for such a purchase. Many capital expenditures have been minimized or alternate solutions have been identified. However, the lives of some assets and equipment may no longer be extended and some items will need to be replaced in the near future. Staff will continue to pursue grants and effectively use donations when available for the purchase of these and other items as well.

**WHAT ARE CAPITAL PROJECTS COSTS EXPECTED TO BE FOR THE NEXT 7 YEARS?**

The seven-year projection assumes a flat $90,000 each year to cover anticipated capital projects and expenses.

**Conclusion**

Atascadero has seen some tight economic times over the last decade or so. The economy is now in an expansion period and most indicators point to slow and steady growth for the foreseeable future. Council has shown strong leadership in sticking to its financial strategy; tucking away reserves in the good years and judiciously using them as the economy dipped and now continues to improve. Undoubtedly, as more and more indications of economic recovery appear, concerned individuals, groups, and organizations will come forward to urge the Council to focus resources in a particular direction. The pressure will likely be significant to increase both one-time and on-going spending. The Council’s strategic plan is effectively covering the temporary gap between revenues and expenses; however, revenues do not yet exceed expenditures. While this was the planned and purposeful strategy, the addition of significant
expenditures would extend out the turn-around year. This doesn’t mean that Council can’t entertain anything new until that time; it simply means that the volume and mix of expenses and revenues should continue to be carefully considered, especially as the economy recovers.
Section 4- Long-Term Costs
Long-Term Costs

In the financial strategy diagram to the right, there are two expenditure trend lines. The lower dotted line represents the strategic plan. That is the limit at which the expenditures are budgeted. However, there are many services that are being consumed that are not included in the bi-annual budget. The upper solid line includes not only the budgeted items, but also all of the unseen expenses that will eventually come due. The City currently doesn’t put any funding into Storm Drain Reserves, yet the storm drains are used constantly, and wear out a little more each day. At some point, they will need replacing and there will be a large price tag associated with this. Similarly, there is no reserve being set aside for replacement of park equipment. The parks in our community are very well used and are exposed to the elements. In fact, due to the economic downtown, there are several additional areas that were previously being funded on some level that are not currently budgeted. Although this expense holiday is helpful to keep the immediate use of reserves to a minimum, these unseen costs continue to incur and should be understood for thoughtful future planning.

Let’s take the example of a hard-working teenager named Dominic. His parents agree to give him his first car as long as he can pay for its expenses. He thinks getting a free car sounds great, so he agrees to the deal and gets a job flipping burgers making $10.50/hour. He works 10-15 hours a week. He feels good about himself. After taxes, he takes home $5,800 annually. That’s just the right amount to pay for his insurance, gas, minor car repairs, and of course, his girlfriend and a few video games. Satisfied that he makes enough money to accommodate all of the important things in life, our friend Dominic continues on his merry way.

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Take home pay</td>
<td>$5,800</td>
</tr>
<tr>
<td>Insurance</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Gas</td>
<td>(2,200)</td>
</tr>
<tr>
<td>Repairs</td>
<td>(800)</td>
</tr>
<tr>
<td>Girlfriend</td>
<td>(350)</td>
</tr>
<tr>
<td>Video Games</td>
<td>(450)</td>
</tr>
<tr>
<td>Net</td>
<td></td>
</tr>
</tbody>
</table>

$ -
Time moves on, and eventually Dominic finds himself several years down the road. Feeling successful that he’s always been able to take care of himself without getting a loan from mom and dad, he hasn’t made any lifestyle changes to improve his ability to earn more income or tuck away extra in savings. Therefore, he still works flipping burgers, an honest living. Thankfully, he gets a cost of living raise each year, so he has been able to keep up with inflation. Tragedy strikes when his beloved car finally breaks down and he has to buy a new one. He has not been saving up any money over the last several years, so he has to apply for a loan. Now, with the new car payment, he is unable to make ends meet. Dominic truly regrets not looking forward to prepare for this day by having made the changes that could have allowed him options now that his car is broken and he still has to get to work.

It is true that the City is successfully navigating through the slow recovery after one of the most severe recessions in recent history, and a few more years of deficit spending appear likely. As we plan for the future, understanding some of the unfunded costs will help us to avoid making the same mistake that Dominic made.

This section analyzes some of the annual “hidden” costs facing the City. The information developed within the following pages has been verified to the extent possible. However, as more information becomes known or as experience modifies the facts or assumptions, the information will be modified. The intent is one of information; to provide general facts about significant business concerns facing the City. This information is essential to establishing a practical financial strategy.

This section of the report includes an in-depth discussion of issues surrounding street and bridge maintenance, storm drains, building replacement, technology replacement, vehicle replacement, and equipment replacement (collectively referred to as infrastructure); followed by a general discussion of wastewater assets; and finally a discussion of long-term leave liability.

**Infrastructure**

Infrastructure includes the basic facilities and equipment needed to run the City. It includes public infrastructure such as streets, roads, storm drains, street lights, sidewalks, bridges and other large capital items needed for transportation and water to flow smoothly. It includes facilities such as fire stations, police station, parks, the zoo, City Hall and other large capital assets that are needed to provide services to the public. It also includes the basic underlying capital assets needed for the day to day operations of the City including computers, software, radios, breathing apparatus, police cars, tractors, fire engines, etc.
The research into these areas illustrates the need for reserve funds to deal with these business costs. The following table summarizes the findings contained in this Section. The Reserve Fund Strategy is the amount set aside in that fiscal year. The Annual Reserve Fund Requirement is the annual need for each of the areas if the City was able to provide full funding. The Reserve Deficit is the amount of money that should have been placed in the reserve fund to date.

<table>
<thead>
<tr>
<th>INFRASTRUCTURE REPLACEMENT</th>
<th>Annual Reserve Requirement</th>
<th>Reserve Fund Strategy</th>
<th>Reserve Surplus / (Deficit) Balance 6/30/2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Streets &amp; Bridges</td>
<td>$4,850,000</td>
<td>$3,162,000</td>
<td>$(120,000,000)</td>
</tr>
<tr>
<td>Storm Drains</td>
<td>$200,000</td>
<td>-</td>
<td>$(1,800,000)</td>
</tr>
<tr>
<td>Building and Park Replacement</td>
<td>1,727,400</td>
<td>-</td>
<td>$(15,846,740)</td>
</tr>
<tr>
<td>Technology Replacement</td>
<td>153,040</td>
<td>141,280</td>
<td>10,590</td>
</tr>
<tr>
<td>Vehicle Replacement</td>
<td>169,560</td>
<td>131,660</td>
<td>128,975</td>
</tr>
<tr>
<td>Equipment Replacement</td>
<td>107,840</td>
<td>-</td>
<td>$(2,612,240)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$7,207,840</td>
<td>$3,434,940</td>
<td>$(140,119,415)</td>
</tr>
</tbody>
</table>

While this infrastructure deficit may seem daunting, remember this is what the City should have on hand to bring all of its assets up to a new status today. The City does not need to have all of assets in new condition to function smoothly and provide services to its citizens, and they certainly won’t all come due in the near term. A “fair” condition for the roads might be the realistic targeted service level, and that is a much different reserve than assuming all roads need to be in “excellent” condition. Each infrastructure system needs to be looked at individually and when analyzing infrastructure funding, the City should look at immediate needs, long-term funding needs, when an asset needs to be replaced, what has worked historically, and what are the service levels the City can maintain.

Street and Bridge Maintenance

Introduction:

The City of Atascadero is responsible for maintaining almost 140 centerline miles of roadway. This network represents a substantial investment by the City, and has been identified as a critical concern of the community. This section deals with the street, bridge and other similar infrastructure maintenance responsibilities of the City.
Analysis:
The Atascadero Road Program was developed in 1999 to focus the City’s efforts in maintaining and protecting the roads of Atascadero in an organized, efficient and cost-effective manner. With the relatively high miles of road to maintain and the relatively low revenue per capita, keeping the City’s roads maintained in a fair or good condition has always been a challenge. Ironically, some of the conditions that make the community so wonderful to live in, such as Atascadero’s rural nature and relatively low population, make it the most difficult to secure funding. Many federal and state road maintenance funds (i.e. Gas Tax revenue) are derived from population statistics. Similar to many other cities, Atascadero suffers from a funding short fall for road maintenance due to the aging road system, the economy that is still recovering, and the City’s revenue base. The reality is that funding options from federal and state agencies continue to be reduced, leaving the City with fewer options for maintenance and rehabilitation.

Since the inception of the Atascadero Roads Program, significant effort has been made toward repairing the roads and minimizing the maintenance deficit. The Atascadero Road Program is based on local pavement management strategy. Pavement management is the process of planning the maintenance and repair of City streets, in order to optimize pavement conditions over the entire network. Pavement management incorporates life cycle costs into a more systematic approach to minor and major road maintenance and reconstruction projects. The needs of the entire network as well as budget projections are considered before projects are executed. Pavement management encompasses the many aspects and tasks needed to maintain a quality pavement inventory, and ensure that the overall condition of the road network can be maximized to the extent possible.

In March 2015, the City Council endorsed the Critical Point Management methodology for the City’s Pavement Management System. The City utilizes a software program called StreetSaver® to manage roadway pavements. This software is the accepted industry leader in pavement management technology. The road network and GIS information were entered into the program and then streets were field inspected for pavement distresses. The collected data is used to calculate a Pavement Condition Index (PCI) based on the 0 to 100 rating scale, 100 being excellent and 0 representing a failed road. StreetSaver® keeps track of the inspected conditions for each roadway segment (intersection to intersection) and any maintenance and improvement work is logged to keep conditions current. Funding scenarios are run using the critical point management and PCI break points to develop a priority list of roadway segments that are included in the City 5-year Capital Improvement Program.

Visual field inspections were last performed in June 2014 for the 139 miles of municipally maintenance roadway system. At that time, the overall weighted PCI was 47 on a 100 point scale, which corresponds to “poor” pavement
conditions. It is important to keep in mind that PCI numbers are relevant to one another and used as a planning tool for prioritizing where monies are best spent.

The breakdown by functional road classification is summarized in the following table:

<table>
<thead>
<tr>
<th>Street Classification</th>
<th>Centerline Miles</th>
<th>Area (Square Feet)</th>
<th>Percent of System</th>
<th>Average PCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arterial</td>
<td>31.97</td>
<td>5,864,600</td>
<td>31.5%</td>
<td>58</td>
</tr>
<tr>
<td>Collector</td>
<td>21.62</td>
<td>2,793,731</td>
<td>15.0%</td>
<td>46</td>
</tr>
<tr>
<td>Residential</td>
<td>85.57</td>
<td>9,968,764</td>
<td>53.5%</td>
<td>41</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>139.16</strong></td>
<td><strong>18,627,095</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>47</strong></td>
</tr>
</tbody>
</table>

The following table shows the PCI distribution in the street system:

<table>
<thead>
<tr>
<th>Condition</th>
<th>PCI Range</th>
<th>Percent of System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excellent – Very Good</td>
<td>100 - 90</td>
<td>7.89%</td>
</tr>
<tr>
<td>Good</td>
<td>79 - 70</td>
<td>9.47%</td>
</tr>
<tr>
<td>Fair</td>
<td>69 - 50</td>
<td>28.24%</td>
</tr>
<tr>
<td>Poor</td>
<td>49 - 25</td>
<td>38.76%</td>
</tr>
<tr>
<td>Failed</td>
<td>25 – 0</td>
<td>15.65%</td>
</tr>
</tbody>
</table>

Critical Point Management involves utilizing pavement management strategies, improvement techniques, and prioritization for roadway projects with the available funding that are geared to provide the lowest life cycle costs for the roadway system.

There are three common strategies in pavement management and project prioritization:

1. “Best First” – focuses on keeping best conditioned streets in good condition;
2. “Worst First” – focuses on improving the worst conditioned street; and
3. “Critical Point” – focuses on preventing streets from dropping into PCI ranges that trigger more expensive maintenance and improvements.

There are economical, safety, and social/political considerations in each of the strategies. The first two strategies are short-sighted and will allow roadways to degrade and slip into a more costly PCI range for needed improvements. The critical point strategy in a long-range methodology maintains and improves roadways before they slip into a more costly PCI range.
The charts to the right provide an example of the costs savings by employing the critical point management theory.

State and federal revenue streams for transportation are primarily funded through the fuel tax, which hasn’t increased since 1993. According to the federal Department of Labor’s statistics inflation calculator, the gas tax in 2013 has lost almost 37 percent of its buying power since 1993. Higher fuel efficiency vehicles, increases in electric vehicle use (which do not pay any gas tax) and changes in vehicle use patterns all affect the current revenue stream and foreshadow continuing declines in fuel tax receipts for future transportation investments. Even though vehicle miles traveled in California have increased by 25 percent and fuel prices have fluctuated significantly in that same time period, the California gas tax remains flat with no index to inflation.

Because of this and other factors, funding available to the City for road projects has been on the decline. The City continues to maximize the projects that can be completed with the funding that is available, in addition to actively looking for any grant opportunities that may become available. The cost to maintain Atascadero’s road system, combined with the declining availability of road funds to accomplish this maintenance, were key considerations for a sales tax increase that would primarily fund road projects.

In November 2014, Atascadero voters approved Measure F-14, a half-cent sales tax increase that became effective April 1, 2015. The voters also approved advisory Measure E-14 at the same time, indicating that the community preferred to spend that additional revenue on roads. Measure F-14 provides additional road funding and will work together with the City’s existing funding sources to maintain/increase the citywide road conditions.

The City has developed a 5-year Capital Improvement Program (CIP) for roadway projects, which includes projects funded by both Measure F-14 fund and existing City capital project funds. Over the five year period, the City anticipates spending about $15 million to maintain and improve roads. StreetSaver®, using critical point management, is used to develop a list of roadway segments for consideration each fiscal year.
Roadway projects utilizing Measure F-14 funds are not combined with other roadway segments utilizing other funding sources. A separate list is generated for Measure F-14 roadway segments and non-Measure F-14 roadway repairs.

Staff projects that just over 23% of city-maintained road system will be improved over the course of the current CIP.

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>5-Year CIP Cost</th>
<th>Centerline Miles</th>
<th>Pavement Area (sq. ft.)</th>
<th>Percent of System</th>
<th>Average PCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measure F-14</td>
<td>$10,427,970</td>
<td>18.80</td>
<td>2,205,407</td>
<td>11.8%</td>
<td>46</td>
</tr>
<tr>
<td>Non F-14</td>
<td>$ 4,709,160</td>
<td>11.64</td>
<td>2,123,188</td>
<td>11.4%</td>
<td>53</td>
</tr>
<tr>
<td>Totals</td>
<td>$15,137,130</td>
<td>30.44</td>
<td>4,328,595</td>
<td>23.2%</td>
<td>49</td>
</tr>
</tbody>
</table>

The StreetSaver® pavement management approach will assist the City in optimizing available funding by focusing projects in the highest need ranked areas and performing lower cost preventative maintenance as much as possible to avoid higher cost reconstruction project. Spending funds on preservation (crack filling, seal coating, chip seals, etc.) delays or prevents major restoration projects, and results in lower long-term costs. Well-timed preventative maintenance of a roadways’ surface increases its service life and delays the need for expensive rehabilitation or reconstruction. This is illustrated below in the cost per square yard for minor maintenance all the way up to major reconstruction.
In addition to roads, the City’s infrastructure also includes bridges, the pedestrian tunnel, sidewalks, curbs, gutters, traffic signals, parking lots, and medians. The annual reserve deficit for the roads and bridges is estimated at $4.8 million and an additional $50,000 for the other items.

<table>
<thead>
<tr>
<th></th>
<th>Accumulated Reserve Deficit at 6/30/16</th>
<th>Estimated Annual Reserve Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Street and Bridge Maintenance</td>
<td>$120,000,000</td>
<td>$4,850,000</td>
</tr>
</tbody>
</table>

**Conclusion:**

It is the City’s goal to fully fund street maintenance and the Public Works Department has developed a strategy to maximize available road project funding. Measure F-14 will go a long way in improving the PCI of Atascadero’s road system.

### Storm Drain Maintenance

**Introduction:**

Atascadero’s Storm Drain system has historically been a source of mystery and concern. The collection system is primarily a covert system; its purpose is to quietly collect excess runoff and keep the streets from flooding. Thanks to the efforts of the Public Works department, the storm drain system is fairly effective now in keeping the water off the streets, but it hasn’t always been like that. In the not too distant past, rains typically brought uncontrolled flooding, primarily due to the “organic” nature in which the system was constructed. By better understanding the system and evaluating the condition of each of the components, the City is better able to manage the system and be proactive in preventing problems.

**Analysis:**

To this end, in 2012, the Public Works Department inventoried the complete drainage system of all pipes, inlets, manholes and bridges and measured and characterized the location, size, material and general condition of each facility. There are currently over 28-miles of culvert or storm drain piping within City road right-of-way. The study created an initial priority list for future projects, and established a replacement schedule and the funding needs based on conservative lifespan and construction costs so as to not overstate the cost to maintain these facilities.

Using the information collected, a number of immediate maintenance and replacement projects were identified, and carried out within the limitations of the current Operations budget.
The following are some highlights of the study’s findings:

**Existing Storm Drain Inventory**
- 28 miles of existing culverts within the city’s storm drain network
- A total of 1,740 individual pipe segments
  - 1,022 segments are CMP (shortest lifespan)
  - 416 segments are HDPE
  - 238 segments are RCP
  - 60 segments are PVC
  - 4 segments are Steel
- 1,440 segments are City maintained
  - The length of city maintained culverts is 24.4 miles
  - 48% of all city maintained culverts are CMP
  - Currently 3,180 feet of culvert is characterized as needing near term replacement

The following graph illustrates the condition of the segments:

**Storm Drain Segment Condition**

The good news is that 86% of pipes currently in place are considered “Fair” or better. That leaves only 14% in a condition that need replacement in the next 6 to 12-years. There is an immediate need to replace 5% of the culverts and storm drains over the next 5 years. A rough estimate of the annual storm drain replacement needs over the next 9 years is $200,000 per year.
The future replacement schedule will significantly increase as CMP material culverts (primarily) installed in the ’70’s, 80’s and ’90’s reach their expected lifespan. The study concludes that replacement costs are estimated as follows:

<table>
<thead>
<tr>
<th>Storm Drains</th>
<th>Accumulated Reserve Deficit at 6/30/16</th>
<th>Estimated Annual Reserve Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1,800,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Conclusion:

The City has a much better understanding of the Storm Drain system than it ever has before. The 2012 study, combined with additional data gathered during street inspections, has provided valuable information on the condition and location of each of the many components so the Public Works Department can best focus resources on the issues of highest concern. Although the system is aging, the bulk of it is in relatively good shape. The proactive approach to repairs of the storm drain components protect life and property by reducing or preventing flooding and helping to preserve the adjoining roads and infrastructure.

Building Replacement

Introduction:

The City of Atascadero owns a number of different buildings including City Hall, Police and Fire Stations, the Pavilion on the Lake, and the Colony Park Community Center.
This section also encompasses a wide range of assets such as park restrooms, playgrounds, sports areas, building improvements, and Zoo exhibits, just to name a few. Assets of most departments are included in the following discussion, with the exception of the Wastewater Department.

Analysis:

The City keeps a list of all buildings and improvements within the City. The list estimates the original cost, replacement cost, size, age and remaining life of the assets. The list tracks all buildings, storage structures, park buildings and improvements, and Zoo exhibits along with the corresponding costs and depreciation. The amount of annual depreciation on the assets is approximately what the City should be setting aside each year in the reserve account to fund replacements and major repairs. The reserve deficit, the amount that should currently be in reserves, is estimated at $5.4 million. This amount was previously much larger, but the recent repairs and renovations to the Historic City Hall have rejuvenated that large asset. However, the cost to maintain that building will continue to be significant, and will require an annual reserve contribution of about $640,000.

Fire Station #1 is showing signs of its age and has needed additional repairs in recent years. Staff is currently working with a consultant on a fire station needs assessment. Once the results of that study are available, they will be further discussed and analyzed as part of the upcoming budget cycle.

Maintenance and enhancement of the Charles Paddock Zoo and the animal exhibits will continue to be a priority, particularly as the accreditation period draws near. Many of the Zoo’s needs could potentially be met through the generous donations of the community. The Zoo has historically received donations both through the Friends of the Zoo, and directly from members of the community. The Thelma Vetter Red Panda Exhibit is a great example. Staff work diligently to maximize these funding sources by fulfilling the unmet needs of the Zoo, and follow up with City-funded resources when possible.
The current and annual reserve liability for building replacement is demonstrated below:

<table>
<thead>
<tr>
<th>City Department</th>
<th>Estimated Accumulated Reserve Requirements 06/30/16</th>
<th>Estimated Annual Building Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historic City Hall</td>
<td>(3,010,830)</td>
<td>(902,260)</td>
</tr>
<tr>
<td>Fire</td>
<td>(2,054,590)</td>
<td>(84,890)</td>
</tr>
<tr>
<td>Parks</td>
<td>(1,583,800)</td>
<td>(137,200)</td>
</tr>
<tr>
<td>Pavilion</td>
<td>(3,291,350)</td>
<td>(138,660)</td>
</tr>
<tr>
<td>Police</td>
<td>(2,803,060)</td>
<td>(119,630)</td>
</tr>
<tr>
<td>Recreation</td>
<td>(2,592,670)</td>
<td>(251,440)</td>
</tr>
<tr>
<td>Public Works</td>
<td>(187,670)</td>
<td>(31,490)</td>
</tr>
<tr>
<td>Zoo</td>
<td>(533,150)</td>
<td>(61,830)</td>
</tr>
<tr>
<td><strong>Total Ideal</strong></td>
<td>(16,057,120)</td>
<td>(1,727,400)</td>
</tr>
<tr>
<td><strong>Current Funding Level</strong></td>
<td>210,380</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL (Deficit) / Surplus</strong></td>
<td>$ (15,846,740)</td>
<td>$ (1,727,400)</td>
</tr>
</tbody>
</table>

Conclusion:

It is the City’s goal to fully fund building replacement. The City was able to begin partially funding building replacement in fiscal year 2000-2001, and continued through 2008-2009. There is currently about $210,000 saved up in the fund. (This amount was previously much greater, but has been reduced by about $2.6 million of FEMA de-obligated funding related to temporary relocation of City Hall after the 2003 San Simeon Earthquake. The City has appealed FEMA’s decision and is awaiting a response. A recent court case has supported similar appeals.) Historically, the building reserves were largely used to pay for repair projects and improvements which prolong the lives of the assets and keep them in good working order. In addition, staff actively looks for grants and other opportunities to augment available funds. The City has been successful with FEMA/OES and California Cultural and Historical Endowment (CCHE) funding for City Hall, grant programs such as the Energy Efficiency Grant for municipal buildings, and local donations. This has been an effective strategy thus far, and with a “new” City Hall, it is anticipated that the strategy will effectively meet the City’s short-term (next ten years) needs. Like other long-term assets, however, the City should begin looking for long-term solutions.
Technology Replacement

Introduction:

The City has a significant investment and dependence on technology equipment throughout the different departments. The computers and associated software make up a technology system that is crucial to the day-to-day operations of the City. The system represents a total value of over $2 million including specialized software. This section deals with the current technology replacement responsibilities of the City.

Analysis:

Each department was reviewed for the number of computers and associated software necessary to complete department objectives. Expected useful lives and replacement costs are determined and used to calculate the amount of reserve necessary each year. As technology continues to emerge quickly, it can be difficult to know what the future brings. Technology staff are always on the lookout for newer and more efficient technology that will provide safe and effective computing tools for managing City business. The City has been funding replacement and maintenance reserve for technology for almost 19 years, and as a result, the technology reserve is fully funded. Both hardware and software are maximized and best efforts are made to stretch the useful life out as long as possible, while keeping a tight balance with efficiency.

The reserve fund allows for hardware and upgrades as determined necessary. Daily City business functions are dependent on the consistent operation of the City’s computers, associated technologies, safety, data backup, and data integrity. Therefore, it is critical that the City have a designated reserve for the replacement of computers and other technology equipment as it becomes obsolete.
The annual cost to provide for replacement of the technology system is as follows:

<table>
<thead>
<tr>
<th>City Department</th>
<th>Estimated Accumulated Reserve Requirements 06/30/16</th>
<th>Estimated Annual Technology Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Council</td>
<td>(3,000)</td>
<td>(300)</td>
</tr>
<tr>
<td>City Manager</td>
<td>(40,550)</td>
<td>(2,850)</td>
</tr>
<tr>
<td>Administrative Services</td>
<td>(183,700)</td>
<td>(17,460)</td>
</tr>
<tr>
<td>Police</td>
<td>(638,800)</td>
<td>(14,700)</td>
</tr>
<tr>
<td>Fire</td>
<td>(219,000)</td>
<td>(12,620)</td>
</tr>
<tr>
<td>Community Development</td>
<td>(80,270)</td>
<td>(10,880)</td>
</tr>
<tr>
<td>Community Services</td>
<td>(31,800)</td>
<td>(5,290)</td>
</tr>
<tr>
<td>Public Works</td>
<td>(54,450)</td>
<td>(8,680)</td>
</tr>
<tr>
<td>Information Technology</td>
<td>(532,400)</td>
<td>(80,260)</td>
</tr>
<tr>
<td><strong>Total Ideal</strong></td>
<td><strong>(1,783,970)</strong></td>
<td><strong>(153,040)</strong></td>
</tr>
<tr>
<td><strong>Current Funding Level</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL (Deficit) / Surplus</strong></td>
<td><strong>$ 10,590</strong></td>
<td><strong>$ -</strong></td>
</tr>
</tbody>
</table>

**Conclusion:**

It is the City’s goal to maintain a technology fund that will provide for the replacement and upgrading of technology as needed. Since the City began funding technology replacement in the 1998-99 budget, an adequate reserve exists to fund the City’s technology needs in order to keep operations running smoothly and efficiently. Costs to fully fund technology have not been delayed as other reserve funds were. In addition to providing the opportunity to replace items as needed, the technology reserves allow the City to take advantage of newer and more efficient technologies as they become mainstream.

**Vehicle Replacement**

**Introduction:**

The City owns many vehicles that are operated in the various City departments, from patrol cars to parks vehicles. The estimated replacement value of this rolling stock is about $4 million. Eventually, all of this equipment must be replaced as it becomes ineffective. Like similar tools addressed previously, vehicles are critical to performance of department objectives and in order to carry out the priorities of the community.
**Analysis:**

Ninety-seven percent of the value of the $4 million in vehicles belongs to the police, fire and public works departments. All of these departments require employees to travel throughout the community with very specialized vehicles. Police officers need patrol cars to keep criminal activity in check, fire fighters need fire trucks and engines to fight fires, and public works need tractors, mowers, and service trucks to keep up the infrastructure and the community treasures.

These specialized vehicles are critical to the operations of the departments and are typically higher priced purchases. The Council has been successful at fulfilling its goal to fully fund the vehicle replacement fund. Vehicles, like technology, are used until they either become inefficient or inoperable. Savings can be achieved when a vehicle’s useful life can be stretched out by one or more extra years. Staff has been conscientious about how this affects the City’s bottom line and has utilized this technique effectively.

However, when the economy started collapsing, additional savings needed to be made. Beginning with the 2009-2011 budget cycle, it was necessary to cut costs beyond what was comfortable. The decision was made to delay annual replacement contributions on vehicles with useful lives exceeding 20 years: fire engines, fire trucks, dump trucks, and tractors. These vehicles in particular were delayed for annual funding because of the longer replacement period. The longer replacement period allows the City to fluctuate funding levels without affecting replacement timing. Similar to the City’s economic strategy, the City can put away more when times are good and less when times are bad.

Most of these 20+ year life vehicles have not been annually funded for 3 budget cycles now. Through the generous donations of Bertha Shultz and the alternative solution thinking of fire department staff, however, two Type I fire engines were refurbished and one Type II engine was replaced by an additional Type I fire engine. All of these purchases were funded by Ms. Shultz but would otherwise have required funding from the Vehicle reserves.
The accumulated reserve and the estimated annual reserve for vehicle replacement is as follows:

<table>
<thead>
<tr>
<th>City Department</th>
<th>Estimated Accumulated Reserve Requirements 06/30/16</th>
<th>Estimated Annual Vehicle Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Police</td>
<td>$(421,130)</td>
<td>$(111,360)</td>
</tr>
<tr>
<td>Fire</td>
<td>$(1,255,267)</td>
<td>$(29,200)</td>
</tr>
<tr>
<td>Community Development</td>
<td>$(22,701)</td>
<td>$(5,760)</td>
</tr>
<tr>
<td>Recreation</td>
<td>$(22,500)</td>
<td>-</td>
</tr>
<tr>
<td>Zoo</td>
<td>$(28,033)</td>
<td>$(3,290)</td>
</tr>
<tr>
<td>Public Works</td>
<td>$(285,379)</td>
<td>$(12,830)</td>
</tr>
<tr>
<td>Parks</td>
<td>$(50,965)</td>
<td>$(6,640)</td>
</tr>
<tr>
<td>Building Maintenance</td>
<td>$(43,460)</td>
<td>$(480)</td>
</tr>
<tr>
<td><strong>Total Ideal</strong></td>
<td><strong>$(2,129,435)</strong></td>
<td><strong>$(169,560)</strong></td>
</tr>
<tr>
<td><strong>Current Funding Level</strong></td>
<td><strong>$2,258,410</strong></td>
<td><strong>$169,560</strong></td>
</tr>
<tr>
<td><strong>TOTAL (Deficit) / Surplus</strong></td>
<td><strong>$128,975</strong></td>
<td><strong>-$</strong></td>
</tr>
</tbody>
</table>

**Conclusion:**

As part of the normal budget cycle, staff will look at the City’s fleet of vehicles to determine the appropriate amount of annual funding to ensure that vehicles are replaced in a timely manner without affecting General Fund operations.

Thanks to the careful planning of the Council and in part to generous community donations, the City has met its goal to have sufficient funding for replacement vehicles. Because the City has committed to annual contributing to vehicle replacement, vehicles are replaced as needed. The City’s fleet is now efficient, safe, and dependable.

**Equipment Replacement**

**Introduction:**

The City has a significant amount of equipment which is essential to the operation of the City. These tools are necessary and allow employees to effectively perform their duties. The ideal strategy would be to work toward a program where replacement is funded annually, allowing the City to stay current with equipment. Wastewater equipment is not included in the estimates for this section.
Analysis:

Each department has specialized equipment that assists employees in performing their duties as expected. Office staff need office machines such as copiers, police officers need radios and radio repeaters, fire fighters need breathing apparatuses and jaws of life, parks employees need mowers and irrigation equipment. Grants have been an effective funding source for some of this type of equipment, but grants are not always available, and are even more competitive in today’s environment.

While Staff does their best to keep existing equipment running for the maximum amount of time, eventually equipment ceases to be effective. Often times, specific items of equipment must be replaced to comply with new regulations or safety requirements. The City’s budget has included some contribution to the equipment replacement fund during most of the fiscal years 2000/2001 through 2007/2008. And fortunately that was the case, because some of these funds were later used to either repair or replace equipment. However, with the economic downturn, the equipment replacement was one of the reserve contributions that was postponed in order to more closely make ends meet. There is currently about $250,000 saved up in this fund for equipment.

The estimate of the reserve deficit is approximately $2.6 million, and the amount that should annually be placed into a reserve account to fund the equipment replacement is about $108,000.

<table>
<thead>
<tr>
<th>City Department</th>
<th>Estimated Accumulated Reserve Requirements 06/30/16</th>
<th>Estimated Annual Equipment Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration</td>
<td>$ (24,900)</td>
<td>$ (2,200)</td>
</tr>
<tr>
<td>Police</td>
<td>(686,500)</td>
<td>(35,620)</td>
</tr>
<tr>
<td>Fire</td>
<td>(529,100)</td>
<td>(44,970)</td>
</tr>
<tr>
<td>Recreation</td>
<td>(206,800)</td>
<td>(1,670)</td>
</tr>
<tr>
<td>Pavilion</td>
<td>(92,470)</td>
<td>(870)</td>
</tr>
<tr>
<td>Zoo</td>
<td>(259,700)</td>
<td>-</td>
</tr>
<tr>
<td>Public Works</td>
<td>(283,000)</td>
<td>(2,940)</td>
</tr>
<tr>
<td>Parks</td>
<td>(779,770)</td>
<td>(19,570)</td>
</tr>
<tr>
<td><strong>Total Ideal</strong></td>
<td><strong>(2,862,240)</strong></td>
<td><strong>(107,840)</strong></td>
</tr>
<tr>
<td><strong>Current Funding Level</strong></td>
<td>250,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL (Deficit) / Surplus</strong></td>
<td>$ (2,612,240)</td>
<td>$ (107,840)</td>
</tr>
</tbody>
</table>
**Conclusion:**

It is the City’s goal to fully fund equipment replacement; however, the recent economic climate has made this a difficult goal to achieve. Equipment replacement was funded from about fiscal year 2000 to fiscal year 2008. Fortunately, these funds have been available to fund the replacement of needed equipment. City staff has been very successful obtaining grants for critical equipment replacement as it arises, and have recently received generous community donations to fund equipment such as a large portion of the breathing apparatus equipment. City staff will continue to maximize the equipment life to the extent possible, take advantage of savings opportunities as they arise, and continue to pursue grant funding as an alternative funding source. It is anticipated that with increased capital funding from the General Fund and anticipated grant funding, that the City will be able to meet its equipment needs for the short-term (within ten years); however like other long-term assets, the City should begin looking for long-term solutions.

**Wastewater**

The Wastewater system is a significant part of the City’s infrastructure, but is excluded from the analysis in this Section. The Public Works Department is in the process of updating its Wastewater Treatment Plant and Collection System Master Plan. From this study, the City’s current list of necessary Capital Improvement Projects and system upgrades will be updated to meet changing State and Federal regulatory requirements, General Plan modifications since the last master plan update in 2002 that will increase flows to the sewer system, and new system collection and treatment deficiencies identified by staff and consultants.

Wastewater collection and treatment involves year round, 24-hour per day energy intensive and highly mechanical processes. Even pipes and manholes are constantly exposed to highly corrosive liquids and gasses. Pumps and equipment are particularly susceptible to constant repair, reconditioning, and replacement. Pipes and manholes have finite lifespans. Currently, the City has a relatively simple and low cost treatment plant technology compared to some other surrounding communities.

Future increased wastewater treatment plant technology is expensive as evidenced by the recent Paso Robles Wastewater Treatment Plant upgrade that cost $50 million dollars.

The City’s current challenge is to maintain and operate what we have today, keep up with the replacement costs of the equipment and facilities described above, and prepare for future growth to build out as identified in the City’s General Plan. While the revenues are stable and the City has benefited from low cost treatment and a relatively young collection system (1960’s and 1970’s), service fees haven’t been updated for over two decades. The City is at a point where the current fees and rates only cover the on-going operations costs and near-term replacement costs. Staff is currently working with a consultant to complete a fee study to determine if and by how much those connection fees and annual sewer fees may need to be adjusted.
Once the wastewater treatment plant and collection system Master Plan and the Fee Study are complete, staff will be able to more accurately update the Council on long-term wastewater system needs and direction for moving forward. Until then, suffice it to say that while the system is aging, it is still in fair condition and immediate needs can be addressed with current resources.

Leave Accruals

Introduction:

There are several different types of paid leave that accrue to full-time employees. These include vacation, holiday, administrative leave, sick leave, and compensatory time accruals. The amount of leave employees are eligible to accrue is governed by Memorandum of Understandings (MOUs), personnel contracts, and the Personnel Rules and Regulations (Rules and Regs).

Analysis:

Each employee is required to record time worked and time off in official attendance records that are recorded with payroll. Depending on the specifics of the governing MOU, contract and Rules and Regs, employees earn paid time off each year. As the employee earns leave, it is accrued in an appropriate leave bank as leave hours. The employee may take these hours off of work during the year and be paid for their regular rate of pay for the hours, thus decreasing their leave bank hours. When an employee leaves the City they must also be paid for certain leave hours they have on the books. What is paid off is governed by law, MOUs, Rules and Regulations and past practice. If all City employees left the City on June 30, 2016, the total value of all leave accruals eligible to be paid off would have been just under $1.1 million.

<table>
<thead>
<tr>
<th>Leave Accrual</th>
<th>Dollar Value of Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vacation Leave</td>
<td>$ 487,210</td>
</tr>
<tr>
<td>Holiday Leave</td>
<td>283,350</td>
</tr>
<tr>
<td>Administrative Leave</td>
<td>1,040</td>
</tr>
<tr>
<td>Sick Leave</td>
<td>201,160</td>
</tr>
<tr>
<td>Compensatory Time</td>
<td>110,510</td>
</tr>
<tr>
<td><strong>TOTAL AMOUNT FUNDED</strong></td>
<td><strong>$ 1,083,270</strong></td>
</tr>
</tbody>
</table>

Vacation Accrual

Typically the City’s vacation accrual balances ebb and flow with the economic tide. As the economy is tight, fewer employees leave the City and thus there are fewer vacation
payouts, increasing the liability balance. As the economy perks up, employees take more vacations and the vacation liability balance decreases. Affecting the leave balance to an even greater extent is the tight staffing in each of the departments. Atascadero employees are a loyal group of individuals and are dedicated to getting their work done. Because staffing is tight, overtime budgets are tight and the work doesn’t go away, employees tend to forgo taking time off. This increases the leave balances.

Historically, the City has had enough vacancies throughout the course of each year that the cost of paying out the vacation accruals was covered by the payroll savings with the unfilled positions. However, the extended downturn in the economy was increasing the leave liability and this long-term practice was inconsistent with the City’s written Rules and Regs which required a cap on vacation accruals. In order to achieve more consistency between established practice and written policy, the Council approved changes on June 12, 2012, to the Rules and Regs affecting the maximum vacation accruals.

Individuals employed with the City prior to July 1, 2012, had their vacation leave split into two banks on October 20, 2012; a historical bank and a current leave bank. All vacation time earned subsequent to that date accrues to the current leave bank and will cease to accrue when that bank balance has reached two times the employee’s current annual accrual. After the one-time split into the historic bank, no more time will be accrued into that bank. Time in the historic bank may only be used after all the time in current bank has been exhausted. Employees hired after July 1, 2012 only have a current bank and all employees cease to accumulate vacation once their accrued vacation balance has reached two times their current annual accrual.

<table>
<thead>
<tr>
<th>Vacation Accrual at 6/30/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
</tr>
</tbody>
</table>

The new vacation accrual policy requires that employees take enough time off to avoid hitting the maximum accrual amount. This new practice has reduced the long-term liability, and is healthier for the employee; but it does not come without operational costs. The operational issue with this is that the work of the vacationing employee doesn’t dissolve as the person vacations, and there is still the same number of employees to get the work done. This often means overtime to cover the shift or get the work done. Staff will continue to consider this effect as the new 2017-2019 budget is developed.

**Holiday Accrual**

There are similar staffing issues that result in increasing holiday pay accruals. Employees receive 12 paid holidays per year (Fire receives 5.6 shifts per year). Some
employees are unable to take the holidays off when the holiday occurs due to the nature of their position. Primarily, this is a function of the 24/7 scheduling of public safety. Employees of both Police and Fire work regularly on holidays and accrue the paid time off. The MOU between the City and the Police department allows employees to either take the time off or to be paid off annually for the holiday time accrued. (Most eligible employees are paid off annually and this amount is included in the police budget.) The MOU with the Fire department does not include a similar annual payoff. Because the staffing levels of the Fire department are also lean, employees tend to build up paid holiday time off as an alternative to causing the department to pay overtime to backfill their shift. Gradually, the accruals build up. There is no maximum cap for holiday accruals. The value of this accrued time is paid out to the employee upon termination of employment. Hiring of a replacement employee has historically been postponed until payroll savings on the vacancy is enough to cover the payout amount.

<table>
<thead>
<tr>
<th>Fire Department Holiday Accrual at 6/30/16</th>
<th>Other Departments Holiday Accrual at 6/30/16</th>
<th>Total Holiday Accrual at 6/30/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>$216,470</td>
<td>$66,880</td>
<td>$283,350</td>
</tr>
</tbody>
</table>

Administrative Leave Accrual

Administrative Leave is paid leave granted to certain positions that are exempt from overtime. It is common practice to include administrative leave in compensation packages for salaried positions. The employees in these positions usually work a significant number of extra hours, and receive administrative leave as a benefit in lieu of overtime that is typical of non-exempt employees. Administrative leave functions similar to vacation time except that it is tracked separately and is carried over to the next fiscal year only under specific conditions.

<table>
<thead>
<tr>
<th>Administrative Leave Accrual at 6/30/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,040</td>
</tr>
</tbody>
</table>

Sick Leave Accrual

Sick Leave is provided to employees to minimize the economic hardship that may result from an unexpected personal or dependent illness or injury. It is accrued at the rate of eight hours per month (12.01 for Fire personnel) without a maximum cap. Some employee groups are eligible for an annual Stay Well Bonus that pays out a portion of the employee’s sick leave accrual, at the employee’s option, up to an established maximum. Additionally, some employee groups are eligible to receive up to one-half of the employee’s accrued sick time paid out at termination. The City’s policy and practice
support an employee’s use of his/her entire sick leave accrual bank, as necessary, with an appropriate verification documenting the illness or injury.

<table>
<thead>
<tr>
<th>Total Sick Leave Accrual at 6/30/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>$201,160</td>
</tr>
</tbody>
</table>

Compensatory Time Accrual

Non-exempt employees may choose to accumulate compensatory time instead of receiving overtime pay. The compensatory time credit is computed at time and one-half. The maximum hours non-exempt employees may accumulate is determined by the employee’s MOU or Compensation Resolution. Compensatory time may be partially or fully paid out at any time at the request of the employee or may be used as paid time off in place of vacation or other similar paid leave. Compensatory time accrual is paid out to the employee at termination.

<table>
<thead>
<tr>
<th>Total Compensatory Time Accrual at 6/30/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>$110,510</td>
</tr>
</tbody>
</table>

Conclusion:

While the City’s leave accruals are real liabilities, they have different characteristics than other long-term liabilities. As an employee terminates employment, the City pays out that person’s leave liability. The City then has an option as to how quick to hire a replacement employee for that position and can opt to hold off until sufficient salary savings has been achieved to cover the outgoing employee’s payoff. Of course, this can also cause operational issues, as the work does not go away. While often times a department is able to move around shifts or workloads to minimize overtime while a replacement is recruited, there is some level of service reduction during this period.

The City is a service organization and much of the General Fund is spent on labor. The leave liability is a part of doing business. This is not a liability that we would expect to have to payout all at once, but instead it’s a liability that grows and contracts by relatively small amounts each year. The balance of the leave liability has always been very closely tied to the economy. As the economy booms, leave liability is used or paid off. Employees take vacations when they can afford to go nice places and as staffing is less of an issue. Employees are also more mobile in a growing economy, not staying with the City for long periods and thus taking earlier payoffs. It is projected that because of the uptick in the economy, the recent departures of long-term employees and the implementation of a new vacation policy, that the liability will be contracting (or getting smaller) for the next few years.
Summary

While the reserves and deficits discussed in this section may seem daunting, they are not unlike what other cities face. The nature of government, its accounting methods, and citizens’ desire for services make the funding of long-term assets very difficult until it becomes critical. Atascadero is ahead of the game by looking at these costs, analyzing them bi-annually, and determining what the horizon looks like.

The City has made incredible strides toward funding long-term assets since 1997 when the City did not have a financial plan and did not have a funding plan for any of its long term assets: vehicles and technology equipment are fully funded with scheduled replacement of all assets, building reserve deficits have decreased, Measure F-14 and the road program is in place and has made great strides towards roads, and the immediate needs for equipment replacement have been funded through grants, donations and available funding. Evaluation of assets and the seven year projection show that the City can continue to fund immediate infrastructure needs throughout the projection period. There are no known immediate needs that the City cannot meet with current funding levels, so the City is fine and will continue to be fine for at least 10 years.

Unpalatable as it may be, the City will at some point need to look for additional funding mechanisms for funding long-term infrastructure needs. No matter how much we stimulate the local economy, the fundamental funding make-up of the City cannot support the vast infrastructure required for a City of this size. The City is meeting its short-term needs, so there is no action needed at this time, but the long-term needs should be kept in mind as the City moves forward.
Reserves

RESERVES

WHAT ARE RESERVES?

City finances are comprised of various funds, which for legal purposes have to be separated. For example, sewer charges are to be spent on maintaining and operating the wastewater system and may not be used to hire police officers or firefighters. One fund over which the Council may exercise considerable discretion is the General Fund. General taxes and receipts are deposited into this fund and the Council decides on how to spend these general revenues, whether it’s for police, fire, parks maintenance, recreation services or other public services. (Of course restricted revenues such as grants or fees for services are also deposited into the General Fund and the City must ensure that these receipts are spent appropriately.) The City must cautiously guard its General Fund to ensure that there are always adequate resources to provide critical services to the public.

The term *reserves* is used quite universally in governmental finance. There are different types of reserves, different purposes, and different legal restrictions on them. Essentially, they are the collective amount of revenues in excess of expenses, or similar to what a company might term *retained earnings*. Typically, the General Fund reserves are the most carefully monitored as these are the most flexible and discretionary of all the funds. In a pinch, however, there are reserves in other City funds that could legally be tapped into if the City found it necessary.

General Fund reserves are often thought to be one indicator of the fiscal stability of an organization. In the early 1990’s, the City of Atascadero had a negative General Fund balance, forcing layoffs and service reductions in order to weather the storm. In fiscal year 1995, the collapse of the Orange County Investment Pool hit the City and the General Fund reserves fell to an all-time low of $-790,360. At that time, the City’s audit carried a going concern: in other words, the City’s finances were so bad that there was a serious question of ongoing solvency. Around 1998, as the economy was starting to turn around, Council adopted a fiscally conservative reserve policy and began to aggressively go about building reserves in order to avoid history repeating itself.

The General Fund reserves are broken down into different components, each with separate ramifications and costs. The Governmental Accounting Standards Board (GASB) changed how fund balances are classified and reported effective June 30, 2011. While the categories are similar, there are some differences. In the past, the Council, through the budget process, would designate a portion of the fund balance to be used for a specific purpose. This would show up as a designation in the financial statements. Under current GASB guidelines, the Council may still designate a portion...
of the fund balance for items such as roads, libraries, economic uncertainties, etc; however this has no legal effect on the funds and thus does not show up in the fund balance designations. The new fund balance (or reserve) designations are as follows:

**Non-spendable**- includes fund balance amounts that cannot be spent either because it is not in spendable form or because of legal or contractual constraints. Because some assets are not easily convertible to cash in a timely manner, the fund balance is designated to show the portion that is non-spendable or can’t be spent within a timely manner. For example, the General Fund loaned the Redevelopment Agency $1,375,175. This is reported as an asset of the General Fund, but because of recent legislation, the General Fund will not get paid back on this loan for some time. Thus when taking assets minus liabilities to arrive at fund balance, we must report that $1,375,175 of the fund-balance is non-spendable.

**Restricted**- includes fund balance amounts that are constrained for specific purposes which are externally imposed by providers, such as creditors or amounts constrained due to constitutional provisions or enabling legislation. For the City, these typically include the fund balances of most other funds. For example the fund balance in the Circulation System Impact Fees fund is constrained by state legislation (AB1600) which sets forth specific criteria for collecting and expenditure of these funds. The use of the fund balance is restricted.

**Assigned**- includes fund balance amounts that are constrained for specific purposes by the City through formal action of the City Council and does not lapse at fiscal year end. These amounts typically include encumbrances or amounts that Council has formally set aside by resolution or contract.

**Unassigned**- includes positive fund balance within the General Fund which has not been classified within the above mentioned categories and negative fund balances in other governmental funds. These are funds that have not been earmarked for any specific purpose and are available for Council discretionary spending.

**WHAT IS THE CURRENT STATUS OF RESERVES?**

The City first adopted a Financial Strategy in 1998 and the results of having such a plan are clear. Over the years, the overall strategy has consistently been to maintain a conservative outlook by putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. By employing this cautious strategy in the past, the City has been weathering the current valley in
revenue fluctuations. The City has used reserves along with other fiscal strategies to maintain services and ensure the City’s long-term financial viability.

As of June 30, 2016, the General Fund reserve balance, excluding Sales Tax Measure F-14 activity, was almost $9.3 million. During the 2015-2017 budget process, Council continued to support using reserves annually to close the gap between projected revenues and expenses. While the City originally budgeted the use of almost $1.1 million in reserves for fiscal years 2014-2015 and 2015-2016, the City actually saw a net positive of the two years combined of $644,295.

In addition to General Fund reserves, it is equally as important to understand which other accounts there might be within the City that are legally accessible to the General Fund in order to meet its operational needs. There are two other sources of potential funds that could be considered. The first is the internal service account replacement funds and the second is unspent funds transferred to the Capital Projects Fund for road replacement.

**Internal Service Account Replacement Funds** - The City also has amounts set aside for replacement of vehicles, equipment, buildings and technology. The City has the legal right to transfer these funds back to the General Fund; however, it is not necessarily prudent to do so. Historically, the City has put away amounts annually so that as vehicles, computers, software and buildings become old and no longer function, the City has funds to replace them. These funds are legally available to transfer back to the General Fund; however, it does not change the time frame that roofs will have to be replaced or software will no longer be supportable. The City had $6.2 million in unrestricted net position in the internal services funds as of June 30, 2016.

**Unspent Capital Project Road Funds** – In past budgets, the City Council approved transferring City General Funds to the Capital Projects Funds for road projects. While many road projects were accomplished with the transferred funds, approximately $311,000 of these funds remain unspent. They are a good source of matching funds for capital grants related to projects within the five year capital improvement program; however, they are also available to be transferred back to the City’s General Fund if the Council chose to do so instead.

**WHAT SHOULD OUR RESERVES BE?**

*The Adoption of Reserve Policies in California Cities* by Anita Lawrence asked “What is the amount of fiscally prudent reserve? How much would be enough to cover certain events and develop a sense of security for the organization and the community? At what level would the constituency begin to question it as too much? What is the risk tolerance of the organization and the community? What criteria should be used to make that decision?” There is no easy answer to these questions. Anita’s research showed that “…if you asked 100 city finance professionals these questions, very few would provide the same mix of answers. The elements that are right for one city are entirely wrong for another.”
The real question is: What is the right amount of reserves for the City of Atascadero, both at this point in time and for the foreseeable future? In order to formulate a reserve policy, it is important to answer the following:

1. State of the Economy
2. The level of diversity in General Fund revenues
3. The stability of the revenue base
4. Potential actions of State and Federal agencies
5. Cash flow needs
6. Costs of potential natural disasters and emergencies
7. Asset replacement requirements
8. The consistency desired in service levels
9. Available opportunities

Measurement #1 – State of the Economy

In the City’s reserve strategy, the largest driver of what should be done with reserves is the state of the economy. Are we in an economic boom?- if so we should be putting away reserves for a rainy day. Are we in a severe recession?- if so, we should be using those reserves to stabilize services and the organization. Are we in a period of recovery?- if so we may still need reserves to stabilize services, but we need to be looking to the future to ensure that reserves will last. Are we in a stable period of flat growth?- if so, we should neither add to, nor use reserves. Our simple reserve strategy graph tells us what action we should take. So the question becomes, where are we on the graph? Is the economy booming, busting, recovering or somewhere in between?

Most economists agree that we have just gone through the worst recession since the Great Depression, and are even calling it the “Great Recession”. Economists also agree that the economy is now in a state of expansion. The U.S. Bureau of Economic Analysis (BEA) reports that in 2016, the real Gross Domestic Product was up 1.6% over the prior year. The BEA also reports that personal income in California is up 4.2% in the third quarter of 2016 versus the same quarter in 2015. The U.S. Bureau of Labor Statistics reports that California’s unemployment rate is down to 5.2% as of December 2016, the lowest since the recession began, and a stark difference from the high of 12.2% during late 2010. The California Legislative Analysts’ Office reports that assessed property values increased 6% in both 2014-15 and 2015-16. Existing home sales are up statewide, and HdL Companies report California’s median existing home prices is expected to continue steady growth (See Attachment C- HDL’s California Forecast: Sales Tax Trends and Economic Drivers.) All of these are positive signs that
the economy is in recovery. The National Bureau of Economic Research indicates that
the current economic expansion is the fifth longest on record in this country. Beacon
Economics reports that “…the nation is currently in the midst of its seventh year of
economic expansion, with little sign that the trend is anywhere close to ending. Labor
markets are at full employment and asset prices are at or near record high levels.”
While there is no reliable tool to predict the timing or the severity of a recession far in
advance, many of the indicators are continuing on a slow and steady growth trend.

Atascadero’s General Fund revenue picture seems to support this theory. General
Fund revenues hit a low of $15.6 million in 2009-2010 (from a high of $19.1 million in
2006-2007). In 2014-2015, General Fund Revenues were finally back to pre-recession
levels of $19.1 million, and were $20.2 million in 2015-2016. These figures are in line
with other economic indicators across the state and nation, and the opinions of many
economists.

Based on the financial strategy that the Council has been following, this means that the
City should be still using reserves in order to maintain service levels for a few more
years, but should do so judiciously. Continued monitoring and evaluation of the
financial situation, reserves and reserve projections should continue to be used to
ensure that reserve levels do not fall below the reserve minimum.

The next eight measurements should be used in determining what level of reserve
minimum is right for Atascadero.

Measurement #2 – Level of Diversity in General Fund Revenue

One measurement to quantify an appropriate level of reserves concerns how broad a
range of General Fund revenues the City receives and what the future holds for such
revenue. Some cities have a very broad range of General Fund revenues not
associated with fees. For example, Pismo Beach and Morro Bay enjoy a large amount
of transient occupancy taxes (hotel tax). Other cities, such as Grover Beach and San
Luis Obispo, have a utility user tax. This is a percentage of the cost of all utilities used
by citizens of those cities, including gas, electric, phone, cable TV, and even those
cities’ own utilities of water, sewer, and garbage.
This table show General Fund revenue by type for Atascadero as compared to other cities in the county:

Cities with fewer sources of General Fund revenue will require a greater amount in reserves in order to successfully weather a downturn in one revenue area. This is true for the City of Atascadero. Property based taxes accounted for 41% of General Fund revenues in 2015-2016, with sales tax accounting for an additional 19%. These two revenues sources alone account for 60% of the City’s General Fund revenues. In the graph above, you can compare this to the revenue base for a city such as San Luis Obispo, which has a more diverse revenue base.

One reserve methodology dictates that reserve levels should be tied to the broadness of General Fund tax revenues sources. The greater number of revenue sources require
fewer layers of reserves. Conversely, the fewer number of revenue sources require higher levels of reserves. As Atascadero’s property tax and sales tax revenues comprise $12.1 million of the $20.2 million in General Fund revenues, the City is defined as having a narrow base of revenue—just two significant categories.

**Measurement #3 – Stability of Revenue Base**

As discussed above, General Fund revenues for fiscal year 2015-2016 were $20.2 million. Seventy-three percent of this was from taxes, with the balance coming from fees, grants, and other sources. The fees and grants pay for specific services or projects. To examine the tax base more closely, it is helpful to break it down further. Property tax comprises 41% of the revenues, sales tax 19%, TOT is 6%, other taxes 7%, development costs and other fees for services 15% and other revenues/interfund charges make up 12%.

Property tax is considered to be one of the more stable sources of revenue. Although we saw large increases in the boom years 2000-2008, most other years since incorporation have seen either modest (1-4%) increases or decreases in the tax base. Historically the property tax revenues have two components: (1) a stable base that does not vary drastically from year to year and (2) a housing market boom and correction component.

While there is a stable underlying base, this revenue does vary with the strength of the housing market. The table below shows property tax per capita on a constant dollar basis. The constant dollar smooths out changes for normal inflation so that we can see if we are better off than we were in 1987 or worse.

![Property Tax per Capita (Constant $)](image-url)
In California in the late 80’s/early 90’s and then again in the mid-2000’s, the housing market did not follow normal inflation. Housing prices and new construction boomed causing spikes in the property tax revenue base, followed by a smoothing or flat period. Overall the smooth or flat period of revenue is the stable portion of the revenue base and is what the City can count on year after year. The spikes are periods of boom where there are opportunities for the City to sock away reserves and address one-time fixes. Since it appears that the real estate market has generally corrected itself and we are seeing signs of growth and recovery in the property tax base, it is reasonable to assume that we are now again the gentle growth period where the entire property tax base is considered very stable.

It is also interesting to compare Atascadero’s property tax per capita with other cities in the county. The chart to the right shows that our community has the lowest per capita property tax in the county of the cities listed (information from the City of Grover Beach was not available at the time of publication of this document). It is true that in this county, each city has its own unique characteristics which often make it hard to do comparisons. Even with that in mind, however, this chart does make one thing painfully clear. Atascadero has less money per person to spend on essential functions such as public safety and parks that are critical to citizens of the community. In other words, the relative strength of our dollars per capita is not as good as that of our neighbors.

Sales tax is much more susceptible than property tax to fluctuations in the economy. As of 2015-2016, 19% of General Fund revenues came from sales tax. There are over 1,000 businesses that report sales tax within the City of Atascadero, however, the top 25 businesses account for 52% of the sales tax revenue. The City’s sales tax is currently heavily reliant on the continued health of the top 25 businesses listed in Attachment B- HDL’s City of Atascadero Sales Tax Update Q2 2016.

The chart below depicts sales tax per capita, constant dollar, over the last 30 years. Like property tax, it too shows evidence of the ebbs and flows of the market, but to a greater extent. Atascadero started experiencing an increase in this revenue after Home Depot came on line in fiscal year 2000-2001, but then a sharp decrease with the loss of large sales tax producers such as Atascadero Ford and Ted Miles Jeep. The good news is that the City is starting to turn around again. Although we are not quite back up to the $60.00 (1987 dollar value) per capita benchmark that we have historically
enjoyed, the planned development at Del Rio along with the aggressive economic development policies of the City Council should bring us back over that benchmark in the near future.

One silent thief comes in the form of internet transactions. These transactions, when done via the internet, replace retail sales that the City would otherwise have earned sales tax revenue for. This trend has steadily grown and will continue to do so, further impacting future sales tax revenue.

Sales tax revenue on fuel is the single largest source of revenue by business group at 19% of the total. As alternative energy vehicles continue in popularity and oil prices fluctuate widely, sales tax revenue from fuel will become even more volatile.

**Measurement #4 – Potential Actions of Federal and State Agencies or Public Policy**

When the State faced fiscal challenges in the early 1990’s it simply transferred property tax revenues from cities and counties in effect to itself (known as the ERAF I & II shifts). In addition, the State reduced funding for counties, and in turn allowed counties to recoup these lost revenues by charging cities for services such as collection of property taxes and booking people into county jail. In the late 1990s, the State was in very good financial position and desired to give constituents a tax break. The State did this by reducing one City revenue (VLF) and promising to backfill it with a different one. Further, in 2012, in spite of the passage of two separate local revenue protection measures, the State eliminated Redevelopment Agencies.

The City is currently more vulnerable to continued increased costs due to added regulations and shifting of costs. Unfunded mandates are becoming more typical and apply to regulations concerning water, storm water, pollution, employment, reporting/transparency, and law enforcement, just to name a few.
Additionally, propositions that are passed by the taxpayers can often have a fiscal impact on the City. Propositions 47 (2014) and 57 (2016) changed laws related to public safety and while these propositions reduce costs to the State Corrections system, they increase local law enforcement costs.

With the passage of Proposition 30 and the improved financial health of the State, the risk of State revenue raids is lower than it has been in years. Although in a better position than in years past, the City’s financial well-being continues to be vulnerable to political action.

Measurement #5 – Cash Flows Needs

The cash flow needs of the City have a direct bearing on the amount of reserves needed. Unlike many private organizations and businesses with a steady cash stream, the City receives large portions of its annual revenues in chunks, twice a year. The fiscal year begins in July and ends in June. During the summer months, the City incurs more expenses for fire reserves, recreation programs, and capital projects than during other months of the year. However, the City does not receive its first fiscal year injection of property tax until late December, and then waits to receive the rest in late April. In other words, the City’s general fund receipts go down from April through November while the City’s disbursements go up during the same period.

At the current rate of continued use of General Fund reserves, the General Fund is not anywhere near having a negative cash balance. However, in the event the economy has another severe and prolonged downturn that further depletes the General Fund reserve, the City does have a couple of fairly simple options at its disposal.

1. The City overall does NOT have a cash flow issue. The cash balance on hand at June 30, 2016 was over $41.5 million and the lowest cash balance in the last 3 years is $25.3 million.
The City’s General Fund can borrow funds from other available funds within the City. The City has over 40 funds in total. Some funds, such as the internal service funds mentioned previously, are not restricted at all and may be loaned or transferred back to the General Fund at Council’s direction. Other funds may have legal restrictions on how they can be spent. The restricted funds, however, may be loaned to other funds as long as they receive at least the same interest as they would’ve received without the loan, and the loan does not interfere with the purpose of the funds (i.e. the monies are not slated to be spent prior to the payback period). The City does have many funds available to loan, especially for the very short period (2 – 3 months) that we are discussing. As always, borrowing funds does not come without concerns. Prior to any borrowing projections of incoming funds and the ability to pay back should be evaluated and assessed.

2. As of June 30, 2016, the General Fund had over $627,000 in loans that it had made to other funds. Typically loans to other funds are made for expenditures purposefully made in advance of receiving the revenues. This may be for a grant, where the funds must spend funds first and then be reimbursed, or it may be for impact fees, where the Council decides to build a specific project now in order to benefit future development, and then collects the funds as development occurs. These loans have historically been from the General Fund as it has had available funds on hand. Council could determine that these loans would be more appropriate from different funds, thus paying the General Fund back its cash.

3. Historically, the City was one of many cities that issued Tax Revenue Anticipation Notes or TRANs to cover annual General Fund cash shortfalls. The TRANs were issued through the California Statewide Communities Development Authority. Because the TRANs were tax free issuances and the funds were needed for just
a short period of the year, it was an opportunity for the City to cover the short period of negative cash, and earn interest on the funds for the rest of the year. The City was not allowed to participate in the TRANs issuance once it had positive General Fund cash flow throughout the year.

Ideally the City General Fund would have enough cash on hand to cover the annual cash ebbs and flows; however the City does have options for these annual fluctuations. A much harder look must be taken though, when the annual negative cash balance is no longer annual, but instead a long-term loan. It would not be consistent with Council’s conservative fiscal policy to allow reserves to fall so low that interfund loans are not paid back within the fiscal year. While the current seven year projection does not anticipate such an occurrence, it is something that must be monitored.

Measurement #6 – Potential Natural Disasters or Emergencies

Atascadero is subject to potential natural disasters including earthquakes, floods, fires, major auto and train accidents, and hazardous materials spills. The 2003 San Simeon Earthquake and recent storms are proof of that. City staff are well trained in responding to emergencies and meeting the needs of the community. Any natural disaster or emergency will undoubtedly cause unbudgeted expenditures, fortunately, however, in the event of a declared disaster, agencies such as FEMA and CalEMA provide assistance to help the City recover. The funding received from these agencies are reimbursement funds; in other words, the City spends the funds and then requests reimbursement. In the event of a disaster or emergency, the number one priority of the City must be to respond to the emergency. When looked at as a whole, the City has ample cash on hand to respond to an emergency until assistance funds could be received. It may mean once the emergency is over and the accounting done, that the General Fund cash was negative and it had to borrow from other funds, but the Council’s higher priority to ensure the safety of its citizens was attained.

The City is fully insured against property damage and liability claims. Additionally, Atascadero is very aggressive in applying for all applicable grants, when available, particularly to pay for the cost of responding to emergency situations.

Measurement #7 – Asset Replacement Requirements

The City of Atascadero owns large amounts of assets that have lives longer than a year such as buildings, infrastructure, technology, and vehicles. Council began back in the late 1990’s putting money into the reserves for many of these items so they could be replaced as needed. While not all of these assets reserves are fully funded, many of those that most directly affect community service levels have been funded. These include technology and vehicles. Asset replacement reserves have been evaluated in Section 4 of this report. See Section 4 for more detail on this subject.
Measurement #8 – Service Level Consistency

Another issue to consider is how important it is to the organization and constituents that services levels are consistently maintained. Looking back two decades, this was a key concern. A less fiscally conservative policy was in effect during that time, and when the economy became sluggish, reserves were insufficient to carry the City through the tight times. Services were cut. Many families had to seek alternate sources for youth recreational activities. Parks and Public Safety services were at a bare minimum. Employees were laid off. The few employees that remained to run the City were overworked and frustrated. Morale was at an all-time low. Recruitment during the recovery period was difficult at best.

Fortunately, as the Council put the fiscal sustainability policy in place, things began to turn around. This strategy of putting aside reserves in good times and then using those reserves during down periods to achieve stable operations has allowed the City to maintain fairly consistent operations over the last two budget cycles. Instead of burdening the ongoing operations budget with significant new purchases and programs when times were good, the Council kept level heads and tucked away some extra funds. As the economy started to turn south, instead of cutting programs and staff to uncomfortable levels, Council was again able to maintain services to the public by utilizing some of the reserves that were saved up. The ability to maintain level and consistent services is important to consider when evaluating reserve levels.

Maintaining a service level consistency is even more of a delicate balance as we begin to come out of the economic downturn. The wants of the citizens, employees and other constituents are immediate. During the downturn, people understood why services may have been somewhat minimized. Now that the economy is coming back, it is a natural reaction to want service levels to improve. The economy is better; therefore the City is receiving more revenue, so services should be better. Remember the cornerstone of the fiscal policy is to set aside money in good times for use in bad times so that service levels remain constant. This means that in the bad times, while the City did cut back in some small areas, in most areas, the service levels remained constant. The City was providing services at a level higher than revenues could afford. Consistent with the policy the City was using, and continues to use, reserves to maintain service levels. In order for this strategy to work, the City has to continue to maintain service levels during the upturn. While the next few years will bring higher revenues, it will be some time before revenues are equal to the costs of the service levels that the City provides. The reserve policy will be even more difficult to adhere to as public pressure mounts to increase service levels, however the current service levels are the levels that the City can afford in the long run. New or improved service levels or programs can only be added with a fundamental shift or a change in funding for the City.

Measurement #9 – Available Opportunities

In the good years, previous Councils have wanted the flexibility to take advantage of opportunities as they arose, and used reserves at times as a tool to achieve such goals.
Beginning with the economic downturn, the focus was directed not at new programs or services, but ways to improve and streamline existing programs and services to better serve the public and attract businesses and visitors. Available reserves can be used for these opportunities. Alternatively, if it makes fiscal sense, financing can be another option to achieve identified goals or pursue opportunities.

Looking at the Big Picture

Nine criteria have been analyzed in order to ascertain what constitutes a prudent reserve for the City of Atascadero. While each of these is an important measurement, they should not be looked at individually but instead as a whole. They must also be considered within the framework of the financial picture for the entire organization rather than just the General Fund.

If each reserve was to be considered individually, it might be recommended that the City reserve 10% of sales tax in case a major sales tax provider closes its doors, plus three months’ worth of expenditures for natural disasters, plus $3.8 million for annual cash flow needs, plus $2 million on hand just in case an opportunity comes up, etc. Each item listed is an individual event, and, in theory, could all happen at the same time, but the risk of that happening is minimal. It would be irresponsible to our constituents to keep the cumulative amount of what would otherwise be prudent individual reserves. These are funds that could be used to fund City services. Instead, as looked at above, it is sensible to analyze each potential use of reserves and determine what risk and use level is acceptable to the City and what other options are available.

As of June 30, 2016 the City’s General Fund had a reserve balance (excluding Sales Tax Measure F-14 funds) of $9.3 million. This represents a healthy 48% of General Fund expenditures. While this is not quite equal to the all-time high level of $11 million reached in 2006-2007, the reserve levels are very consistent with the financial strategy set by the City Council.

In accordance with the City’s financial strategy, the City should have its highest level of reserves just prior to an economic slowing. Fiscal year 2006-2007 was the last strong year for the City and it was the year the City had the largest reserves. In 2007-2008 the bottom dropped out of the economy and the City began using reserves. By 2008-2009, the City was using reserves and began to realize that this was no ordinary recession, so Council made the tough decision to reduce some service levels. Staff has continued to monitor reserves levels, allowing the City to remain financially healthy in this downturn. Staff recommends that City continue to use reserves to keep service levels, monitor and adjust through the budget and strategic planning process. Staff recommends that if there is a substantial change that it would be addressed immediately and adjustment made accordingly.
The General Fund reserve balance in dollars is depicted in the following graph:

The financial policy has worked for the City in the past, and if we stick to it, it appears that it will work through this next financial planning horizon. Current projections show that using current assumptions and strategies in place, reserves will fall to a low of $7 million. During this outlook period, reserves as a percentage of General Fund expenditures do not dip below 30%. This is well above 15% - 20% that the Council has set as the “norm” in our historical financial strategy. In prior strategic planning sessions, the Council agreed that it was critical to maintain service levels and felt that it was prudent to cut a little bit deeper into reserves (dropping to as low as 15%), with the mindset to turn to building reserves again as soon as possible. It is important that as we continue to recover from the Great Recession that the organization is intact and ready to take advantage of opportunities. The general financial plan laid out in the Seven Year Projection ensures that we are not borrowing against our future and that there are sufficient reserves on hand to address the needs of the City throughout this downturn and recovery.

Conclusion

It is important that the City maintain an appropriate level of reserves. The fiscal strategy has been an effective tool to keep the City in a respectable financial position. Historically, Council has agreed that reserves should not drop below 15% of General Fund expenses. Through careful planning and many years of belt tightening through the worst of it, this continues to be an achievable goal. While it will continues to be a
slow and steady climb out of this current economic downturn, overall the City is in a respectable position. Staff will continue to monitor actual figures as they come in and compare them to the projected numbers. With consistent monitoring, the Council has been, and will continue to be, alert and effective leaders guiding the City toward future abundance.
Review of Fiscal Policies

The budget document allocates City resources such as personnel, materials, and equipment in tangible ways to achieve the general goals of the community. It is prudent, therefore, for the City to have in place fiscal policies and practices to guide the City Manager and City Council through the budget decision-making process. These policies and practices are:

Operational Efficiencies:

- Implement and practice ongoing operational efficiencies to the extent reasonable;
- Enter into joint operating arrangements with other organizations so as to provide services more cost effectively;
- Continue the use of valuable volunteers.

Staffing:

- Continue to have the Department Head team evaluate key personnel needs of the City. A supplemental request is submitted by each Department Head for staffing needs within the department, and these are evaluated, discussed and prioritized. Tough decisions are made as part of the budget process based on Council priorities, safety concerns, and work volume changes;
- Utilize private contractors when the same or higher level of service can be obtained at lower total cost;
- Utilize consultants and temporary help instead of hiring staff for special projects or peak workload periods.
- Attract and retain competent employees by providing a professional work environment, competitive salaries, safe working conditions, and adequate training opportunities;
- Base salary increases on individual merit and job performance levels;
- Strive toward maintaining above competitive compensation packages in order to recruit and maintain the best and the brightest;
- Work toward adequate staffing for the service levels being provided;
- Be aware of and plan for state, federal and OSHA mandates which might have an effect on staffing levels;
- Be aware of, monitor and avoid the "hidden" costs of employee turnover, burnout, and stress due to overwork;
- Look for service level reductions in areas where there will be minimal impacts to citizens, thus "freeing" employee time.

Education and Communication:
Dissemination of important financial information to staff through City Manager roundtables, meetings, emails, and other means of communication;

- Encourage employee ideas for efficiency, reduction in costs, or increases in revenues;
- Provide Council and public with information regarding the City’s financial outlook through both the audit and budget process, and continue to update with any changes that occur.

**Economic Development:**

- Provide a climate that encourages healthy commercial areas that capture more of the purchasing power of the community and creates more destination commercial activities to capture regional money;
- Aggressively pursue new developments and businesses which are consistent with the community’s quality of life and add to the City’s economic base, particularly those that generate sales tax revenue;
- Promote a mix of businesses that contributes to a balanced community;
- Continue to improve programs to enhance and retain existing businesses;
- Continue the promotion and tourism programs as a key component of the economic development strategy.

**Community Development:**

- Ensure that adequate funding is in place to provide essential services to new residents without diluting services for existing residents by:
  - Supporting the Community Facilities District to fund the addition of the necessary police, fire and parks personnel needed to provide services to these new residents;
  - Continuing to require each project that comes before Council to annex into the Community Facilities District. (The general plan requires that only developments with 100 or more units be fiscally neutral);
  - Have staff explore other expanding the requirement to annex into the Community Facilities District to include all housing developments.
  - Formation of road maintenance districts in order to provide an ongoing revenue source needed to maintain new, expanded or recently accepted roads.
- Require that new growth pay for the expansion of facilities and infrastructure necessary to serve the expanding population;
- Plan community growth with service and maintenance funding requirements in mind.

**Infrastructure:**

- Fully fund technology replacement funds;
- Work toward fully funding vehicles, equipment, buildings, and other infrastructure;
Continue to determine and implement strategies to reduce the current backlog of deferred maintenance projects;

Provide sufficient routine maintenance each year to avoid increasing the deferred maintenance backlog;

Determine a maintenance plan and funding strategy prior to the construction, improvement or acceptance of new infrastructure.

**New Services:**

- New or expanded programs should only be implemented when a new funding source has been developed or when an equal or greater cost program has been eliminated;
- Require agreements for specific services and monitor effectiveness on an ongoing basis.

**Construction of New Facilities:**

- Plan for new facilities only if construction and maintenance costs will not negatively impact the operating budget.

**Cash Investment:**

- Follow adopted Investment Policy guidelines for the prudent investment of City funds not required for the immediate needs of the City;
- Maximize the efficiency of the City's cash management system;
- Enhance the economic status of the City while protecting its pooled cash.

**Fiscal Management:**

- Maintain appropriate reserve levels;
- Consider the long-term and the short-term when making financial decisions;
- Continuously monitor operations and make adjustments as necessary;
- Take full advantage of opportunities to receive reimbursement funding at maximum rates possible;
- Generate additional revenue by marketing City services to other agencies on a contract basis;
- Maximize revenues by utilizing grants from other agencies to the fullest extent possible;
- Charge fees for services that reflect the true cost of providing such services and to review fee schedules on a regular basis;
Fully account for the cost of enterprise operations to avoid any subsidy by the General Fund and to charge all enterprise funds their fair share of the cost of City support services;

Maintain accurate accounting records to keep the City Manager, City Council and public informed of the financial condition of the City at all times;

Think outside of the box to achieve revenue opportunities that wouldn’t otherwise exist;

Consider partnerships and taxing opportunities when appropriate.

**Conclusion**

The policies and practices listed in this section have been practical guides toward a consistently healthy fiscal condition. The importance of these and a well-defined financial strategy to anticipate and conquer difficult issues cannot be understated. The responsibility to maintain a strong organization is shared community wide, but as the City Council and City employees, we agree to be the leaders in this effort. Council has shown integrity in the decisions made to maintain the conservative fiscal strategy. When resources are tight and needs are plenty, it is difficult to commit to saving some of those precious resources for the future. Those reserves are most appreciated now as the City continues to recover and expand revenues. Certainly, the fiscal strategy is working. The recovery is slow and steady. Decisions will continue to be difficult, especially as public pressure builds to increase one-time and on-going spending. The fiscal strategy has provided the option to keep operations and service level somewhat stable and continues to provide the City with a sustainable future.

**ATTACHMENTS:**

Attachment A- The State Legislative Analyst’s Office’s (LAO’s) California Fiscal Outlook November 2016, Chapter 2

Attachment B- HDL’s City of Atascadero Sales Tax Update Q2 2016

Attachment C- HDL’s California Forecast: Sales Tax Trends and Economic Drivers
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a Fiscal Outlook publication coordinators.
Executive Summary

In this report, we describe our office’s assessment of the condition of the California economy and budget over the 2016-17 through 2020-21 period.

Outlook Subject to Considerable Uncertainty. The condition of the state’s budget depends on many volatile and unpredictable economic conditions, including fluctuations in the stock market. Even in the short term, these conditions cannot be predicted with precision. They are even more difficult to anticipate years in the future. As such, while we have reasonable confidence in our expectations about the economy’s performance in 2017-18, we are much less able to anticipate the economic future in each year thereafter. To reflect these uncertainties, this report emphasizes one estimate of the near-term budget condition through 2017-18 and displays two different estimates of the budget’s condition in 2018-19 through 2020-21.

Positive 2017-18 Budget Outlook. For the near term, under our current economic projections and assuming the state makes no additional budget commitments, we estimate the state would end the 2017-18 fiscal year with $11.5 billion in total reserves. This total includes $2.8 billion in discretionary reserves, which the Legislature can appropriate for any purpose, and $8.7 billion in required reserves, which will be available for a future budget emergency. These reserve levels reflect the continued progress California has made in improving its budget situation.

State Is Increasingly Prepared to Weather a Mild Recession. For the longer term, we estimate the condition of the state budget under two different economic scenarios. They are: (1) an economic growth scenario, which assumes the economy continues to grow, and (2) a mild recession scenario, which assumes the state experiences a mild economic downturn beginning in the middle of 2018. Under the growth scenario, we estimate the budget remains in surplus over the outlook period. Under the recession scenario, we find that the state would have enough reserves to cover almost all of its operating deficits through 2020-21. This means, under our assumptions, the state could weather a mild recession without cutting spending or raising taxes through 2020-21.

New Commitments or Policy Changes Would Affect Outlook. Importantly, these estimates assume the state does not make any changes in any year during the outlook period to its current policies and programs. In addition, the outlook also assumes no new changes in federal policy, even though the recent election results suggest some such changes are now likely. Any such state or federal policy changes could have a significant impact on the state’s “bottom line.”
Introduction

Each year, our office publishes the Fiscal Outlook in anticipation of the upcoming 2017-18 budget process. In this report, we summarize our office’s assessment of the condition of the California economy and budget for the upcoming fiscal year (2017-18) as well as the following three years (through 2020-2021). Below, we explain the organization of this report and the basis for our projections.

Organization of This Report

Uncertainty in the Outlook. As this report is published, the first day of the 2017-18 fiscal year is over seven months away. Our expectations about the budget’s condition over the forecast period depend, in large part, on our assumptions about trends in the economy and the stock market. While there is uncertainty over these assumptions in the near term, that uncertainty becomes even greater in each subsequent year. As such, we have reasonable confidence in our expectations about the economy’s performance in 2017-18, but we are much less able to anticipate the economic future in each year thereafter. Figure 1 illustrates this point with regard to General Fund revenues. The figure shows our revenue outlook for the near term, and our two separate revenue outlooks for the out-years, based on two different economic scenarios (described further below). The shaded area in the figure illustrates the uncertainty around these two scenarios. Through 2017-18, revenues could be a few billion dollars above or below our estimates. After 2017-18, revenues could be many billions of dollars above or below our illustrative scenarios, with uncertainty growing in each subsequent year.

This report is organized to reflect our uncertainty about our projections while still producing what we hope is a useful planning document for the Legislature. As such, we...
emphasize the near-term economic and budget outlook in Chapters 1 through 3 and present out-year budget and economic scenarios in Chapter 4. This organization is discussed in greater detail below.

**Chapters 1 and 2 Present One Near-Term Scenario.** In Chapter 1 of this report, we present our assessment of the condition of the state General Fund for 2015-16, 2016-17, and 2017-18. Chapter 2, similarly, discusses our estimates of key revenue trends and economic performance through 2017-18. All of our projections through 2017-18 are based on a consensus economic forecast (developed before the election). In these years, there is less uncertainty regarding our assumptions. Also, we hope that presenting one scenario will better assist the Legislature as it plans for the upcoming 2017-18 budget process. However, our estimates of revenues, expenditures, and reserve requirements will change in the following months—especially after the large influx of 2016 tax return payments in April 2017.

**Chapter 3 Presents Outlook for State Spending.** In Chapter 3 of this report, we discuss our state General Fund spending outlook, again emphasizing the near term. We also comment on key spending trends over the entire outlook period. Generally, these out-year trends are based on our economic growth scenario. The spending estimates aim to reflect the cost of maintaining the state’s existing program commitments and budget act policies over the outlook period. (As such, we have generally provided adjustments to address the impact of inflation with the aim of maintaining the purchasing power of current legislative commitments.) Our estimates also assume the state makes no changes to its programs and policies in the future. This does not mean, however, we believe these policies will or should stay the same. On the contrary, the essence of budgeting is making year-to-year adjustments to spending to accommodate legislative priorities.

**Chapter 4 Presents Two Out-year Scenarios.** In Chapter 4, we present two estimates of the state’s General Fund condition in 2018-19 through 2020-21. These estimates are based on two different examples of how the economy could perform over the outlook period. They are: (1) an economic growth scenario, which assumes the economy continues to grow throughout the outlook period, and (2) a mild recession scenario, which assumes an economic downturn—with a big stock market decline—begins in the middle of calendar year 2018. These alternate scenarios are only two of many possible future economic realities. Actual experience could be more positive than the growth scenario or more negative than the mild recession scenario.

**How We Build Our Outlook**

**Three Main Outlook Techniques for Spending.** In broad terms, we use three different methodologies to build our spending outlook in Chapter 3. They are:

- **Formula-Driven Outlooks.** These programs have constitutionally required minimum funding levels based on formulas with specified inputs. These include the formulas for determining schools and community college funding (Proposition 98) and reserve deposits and debt payments (Proposition 2).

- **Outlooks Based on Caseload, Utilization, and Price.** These programs experience changes in funding levels based on a combination of changes in their number of participants (caseload), the intensity at which participants use services (utilization), and the costs per enrollee (price). Examples include Medi-Cal, the state’s insurance program for low-income Californians, and the California Department of Corrections.
and Rehabilitation, which operates the state's correctional facilities and parole system. The outlook for these programs use models that identify relationships between economic and demographic trends and spending levels.

- **Discretionary Outlooks.** These programs have funding levels that are generally determined by legislative priorities. We typically assume a continuation of recent budget practices—for example, funding for universities and employee salaries and health benefits.

- **Revenues Depend on Volatile Economic Indicators.** Our revenue outlook depends, in large part, on our assumptions about the performance of the economy and the stock market. In particular, revenues from the personal income tax, which make up about 70 percent of General Fund revenues, depend on highly volatile estimates of capital gains. As a result, ordinary movement in the stock market—over just a period of weeks or months—can result in billions of dollars in higher or lower revenues for the state. Our revenue estimates also assume current laws and policies stay in place—both at the state and federal levels. For example, our outlook assumes the tax on managed care organizations will expire at the end of 2018-19, consistent with current law. Similarly, our estimates of growth in the sales and use tax reflects a quarter-cent reduction in the tax rate after December 2016 as that provision of Proposition 30 (2012) expires.

**Effects of November 2016 Voter Initiatives Included.** Our fiscal outlook reflects the fiscal effects of propositions approved by the voters on the November 8, 2016 ballot. (We have assumed that Proposition 66, which deals with the death penalty processes, is approved, although votes are still being counted.)
Chapter 1: General Fund Through 2017-18

This chapter summarizes our office’s assessment of the near-term condition of the state General Fund, the state’s main operating account.

OUTLOOK FOR THE 2017-18 BUDGET

Figure 2 displays our estimate of the General Fund condition through 2017-18. We estimate that 2016-17 will end with $7.5 billion in total reserves, about $1 billion lower than the assumptions in the budget act. Assuming no new commitments are made in the 2017-18 budget, we estimate total reserves will grow to $11.5 billion at the end of the fiscal year—an increase of $4 billion. This $11.5 billion total includes $2.8 billion in the Special Fund for Economic Uncertainties (SFEU), the state’s discretionary budget reserve, and $8.7 billion in the Budget Stabilization Account (BSA), the state’s required budget reserve.

2016-17: Revised Reserve Levels of $7.5 Billion

The estimated $1 billion decrease in 2016-17 reserves is the net result of the following:

- **$510 Million Downward Revision to Entering Fund Balance.** We include two revisions to the budget condition before 2015-16 that affect the current budget situation. First, based on our estimates of required funding for schools and community colleges, we assume the state will pay an additional $351 million in “settle up” payments related to earlier minimum funding guarantees. (We discuss these settle up payments further in Chapter 3.) Second, our estimate reflects a $159 million reduction in prior years’ estimated revenue collections and accruals.

- **Revenues Lower by $1.7 Billion in 2015-16 and 2016-17.** Between 2015-16 and 2016-17, we estimate revenues will be lower than the budget

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### Figure 2

**LAO General Fund Condition**

<table>
<thead>
<tr>
<th>(In Millions)</th>
<th>2015-16</th>
<th>2016-17</th>
<th>2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior-year fund balance</td>
<td>$2,935</td>
<td>$3,715</td>
<td>$1,717</td>
</tr>
<tr>
<td>Revenues and transfers</td>
<td>115,643</td>
<td>119,991</td>
<td>128,123</td>
</tr>
<tr>
<td>Expenditures</td>
<td>114,863</td>
<td>121,988</td>
<td>126,109</td>
</tr>
<tr>
<td>Ending fund balance</td>
<td>$3,715</td>
<td>$1,717</td>
<td>$3,731</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>966</td>
<td>966</td>
<td>966</td>
</tr>
<tr>
<td>SFEU balance</td>
<td>2,749</td>
<td>751</td>
<td>2,765</td>
</tr>
<tr>
<td><strong>Reserves</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SFEU balance</td>
<td>$2,749</td>
<td>$751</td>
<td>$2,765</td>
</tr>
<tr>
<td>BSA balance</td>
<td>3,420</td>
<td>6,714</td>
<td>8,694</td>
</tr>
<tr>
<td><strong>Total Reserves</strong></td>
<td><strong>$6,169</strong></td>
<td><strong>$7,466</strong></td>
<td><strong>$11,459</strong></td>
</tr>
</tbody>
</table>

SFEU = Special Fund for Economic Uncertainties (the General Fund’s discretionary budget reserve) and BSA = Budget Stabilization Account.
act estimates by $1.7 billion. In particular, our estimates for total revenues—across the two fiscal years—associated with the sales and use tax (SUT) and corporation tax (CT) are $2.6 billion lower than budget act assumptions. These shortfalls, however, are partially offset by net upward revisions in our estimate of personal income tax (PIT) revenues over the two fiscal years—$923 million below budget estimates in 2015-16 and $1.7 billion above estimates in 2016-17.

- **Expenditures Lower by $1.2 Billion in 2015-16 and 2016-17.** We estimate expenditures in 2015-16 and 2016-17 will be lower than budget act assumptions by a net $1.2 billion. Two factors explain most of the lower spending. First, General Fund Proposition 98 spending declines by $640 million in 2015-16, due to lower state revenues and higher local property taxes. Second, in 2016-17, we assume the $400 million set-aside for affordable housing in the budget package is not spent because it was contingent on changes in state law that did not occur.

- **Required BSA Deposits Unchanged.** Proposition 2 establishes a minimum amount that the state must deposit each year into the BSA, the state’s required budget reserve. Under the measure’s “true up” provisions, the state revisits these estimates twice: once in each of the two subsequent budgets. However, the 2016-17 budget package set aside a $2 billion optional deposit and specified that these funds would be used to meet true up requirements for 2015-16 and 2016-17. The estimated true up deposits associated with 2015-16 and 2016-17 are together less than $2 billion. As a result, we assume no additional true ups are made, leaving the already revised 2015-16 deposit and initial 2016-17 deposits unchanged.

**2017-18 Outlook:**
**Year Ends With $11.5 Billion Reserve**

**Revenues and Transfers Grow $8.1 Billion.** We estimate that revenues and transfers will grow by $8.1 billion in 2017-18, including a $6.4 billion (5.4 percent) increase in the “Big Three” revenues: the PIT, SUT, and CT. Most of this growth is driven by a 6.9 percent year-over-year increase in the PIT.

**Spending Grows $4.1 Billion.** We estimate that General Fund expenditures—absent any new program commitments—would grow $4.1 billion between 2016-17 and 2017-18. This increase is in part attributable to a $1.4 billion increase in the General Fund share of the minimum funding guarantee for schools and community colleges. Another $1.5 billion is attributable to the net increase in spending related to health and human services programs, including about an $800 million increase in Medi-Cal, the state’s health insurance program for low-income Californians. Various other spending items grow too. In contrast, spending declines between 2016-17 and 2017-18 due to the expiration of many one-time expenditures in the 2016-17 budget. These items include, for example, one-time spending on deferred maintenance, capital outlay, and several criminal justice programs.

**Reserves Grow to $11.5 Billion.** Based on our current estimates of revenues, particularly those related to capital gains, we estimate the state will be required to make an initial deposit of $2 billion into the BSA for the 2017-18 fiscal year. In addition, based on our estimates that growth in revenues will outpace expenditures, and assuming no new budget
commitments are made, we estimate 2017-18 would end with additional reserves of $2 billion in the SFEU. Together, these reserves would build on the

$7.5 billion balance estimated in 2016-17, bringing total reserves to $11.5 billion by the end of 2017-18.

LAO COMMENTS

Positive 2017-18 Budget Outlook. Based on our current economic and budget projections, we estimate the General Fund will end 2017-18 with $11.5 billion in total reserves, including $2.8 billion in discretionary reserves. (That $2.8 billion amount is displayed in our figures as the balance in the SFEU.) These reserve levels reflect the continued progress California has made in improving its budget situation. The state budget remains on steady footing.

Lower 2017-18 Revenue Estimates Would Mean Fewer Discretionary Resources. Our revenue outlook is based, in part, on assumptions about the stock market. As we describe in Chapter 2, this outlook makes certain assumptions about how estimated and final PIT payments will strengthen during the second half of 2016-17. We believe these assumptions are reasonable, but if they do not come to pass, our revenue estimates easily could be about $2 billion lower in both 2016-17 and 2017-18. In this case, 2017-18 would end with over $2 billion less in discretionary reserves. (The $4 billion revenue decline over the two fiscal years would be offset by lower Proposition 98 and Proposition 2 requirements.) In this scenario, the Legislature would have significantly fewer discretionary resources in the 2017-18 budget process.

Outlook for Future Shapes Decisions Today. Under our current estimates, the Legislature will face decisions in the 2017-18 budget process about how to allocate the $2.8 billion in discretionary reserves. The Legislature could opt to hold some or all of this in reserves or make some new one-time or ongoing commitments. The choices the Legislature makes for these funds may depend, in large part, on its consideration of the future prospects for the state budget. We present two possible out-year budget scenarios in Chapter 4 of this report. We hope these scenarios help inform the Legislature’s decisions as the 2017-18 budget process begins.
Chapter 2: The Economy and Revenues

THE ECONOMY

Our near-term projections are based on a consensus of economists about the likely trend of the U.S. economy through 2018, as reported in October (prior to the election) by Moody’s Analytics, a national economics consulting firm. This differs from our most recent projections, which were premised on the analyses of just the economists at Moody’s Analytics. (The administration’s projections are based on analyses by a different firm.) Using these consensus views about the U.S. economy, our office develops a California-specific macroeconomic scenario.

Our near-term economic projections are summarized in Figure 3 and compared to the administration’s May 2016 projections—the underlying basis for the revenue estimates in the 2016-17 state budget—in Figure 4 (see next page). Our near-term projections reflect the consensus

### Figure 3
LAO Economic Assumptions Through 2018

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>California</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real gross domestic product</td>
<td>2.6%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Personal income</td>
<td>4.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Wage and salary employment</td>
<td>2.1</td>
<td>1.7</td>
</tr>
<tr>
<td>Unemployment rate (percent)</td>
<td>5.3</td>
<td>4.9</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>0.1</td>
<td>1.1</td>
</tr>
<tr>
<td>Core Personal Consumption Expenditures price index</td>
<td>1.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Federal funds rate (percent)</td>
<td>0.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Housing permits (thousands)</td>
<td>1,178</td>
<td>1,158</td>
</tr>
<tr>
<td>S&amp;P 500 (annual average)</td>
<td>2,061</td>
<td>2,078</td>
</tr>
</tbody>
</table>

Note: Based generally on Moody’s Analytics’ October 2016 U.S. macroeconomic “consensus scenario,” a scenario that incorporates the central tendency of a range of baseline projections from various institutions and professional economists. S&P 500 index levels, however, are lowered from those assumed in the Moody’s Analytics’ consensus scenario. The California-specific assumptions above reflect a California state macroeconomic scenario developed by the LAO based on the U.S. consensus scenario.
view that the economic expansion is likely to continue in the U.S. over at least the next couple of years. This, however, is not a certainty. The possibility exists that a slowdown or recession could emerge in the short term. In addition, the October consensus of economists does not reflect federal policy and budget changes that may result from this month’s election of a new President and a new Congress.

The U.S. Economy

*Long Economic Expansion Continues.* The national economy has been expanding since the end of the last recession in June 2009. This month marks the 89th month of the expansion, which makes it the fourth-longest in the U.S. since at least 1854, as shown in Figure 5. Early next year, if the expansion continues, it will surpass the expansion of the 1980s to become the third longest in U.S. history.

Economic expansions do not die of old age. (Australia, for example, just marked 25 years of its current expansion—now the longest in the developed world.) Instead, expansions commonly

---

**Figure 4**

*Comparison to 2016-17 Budget Act Economic Assumptions*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>United States</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real gross domestic product</td>
<td>2.1%</td>
<td>1.6%</td>
<td>2.8%</td>
<td>2.3%</td>
<td>2.7%</td>
<td>2.2%</td>
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<tr>
<td>Personal income</td>
<td>3.9</td>
<td>3.3</td>
<td>4.9</td>
<td>4.3</td>
<td>5.1</td>
<td>4.8</td>
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<tr>
<td>Wage and salary employment</td>
<td>1.9</td>
<td>1.7</td>
<td>1.4</td>
<td>1.1</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Unemployment rate (percent)</td>
<td>4.8</td>
<td>4.9</td>
<td>4.7</td>
<td>4.6</td>
<td>4.7</td>
<td>4.6</td>
</tr>
<tr>
<td>Consumer price index</td>
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<td>1.1</td>
<td>2.2</td>
<td>2.3</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Federal funds rate (percent)</td>
<td>0.6</td>
<td>0.4</td>
<td>1.4</td>
<td>1.0</td>
<td>2.4</td>
<td>1.9</td>
</tr>
<tr>
<td>S&amp;P 500 (annual average)</td>
<td>2,075</td>
<td>2,078</td>
<td>2,117</td>
<td>2,165</td>
<td>2,160</td>
<td>2,231</td>
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<tr>
<td><strong>California</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income</td>
<td>5.5%</td>
<td>3.9%</td>
<td>5.3%</td>
<td>5.0%</td>
<td>4.5%</td>
<td>5.6%</td>
</tr>
<tr>
<td>Wage and salary employment</td>
<td>2.1</td>
<td>2.6</td>
<td>1.7</td>
<td>1.9</td>
<td>1.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Unemployment rate (percent)</td>
<td>5.3</td>
<td>5.4</td>
<td>5.2</td>
<td>5.3</td>
<td>5.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>2.2</td>
<td>2.3</td>
<td>2.8</td>
<td>2.8</td>
<td>2.6</td>
<td>2.7</td>
</tr>
<tr>
<td>Housing permits (thousands)</td>
<td>107</td>
<td>96</td>
<td>126</td>
<td>98</td>
<td>142</td>
<td>100</td>
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<tr>
<td>Single-unit permits</td>
<td>51</td>
<td>47</td>
<td>62</td>
<td>50</td>
<td>71</td>
<td>52</td>
</tr>
<tr>
<td>Multifamily permits</td>
<td>55</td>
<td>49</td>
<td>64</td>
<td>48</td>
<td>71</td>
<td>48</td>
</tr>
<tr>
<td>Population growth</td>
<td>0.9</td>
<td>1.0</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
<td>0.9</td>
</tr>
</tbody>
</table>

*a The 2016-17 Budget Act reflected the administration’s May 2016 revenue assumptions, this figure, therefore, describes the administration’s May 2016 economic assumptions as those reflected in the 2016-17 Budget Act, which was passed in June 2016.*

---

**Figure 5**

*Current Economic Expansion Already Among Longest in U.S. History*

<table>
<thead>
<tr>
<th>Economic Expansion</th>
<th>Number of Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1991 to March 2001</td>
<td>120</td>
</tr>
<tr>
<td>March 1961 to December 1969</td>
<td>106</td>
</tr>
<tr>
<td>December 1982 to July 1990</td>
<td>92</td>
</tr>
<tr>
<td>July 2009 to present</td>
<td>89 (so far)</td>
</tr>
<tr>
<td>July 1998 to February 1945</td>
<td>80</td>
</tr>
<tr>
<td>December 2001 to December 2007</td>
<td>73</td>
</tr>
<tr>
<td>April 1975 to January 1980</td>
<td>58</td>
</tr>
<tr>
<td>April 1933 to May 1937</td>
<td>50</td>
</tr>
<tr>
<td><strong>Average Economic Expansion, 1945 to 2009</strong></td>
<td><strong>58</strong></td>
</tr>
</tbody>
</table>

end because of imbalances that build up and “overheat” the economy. Economic shocks and major changes in the economy or public policy also can depress activity enough to end an expansion. While policy makers should note this expansion’s age, they also should be aware that economic expansions have been getting longer. The last three lasted an average of 95 months—longer than the 58-month average for expansions since 1945.

Improved management of U.S. monetary policy and other government policies have been credited with a reduction in macroeconomic volatility over time. Also credited are better management by businesses of inventories, the rise of the relatively stable service sector, and technological change.

When Will the Expansion End? Economists and other forecasters (including us) are not good at projecting the end of expansions far in advance. (That is one reason why—later in this publication—we consider one scenario of what could happen to the state budget if a mild recession hits around 18 months from now.) History provides us with a few instructive lessons to foreshadow the demise of the current expansion. The past few U.S. expansions have ended about three years after the economy reached what is considered “full employment.” Once an economy reaches that point, wages and inflation may accelerate, necessitating tighter monetary policy (including higher interest rates). The U.S. unemployment rate has been at or below 5 percent—a commonly estimated level of full employment—since last October. If the experience of the past few expansions repeated itself, the current expansion would continue over the next couple of years.

Some economists, however, have been saying that the lack of robust wage growth, among other factors, suggests that full employment currently requires an even lower unemployment rate. That reasoning would be consistent with an expansion that continued for an even longer period of time.

We note, however, that wage growth recently has picked up somewhat. A related uncertainty is how much “slack” remains in the labor market—as in, how many more people not currently seeking work will return to the labor force in the coming years. Labor market slack can help prolong the expansion by preventing the economy from overheating.

The California Economy

California’s economy has grown at a good pace in recent years. Different groups and regions have shared in that growth to varying degrees.

Incomes Up. According to the Census Bureau’s American Community Survey (ACS), median household income in California rose 4 percent in 2015—slightly outpacing the nationwide growth rate of 3.8 percent. California’s $64,500 median household income ranked 9th among the 50 states. With 6.2 percent growth in 2015, median household incomes reported in the ACS data for the San Francisco-Oakland metro region was surpassed, among the nation’s large metro areas, only by Atlanta’s 7.1 percent growth. Median household incomes grew by 3.3 percent in the Los Angeles-Orange County region, 2.6 percent in the Inland Empire (Riverside and San Bernardino Counties), and 1.6 percent in San Diego County. (We note, however, that these ACS results have a relatively high margin of error for San Francisco-Oakland, San Diego, and the Inland Empire.)

Official Poverty Rate Down. According to ACS data, the official poverty rate in California fell from 16.4 percent in 2014 to 15.3 percent in 2015, representing about 370,000 fewer Californians counted under this poverty measure. While this official poverty measure (OPM) is just above the national average, California’s high housing costs mean that its “supplemental poverty measure” (SPM)—which accounts for forms of public assistance not included in the OPM and adjusts poverty thresholds for housing costs and other
factors—is much higher than the rest of the country’s. Based on data from 2013 through 2015, California’s SPM is 20.6 percent—versus 14.4 percent for the rest of the country.

**Job Growth Has Been Outpacing the Nation.**
In September, the number of payroll jobs in California was up by about 380,000 over the prior year, a growth rate of 2.3 percent—better than the 1.7 percent job growth rate for the nation as a whole. California’s job growth rate over the past year ranks 14th best among the 50 states. Among the state’s major employment sectors, professional and technical services jobs (many of them in technology) are up 4.6 percent over the past year, and construction jobs are up 4.2 percent. Oil and gas jobs, which account for only a small fraction of the state total but are very important in some areas such as Kern County, are down 12.5 percent over the past 12 months, but losses have slowed with more stable energy prices recently.

While California’s official unemployment rate—5.5 percent as of September—remains tied for 10th worst with three other states, it has dropped half a percentage point in the last year and 6.7 percentage points from its high point in October 2010. In Los Angeles County, the seasonally adjusted jobless rate was 5 percent in September 2016—down 1.2 percentage points from one year before. In September, unadjusted unemployment rates in the state ranged from just 3.1 percent in San Mateo County to 22.7 percent in Imperial County (among the nation’s highest local unemployment rates). Imperial County’s September unemployment rate was down 2.3 percentage points from one year before. Other rural and agricultural areas continue to have high unemployment rates.

**Other Labor Market Improvements.** By many measures, California’s labor market has been heating up:

- **Participation Up.** Even as more and more baby boomers reach retirement age, California’s labor force participation rate—those participating in the labor force as a percentage of the population aged 16 and older—grew from 62 percent in September 2015 to 62.6 percent in September 2016 (its highest level in over two years), according to U.S. and state labor surveys. On a seasonally adjusted basis, the number of those participating in the labor force grew by 380,000 statewide (an increase of 2 percent) over the past year, including 131,000 in Los Angeles County (an increase of 2.6 percent there). Those choosing not to be in the labor force because they were discouraged over their job prospects dropped more than 10 percent over the last 12 months to just 68,000 statewide—down from over 175,000 in early 2011.

- **Full-Time Work Up.** According to Current Population Survey data, almost all of the net growth in California jobs over the past year has been in full-time positions, as the percent of those employed working full-time in the state grew from 80.3 percent a year ago to 80.6 percent now. Between September 2015 and September 2016, the three-month moving average of private-sector hourly earnings grew by more than 3 percent. The number of those working part-time for economic reasons (generally because there is insufficient demand from their employer) dropped 11 percent over the past year to 946,000—down from over 1.5 million in 2010.

- **Jobless Claims and Underemployment Down.** Initial jobless claims have fallen to near prerecession levels—under 40,000 per week in some periods this year. California’s “U-6” jobless rate—a broader jobless measure that counts those unemployed,
marginally attached to the labor force, and working part-time for economic reasons—fell to 11.6 percent in September (down 1.7 percentage points from one year before). This remains high compared to the rest of the nation, but California's U-6 rate is far below its 22.1 percent annual peak in 2010.

**LAO Projections for 2016 Through 2018.** As shown in Figures 3 and 4, our office anticipates that personal income in California will grow a modest 3.9 percent in 2016—faster than the 3.3 percent growth rate expected for the U.S. as a whole. While the 3.9 percent growth rate is disappointing, we note that wages and salaries—the largest component by far of personal income subject to state taxation—are expected to grow by 5.2 percent, which is consistent with the fairly strong trend of personal income tax (PIT) withholding growth we have been seeing this year. The anticipated wage and salary growth in 2016 offsets weak growth in some other personal income categories like dividends, interest, and rent and transfers (such as Social Security payments), some parts of which are not subject to the state income tax. Our current projections anticipate stronger personal income and wage growth in 2017 and 2018, as California's unemployment rate dips below 5 percent. We anticipate less growth in jobs and more growth in wages over the next few years, as the labor market tightens more and nears full employment. California's minimum wage also will increase in future years under state law.

**Silicon Valley Job Growth.** Jobs in the San Jose region (Santa Clara and San Benito Counties) grew by a net 3.6 percent during the 12 months ending in September—far outpacing job growth in the state and its other large metro areas. The bulk of the region's job growth came in professional and business services—primarily in technology-dominated job categories. Other contributors to Silicon Valley job growth have been private education and health facilities, construction, and restaurants. The San Francisco (San Francisco and San Mateo Counties) and East Bay (Alameda and Contra Costa Counties) regions recorded 2.6 percent year-over-year job growth through September, with noteworthy growth rates in technology, health care, and construction, among other sectors.

**Bay Area Contributes Heavily to State Taxes.** The state PIT makes up about 70 percent of state General Fund revenues. As shown in Figure 6 (see next page), Bay Area residents—16.8 percent of the state's population—receive 29.1 percent of the income reported on state resident tax returns as of 2014 and pay 37 percent of the income taxes assessed. This means that per capita PIT payments by Bay Area residents are far above those of any other region in the state. Among the state's major regions listed in Figure 6, the Bay Area's per capita tax payments are almost twice those of Orange County, the next highest area. Below Orange County on the list, all other major regions of the state have per capita PIT payments below the statewide average.

The Bay Area contributes so much to PIT because individuals there, on average, have higher incomes than those in other areas of the state. In California's income tax system, those with higher incomes pay taxes at higher marginal rates. In terms of median adjusted gross income shown on state tax returns, eight of the top ten counties in the state are in the Bay Area. Prior research by our office has shown that Bay Area residents also spend
more, on average, on goods subject to the sales tax, compared to other regions of the state. Per capita assessed valuation—for local property taxes—also is higher in the Bay Area than in other areas of the state.

**Dependence on the Bay Area.** The state’s job growth has been centered in the Bay Area, and its key income, sales, and property taxes are all paid disproportionately by Bay Area residents. Boom times in the Bay Area tend to mean the statewide economy and the state budget are doing well. Economic weakness there hinders the economy and can throw the state budget into a tailspin. With the Bay Area economy dependent on what has been a thriving technology sector, one major risk to the state’s near-term economic health is the possibility of a big slowdown in that sector. While venture capital investments in the Bay Area have fallen from 2014 and 2015 levels, they remain substantial and there is little evidence that a significant slowdown of the Bay Area technology sector is imminent.

**Housing Costs a Growing Concern.** Home prices and rents remain very high in both the Bay Area and Los Angeles, as well as other parts of the state. Housing affordability is a growing concern in California. Given the importance of the Bay Area to the state budget, as noted above, we focus below on housing affordability issues there.

Over the past year, the San Francisco-Oakland and San Jose metro areas have experienced home price growth of 5.7 percent and 4.7 percent, respectively. This is well below the double-digit growth that occurred in these areas in recent years. Nonetheless, home prices remain high compared
to just about anywhere else. Median home prices in the San Jose ($944,000) and San Francisco-Oakland ($813,000) areas ranked first and second highest among major urban areas in the country.

Rents continued to rise quickly in the San Francisco-Oakland (12 percent) and San Jose (13 percent) areas in 2015, according to ACS data. Monthly rents in San Jose ($2,300) and San Francisco-Oakland ($2,000) were rivaled only by those in Honolulu among major urban areas. While there is some anecdotal and survey information showing that rents have stabilized or fallen slightly in 2016, other data sources, such as Zillow’s rental index, show 3 percent to 4 percent growth in rental costs this year in parts of the Bay Area. (ACS data on rents for 2016—which is generally considered to be the most comprehensive—will not be available until next year.)

More residential construction would moderate home price growth over the long term. Building activity in the Bay Area generally has returned to prerecession levels. Building permits in San Francisco-Oakland are at their highest levels since 2006. Despite this recovery, building levels remain low relative to other urban areas throughout the country. Over the past year, the San Francisco-Oakland and San Jose areas approved about 2.8 building permits per 1,000 residents—well below the national average among major urban areas of 3.9 permits per 1,000 residents. Other urban areas with rapidly growing economies—such as Austin, Houston, Portland, and Raleigh—approved over six permits per 1,000 residents during the past year. Over the long term, a constrained supply of new housing may limit prospects for job and economic growth in the Bay Area.

REVENUES

Figure 7 displays our office’s revenue outlook through 2017-18. This outlook reflects the U.S. economic projections of an October 2016 consensus of economists, described earlier. (In Chapter 4, we display revenue estimates through 2020-21 under two possible economic scenarios—an economic growth scenario and a recession scenario.)

<table>
<thead>
<tr>
<th>General Fund (Dollars in Millions)</th>
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<tbody>
<tr>
<td>2015-16</td>
</tr>
<tr>
<td>Amount</td>
</tr>
<tr>
<td>Personal income tax</td>
</tr>
<tr>
<td>Sales and use tax</td>
</tr>
<tr>
<td>Corporation tax</td>
</tr>
<tr>
<td>Subtotals, “Big Three” Revenues</td>
</tr>
<tr>
<td>Insurance tax</td>
</tr>
<tr>
<td>Other revenues</td>
</tr>
<tr>
<td>BSA transfer</td>
</tr>
<tr>
<td>Other transfers</td>
</tr>
<tr>
<td>Totals, Revenues and Transfers</td>
</tr>
</tbody>
</table>

BSA = Budget Stabilization Account.
Revenue Estimates $1.7 Billion Below Budget Assumptions for 2015-16 and 2016-17 Combined. Our revenue estimates for 2015-16 and 2016-17 combined are modestly lower than the administration’s May 2016 estimates that served as the basis for the June 2016 budget plan, as shown in Figures 8 and 9. In particular, our estimates of sales and use tax (SUT) and corporation tax (CT) revenues are $2.6 billion below budget act assumptions for 2015-16 and 2016-17 combined. On the other hand, our estimate of PIT revenues is $768 million above budget assumptions for those two fiscal years combined, somewhat offsetting our weak SUT and CT estimates. After accounting for minor revenues and transfers, our bottom line estimates of General Fund revenues and transfers are $1.7 billion below budget assumptions.

Strong PIT Growth Drives Healthy Revenue Growth in 2017-18. Looking beyond the current fiscal year, we estimate that the state’s “Big Three” revenues—PIT, SUT, and CT—will grow 5.4 percent in 2017-18, as shown in Figure 7. This growth is driven by a projected 6.9 percent year-over-year increase in the PIT, which makes up about 70 percent of General Fund revenues. We estimate SUT and CT to grow by 1.1 percent and 2.7 percent, respectively, in 2017-18. Year-over-year growth in the SUT would be higher were it not for the end of the quarter-cent Proposition 30 (2012) SUT rate after December 2016. We describe near-term estimates of these tax revenues in more detail below.

Personal Income Tax

June 2016 Cash Receipts Were Disappointing . . .

As the Governor signed the 2016-17 Budget Act, PIT cash collections for June came in $888 million below projections, as shown in Figure 10. June is an important revenue collection month as taxpayers submit estimated payments for that year’s tax liability. (Estimated payments are quarterly payments made by individuals and businesses on expected taxable income for which there is no withholding, such as realized capital gains on sales of stocks and other assets.) Estimated payments fell short of projections by $622 million (about 9 percent) in June 2016. Moreover, withholding came in nearly 6 percent, or $250 million, below projections.

. . . But Recent Collections Have Been on Target. Since June 2016, however, cash receipts have largely hit their mark. Withholding and “other Franchise Tax Board collections” (such as final payments) exceeded budget projections by $72 million and $312 million, respectively. Offsetting these results, estimated payments and

### Figure 8

**Comparing LAO November 2016 Revenue Estimates With June 2016 Budget Act Assumptions**

<table>
<thead>
<tr>
<th>General Fund (In Millions)</th>
<th>2015-16</th>
<th>2016-17</th>
<th>Change</th>
<th>2015-16</th>
<th>2016-17</th>
<th>Change</th>
<th>Total Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>$79,039</td>
<td>$79,962</td>
<td>-$923</td>
<td>$85,085</td>
<td>$83,393</td>
<td>$1,691</td>
<td>$768</td>
</tr>
<tr>
<td>Sales and use tax</td>
<td>24,766</td>
<td>25,028</td>
<td>-262</td>
<td>24,747</td>
<td>25,727</td>
<td>-980</td>
<td>-1,242</td>
</tr>
<tr>
<td>Corporation tax</td>
<td>10,032</td>
<td>10,309</td>
<td>-277</td>
<td>9,892</td>
<td>10,992</td>
<td>-1,100</td>
<td>-1,377</td>
</tr>
<tr>
<td>Subtotals, “Big Three” Revenues</td>
<td>($113,837)</td>
<td>($115,299)</td>
<td>(-$1,462)</td>
<td>($119,724)</td>
<td>($120,113)</td>
<td>(-$389)</td>
<td>(-$1,851)</td>
</tr>
<tr>
<td>Other revenues and transfers</td>
<td>$1,806</td>
<td>$1,702</td>
<td>$104</td>
<td>$267</td>
<td>$197</td>
<td>$70</td>
<td>$174</td>
</tr>
<tr>
<td>Totals, Revenues and Transfers</td>
<td>$115,643</td>
<td>$117,001</td>
<td>-$1,358</td>
<td>$119,991</td>
<td>$120,310</td>
<td>-$319</td>
<td>-$1,677</td>
</tr>
</tbody>
</table>
refunds were worse than projections ($198 million and $221 million, respectively). In total, PIT receipts over the July through October period fell short of projections by just $34 million (or about two-tenths of 1 percent).

*June Collections and the Weak Early 2016 Stock Market.* Our working theory is that much of the recent trend in estimated payments can be explained by stock market performance since early 2016. Figure 11 (see next page) shows S&P 500 index values from January 2016 through October 2016. As shown in the figure, the index was under 1900 for much of the first quarter of 2016. We think that this may help explain the disappointing level of estimated payments in June. Since then, however, the market has largely recovered. Our economic projections assume that the S&P 500 index will average 2,078 in 2016 and 2,165 in 2017, notably higher than early 2016 levels.

*Assuming Steady Stock Prices, PIT Estimates Exceed Budget Projections Through 2016-17.* If our assumptions come to pass, we estimate that taxpayers will make larger estimated and final payments beginning in December 2016 through early 2017 than was projected in the state budget package. This would essentially “make up” for...
the weak June collections. Relative to budget act assumptions, this has the effect of shifting revenues from 2015-16 into 2016-17. On net, we estimate PIT revenues will be $768 million higher than assumed in the budget for 2015-16 and 2016-17 combined.

**Healthy PIT Growth in 2017-18.** Looking beyond the current fiscal year, our assumptions of wages and salaries and capital gains continue to be higher than the administration’s most recent assumptions. While our estimates of personal income growth are below state budget assumptions, we currently project stronger growth in 2018. These and other factors result in healthy PIT growth of nearly 7 percent in 2017-18.

**Risks to PIT Estimates.** Our revenue estimates are premised upon our near-term projections about the economy and assumptions about the stock market. If those assumptions do not come to pass, revenues in 2016-17 and 2017-18 could be a few billion dollars higher or lower than the estimates reflected in Figure 7. If, for example, the S&P 500 index returns to first quarter 2016 levels, our estimates of taxpayers’ estimated and final payments described above could prove billions of dollars too high for 2016-17 and 2017-18 combined.

**Sales and Use Tax**

**Sales Tax Estimates Down.** Estimated General Fund SUT revenue totaled $24.8 billion in 2015-16, $262 million lower than the amount assumed in the June 2016 budget plan. We estimate that SUT revenues remain steady at around $24.7 billion in 2016-17, about $1 billion lower than budget assumptions. Thereafter, estimated SUT revenues increase slightly to $25 billion in 2017-18.

**Reasons for Sales Tax Weakness.** This short-term weakness in SUT revenue is due to several factors, including: (1) lower-than-expected revenue in 2015-16, (2) a quarter-cent rate reduction, and (3) modest growth in California personal income. At the end of 2015-16, SUT revenue was about a quarter of a billion dollars below the budget’s assumption, setting a lower starting point for subsequent growth. The temporary quarter-cent rate established by Proposition 30 will expire at the end of 2016. This rate expiration likely will reduce annual SUT revenue growth by about 3 percentage points in 2016-17 and in 2017-18 relative to revenue growth with constant tax rates. Finally, we project modest personal income growth of 3.9 percent in 2016, bringing down our near-term SUT estimates.

![S&P 500 Index Has Recovered From First Quarter Dip](image)
Corporation Tax

Corporate Profits Expected to Grow Slowly. The CT is levied on profits of California corporations and, for multistate corporations, a share of their total national profits. National corporate profits peaked in 2014 and declined over 2015. As described earlier in this chapter, our near-term economic projections are based on the consensus of various economists about the likely trend of the U.S. economy through 2018. In those projections, national corporate profits grow relatively slowly over the next several years, as rising wages and commodity prices offset increased consumer and business consumption. Consequently, we project CT revenue to decline by about 1 percent in 2016-17, followed by several years of growth that is roughly on pace with the broader economy.

CT Revenue Has Underperformed Budget Assumptions to Date. Our near-term estimates are consistent with recent cash flow trends. Through the first four months of 2016-17, net CT receipts are 14 percent below budget act projections. Last year had elevated levels of refunds, and we see this trend continuing in 2016-17.
Chapter 3: Spending Outlook

Figure 12 displays our General Fund spending estimates, by major program, through 2017-18. (Our spending projections for the entire outlook period are discussed in Chapter 4.)

One-Time and Temporary Spending Obscure Underlying Growth Rates. One-time spending in the 2016-17 budget package obscures underlying growth in some of these programs. This includes, for example, one-time spending for deferred maintenance in the California Department of Corrections and Rehabilitation, the judicial branch, and the universities. The estimate of “remaining programs” includes one-time funding of $1 billion for the new State Project Infrastructure Fund and other, smaller one-time items. Similarly, the figure overstates the underlying growth in the California Work Opportunity and Responsibility to Kids (CalWORKs) program.

### Figure 12
General Fund Spending Outlook

<table>
<thead>
<tr>
<th></th>
<th>Estimates</th>
<th>Outlook</th>
<th>Change From 2016-17</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015-16</td>
<td>2016-17</td>
<td>2017-18</td>
</tr>
<tr>
<td><strong>Education Programs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proposition 98b</td>
<td>$49.1</td>
<td>$51.0</td>
<td>$52.4</td>
</tr>
<tr>
<td>UC</td>
<td>3.2</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>CSU</td>
<td>3.0</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Student Aid Commission</td>
<td>1.4</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Child Care</td>
<td>0.9</td>
<td>0.9</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Health and Human Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medi-Cal</td>
<td>17.5</td>
<td>17.9</td>
<td>18.7</td>
</tr>
<tr>
<td>CalWORKs</td>
<td>0.7</td>
<td>0.7</td>
<td>1.0</td>
</tr>
<tr>
<td>SSI/SSP</td>
<td>2.8</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>IHSS</td>
<td>3.0</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>DDS</td>
<td>3.5</td>
<td>4.0</td>
<td>4.1</td>
</tr>
<tr>
<td>DSH</td>
<td>1.6</td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td>Other major programsd</td>
<td>2.2</td>
<td>2.4</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>Criminal Justice Programs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CDCR</td>
<td>9.7</td>
<td>10.0</td>
<td>9.8</td>
</tr>
<tr>
<td>Judiciary</td>
<td>1.6</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>Infrastructure Debt Service</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5.3</td>
<td>5.4</td>
<td>5.5</td>
</tr>
<tr>
<td><strong>Other Programs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CalSTRS</td>
<td>1.9</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Proposition 2 debt paymentsg</td>
<td>—</td>
<td>—</td>
<td>2.0</td>
</tr>
<tr>
<td>Remaining programs</td>
<td>7.4</td>
<td>9.7</td>
<td>8.6</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$114.9</strong></td>
<td><strong>$122.0</strong></td>
<td><strong>$126.1</strong></td>
</tr>
</tbody>
</table>

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*Declarations:

**Proposition 98** includes the General Fund component of the minimum guarantee.

**UC** payments include those for the UC Retirement plan. These payments are included under "other programs."

**IHSS** includes family health and state operations, DPH, DCSS, and DSS programs not itemized above. Smaller health and human services programs are included in "remaining programs."

**CDCR** includes smaller departments—such as the Department of Justice—that are included in "remaining programs."

**DSH** includes debt service on general obligation and lease revenue bonds generally used for infrastructure. Does not include: (1) lease revenue debt service for community colleges, which is included under Proposition 98, or (2) UC's and CSU's debt service, which is included in their respective line items.

**Proposition 2** debt payment amounts are reflected elsewhere. Included in 2017-18 is the entire estimate of Proposition 2 debt payment requirements.
because 2017-18 spending in that program reflects General Fund backfill of one-time federal funds carried in from prior years (see our “CalWORKs” write-up for more information).

EDUCATION

Education Spending. In this section, we focus on Proposition 98, the universities, student financial aid programs, and child care programs. The “Proposition 98” section estimates total combined spending for elementary and secondary education (commonly referred to as K-12 education), the California Community Colleges, and a large portion of the state’s subsidized preschool program. The next section estimates spending for the University of California and the California State University. The “Financial Aid” section focuses on spending for Cal Grants and Middle Class Scholarships. The last section estimates non-Proposition 98 General Fund spending for the rest of the state’s preschool program as well as most child care programs.

Proposition 98

Proposition 98 Minimum Guarantee for Schools and Community Colleges. State budgeting for schools and community colleges is governed largely by Proposition 98, passed by voters in 1988. The measure, modified by Proposition 111 in 1990, establishes a minimum funding requirement, commonly referred to as the minimum guarantee. Both state General Fund and local property tax revenue apply toward meeting the minimum guarantee. In addition to Proposition 98 funding, schools and community colleges receive funding from the federal government, other state sources (such as the lottery), and various local sources (such as parcel taxes).

Calculating the Minimum Funding Guarantee.
The Proposition 98 minimum guarantee is determined by one of three tests set forth in the State Constitution (see Figure 13). These tests depend upon several inputs, including changes in K-12 average daily attendance, per capita personal income, and per capita General Fund revenue. Though the calculation of the minimum guarantee is formula-driven, a supermajority of the Legislature can vote to suspend the formulas and provide

<table>
<thead>
<tr>
<th>Test 1—Share of General Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensures Proposition 98 General Fund is at least about 40 percent of state General Fund revenue.</td>
</tr>
<tr>
<td>Applies when it results in a higher funding level than Test 2.</td>
</tr>
<tr>
<td>Has been operative 4 of the last 28 years.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test 2—Growth in Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusts prior-year Proposition 98 funding for changes in K-12 attendance and per capita personal income.</td>
</tr>
<tr>
<td>Applies when it results in a lower funding level than Test 3.</td>
</tr>
<tr>
<td>Has been operative 14 of the past 28 years.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test 3—Growth in General Fund Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusts prior-year Proposition 98 funding for changes in K-12 attendance and per capita General Fund revenue.</td>
</tr>
<tr>
<td>Applies when it results in a lower funding level than Test 2.</td>
</tr>
<tr>
<td>Has been operative 8 of the past 28 years.</td>
</tr>
</tbody>
</table>

Note: The state has suspended Proposition 98 twice.
less funding than they require. This happened in 2004-05 and 2010-11. In some cases, including as a result of a suspension, the state creates a higher out-year funding obligation referred to as a “maintenance factor.” The state is required to make progress toward meeting this higher obligation when year-to-year growth in state General Fund revenue is relatively strong. Though in most years the state has provided an amount at or close to the minimum guarantee, the state has discretion to provide any amount above the minimum guarantee.

2015-16 and 2016-17 Updates

2015-16 Minimum Guarantee Down $378 Million From Budget Act Estimate. The decrease in the minimum guarantee (see Figure 14) is due to our estimated $1.4 billion drop in General Fund tax revenue relative to budget act estimates. As a result of this revenue drop, the state is no longer required to make the $379 million maintenance factor payment included in the June budget package. This drop in the guarantee is offset by a $1 million increase due to various other adjustments.

2015-16 Local Property Tax Estimate Revised Upward. Though the minimum guarantee has fallen from budget act estimates, Proposition 98 local property tax revenue is up $262 million. The bulk of this increase is attributable to higher-than-expected transfers from Educational Revenue Augmentation Funds to schools and community colleges. The increase in property tax revenue reduces Proposition 98 General Fund costs on a dollar-for-dollar basis. Coupling the increase in property tax revenue with the decline in the guarantee results in Proposition 98 General Fund dropping $640 million.

Further Downward Revisions in General Fund Revenue Unlikely to Affect 2015-16 Minimum Guarantee. Under our latest revenue estimates, the operative test for calculating the guarantee in 2015-16 changes from Test 2 to Test 3. Whenever Test 3 is operative, statute requires the state to make a supplemental appropriation if needed to ensure Proposition 98 funding grows as quickly as the rest of the budget. In 2015-16, shifting to Test 3 results in the state needing to make a $53 million supplemental appropriation. This additional funding raises the guarantee up to the Test 2 level. In 2015-16, were General Fund revenue to be further revised downward by as much as $1.6 billion, the required supplemental appropriation would increase correspondingly, bringing the guarantee back up to the Test 2 level. That is, further revenue declines in 2015-16 likely would have no effect on the minimum guarantee.

2016-17 Minimum Guarantee Down $10 Million From Budget Act Estimate. At the time of budget enactment, Test 3 was the operative test in 2016-17. Even under our latest estimates, Test 3 remains operative. In Test 3 years, the minimum guarantee builds upon the prior-year funding level adjusted for changes in per capita General Fund revenue and

---

**Figure 14**

**Updating Estimates of 2015-16 and 2016-17 Minimum Guarantees**

<table>
<thead>
<tr>
<th></th>
<th>2015-16</th>
<th></th>
<th>2016-17</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>June Budget Plan</td>
<td>November LAO Estimate</td>
<td>Change</td>
<td>June Budget Plan</td>
</tr>
<tr>
<td>Minimum Guarantee</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Fund</td>
<td>$49,722</td>
<td>$49,082</td>
<td>-$640</td>
<td>$51,050</td>
</tr>
<tr>
<td>Local property tax</td>
<td>19,328</td>
<td>19,589</td>
<td>262</td>
<td>20,824</td>
</tr>
<tr>
<td>Totals</td>
<td>$69,050</td>
<td>$68,672</td>
<td>-$378</td>
<td>$71,874</td>
</tr>
</tbody>
</table>
K-12 attendance. Compared with June budget act assumptions, we estimate General Fund revenue is $1.4 billion lower in 2015-16 and $350 million lower in 2016-17. Because the drop in the prior year is greater than the drop in the current year, the year-to-year growth rate increases. The higher growth rate offsets the decline in the prior-year funding level. After updating for various other inputs, including slightly lower estimates of K-12 attendance, the minimum guarantee is only $10 million below the level assumed in June. Under the latest inputs, the state creates $321 million in new maintenance factor, for a total outstanding maintenance factor obligation at the end of 2016-17 of $873 million. The new maintenance factor created dropped from the June budget package level of $746 million, due largely to the higher General Fund growth rate.

Forecast Assumes State Funds at the Revised Estimates of the Prior-Year and Current-Year Minimum Guarantees. Although the 2015-16 minimum guarantee has fallen by $378 million, the state allocated funding to schools and community colleges based upon the higher June 2016 estimate of the guarantee. After adjusting for changes in various program costs, we estimate that currently authorized 2015-16 spending exceeds the minimum guarantee by $351 million. Historically, in virtually all cases when the prior-year or current-year guarantee has been revised downward, the state has acted to reduce associated spending. For purposes of our outlook, we assume the state designates the $351 million as payment toward its outstanding settle-up obligation. (The state currently has an outstanding settle-up obligation of about $1 billion, mostly related to the 2009-10 minimum guarantee. The state creates a settle-up obligation when the minimum guarantee rises above the level initially assumed in the budget act.) Under this approach, the $351 million is not built into the 2016-17 Proposition 98 base.

2017-18 Budget Planning

2017-18 Guarantee $2.6 Billion Higher Than Revised 2016-17 Level. As shown in Figure 15, we estimate that the minimum guarantee will grow

<table>
<thead>
<tr>
<th>Figure 15: Proposition 98 Key Inputs and Outcomes Through 2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(Dollars in Millions)</strong></td>
</tr>
<tr>
<td><strong>2015-16</strong></td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td><strong>Minimum Guarantee</strong>a</td>
</tr>
<tr>
<td>General Fund</td>
</tr>
<tr>
<td>Local property tax</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
</tr>
<tr>
<td><strong>Change From Prior Year</strong></td>
</tr>
<tr>
<td>General Fund</td>
</tr>
<tr>
<td>Percent change</td>
</tr>
<tr>
<td>Local property tax</td>
</tr>
<tr>
<td>Percent change</td>
</tr>
<tr>
<td><strong>Total guarantee</strong></td>
</tr>
<tr>
<td>Percent change</td>
</tr>
<tr>
<td><strong>Operative Test</strong></td>
</tr>
<tr>
<td><strong>Maintenance Factor</strong></td>
</tr>
<tr>
<td>Amount created (+) or paid (-)</td>
</tr>
<tr>
<td><strong>Total outstandingb</strong></td>
</tr>
<tr>
<td><strong>Growth Rates</strong></td>
</tr>
<tr>
<td>K-12 average daily attendance</td>
</tr>
<tr>
<td>Per capita personal income (Test 2)</td>
</tr>
<tr>
<td>Per capita General Fund (Test 3)c</td>
</tr>
<tr>
<td>K-14 cost-of-living adjustment</td>
</tr>
</tbody>
</table>

a Assumes state funds at revised estimate of minimum guarantee each year.
b Outstanding maintenance factor is adjusted annually for changes in K-12 attendance and per capita personal income.
c As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.
from $71.9 billion in 2016-17 to $74.5 billion in 2017-18, an increase of $2.6 billion (3.6 percent). Test 2 is operative, with the guarantee adjusted for a 2.7 percent increase in per capita personal income and a 0.2 percent decline in K-12 attendance. In addition, because General Fund revenue is growing more quickly than per capita personal income, the state is required to make an $894 million maintenance factor payment. After making this payment, the state would end the year with no outstanding maintenance factor for the first time since 2005-06.

**Nearly Half of Increase Covered With Property Tax Revenue.** Of the $2.6 billion increase in Proposition 98 funding, state General Fund revenue covers $1.4 billion and local property tax revenue covers $1.2 billion. The main factor explaining the increase in property tax revenue is a 5.3 percent increase in assessed property values. This factor accounts for about $930 million of the increase. The other large contributing factor is a $340 million increase in the ongoing savings associated with the dissolution of redevelopment agencies. This increase is primarily due to the phase out of certain one-time costs related to recent changes in the dissolution process.

**$2.8 Billion Available for Proposition 98 Priorities.** As shown in Figure 16, the 2016-17 Budget Act provided $71.9 billion in funding for schools and community colleges. Of this amount, $496 million was allocated for one-time activities. Though this funding is freed up for other purposes moving forward, the state already has committed through previous budget agreements to $276 million in higher 2017-18 spending. The net effect of these changes, in combination with the $2.6 billion increase in the minimum guarantee, results in the state having $2.8 billion to spend on its 2017-18 Proposition 98 priorities.

**State Could Achieve Almost Full Implementation of the Local Control Funding Formula (LCFF) in 2017-18.** In recent years, the state has dedicated most new Proposition 98 funding to implementing the LCFF. If the state continued this practice in 2017-18, we estimate it could fund 99 percent of LCFF’s full implementation cost. Specifically, we estimate the state could spend $2.5 billion to close the remaining LCFF gap, increasing per-student LCFF funding by 4.5 percent over 2016-17 levels. Our estimate assumes community colleges continue to receive 11 percent of Proposition 98 funding, the state funds previously agreed-upon commitments, and

---

**Figure 16**

$2.8 Billion Increase in Proposition 98 Funding Projected for 2017-18

(In Millions)

<table>
<thead>
<tr>
<th>2016-17 Budget Act Spending</th>
<th>$71,874</th>
</tr>
</thead>
<tbody>
<tr>
<td>Back out one-time actions:</td>
<td></td>
</tr>
<tr>
<td>Secondary school career technical education grants (year two)</td>
<td>-$292</td>
</tr>
<tr>
<td>CCC maintenance and instructional equipment</td>
<td>-154</td>
</tr>
<tr>
<td>CCC Innovation Awards</td>
<td>-25</td>
</tr>
<tr>
<td>CCC intersegmental college partnerships</td>
<td>-15</td>
</tr>
<tr>
<td>CCC zero-textbook-cost degree startup funding</td>
<td>-5</td>
</tr>
<tr>
<td>Adult education consortia technical assistance</td>
<td>-5</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>(-$496)</strong></td>
</tr>
<tr>
<td>Fund previously approved commitments:</td>
<td></td>
</tr>
<tr>
<td>Secondary school career technical education grants (year three)&lt;sup&gt;a&lt;/sup&gt;</td>
<td>$200</td>
</tr>
<tr>
<td>Preschool rate and slot increases&lt;sup&gt;b&lt;/sup&gt;</td>
<td>76</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>($276)</strong></td>
</tr>
<tr>
<td><strong>New Funds Available in 2017-18</strong></td>
<td><strong>$2,833</strong></td>
</tr>
<tr>
<td><strong>2017-18 Minimum Guarantee</strong></td>
<td><strong>$74,486</strong></td>
</tr>
</tbody>
</table>

<sup>a</sup> The state could fund all or a portion of this program with unspent prior-year funds.

<sup>b</sup> Reflects augmentations of $44 million for the full-year cost of increasing the Standard Reimbursement Rate effective January 1, 2017; $24 million for the full-year cost of additional slots that will begin on April 1, 2017; and $8 million for the partial-year cost of additional slots that will begin on April 1, 2018.
other K-12 categorical programs are adjusted for changes in attendance and cost of living.

**2017-18 Guarantee Moderately Sensitive to Declines in State Revenue.** We estimate that General Fund revenue could fall as much as $500 million below our estimates in 2017-18 with no change in the minimum guarantee. Even at this lower level, Test 2 would remain operative and year-to-year revenue growth would be large enough to require the state to pay down all remaining maintenance factor. For each additional dollar of revenue decline beyond this level, the guarantee would drop by about 40 cents. Regarding possible revenue increases, the minimum guarantee is mostly insensitive to any increase above the level assumed in our outlook. We estimate that 2017-18 General Fund revenue could increase about $5.5 billion before having any effect on the minimum guarantee. (An increase of this magnitude would make Test 1 operative and provide schools and community colleges about 40 cents of each dollar above the $5.5 billion threshold.) For the purpose of this sensitivity analysis, we assume prior-year revenue and other inputs remain constant. Changes to these factors could affect the thresholds and make the guarantee more or less sensitive.

**Outlook for Later Years**

**Many Economic Scenarios Could Unfold Over the Period.** State General Fund revenue over the next four years is likely to be affected by a variety of short-term developments (such as swings in the stock market) as well as long-term trends (such as growth in housing prices). In this section, we describe how the minimum guarantee would respond to two hypothetical economic scenarios—one assuming continued moderate growth over the period and one assuming a mild recession beginning in the middle of 2018. (These scenarios are discussed in greater detail in Chapter 4.) Both scenarios have built in the additional state General Fund revenue resulting from the recent passage of Proposition 55, which extended the income tax rates paid by high-income earners for an additional 12 years. (Though it does not affect the calculation of the guarantee, the recent passage of Proposition 51 is another significant development for schools and community colleges. The measure provides $9 billion in bonds for building and renovations school facilities.)

**Under Growth Scenario, Minimum Guarantee Continues to Rise.** As shown in the top part of Figure 17, the minimum guarantee under the growth scenario increases from $71.9 billion in 2016-17 to $83.5 billion in 2020-21. The average annual growth rate under this scenario is 3.8 percent. Under this scenario, the state creates little new maintenance factor, ending the period with about $200 million in outstanding maintenance factor obligation.

**Under Recession Scenario, Minimum Guarantee Declines in 2018-19 and Remains Below Growth Scenario.** As shown in the middle part of Figure 17, the guarantee under the recession scenario declines by $1.4 billion (1.9 percent) from 2017-18 to 2018-19. In 2018-19, the state creates more than $4 billion in new maintenance factor. Even with the state making maintenance factor payments the subsequent two years, the state ends the period with $3.1 billion in outstanding maintenance factor obligation. Under the recession scenario, the guarantee grows from $71.9 billion in 2016-17 to $78.1 billion in 2020-21, an average annual growth rate of 2.1 percent. As shown in the bottom section of Figure 17, by 2020-21 the minimum guarantee under the recession scenario is more than $5 billion below the level in the growth scenario. (Though this scenario assumes the recession does not begin until 2018-19, the 2017-18 year also is affected due to state accrual policies.)
Recession Scenario Serves as Cautionary Tale. Although the recession scenario illustrates one way an economic downturn could unfold, the timing and magnitude of the next recession is highly uncertain. Rather than being a prediction, the recession scenario serves as a cautionary tale about the volatility of Proposition 98 funding. To provide a measure of protection against such volatility, the state in recent years has allocated some of the available Proposition 98 funding for one-time activities. If the guarantee experiences a year-over-year decline, the expiration of this one-time funding provides a buffer that reduces the likelihood of cuts to ongoing school and community college programs.

Local Property Tax Revenue Projected to Rise Steadily Over the Period. Unlike the state General Fund, which tends to be highly sensitive

<table>
<thead>
<tr>
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<td>Proposition 98 Outlook Under Two Economic Scenarios</td>
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</tr>
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<td>—</td>
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<td>Per capita personal income (Test 2)</td>
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<tr>
<td>Per capita General Fund (Test 3)&lt;sup&gt;b&lt;/sup&gt;</td>
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<tr>
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<sup>a</sup> Outstanding maintenance factor is adjusted annually for changes in K-12 attendance and per capita personal income.

<sup>b</sup> As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.
to short-term economic developments, property tax revenue typically grows at a steadier rate. Under both our scenarios, the outlook assumes that property tax revenue grows from $20.9 billion in 2016-17 to $25.6 billion by 2020-21. Property tax revenue covers about 40 percent of the annual increases in the minimum guarantee under the growth scenario and about 65 percent of the increases under the recession scenario. Property tax revenue projections are driven primarily by assumptions of growth in assessed property values. We assume assessed values grow about 5.5 percent per year over the outlook period.

**K-14 Cost-of-Living Adjustments (COLA)**

**Projected to Remain Low.** The statutory COLA for most K-14 programs is based upon a national price index for state and local government goods and services. Our outlook assumes the statutory COLA remains low throughout the period—hovering around 1 percent.

**K-12 Attendance Projected to Decline.** Our outlook assumes that K-12 attendance declines by 0.2 percent per year in 2016-17 and 2017-18 and by 0.3 percent per year later in the period. The largest factor explaining this decline is the outlook for birth rates. Whereas the state had about 550,000 births in 2007-08, births had dropped to about 500,000 in 2010-11. We assume births remain at this lower level throughout the period and that the school-age population declines as these smaller cohorts of students replace their larger cohort predecessors. We also assume relatively stable rates of migration from other states and countries.

**LCFF Could Reach Full Implementation Soon, Grow for COLA Thereafter.** Under our growth scenario, we estimate the state could fully fund the LCFF as soon as 2018-19. In this and subsequent years, growth in Proposition 98 funding would be more than sufficient to cover the LCFF targets as adjusted for changes in attendance and cost of living. Under the growth scenario, after supporting LCFF, the Legislature would have an additional $1.5 billion to $2.5 billion per year to spend on other Proposition 98 priorities. Under the recession scenario, we estimate the state would not fully fund LCFF until 2020-21.

**Pension Costs Rising Over the Period.**

Employer contributions to the California State Teachers’ Retirement System (CalSTRS) and California Public Employees’ Retirement System (CalPERS) are a key factor affecting the budgets of schools and community colleges. (CalSTRS administers the pension system for teachers and other certificated employees, whereas CalPERS administers the pension system for classified employees.) The 2014-15 budget included a plan to fully fund the CalSTRS pension system within about 30 years. Under the plan, district contribution rates increase from 8.25 percent of payroll in 2013-14 to 19.1 percent of payroll by 2020-21. In addition, the governing board of CalPERS has taken action in recent years to increase rates and pay down these liabilities more quickly. The latest actuarial estimates suggest that employer contribution rates for CalPERS will increase from 11.4 percent in 2013-14 to 21.1 percent by 2020-21. Compared with 2013-14 levels, total district contributions to CalSTRS and CalPERS are anticipated to be nearly $6 billion higher annually by 2020-21. (Of this total cost increase, about 70 percent relates to CalSTRS.) Under the growth scenario, these higher costs represents about one-quarter of the $24 billion cumulative increase in Proposition 98 funding districts would receive by 2020-21. Under the recession scenario, these costs represent about one-third of the $19 billion cumulative increase in Proposition 98 funding.

**Universities**

**Overview of Public Universities.** The state has two public university systems. The
University of California (UC) educates slightly more than 250,000 full-time equivalent (FTE) undergraduate and graduate students at ten campuses. The California State University (CSU) educates almost 400,000 FTE undergraduate and graduate students at 23 campuses. These counts include resident and nonresident students. Resident enrollment comprises 83 percent of total systemwide enrollment at UC and 94 percent at CSU. Both university systems receive support for their undergraduate and graduate programs from a combination of state General Fund and student tuition revenue. In 2015-16, UC received $3.2 billion in state General Fund and $3 billion in student tuition revenue. CSU received $3 billion in state General Fund and $2.3 billion in student tuition revenue.

Challenges in Basing UC and CSU Forecasts on Current Law, Base Instead on Current Practice. Whereas the State Constitution, state law, and federal law notably constrain some areas of the state budget (for example, K-14 education and health care), they do not notably constrain budgeting for UC and CSU. In any given year, the Legislature and the two university systems have significant discretion in deciding both what cost increases to fund and how to fund those increases. As current law does not contain explicit guidance relating to UC and CSU cost increases, we assume UC and CSU costs will increase similar to recent years. We describe the baseline and specific assumptions we use for the UC and CSU forecasts below.

The Baseline for the University Forecasts. We use UC’s and CSU’s main state General Fund appropriations as the starting point for our forecasts. These main appropriations include ongoing and one-time funding the state provided in 2016-17. For UC, however, we back out one-time Proposition 2 payments for outstanding pension liabilities. For CSU, we exclude cost increases for retiree health and most pension contributions, as we forecast these as part of overall state employee costs. (We include Hastings College of the Law in our consolidated forecast of relatively small state programs, as the state provides less than $15 million General Fund annually for the college.)

Assume Annual General-Purpose Base Increases Over Forecast Period. We assume the state will provide UC and CSU with annual base increases from 2017-18 through 2020-21. Consistent with state actions in 2013-14, 2014-15, and 2016-17, we assume UC and CSU receive the same dollar increases. Specifically, we calculate base augmentations for both university systems by increasing UC’s General Fund appropriation by 4 percent annually. UC and CSU likely would use these base augmentations to cover increases in operational costs and state facility debt service costs, as well as support some enrollment growth.

Assume Two Other Increases for CSU in 2017-18. In addition to annual general purpose base increases, we assume CSU receives an ongoing augmentation of $26 million beginning in 2017-18 associated with savings generated from policy changes made to the Middle Class Scholarship program in 2015-16. We also assume an additional $5.1 million ongoing augmentation to cover projected increases in CSU’s lease revenue debt service. Both assumptions are based on previously agreed schedules of payments implemented by the Legislature in prior years.

Based on These Assumptions, UC and CSU Spending Grows a Combined $118 Million in 2017-18. Under these assumptions, General Fund support in 2017-18 grows by $43 million (1.3 percent) for UC and $75 million (2.3 percent) for CSU. The increases in 2017-18 are less than 4 percent because of the significant amount of one-time funds the state provided to UC and CSU in 2016-17. For the remainder of the forecast period, state spending on UC and CSU increases each year by 4 percent and 4.1 percent, respectively. By
2020–21, state spending on UC and CSU reaches $3.8 billion for each system, reflecting increases of about 15 percent over their 2016–17 levels.

Spending Would Increase if State Funded Enrollment Growth on Top of Base Increases. The university forecasts assume UC and CSU fund enrollment growth from their base increases. If the Legislature funded enrollment growth on top of the base increases in 2017–18 (as it has the past two years), it would cost the state $29 million at CSU and between $11 million and $16 million at UC for each 1 percent growth. (The range for UC reflects the notably different per-student funding rates provided by the Legislature in recent budgets—$5,000 per student in 2015–16 and $7,400 per student in 2016–17.)

Spending Also Could Be Affected by Tuition Decisions. The UC and CSU forecasts noted above make no explicit assumption about tuition levels. Historically, however, state General Fund and tuition decisions have been closely intertwined. In some prior years, the state has provided additional General Fund on the condition UC and CSU do not raise tuition levels. In other years, when state General Fund has been reduced, UC and CSU have raised tuition levels. Since 2011–12, the main systemwide tuition charges at UC and CSU have been flat. In May 2015, the UC Regents endorsed a long-term plan that would increase tuition levels at about the rate of inflation beginning in 2017–18. CSU also has initiated discussions with stakeholders to adopt tuition increases (of 4.9 percent for undergraduates and 6.5 percent for graduates) in 2017–18. We estimate every 1 percent increase in the main systemwide tuition charge would raise $19 million and $16 million for UC and CSU, respectively, in 2017–18. If tuition levels were raised, the Legislature, as in the past, could decide whether the additional revenue should supplement or replace General Fund support.

Financial Aid

Overview of State’s Financial Aid Programs. The California Student Aid Commission (CSAC) is responsible for administering most state financial aid programs. The largest of these programs is the Cal Grant program, which serves about 330,000 undergraduate students. This program primarily covers tuition for financially needy students who meet academic and other eligibility requirements. The program currently costs $2 billion and is funded almost entirely with a combination of state General Fund and federal Temporary Assistance for Needy Families (TANF) monies. The second largest CSAC program is the Middle Class Scholarship program. This program provides partial tuition coverage for UC and CSU students who do not meet the financial need criteria for a Cal Grant but whose family income and assets fall below certain thresholds. Currently costing less than $100 million, this program is funded entirely with state General Fund.

Key Assumption About Cal Grant Participation. For Cal Grants, we assume participation growth of 2 percent each year. This assumption is based on two factors. First, we assume Cal Grant participation grows in line with projections of high school graduates. We believe this is a reasonable assumption given the Cal Grant high school entitlement program accounts for three-quarters of Cal Grant recipients. Average annual growth in high school graduates over the forecast period is projected to be slightly less than half of 1 percent. Second, we assume Cal Grant participation increases another 1.5 percent each year due to ongoing efforts to increase the share of eligible students receiving awards. In recent years, such efforts appear to have increased Cal Grant participation beyond what would be expected based on demographic trends alone. Moreover, the federal government recently made additional changes to
simplify the aid application process for students applying for the 2017-18 academic year.

Other Key Assumptions Underlying Forecast. For Cal Grants, we also assume the award amount for new students attending nonprofit colleges is reduced from $9,084 to $8,056 starting in 2017-18 (consistent with state law). Additionally, we assume the state continues to use the same amount of federal TANF funds to offset a portion of General Fund Cal Grant costs. For Middle Class Scholarships, we assume the final phase in of award amounts scheduled under current law, with maximum tuition coverage increasing from 30 percent in 2016-17 to 40 percent in 2017-18. We assume year-to-year changes in participation consistent with changes in high school graduates. Consistent with changes in tuition and fee levels over the past two years, we assume flat tuition at UC and CSU throughout the period as well as 5 percent annual increases in UC’s Student Services Fee. Additionally, we assume the continued phase out of loan assumption programs and the removal of one-time state operations funding for CSAC.

Based on These Assumptions, General Fund Costs Increase $44 Million in 2017-18. Under these assumptions, financial aid costs grow from $2 billion in 2016-17 to $2.1 billion in 2017-18—growth of $44 million (2 percent). Of this amount, $28.3 million reflects higher net Cal Grant costs and $20.5 million is associated with higher Middle Class Scholarship costs. These two cost increases are offset by $5.2 million in reductions associated with the phase out of loan assumption programs and backing out prior-year one-time funds.

Costs Over Forecast Period Very Sensitive to Assumptions About Cal Grant Participation and Tuition Levels. Growth in Cal Grant participation could be higher than the level assumed in our forecast. For instance, had we assumed recent growth rates in participation continue throughout the forecast period, annual Cal Grant spending would be around $230 million higher by 2020-21. As a rule of thumb, assuming no other program changes, we estimate every 1 percent increase in Cal Grant participation increases annual costs by roughly $20 million. Financial aid costs throughout the period also could be higher if UC and CSU were to increase tuition. Assuming no other program changes, we estimate each 1 percent increase in tuition would increase financial aid spending by roughly $15 million annually.

Child Care

Overview of State-Subsidized Child Care. The state subsidizes child care for some low-income, working families. Specifically, the state guarantees subsidized care for families participating in the California Work Opportunity and Responsibility to Kids (CalWORKs) program. Slots for other families are capped, with the lowest-income families receiving priority. The 2016-17 budget provides $982 million in non-Proposition 98 General Fund for subsidized child care. Below, we discuss the forecast for non-Proposition 98 General Fund child care spending, excluding Stage 1 CalWORKs child care ($40 million non-Proposition 98 General Fund). We include Stage 1 in our forecast for the Department of Social Services. (Child care programs are supported with state and federal funding. In 2016-17, CalWORKs and non-CalWORKs child care programs received a total of $1 billion in federal funds, roughly two-thirds of which came from the Child Care and Development Block Grant and one-third from TANF.)

Assumptions Underlying Child Care Forecast. As part of the 2016-17 budget package, the Legislature and the Governor agreed on a multiyear plan to increase spending on child care and preschool. The plan would result in a roughly $300 million non-Proposition 98 increase in child care and preschool spending by 2019-20.
Some parts of the agreement, such as certain rate increases, were detailed in statute or provisional budget language. Other parts, such as set-asides for future rate increases, were reflected in back-up budget documents. For the child care forecast, we assume the state adheres to all associated statutory provisions as well as provides all the future set-asides included in the multiyear plan. In addition, the forecast assumes the state will adjust non-CalWORKs child care and preschool spending annually for COLA and the change in the birth-to-four population in California (consistent with state law).

**Child Care Costs Projected to Increase Notably in 2017-18.** We project General Fund child care spending to increase from $9.41 billion in 2016-17 to $11 billion in 2017-18, an increase of $1.65 billion (17.5 percent). The bulk of this increase ($1.58 billion) is due to annualizing rate increases initiated in January 1, 2017 and implementing additional rate increases in 2017-18 consistent with the multiyear budget deal. The rest of the increase is due to applying a 1.12 percent COLA to non-CalWORKs programs and accounting for slightly higher projected Stage 2 caseload. These cost increases are partly offset by a projected 0.3 percent reduction in non-CalWORKs caseload (reflecting a decline in the birth-to-four population) coupled with a slight decline in projected Stage 3 caseload.

**Out-Year Child Care Costs.** We project child care spending will grow to nearly $1.2 billion in 2018-19, an increase of $56 million (5 percent). This is due largely to the set-aside for future rate increases specified in the multiyear budget deal. Costs grow slightly in the following two years.

**California in Midst of Responding to New Federal Requirements.** The federal government reauthorized the Child Care and Development Block Grant in 2014—creating a new set of requirements for states. Most notably, the federal government changed: how states are to set provider reimbursement rates, how frequently states are to inspect providers, how long a family can be eligible for child care, and how much states must spend on activities designed to improve the quality of child care. Decisions the Legislature makes in implementing the new federal requirements could significantly increase state costs. Any associated cost increases would be on top of the cost increases included in our forecast.

**HEALTH AND HUMAN SERVICES**

*Overview of Health Services Provided.* California’s major health programs provide health coverage and additional services for various groups of eligible persons—primarily poor families and children as well as seniors and persons with disabilities. The federal Medicaid program, known as Medi-Cal in California, is the largest state health program both in terms of funding and number of persons served. The Medi-Cal population has grown substantially since January 2014, reflecting an expansion of those eligible for Medi-Cal and a streamlining of eligibility requirements under the Patient Protection and Affordable Care Act (ACA), also known as federal health care reform. In addition, the state supports various public health programs. Although state departments oversee the management of these programs, the actual delivery of many services is carried out by counties and other local entities. Health programs are largely federally and state funded.

*Overview of Human Services Provided.* The state provides a variety of human services and benefits to its citizens. These include income maintenance for the aged, blind, and disabled;
Cash assistance and welfare-to-work services for low-income families with children; protection of children from abuse and neglect; the provision of home-care workers who assist the aged and disabled in remaining in their own homes; and community services and state-operated facilities for the mentally ill and developmentally disabled. Although state departments oversee the management of these programs, the actual delivery of many services is carried out by county welfare and child support offices, and other local entities. Most human services programs have a mixture of federal, state, and county funding.

**Overall Spending Trends.** The 2016-17 budget provides $33 billion in General Fund spending for health and human services (HHS) programs. We now estimate that these General Fund costs will be slightly higher—by $247 million—in part reflecting higher Medi-Cal costs to serve enrollees who are dually eligible for Medi-Cal and Medicare. Based on current-law requirements, we project that General Fund spending for HHS programs will increase to $34.7 billion in 2017-18 and $38.2 billion in 2018-19. A majority of the growth in 2017-18 reflects higher General Fund Medi-Cal spending, due mainly to underlying program growth in caseload and costs per enrollee and an increasing state share of costs for the optional Medi-Cal expansion population under federal health care reform. Other significant factors explaining this growth include increased caseload and costs per consumer and an increasing state share of costs for the optional Medi-Cal expansion population under federal health care reform. Although the average projected annual increase in HHS spending from 2016-17 through 2020-21 is 8.1 percent, there is substantial variation in spending growth rates by program. For example, over these years, General Fund spending growth for Medi-Cal averages 10.9 percent per year, while the Supplemental Security Income/State Supplementary Program (SSI/SSP) is projected to grow more modestly, with average annual growth of 3 percent. General Fund spending for the CalWORKs program is projected to decline after 2017-18, in part reflecting both projected caseload declines as well as the infusion of non-General Fund funding sources to support the program.

Below, we discuss spending trends in the major HHS programs.

**Medi-Cal**

**Overall Spending Trends.** We estimate that 2016-17 General Fund spending for Medi-Cal local assistance will be $17.9 billion—0.7 percent (or $130 million) higher than what was assumed in the 2016-17 Budget Act. This mainly reflects higher General Fund spending on Medicare Part A and B premiums for beneficiaries dually enrolled in Medi-Cal and Medicare as a result of updated projections of 2017 premiums from the federal government. General Fund support
increases 4.5 percent to $18.7 billion in 2017-18 and increases an additional 15.9 percent to $21.7 billion in 2018-19. General Fund costs are projected to increase in 2017-18 largely as a result of underlying program growth in caseload and per-enrollee costs as well as increased costs associated with the newly eligible population under the ACA (the so-called “optional expansion population”) as the state cost share for this population increases. (Under the ACA, the state’s cost share for the optional expansion population is 5 percent beginning in 2017, increasing to 10 percent by 2020 and beyond.) In addition to underlying program growth and the optional expansion, costs are projected to increase in 2018-19 as a result of the passage of Proposition 55. We assume Proposition 55 will result in $2 billion in additional funding from the General Fund for Medi-Cal in 2018-19. (We note that the actual amount of revenue Medi-Cal receives in 2018-19 as a result of Proposition 55 will vary between zero dollars and $2 billion depending on decisions by the administration.) Absent the additional funding resulting from Proposition 55, Medi-Cal’s budget in 2018-19 would otherwise have grown by 5.2 percent relative to 2017-18. General Fund cost growth in 2019-20 and 2020-21 is projected to be 14.3 percent and 9.2 percent, respectively (assuming Proposition 55 continues to result in $2 billion in additional funding annually from the General Fund for Medi-Cal). This largely reflects the sunset of the current MCO tax, the state’s increased share of cost for the optional expansion population, and an end to increased federal funding for the Children’s Health Insurance Program (CHIP).

**Caseload Continues to Grow.** In June 2016—the most recent month for which enrollment counts may be considered nearly complete—total Medi-Cal caseload was around 13.6 million. This includes nearly 3.4 million individuals who became newly eligible for Medi-Cal under the optional ACA expansion. Total enrollment in June 2016 represents a net increase of roughly 800,000 (or 6 percent) from total enrollment in June 2015.

**Caseload Growth Projected to Continue.** We assume enrollment among families, children, and the optional expansion population will grow annually at a rate of about 1 percent throughout the outlook period. This translates into growth of about 100,000 enrollees per year across these populations. We also assume enrollment among seniors and persons with disabilities will grow at their historical annual rates of about 3 percent and 2 percent, respectively, throughout the outlook period. This translates into growth of roughly 50,000 enrollees per year among seniors and person with disabilities.

**Projected Growth in Managed Care and Fee-for-Service (FFS) Expenditures.** The underlying sources of growth in Medi-Cal are changes in caseload and per-enrollee costs. The latter is dependent on growth in health care prices paid by the program in managed care and FFS. We estimate that under our economic growth scenario overall expenditures in managed care will grow by about 5 percent annually through 2020-21. Our outlook also assumes overall FFS expenditures will grow by about 4 percent annually throughout the outlook period. These projections are subject to considerable uncertainty, particularly if future movements in managed care capitated rates or FFS costs differ substantially from recent historical trends.

**State Share of Cost for ACA Optional Expansion Begins in 2017.** From 2014 through 2016, the federal government pays 100 percent of the costs for the optional expansion population. Under current law, the federal share will decline from 2017 to 2020, with the state eventually paying 10 percent of the cost of health care services for the optional expansion population. Our outlook assumes General Fund costs associated with this
population of roughly $900 million in 2017-18 growing to over $1.6 billion in 2020-21.

**CHIP Federal Funding.** CHIP is a joint federal-state program that provides health coverage to children in low-income families but with incomes too high to qualify for Medicaid. In California, both CHIP and Medicaid coverage are provided through Medi-Cal. The ACA authorizes an increase in the federal share of cost for CHIP from 65 percent to 88 percent. The higher federal share of cost will be available from October 1, 2015 through September 30, 2019. On a full-year basis, this results in General Fund savings of over $600 million. However, federal funding for CHIP has only been appropriated through September 30, 2017. Our outlook assumes Congress will appropriate additional funding for CHIP beyond September 30, 2017 and that the enhanced federal cost share authorized by ACA will continue through September 30, 2019. After September 30, 2019, our outlook assumes the enhanced federal cost share will no longer be available, consistent with what is authorized under the ACA, and the federal share of cost will revert to the historical level of 65 percent.

**MCO Tax Assumed to End After July 1, 2019.**

Chapter 2 of the 2015-16 Second Extraordinary Session (SB2X 2, Hernandez) imposes a revised MCO tax on most managed care plans for three years ending July 1, 2019. We assume the MCO tax is not extended by the Legislature beyond this time and therefore ends after July 1, 2019. In 2017-18 and 2018-19, we assume the MCO tax results in annual General Fund savings of about $1.7 billion in Medi-Cal. (The net General Fund savings from the MCO tax are about $1.3 billion in each year after accounting for the General Fund impact of other tax provisions associated with the MCO tax.) We assume the General Fund savings in Medi-Cal phase down to about $450 million in 2019-20 as a result of Medi-Cal being budgeted on a cash basis, before being phased out entirely in 2020-21.

**Coordinated Care Initiative (CCI) Assumed to Continue.** The CCI is a seven-county demonstration project consisting of three main components: (1) the optional enrollment of “dual eligibles” into managed care plans that integrate their Medi-Cal and Medicare benefits (known as “Cal MediConnect”); (2) mandatory enrollment of dual eligibles into managed care for their Medi-Cal benefits; and (3) making Medi-Cal-funded long-term services and supports, including IHSS, available exclusively through managed care. Current law requires CCI to demonstrate net General Fund savings—as estimated by the Department of Finance—to remain operative each fiscal year. We assume CCI remains operative throughout the outlook period.

**Outlook Accounts for Passage of Proposition 52.**

Our outlook accounts for the passage of Proposition 52, which extends the hospital quality assurance fee permanently. While recent federal regulations governing Medicaid managed care have the potential to require changes to the fee to obtain federal approval, we assume the fee will be approved by the federal government and that the General Fund savings generated by the fee will not be impacted by any necessary changes. We assume the fee will result in General Fund savings of $850 million in 2017-18, growing to over $1 billion by 2020-21.

**In-Home Supportive Services**

General Fund expenditures for IHSS are estimated to be $3.5 billion in 2016-17, increasing to about $3.7 billion in 2017-18. This increase is primarily due to projected caseload and hours-per-consumer growth, which we assume will continue throughout the outlook period. We project that IHSS expenditures will reach nearly $5 billion by 2020-21. To a large degree, this growth reflects the implementation of statutorily scheduled statewide minimum wage increases that will significantly
increase the average cost per consumer, particularly beginning in 2018-19. In addition, implementing a new paid sick leave policy for IHSS providers beginning in 2018-19 will likely increase IHSS costs, but the full fiscal impact of this policy is uncertain. These cost pressures are projected to be partially offset by: (1) increases to the county maintenance-of-effort (MOE) that reduce the state share of IHSS costs, and (2) the end of General Fund support for the restoration of IHSS service hours previously reduced by 7 percent (this General Fund support is set to expire with the sunset of the current MCO tax at the end of 2018-19). These factors are discussed in more detail below.

**Rising Statewide Minimum Wage Will Increase Hourly Cost of Care.** The newly enacted statewide minimum wage increases—set to gradually raise the state's minimum wage to $15 per hour by 2022—will generally increase wages for IHSS providers. Since the current average wage for IHSS providers is about $11 per hour (above the current statewide minimum wage), we project that the major costs of the scheduled minimum wage increases will begin when wages increase to $12 per hour and above, beginning in 2019. When the statewide minimum wage increases are fully implemented in 2022, we estimate the costs of the minimum wage increases to total about $1.5 billion General Fund per year, growing with growth in caseload and hours per consumer.

**Costs, Implementation of Paid Sick Leave for IHSS Providers Uncertain.** Beginning on July 1, 2018, IHSS providers will be eligible—pursuant to 2016 legislation—to earn up to 8 hours annually of paid sick leave, ramping up to 24 hours annually when the minimum wage is increased to $15 per hour (scheduled for January 1, 2022). The implementation details of paid sick leave are uncertain and could require significant administrative effort. We anticipate there could be some administrative costs related to paid sick leave in 2017-18 in order to prepare for the launch of paid sick leave in 2018-19.

**County Costs of IHSS Continue to Depend on CCI.** As we discussed in the Medi-Cal section of this report, we assume CCI continues to be implemented throughout the outlook period. Therefore, we also assume that the county MOE for IHSS will continue, increasing by 3.5 percent per year plus a share of any wages and benefits negotiated at the county level. Should the CCI be discontinued and the MOE unwound, counties' contributions to IHSS would return to the share of cost levels in place prior to CCI—about 35 percent of the nonfederal share of IHSS program costs. This increase in county contributions to IHSS costs could decrease our projected state share of cost for the IHSS program by hundreds of millions of dollars annually in the out-years.

**Restoration of the IHSS Service Hours Previously Reduced by 7 Percent Tied to MCO Tax Existence.** Beginning in 2016-17, the General Fund will support the restoration of the IHSS service hours previously reduced by 7 percent so long as the MCO tax is in place. Since the MCO tax is set to expire at the end of 2018-19 under current law and continuation of the tax beyond the sunset date is uncertain, our outlook projections assume that this General Fund support for the restoration of service hours will not be included beginning in 2019-20. We estimate that discontinuing General Fund support would result in General Fund savings of about $300 million annually, growing with growth in caseload and hours per consumer. For further discussion of the MCO tax, please reference the “Medi-Cal” section of this report.

**Developmental Services**

We estimate that General Fund spending for the Department of Developmental Services (DDS) will total $4.0 billion in 2016-17. We project that General Fund expenditures will increase
by $118 million in 2017-18 and reach a total of $4.4 billion by 2018-19. By 2020-21, we project General Fund expenditures to reach $5.6 billion. These projected expenditure increases are mostly due to cost increases for community services resulting from (1) a growing caseload (we project 4 percent annual growth) and (2) increased costs per consumer. The increased costs per consumer in the community are higher due in part to changes in service utilization as well as impacts of statutorily scheduled minimum wage increases throughout the outlook period. (We note that, due to incomplete data, our estimated minimum wage impacts are highly uncertain.) Overall, estimated expenditure increases are partially offset by reductions in the cost for developmental centers (DCs) as a result of individuals transitioning out of the DCs due to anticipated closures. We assume DC closures will occur consistent with DDS’ projected timelines, with Sonoma DC scheduled to close by the end of 2018 and Fairview DC and the general treatment area at Porterville DC scheduled to close by the end of 2021.

Potential Fiscal Pressures. There are a few potentially significant fiscal pressures that could drive further spending not assumed in our outlook. First, we assume that DDS will maintain federal Medicaid funding for individuals in Intermediate Care Facility living units at Porterville and Fairview DCs found by the Department of Public Health to be out of compliance with federal certification requirements. Effective July 1, 2016, the state successfully negotiated settlement agreements with the federal government related to these decertified units to continue federal funding through December 2016 with the possibility of one-year extensions through 2019, if certain requirements are met. While we assume that the state will be able to successfully extend the termination dates of the agreements—and therefore federal funding—annually through 2019, we note that there is a possibility of a loss of federal funds during this time if the terms of the agreements are not met. In such circumstances, the General Fund would likely be called upon to backfill the lost federal funding. Second, we find that compliance by March 2019 with new federal requirements related to Medicaid-funded community-based services could drive additional state spending not included in our outlook. We have not accounted for these potential costs due to the high level of uncertainty regarding the timing and order of magnitude of these costs.

SSI/SSP
State expenditures for SSI/SSP are estimated to be $2.9 billion in 2016-17 and are projected to remain at about the same level in 2017-18. We estimate that caseload growth will increase state costs by about $20 million annually through the outlook period. We have also assumed that the state provides each year over the forecast period a COLA on the state-funded SSP portion of the SSI/SSP grant. Such a COLA was enacted as part of the 2016-17 budget package. We estimate an ongoing COLA would increase SSI/SSP General Fund costs by $60 million to $90 million annually, resulting in total spending on SSI/SSP reaching approximately $3.2 billion by 2020-21.

Housing and Disability Income Advocacy Program Could Increase Caseload, State Costs. The 2016-17 budget provided $43.5 million of one-time General Fund support—to be spent over three years—for the Housing and Disability Income Advocacy Program. Under this program, counties may receive additional funding to help individuals apply for disability-related income support, which includes SSI/SSP. If this program leads to more approved SSI/SSP applications, then caseload—and therefore state costs—could increase.
CalWORKs

We estimate that General Fund spending in the CalWORKs program will be $709 million in 2016-17, roughly consistent with the 2016-17 Budget Act. This 2016-17 estimate, however, masks two adjustments that offset one another: first, increased General Fund costs of $90 million to backfill a reduction in certain realignment funds previously estimated to be available to support the program and, second, a roughly equal amount of General Fund savings due to lower-than-expected caseload. From this 2016-17 funding amount, we project that General Fund spending in CalWORKs will increase by roughly $340 million (48 percent) to a little over $1 billion in 2017-18 (and then decrease in following years) reflecting the net effect of (1) savings due to declining caseload, (2) net costs related to the implementation of prior policy changes, and (3) changes in the availability of other funding sources. We discuss each of these factors in greater detail below.

Savings From Declining Caseload. In recent years, improvements in the state’s economic situation have been accompanied by moderate reductions in the CalWORKs caseload. Under our economic growth scenario, which features the continuation of relatively positive economic conditions, we project that the CalWORKs caseload will continue to gradually decline, but at a slower rate than in recent years. We estimate that declining caseload will result in General Fund savings in 2017-18 of about $150 million relative to 2016-17, with progressively smaller amounts of additional savings in later years.

Net Costs From Implementation of Prior Policy Changes. CalWORKs program spending in the near term will be influenced by several recent policy changes that are not yet fully implemented. Taken together, we estimate that these changes will increase General Fund spending in 2017-18 by a net amount of about $120 million relative to 2016-17. These changes include:

- Costs From Repeal of Maximum Family Grant (MFG) Policy. The MFG policy specifies, with limited exceptions, that a family may not receive an increase to its CalWORKs grant to reflect the birth of a child if the family continuously received assistance in the ten months prior to the child’s birth. The 2016-17 budget package repeals the MFG policy effective January 2017, increasing the grants received by some families. The 2016-17 budget includes $109 million from all funds to pay for increased cash assistance from repealing the MFG policy during the latter half of 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $110 million in 2017-18 to reflect a full year of the policy’s repeal.

- Costs From 1.43 Percent Grant Increase. Pursuant to a statutory mechanism, maximum CalWORKs grant amounts were increased by 1.43 percent in October 2016. The 2016-17 budget includes $36 million from all funds to pay for this grant increase in 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $10 million in 2017-18 to reflect a full year of implementation.

- Costs From Child Care Rate Increases. The 2016-17 budget package increased reimbursement rates for Stage 1 child care providers effective January 2017 and included $20 million from all funds to pay for these higher rates during the latter half of 2016-17. We estimate that total General Fund spending in CalWORKs will rise by roughly $20 million in 2017-18 to reflect a full year of implementation.
Savings From Higher Minimum Wage.
The state’s minimum wage increased
to $10 per hour in January 2016 and
is statutorily scheduled to increase to
$10.50 per hour in January 2017 and
$11 per hour in January 2018, with
additional increases in later years.
Increases to the minimum wage are
expected to result in increased earnings
for some families enrolled in CalWORKs.
Families enrolled in CalWORKs with
higher earnings receive lower cash grants
and some families will have earnings that
exceed eligibility thresholds and cause
them to leave the program, resulting in
savings. The 2016-17 budget assumes
savings of $26 million (all funds) from an
increased minimum wage during 2016-17.
We estimate additional General Fund
savings from a higher minimum wage of
roughly $20 million in 2017-18.

Changes in Availability of Other Funding
Sources. In addition to General Fund support, the
CalWORKs program is supported by federal TANF
block grant funds, realignment funds, and county
funds. Changes in the amount of funding available
from these sources affect how much General Fund
support is required in CalWORKs. We estimate
that General Fund support for CalWORKs in
2017-18 will increase relative to 2016-17 by roughly
$370 million to reflect two main changes in
funding available from these other sources.

First, the 2016-17 budget includes about
$400 million in one-time TANF funds that are
carried over from not being spent in prior years.
We assume that General Fund spending in
CalWORKs will increase in 2017-18 to backfill
these one-time funds available in 2016-17. We note
that the state allocates TANF block grant funds
to other programs in the state budget and has
flexibility to backfill the one-time TANF funds
in some of these other programs. Specifically, the
state could replace a portion of the TANF block
grant funds allocated to CSAC with General Fund
instead of replacing one-time TANF funds with
General Fund in CalWORKs. For simplicity, our
outlook assumes the backfill for one-time TANF
funds will occur in CalWORKs and that the
amount of TANF funds allocated to CSAC remains
constant at the level assumed in the 2016-17 Budget
Act in later years in the outlook. Whether the
backfill for one-time TANF funds takes place in
CalWORKs or in CSAC, the effect on the state’s
General Fund bottom line is the same.

Second, state law dedicates the growth
in certain realignment funds to pay for grant
increases, including certain increases that are
currently supported in part by the General Fund,
such as the repeal of the MFG policy and the
1.43 percent grant increase described above.
As realignment funds dedicated to fund grant
increases grow each year, General Fund support
for repealing the MFG policy and 1.43 percent
grant increase is offset. We estimate that growth in
dedicated realignment funds will reduce General
Fund spending by about $30 million in 2017-18
relative to our 2016-17 estimates. We further
estimate, based on our economic growth scenario,
that growth in dedicated realignment funds will
not be sufficient to fully offset the General Fund
costs of repealing the MFG policy and providing
the 1.43 percent grant increase before the end of
2020-21.

Trends in Total Spending From All Funds.
Figure 18 (see next page) displays projected total
CalWORKs spending from all funding sources,
consistent with our economic growth outlook
scenario and our assumptions about available
TANF block grant and realignment funding
described above. As shown in the figure, we
estimate that total spending will be roughly
$5.3 billion in 2016-17—about $90 million less
than assumed in the 2016-17 Budget Act because of lower-than-expected actual caseload as described previously. Total spending from all funds is projected to decrease slightly by about $20 million in 2017-18, with further decreases (in both total spending and General Fund support) in later years, largely reflecting declining caseloads and increases to the state’s minimum wage.

**Child Welfare Services**

*State Costs for the Continuum of Care Reform (CCR) Expected to Increase in 2017-18, Before Declining in Subsequent Years.* Legislation passed in 2015 and 2016, collectively known as CCR, makes significant changes to the way the state cares for children in foster care. The CCR aims to reduce the state’s reliance on relatively costly group home placements while expanding foster children’s access to mental health and other supportive services. The CCR increases overall county costs in the short run by requiring higher service levels and program standards. These higher costs will be offset—at least partially in the short run—by growing county savings that result from a gradual reduction in the number and duration of group home placements.

The 2011 realignment transferred fiscal responsibility for child welfare services from the state to the counties. The State Constitution requires the state to provide funding for any statewide policy changes, such as CCR, that have the effect of increasing overall county costs. Accordingly, the Legislature appropriated nearly $120 million General Fund in 2016-17 for county welfare departments to implement CCR. We project General Fund costs for CCR implementation to increase to about $180 million in 2017-18. In time, counties’ CCR-related savings are expected to exceed their CCR-related costs, and General Fund support would no longer be required. The amount and timing of CCR-related county savings are uncertain, however, and will affect how much, if any, General Fund is needed for CCR beyond 2017-18.

**JUDICIARY AND CRIMINAL JUSTICE**

The major state judiciary and criminal justice programs include support for the state judicial branch and the California Department of Corrections and Rehabilitation (CDCR).
Judicial Branch

General Fund spending for the support of the judicial branch in 2016-17 is estimated to be $1.8 billion. Our forecast assumes that judicial branch spending will be, on net, roughly the same level in 2017-18. While certain one-time funding increases for the courts will expire at the end of the current year, we assume that such savings will be offset by spending increases in 2017-18. First, we assume inflation adjustments for the compensation of court employees of roughly $50 million each year over the forecast period. Second, as we discuss in more detail below, we estimate that the implementation of Proposition 63 and Proposition 66 will increase annual court costs. Our forecast assumes that General Fund spending on the courts will reach almost $1.9 billion by the end of the outlook period.

Implementation of Proposition 63 and Proposition 66. In November 2016, voters approved two propositions that will likely increase judicial branch costs over the forecast period. First, Proposition 63 creates a new court process to ensure that individuals convicted of offenses that prohibit them from owning firearms do not continue to have them. Second, Proposition 66 implements various changes to court procedures for legal challenges to death sentences, such as imposing time limits on those challenges and revising rules to increase the number of available attorneys for those challenges. Our forecast assumes that the full implementation of Proposition 63 and Proposition 66 will increase judicial branch costs over the forecast period in the high tens of millions of dollars annually. We note that the actual fiscal effects of the propositions on the judicial branch will depend heavily on how the courts choose to implement certain provisions.

Corrections and Rehabilitation

General Fund spending for support of CDCR operations in 2016-17 is estimated to be $10 billion. Our forecast assumes that CDCR spending will decline in 2017-18 by just over 1 percent to about $9.8 billion. This primarily reflects the effect of (1) the expiration of certain one-time funding increases at the end of the current year and (2) the implementation of Proposition 57 and Proposition 66 (as discussed in more detail below). Our forecast for 2018-19 assumes that General Fund spending for the support of CDCR will decline again slightly but then increase annually thereafter to about $9.9 billion by the end of the forecast period, due to modest annual growth in the inmate population. (Funding for increased CDCR employee compensation costs is included under “Remaining programs” in Figure 12 at the beginning of this chapter, not the CDCR line.)

Implementation of Proposition 57 and Proposition 66. Proposition 57, recently approved by voters, (1) makes certain nonviolent offenders eligible for parole consideration—in some cases earlier than otherwise, (2) expands CDCR’s authority to reduce inmates’ sentences through credits, and (3) mandates that judges determine whether youths are subject to adult sentences in criminal court. Our forecast assumes that the prison population will decline in the short term resulting from the implementation of Proposition 57. (Absent the passage of Proposition 57, the state’s prison population would likely have increased modestly over the forecast period, primarily due to an estimated increase in the number of offenders with relatively long sentences.) We assume that the measure will reduce the prison population and associated costs primarily due to some nonviolent offenders serving shorter prison terms. However, by the end
of the forecast period, we project that the prison population will slightly exceed current levels, due to the underlying growth trend.

In addition to changing the court procedures for legal challenges to death sentences, Proposition 66 (as discussed earlier) also allows the state to house condemned inmates in any prison, rather than only at specified prisons. If the state changes the way it houses condemned inmates, the measure could result in state prison savings. We assume that such changes are implemented—resulting in savings reaching the tens of millions of dollars annually over the forecast period.

**EMPLOYEE COMPENSATION AND RETIREMENT COSTS**

As discussed below, our outlook assumes continuation of recent employee compensation practices, pension funding policies, and current pension system investment return assumptions. State spending may increase significantly above our growth scenario assumption if any of the following occur: (1) investment returns are lower than the state’s pension boards assume; (2) the state’s pension boards change their investment or other actuarial assumptions; (3) the state agrees to larger pay increases for state employees in order to implement the Governor’s retiree health prefunding plan; or (4) other factors arise that increase state employee compensation and retirement costs.

**State Employee Pay and Benefits**

显著的成本预期从集体谈判。州的员工补偿成本由劳资协议—劳资协议（MOUs）—制定，其中包括劳动协议和雇主支付的费用。这些费用的支付方式由州劳动部门决定。州政府和其21个劳工团体进行谈判和协商。州政府必须在MOUs生效前进行谈判。州政府通常会支付一定比例的奖金以抵消雇主支付的费用。

州政府可能会被要求在MOUs之后进行谈判，或者在MOUs之后进行谈判。

财政收入的变化。在2015-16财年，州政府支付了约40亿美元的员工工资和福利：约20亿美元用于活跃雇员（约一半来自普通基金）和约20亿美元用于退休人员（近一半来自普通基金）。到2020-21财年，普通基金的累计支出将超过2016-17财年约100亿美元。到2020-21财年，州政府支付了约20亿美元的员工工资和福利：约20亿美元用于活跃雇员（约一半来自普通基金）和约20亿美元用于退休人员（约一半来自普通基金）。

**Rising Health Benefit Costs.** In 2015-16, the state paid about $4 billion for active and retired state employee health benefits: about $2 billion for active employees (about half from the General Fund) and about $2 billion for retirees (nearly
all paid initially from the General Fund, with roughly half of the costs recovered from other funds). By 2020-21, we estimate that these costs will exceed $5 billion. These growing costs result from increased payments for health services and a growing retiree base.

**CalPERS Pension Costs Rising** . . . In recent years, the state’s contribution rates to the California Public Employees’ Retirement System (CalPERS) pension plans have increased due to investment losses during the recession and CalPERS’ decisions to change certain actuarial assumptions. Our growth scenario assumes that CalPERS maintains its current assumption of a 7.5 percent discount rate. We estimate that the state’s contributions to CalPERS will increase each year, with General Fund payments climbing above 2016-17 levels by about $200 million in 2017-18 and very roughly $1 billion by 2020-21.

. . . But Could Rise Above Our Assumptions. CalPERS indicates that it expects average investment returns to be lower over the next decade than the 7.5 percent it currently assumes. To the extent that investment returns are lower than this assumption, the state’s annual costs will increase to pay higher unfunded liabilities. Alternatively, the CalPERS board could decide to lower its assumed rate of return—requiring the state to contribute more money each year to both the normal cost and the unfunded liability. Increases in the normal cost also could increase employee costs to prefund their pension benefits—creating pressure to increase their pay beyond what we currently assume.

**CalSTRS**

**State Contribution Made Up of Three Components.** In 2016-17, the state’s contribution to the California State Teachers’ Retirement System (CalSTRS) totals 8.6 percent of statewide teacher compensation, as measured on a two-year lag. The contribution is a combination of three components. First, the state contributes a base amount of about 2 percent to CalSTRS’ main pension program. Second, Chapter 26 of 2014 (AB 1469, Committee on Budget) provides for a state supplement to pay down a share of CalSTRS’ $76 billion unfunded liability. Figure 19 shows how the funding plan assigns responsibility for CalSTRS’ unfunded liabilities as of the most recent actuarial valuation. In 2016-17, the state’s supplemental rate is 4.3 percent. Finally, the state contributes about

![Figure 19: Responsibility for CalSTRS' $76 Billion Unfunded Liability](image-url)
2.3 percent of compensation to a program that protects retirees’ pension benefits from the effects of inflation, known as the Supplemental Benefits Maintenance Account.

**Previous LAO Outlooks HadProjected Near-Term State Savings.** In our November 2015 *Fiscal Outlook* report, we described how the state’s share of CalSTRS’ unfunded liabilities had decreased since the Legislature passed the funding legislation in 2014. Accordingly, state contributions were expected to decline by several hundred million dollars beginning in 2017-18. This projection reflected the CalSTRS policy at that time, which would have set the state’s supplemental rate to the rate necessary to pay down the state’s share by the mid-2040s.

**Recent Board Decision Pays Down State Share Faster.** In June 2016, the CalSTRS board voted to maintain the state’s supplemental rate at 4.3 percent until the state’s share of CalSTRS’ unfunded liabilities is eliminated. Based on recent estimates from CalSTRS, we assume that the state’s share would not be eliminated until after our outlook period. Accordingly, we assume that the state’s contribution rate will be 8.6 percent through 2020-21. As shown in Figure 20, we estimate that state contributions to CalSTRS would total $2.6 billion in 2017-18 and would rise steadily with growth in payroll to $3 billion in 2020-21.

**Figure 20**

**State Contributions to CalSTRS Continue to Rise Under LAO Outlook**

(In Billions)

- **SBMA** = Supplemental Benefits Maintenance Account.

**UNEMPLOYMENT INSURANCE**

**Interest Payments on Federal Loans.** Reserves in the state’s unemployment insurance (UI) trust fund were exhausted in 2009, requiring the state to borrow from the federal government to continue payment of UI benefits. The state is required to make annual interest payments on these federal loans. California’s outstanding loan balance is estimated to be roughly $4 billion at the end of 2016, with a 2016-17 General Fund interest payment of $111 million. Based on projected unemployment
rates in our economic growth outlook scenario, the remaining federal loans are estimated to be repaid by the end of 2018, with a final estimated General Fund interest payment of roughly $50 million in 2017-18.

DEBT SERVICE ON INFRASTRUCTURE BONDS

_Debt Service Ratio (DSR) Has Fluctuated Historically._ The DSR—the ratio of annual General Fund spending on debt service costs to annual General Fund revenues and transfers—is often used as one indicator of the state’s debt burden. As shown in Figure 21, the DSR has varied considerably in past decades between about 3 percent and 6 percent. In the late 2000s, the DSR grew to about 6 percent as large bond measures were approved and state revenues dropped due to the recession. More recently, however, the DSR has declined to about 5 percent. The modest decline in the DSR occurred for a variety of reasons, including rebounding General Fund revenues, refinancing of existing debt, and state policies shifting some state debt costs from the General Fund to special funds—such as in transportation.

_DSRS Expected to Fall Below 5 Percent._ We estimate that the DSR will fall below 5 percent over the next several years. This is because we project that General Fund revenues will increase somewhat faster than debt service costs. We assume that the state gradually sells bonds that have been approved by voters or the Legislature. These bonds include some of the remaining unsold infrastructure bonds that voters approved in 2006, 2008, and 2014 as well as a portion of the school bond approved in November 2016 (Proposition 51). Our projections do not include any additional debt service costs for new bonds that may be authorized by the voters or the Legislature during the forecast period.
In this chapter, we present two estimates of the budget’s condition through 2020-21. These estimates are sensitive to two types of uncertainty: economic uncertainty and other budget uncertainty. Different economic outcomes can result in billions of dollars of difference in our bottom line estimates for the state’s budget condition. Other uncertainties, particularly changes in state or federal policy or implementation, could similarly change the budget’s bottom line condition—in either direction—by hundreds of millions or even billions of dollars.

**ECONOMIC UNCERTAINTY**

To reflect the economic uncertainty inherent in our budget outlook, we analyze the budget’s condition under two scenarios of the economy’s performance over the next five years: (1) an economic growth scenario and (2) a mild recession scenario. Under the growth scenario, we assume moderate, but steady, growth in employment, personal income, and the stock market as the economy continues to grow throughout the entire outlook period. Under the recession scenario, we assume the state experiences a mild economic downturn, with a big stock market decline, beginning near the middle of calendar year 2018. For reference, this downturn is roughly comparable to the dot.com bust of the early 2000s. (Following a review of our recession modeling, we have reduced somewhat the recession-period revenue loss, compared to last year’s Fiscal Outlook.) Both scenarios account for passage of Proposition 55, which extended higher income tax rates on high-income earners, as well as the fiscal effects resulting from measures approved by voters at the November 2016 election.

**Revenues**

*Revenues Over Outlook Differ Dramatically Between Two Scenarios.* Figure 22 (see next page) displays our revenue outlook under both the growth and recession scenarios. Under our economic growth scenario, between 2016-17 and 2020-21, we assume there is 4.6 percent growth in the state’s “Big Three” tax revenues: the personal income tax (PIT), sales and use tax, and corporate tax. Growth in the PIT drives the majority of this overall increase over the period. In the recession scenario, over the entire outlook period, we assume revenues are roughly $40 billion lower than they are under the growth scenario. Much of this decline is attributable to a decline in PIT revenues in 2018-19, 2019-20, and 2020-21.

**Spending**

*Expenditures Grow 4.5 Percent in Growth Scenario.* Figure 23 (see page 51) compares our estimates of expenditures under the growth scenario and the recession scenario. Under our economic growth scenario, we assume 4.5 percent growth in overall General Fund expenditures.
between 2016-17 and 2020-21. This rate reflects, in particular, significant growth in health and human service (HHS) program spending. Under the growth scenario, we assume spending on major HHS programs reaches $45.2 billion in 2020-21, an 8.1 percent average annual increase from 2016-17. The bulk of this increase is related to expenditures in Medi-Cal, the state’s health insurance program for low-income Californians. Between 2016-17 and 2020-21, we assume expenditures in this program grow from nearly $18 billion to over $27 billion in the growth scenario.

**Automatic Reductions in Formula-Driven Programs in Recession Scenario.** Relative to the growth scenario, expenditures are lower in formula-driven spending in the recession scenario. In particular, this includes the formulas for determining schools and community college funding (Proposition 98) and debt payments (Proposition 2). Together, expenditures related to these two programs are roughly $20 billion lower relative to the growth scenario over the outlook period. These changes are primarily driven by our assumptions about lower revenues, including those related to capital gains, in the recession scenario.

**Moderate Increase in Costs for Some Programs in Recession Scenario.** In our assumptions about spending under the recession scenario, we estimate expenditures are moderately higher for certain caseload-driven HHS programs. We do not estimate changes in spending under the recession scenario associated with other programs.

---

### Figure 22

**Revenue Outlook Under Growth and Recession Scenarios**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Personal income tax</td>
<td>$79.0</td>
<td>$85.1</td>
<td>$91.0</td>
<td>$95.8</td>
<td>$100.5</td>
<td>$104.7</td>
<td>5.3%</td>
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<tr>
<td>Sales and use tax</td>
<td>24.8</td>
<td>24.7</td>
<td>25.0</td>
<td>26.0</td>
<td>26.7</td>
<td>27.3</td>
<td>2.5%</td>
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<tr>
<td>Corporation tax</td>
<td>10.0</td>
<td>9.9</td>
<td>10.2</td>
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<td>10.9</td>
<td>11.2</td>
<td>3.2%</td>
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<tr>
<td>Subtotals, “Big Three” Revenues</td>
<td>($113.8)</td>
<td>($119.7)</td>
<td>($126.1)</td>
<td>($132.3)</td>
<td>($138.1)</td>
<td>($143.2)</td>
<td>(4.6%)</td>
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<tr>
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<td>$4.8</td>
<td>$4.2</td>
<td>$4.1</td>
<td>$4.3</td>
<td>$4.8</td>
<td>$4.9</td>
<td>4.3%</td>
</tr>
<tr>
<td>BSA transfer</td>
<td>-1.8</td>
<td>-3.3</td>
<td>-2.0</td>
<td>-1.8</td>
<td>-1.6</td>
<td>-1.6</td>
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</tr>
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<td>-0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>—</td>
</tr>
<tr>
<td><strong>Totals, Revenues and Transfers</strong></td>
<td>$115.6</td>
<td>$120.0</td>
<td>$128.1</td>
<td>$134.8</td>
<td>$141.0</td>
<td>$146.7</td>
<td>5.1%</td>
</tr>
<tr>
<td><strong>Mild Recession Scenario</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income tax</td>
<td>$79.0</td>
<td>$85.1</td>
<td>$89.1</td>
<td>$88.4</td>
<td>$89.0</td>
<td>$93.6</td>
<td>2.4%</td>
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<tr>
<td>Sales and use tax</td>
<td>24.8</td>
<td>24.7</td>
<td>25.0</td>
<td>24.6</td>
<td>25.1</td>
<td>26.1</td>
<td>1.4%</td>
</tr>
<tr>
<td>Corporation tax</td>
<td>10.0</td>
<td>9.9</td>
<td>10.2</td>
<td>7.9</td>
<td>10.0</td>
<td>10.2</td>
<td>0.8%</td>
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<tr>
<td>Subtotals, “Big Three” Revenues</td>
<td>($113.8)</td>
<td>($119.7)</td>
<td>($124.3)</td>
<td>($120.9)</td>
<td>($124.0)</td>
<td>($129.9)</td>
<td>(2.1%)</td>
</tr>
<tr>
<td>Other revenues</td>
<td>$4.8</td>
<td>$4.2</td>
<td>$4.1</td>
<td>$4.3</td>
<td>$4.7</td>
<td>$4.9</td>
<td>4.0%</td>
</tr>
<tr>
<td>BSA transfer</td>
<td>-1.8</td>
<td>-3.3</td>
<td>-1.9</td>
<td>-0.9</td>
<td>-1.0</td>
<td>-1.0</td>
<td>—</td>
</tr>
<tr>
<td>Other transfers</td>
<td>-1.2</td>
<td>-0.6</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.2</td>
<td>0.2</td>
<td>—</td>
</tr>
<tr>
<td><strong>Totals, Revenues and Transfers</strong></td>
<td>$115.6</td>
<td>$120.0</td>
<td>$126.4</td>
<td>$124.1</td>
<td>$127.6</td>
<td>$133.9</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

a From 2016-17 to 2020-21.
BSA = Budget Stabilization Account.
For example, we do not make changes to programs with largely discretionary budgets set by the Legislature annually. In the presence of a tightening budget condition, however, the Legislature would likely make different choices about these parts of the budget, among others.

### Reserves

The state has two budget reserves: the Special Fund for Economic Uncertainties (SFEU) and the Budget Stabilization Account (BSA). Both reserves help insulate the budget from situations where revenues underperform budget assumptions. The Legislature can appropriate funds in the SFEU for any purpose, while the use of funds in the BSA is more restricted. Below, we present our estimates of total reserves under the growth and recession scenarios. For the purposes of this section, “operating surpluses” or “operating deficits” equal the increases or decreases in total budget reserves in each fiscal year.

#### Operating Surpluses Assuming Continued Economic Growth

Figure 24 (see next page) displays operating surpluses under the economic growth scenario. If our assumptions held and current laws and policies remained in place, the

---

**Figure 23**

General Fund Expenditure Estimates Under Growth and Recession Scenarios

<table>
<thead>
<tr>
<th></th>
<th>Estimates</th>
<th>Outlook</th>
<th>Average Annual Growth</th>
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</thead>
<tbody>
<tr>
<td><strong>Economic Growth Scenario</strong></td>
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<tr>
<td>Education Programs</td>
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<tr>
<td>Proposition 98b</td>
<td>$49.1</td>
<td>$51.0</td>
<td>$52.4</td>
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<tr>
<td>Non-Proposition 98</td>
<td>8.6</td>
<td>8.7</td>
<td>9.0</td>
</tr>
<tr>
<td>Health and Human Services</td>
<td>31.2</td>
<td>33.0</td>
<td>34.5</td>
</tr>
<tr>
<td>Criminal Justice</td>
<td>11.3</td>
<td>11.7</td>
<td>11.6</td>
</tr>
<tr>
<td>Infrastructure Debt Servicec</td>
<td>5.3</td>
<td>5.4</td>
<td>5.5</td>
</tr>
<tr>
<td>Other Programs d</td>
<td>9.4</td>
<td>12.2</td>
<td>13.2</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$114.9</td>
<td>$122.0</td>
<td>$126.1</td>
</tr>
<tr>
<td>Percent Change</td>
<td>6.2%</td>
<td>3.4%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

**Mild Recession Scenario**

<table>
<thead>
<tr>
<th></th>
<th>Estimates</th>
<th>Outlook</th>
<th>Average Annual Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education Programs</td>
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<tr>
<td>Proposition 98b</td>
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<td>$51.0</td>
<td>$51.7</td>
</tr>
<tr>
<td>Non-Proposition 98</td>
<td>8.6</td>
<td>8.7</td>
<td>9.0</td>
</tr>
<tr>
<td>Health and Human Services</td>
<td>31.2</td>
<td>33.0</td>
<td>34.5</td>
</tr>
<tr>
<td>Criminal Justice</td>
<td>11.3</td>
<td>11.7</td>
<td>11.6</td>
</tr>
<tr>
<td>Infrastructure Debt Servicec</td>
<td>5.3</td>
<td>5.4</td>
<td>5.5</td>
</tr>
<tr>
<td>Other Programs d</td>
<td>9.4</td>
<td>12.2</td>
<td>13.1</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$114.9</td>
<td>$122.0</td>
<td>$125.3</td>
</tr>
<tr>
<td>Percent Change</td>
<td>6.2%</td>
<td>2.7%</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

---

a From 2016-17 to 2020-21.

b Reflects the General Fund component of the Proposition 98 minimum guarantee. Average annual growth in the minimum guarantee—the General Fund and Local Property Tax revenue combined—is 3.8 percent in the growth scenario and 2.1 percent in the recession scenario.

c Debt service on general obligation and lease revenue bonds generally used for infrastructure. Does not include: (1) lease revenue debt service for community colleges, which is included under Proposition 98, or (2) UC’s and CSU’s debt service, which is included in non-Proposition 98 education spending.

d Includes employee compensation and retirement cost increases as well as small departments not included in the above categories.

Note: Program groups are defined to include departments listed in Figure 12.
General Fund would be in surplus through 2020-21. BSA deposits would range between $1.6 billion and nearly $2 billion over the period, with the BSA balance available for future budget emergencies. The remaining operating surpluses would be available for new budget commitments—spending increases or tax reductions—or building larger reserves. (The figure assumes no sales tax reductions under two existing state laws due to growing SFEU balances.)

In Recession Scenario, Reserves Cover Operating Deficits Through 2020-21.

Figure 25 shows operating surpluses and deficits and total reserve balances under the recession scenario. Under these assumptions, by the end of 2017-18 the state has $10.4 billion in total reserves. Under this scenario, the state would exhaust that reserve balance by the end of 2020-21, ending with a small portion of that year’s operating deficit—just $154 million—that is not covered by reserves. This means, under these assumptions, the state could weather a mild recession without cutting spending or raising taxes through 2020-21. If deficits continued in 2021-22, the state would face...
decisions about how to solve a budget problem at that time.

**Budget Situation Worse With New, Ongoing Commitments.** Both the growth and recession scenarios assume the state makes no additional commitments in any year over the period. If the state did make such commitments, the budget outlook would be worse than displayed in the recession scenario and less optimistic than the growth scenario. Ongoing commitments compound each year, such that their out-year effect is much larger than their annual amount. For example, if the state committed $1 billion in new ongoing annual spending in 2017-18, total reserves would be lower by around $4 billion in 2020-21.

**BUDGET UNCERTAINTIES**

In addition to economic uncertainty described above, other factors, notably those related to policy decisions, could leave the budget in better or worse condition in the out-years. We describe some of these uncertainties below.

**Decisions by the Legislature.** Both the growth and recession scenarios assume there is no change in state policies. For example, we assume the tax on managed care organizations (MCO) will expire, consistent with current law, in 2019. Currently, some General Fund costs and savings are tied to the MCO tax. Our outlook assumes the MCO tax will expire, resulting in: (1) General Fund costs of about $1.7 billion for Medi-Cal (to backfill the loss of MCO tax revenues), (2) General Fund savings of about $300 million for In-Home Supportive Services (IHSS), and (3) roughly $400 million more in corporation and insurance taxes. If the Legislature extended the tax, the out-year budget condition would improve under both scenarios by about $1 billion annually. Similarly, our outlook assumes recent budgetary practices in programs with largely discretionary budgets set by the Legislature—including expenditure increases for employee compensation and the universities—continue. If the Legislature did not provide these increases, the budget condition would improve.

**Decisions by Other State Entities.** The California Public Employees Retirement System (CalPERS) has indicated it expects average investment returns over the next decade to be lower than the 7.5 percent it currently assumes. If the CalPERS board reduced its assumed rate of return to match its assumptions, the state would have to pay much more each year to both the normal cost and unfunded liability. This could increase state costs annually by hundreds of millions or even billions of dollars—during and/or after our outlook period. In addition, in both the growth and recession scenarios, our outlook assumes $2 billion in additional General Fund annual appropriations for Medi-Cal under the provisions of Proposition 55, beginning in 2018-19. However, decisions by the Director of Finance about how to implement this part of Proposition 55 could result in some or all of that $2 billion not being provided, thereby lowering state costs.

**Decisions by the Federal Government.** Our outlook assumes no major changes in federal policy over the outlook period. Various decisions by the federal government, however, could influence future state General Fund costs, in particular for some HHS programs. For example, recent federal regulations governing Medicaid managed care may require changes to the state Hospital Quality Assurance Fee. Similarly, there is uncertainty about whether the federal government will provide federal financial participation for newly enacted paid sick
leave for IHSS providers. The federal government also could change provisions of the Affordable Care Act. These decisions—and others—could cost or save the state billions of dollars over the outlook period.

**State Minimum Wage Costs.** Our multiyear budget outlook includes hundreds of millions of dollars in additional costs related to the state minimum wage increase. For several programs, however, these costs are highly uncertain. Actual state budgetary costs related to the minimum wage could be hundreds of millions of dollars higher or lower than our assumptions. In addition, for both scenarios, the outlook assumes minimum wage increases go into effect as scheduled under current law. However, under certain economic and budgetary conditions, the law allows the Governor to delay the scheduled minimum wage increases. If the state pursued these delays under the recession scenario, the budget’s condition would improve somewhat.

**LAO COMMENTS**

*Budget Estimates Are Highly Uncertain.* After 2017-18, General Fund revenues could be billions of dollars higher than those in the growth scenario or billions of dollars lower in a recession that is more severe than the one we display. Budget shortfalls would occur sooner, in particular, if a recession began before the middle of 2018. Shortfalls could be greater if the recession were more severe than the mild downturn we illustrate here or if the state made additional budget commitments. On the other hand, the budget could be in even better condition if the economy expanded faster, state spending was lower, or the stock market performed better than we assume in our growth scenario.

*State Is Increasingly Prepared to Weather a Mild Economic Recession.* Our recession scenario shows that the state budget is much better prepared to weather a mild economic downturn with minimal disruptions to programs. However, the reserve balances displayed in this chapter assume the state makes no new budget commitments—whether spending increases or tax reductions. If the state were to make significant ongoing budget commitments in 2017-18 or later, reserve balances would be insufficient to cover operating deficits in a mild recession and the state could face much more difficult choices—such as reducing spending or increasing taxes—to balance the state budget. Similarly, difficult choices would arise if the next recession is more severe than the mild one we have modeled in this report.

*Plan for Size of Next Economic Downturn.* As it crafts future budgets, the Legislature each year will allocate discretionary funds among reserves, one-time spending, and ongoing budget commitments based on its priorities. In deciding what level of reserves to hold, the Legislature may want to consider the size of a potential future recession for which it would like to plan. In the presence of a more severe recession, the state would face larger budget deficits. As such, weathering a more severe recession would require more preparation now, while the economy is still growing.
Atascadero
In Brief

Receipts for Atascadero’s April through June sales were 0.7% lower than the same quarter one year ago. Actual sales increased 0.7%, net of reporting anomalies.

Accounting events that inflated year-ago postings from casual dining and some classifications within the business and industry group were primarily responsible for the difference between cash receipts and actual sales activity. Business group totals were actually up 18.6% while casual dining returns increased 10.2%, helped by a recent addition. Payment deviations understated gains from lumber/building materials and the automotive group, but partially mitigated the impact of lower fuel prices on service station receipts. Sales were also up from used car dealers and garden/agricultural supplies.

In addition to the amounts discussed above, proceeds from voter-approved Measure F-14 totaled $565,465 for the quarter. This was 18.7% more than in last year’s comparison quarter when common start-up issues, including late postings and special reporting periods, temporarily depressed allocations.

Adjusted for aberrations, taxable sales for all of San Luis Obispo County declined 0.4% over the same period; the Central Coast region was up 2.7%.

Sales Tax by Major Business Group

Top 25 Producers

Alphabetical Order

<table>
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<tr>
<th>Store Name</th>
<th>2nd Quarter 2015</th>
<th>2nd Quarter 2016</th>
</tr>
</thead>
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<tr>
<td>Arco AM PM</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Atascadero 76</td>
<td>$962,972</td>
<td>$970,011</td>
</tr>
<tr>
<td>Atascadero Chevron</td>
<td>294,722</td>
<td>294,722</td>
</tr>
<tr>
<td>Atascadero Gas &amp; Mart</td>
<td>123,439</td>
<td>108,462</td>
</tr>
<tr>
<td>Atascadero Shell</td>
<td>$839,240</td>
<td>$860,827</td>
</tr>
<tr>
<td>Chalk Mountain Gas</td>
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<td></td>
</tr>
<tr>
<td>Chalk Mountain Liquor &amp; Deli</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Circle K Union 76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>El Camino Building Supply</td>
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<tr>
<td>Food 4 Less</td>
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<td></td>
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<tr>
<td>Hitching Post Shell</td>
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<tr>
<td>Home Depot</td>
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<tr>
<td>In N Out Burgers</td>
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<tr>
<td>Kmart</td>
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<td></td>
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<td>Miners Ace Hardware</td>
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<td>Pacific Coast RV</td>
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<td></td>
</tr>
<tr>
<td>Rite Aid</td>
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<td></td>
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<tr>
<td>San Anselmo Unocal 76</td>
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<td></td>
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<tr>
<td>Smart &amp; Final</td>
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<td></td>
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<tr>
<td>Ted Miles Motors</td>
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<td></td>
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<tr>
<td>Tesoro Refining &amp; Marketing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Triple 7 Auto Sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valley Speed &amp; Marine</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vons</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Walgreens</td>
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Revenue Comparison

One Quarter – Fiscal Year To Date

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<th>2015-16</th>
<th>2016-17</th>
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<tr>
<td>Point-of-Sale</td>
<td>$860,827</td>
<td>$839,240</td>
</tr>
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<td>County Pool</td>
<td>108,462</td>
<td>123,439</td>
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<tr>
<td>State Pool</td>
<td>722</td>
<td>294</td>
</tr>
<tr>
<td>Gross Receipts</td>
<td>$970,011</td>
<td>$962,972</td>
</tr>
<tr>
<td>Less Triple Flip*</td>
<td>$(242,503)</td>
<td>$0</td>
</tr>
<tr>
<td>Measure F14</td>
<td>$476,544</td>
<td>$565,465</td>
</tr>
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</table>

Published by Hdl Companies in Fall 2016

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California Overall
Statewide local sales and use tax receipts were up 1.9% over last year’s spring quarter after adjusting for payment aberrations.

The largest gains were for building supplies, restaurants, utility/energy projects and countywide use tax pool allocations. Tax revenues from general consumer goods and business investment categories rose slightly while auto sales leveled off.

Interest In Tax Reform Grows
With modest growth in sales and use taxes, agencies are increasingly reliant on local transaction tax initiatives to cover growing infrastructure and employee retirement costs. As of October 1, there are 210 active add-on tax districts with dozens more proposed for the upcoming November and April ballots.

The Bradley-Burns 1% local sales tax structure has not kept pace with social and economic changes occurring since the tax was first implemented in 1933. Technology and globalization are reducing the cost of goods while spending is shifting away from taxable merchandise to non-taxed experiences, social networking and services. Growing outlays for housing and health care are also cutting family resources available for discretionary spending. Tax-exempt digital downloads and a growing list of legislative exemptions have compounded the problem.

California has the nation’s highest sales tax rate, reaching 10% in some jurisdictions. This rate, however, is applied to the smallest basket of taxable goods. A basic principle of sound tax policy is to have the lowest rate applied to the broadest possible basket of goods. California’s opposite approach leads to revenue volatility and causes the state and local governments to be more vulnerable to economic downturns.

The State Controller, several legislators and some newspaper editorials have suggested a fresh look at the state’s tax structure and a few ideas for reform have been proposed, including:

Expand the Base / Lower the Rate:
Eliminate much of the $11.5 billion in exemptions adopted since the tax was first implemented and expand the base to include the digital goods and services commonly taxed in other states. This would allow a lower, less regressive tax that is more competitive nationally and would expand local options for economic development.

Allocate to Place of Consumption:
Converting to destination sourcing, already in use in the state’s transactions and use tax districts, would maintain the allocation of local sales tax to the jurisdiction where stores, restaurants and other carryout businesses are located, but return the tax for online and catalog sales to the jurisdiction of the buyer that paid the tax. One outcome of this proposal would be the redirection of tax revenues to local agencies that are currently being shared with business owners and corporations as an inducement to move order desks to their jurisdictions.

Tax reform will not be easy. However, failing to reach agreement on a simpler, less regressive tax structure that adapts this century’s economy could make California a long-term “loser” in competing with states with lower overall tax rates.

### Sales Per Capita

![Graph showing sales per capita for Atascadero, County, and California](image)

### Revenue By Business Group

Atascadero This Quarter

![Pie chart showing percentage distribution of revenue by business type](image)

### Atascadero Top 15 Business Types

<table>
<thead>
<tr>
<th>Business Type</th>
<th>Atascadero Q2 ‘16</th>
<th>Change</th>
<th>County Change</th>
<th>HdL State Change</th>
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<tbody>
<tr>
<td>Auto Repair Shops</td>
<td>13,727</td>
<td>-1.6%</td>
<td>1.3%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Automotive Supply Stores</td>
<td>23,737</td>
<td>7.5%</td>
<td>5.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Boats/Motorcycles</td>
<td>— CONFIDENTIAL</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Casual Dining</td>
<td>53,059</td>
<td>-7.6%</td>
<td>4.5%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Contractors</td>
<td>15,355</td>
<td>-3.9%</td>
<td>97.3%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Discount Dept Stores</td>
<td>— CONFIDENTIAL</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Drug Stores</td>
<td>24,113</td>
<td>3.3%</td>
<td>5.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Garden/Agricultural Supplies</td>
<td>16,984</td>
<td>18.1%</td>
<td>9.6%</td>
<td>5.6%</td>
</tr>
<tr>
<td>Grocery Stores Liquor</td>
<td>44,249</td>
<td>-4.7%</td>
<td>-5.7%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Hardware Stores</td>
<td>— CONFIDENTIAL</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Lumber/Building Materials</td>
<td>61,977</td>
<td>5.0%</td>
<td>3.5%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Quick-Service Restaurants</td>
<td>178,888</td>
<td>-10.0%</td>
<td>-15.2%</td>
<td>-19.2%</td>
</tr>
<tr>
<td>Service Stations</td>
<td>— CONFIDENTIAL</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Trailers/RVs</td>
<td>42,104</td>
<td>31.8%</td>
<td>13.1%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Used Automotive Dealers</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Total All Accounts             | 839,240           | -2.5%   | -0.4%         | -0.6%            |
County & State Pool Allocation | 123,732           | 13.3%   | 15.8%         | 15.2%            |
Gross Receipts                 | 962,972           | -0.7%   | 1.4%          | 1.4%             |
California Forecast: Sales Tax Trends and Economic Drivers

HdL provides relevant information and analyses on the economic forces affecting California’s local government agencies. In addition, HdL’s Revenue Enhancement and Economic Development Services help clients to maximize revenues.

HdL serves over 400 cities, counties and special districts in California and across the nation.
## Statewide Sales Tax Trends

<table>
<thead>
<tr>
<th>Category</th>
<th>2016/17</th>
<th>2017/18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Autos/Transportation</td>
<td>2.8%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Building/Construction</td>
<td>5.6%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Business/Industry</td>
<td>1.7%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Food/Drugs</td>
<td>2.4%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Fuel/Service Stations</td>
<td>9.1%</td>
<td>9.7%</td>
</tr>
<tr>
<td>General Consumer Goods</td>
<td>3.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Restaurants/Hotels</td>
<td>5.2%</td>
<td>4.5%</td>
</tr>
<tr>
<td>State and County Pools</td>
<td>7.7%</td>
<td>7.2%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2.3%</td>
<td>3.4%</td>
</tr>
</tbody>
</table>

The economic trends that have been driving the automobile industry’s record growth, easy credit, high consumer confidence and a stable job market are still in place. However, some analysts believe that sales incentives and fleet sales will need to play a bigger role to maintain the current pace. Cheap gasoline prices and pent-up demand continue to spur sales of full-size trucks and SUVs while sales of passenger cars slipped 4.0% in the first half of the year.

Construction of new single family units appears to have peaked in mid-2016 but the pace of multi-family and commercial construction should continue to rise in large metropolitan areas through 2017. Large public works and sports venue projects will boost receipts in areas where material suppliers are located.

High land prices and cost of living are making California less attractive for manufacturing businesses, some of which are looking to come back to the U.S. after experimenting with off-shore production. Future gains from this sector are expected to be driven by agriculture, food processing and supplies, energy/utilities, business services and textiles/furnishings.

Overall consumer demand within this segment remains stable but tax receipts are fragmented by turnover in retailers, a rise in online shopping/home delivery services and expanding competition from big box and specialty retailers. Some grocers include sales of gasoline in their sales tax returns which can skew chain store comparisons.

Growing inventories of petroleum products are leading some analysts to conclude that the surplus of oil will persist despite growing demand. Many oil producers have cut costs so deeply that they can turn a profit when oil trades around $50-$60 a barrel. Discussions surrounding limiting global output to lift prices will continue as OPEC nations struggle with financial challenges.

Brick-and-mortar retailers continue to be challenged by the strong dollar, deep discounting and consumer online shopping preferences. Many chain stores are closing locations, shrinking store sizes and investing in omni-channel retailing to become more competitive with their online rivals. Historically, the U.S. has had five times more retail space per person than any other country. Online sales may not reduce this ratio but merely exchange space in downtowns and malls for cheaper land outside major urban centers.

A prominent industry analyst rang alarm bells in July by forecasting an imminent restaurant recession though recent data indicates that this call appears premature. While sales at major national chains have dropped, consumers have instead shifted spending to local and regional eateries in search of more unique dining experiences. Nevertheless, the rate of year-over-year growth has slowed for five consecutive quarters as the industry faces increasing headwinds which include rising labor and rent costs that have made eating at home comparatively less expensive.

Growth in countywide pool allocations are expected to remain strong as online shopping for goods shipped from out-of-state fulfillment centers continues to accelerate. Increased private party vehicle transactions registered at the DMV, out-of-state materials purchases and long-term equipment leasing will contribute to future gains.

*Proposition 172 projections vary from statewide Bradley-Burns calculations due to the State’s utilization of differing collection periods in its allocation to counties. HdL forecasts an increase of 3.58% for Fiscal Year 2016-17 compared to State Controller’s Office remittance totals in Fiscal Year 2015-16. A statewide gain of 3.40% is projected for Fiscal Year 2017-18.*
2016 has been a disappointing year for the U.S. economy. After solid GDP growth through the middle of 2015, the pace of growth slowed to a crawl over the last three quarters. Recent headwinds have come largely from external sources, rather than internal ones. In contrast, domestic consumer demand—representing two-thirds of overall economic activity in the United States—has remained quite strong. Consumers contributed almost 3% to growth in the 2nd quarter, more than enough to offset declines in business spending. Importantly, consumers are increasing their spending for the right reason—they are earning more.

U.S. Unemployment Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>4.8%</td>
</tr>
<tr>
<td>2017/18</td>
<td>4.7%</td>
</tr>
</tbody>
</table>

U.S. labor markets continue to expand, with the number of payroll jobs growing by 1.8% year-to-date, only moderately slower than last year. Even more important, the modest slowing of job creation seen in the spring has reversed itself—the nation added 275,000 jobs per month in June and July. Workers in the United States are finally starting to see the impact of the low unemployment rate, which has been hovering just below 5% over the past year. Median real wages for a full-time worker have grown 4% over the past two years, still modest but better than the previous 8 years when real earnings didn't grow at all.

California Total Nonfarm Employment Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>2.5%</td>
</tr>
<tr>
<td>2017/18</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

California has stayed on course with solid economic performance through the first three quarters of 2016 despite slower growth nationally. Although the pace of growth in 2016 has been somewhat slower than last year, the state outpaced the nation in terms of economic growth and job creation. Through the first seven months of 2016, nonfarm jobs grew at 2.7%, compared to 1.8% nationally, and nearly every industry in the state continues to add jobs.

California Unemployment Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>5.2%</td>
</tr>
<tr>
<td>2017/18</td>
<td>5.0%</td>
</tr>
</tbody>
</table>

The unemployment rate dropped below 6% late last year, moving sideways in the mid-5% range for most of the summer as sustained job growth and wage gains have drawn more people into the labor force. With a labor market that is outperforming the nation overall, Beacon Economics expects to see the unemployment rate trend lower still and move closer towards parity with the national rate.

California Population Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>1.0%</td>
</tr>
<tr>
<td>2017/18</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

The California Department of Finance estimated that statewide population grew by 0.9% from January 2015 to January 2016 which was in line with expectations of around 1% growth. With the statewide labor market on the rise, household formation is expected to follow suit and boost population growth through natural increase. Beacon Economics expects the state's population to grow by 1.0% in 2016/17.

California Median Existing Home Price

<table>
<thead>
<tr>
<th>Year</th>
<th>Median Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>$448,800</td>
</tr>
<tr>
<td>2017/18</td>
<td>$489,600</td>
</tr>
</tbody>
</table>

The picture for housing has been mixed since the recession, with prices advancing modestly despite many hurdles that have limited sales activity. Outside of the San Francisco Bay Area, home prices have yet to surpass their pre-recession peaks. Demand for homes has been sustained by low interest rates but has also been impeded by limited inventories, high underwriting standards and large down payment requirements.

California Residential Building Permits

<table>
<thead>
<tr>
<th>Year</th>
<th>Permits</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016/17</td>
<td>105,900</td>
</tr>
<tr>
<td>2017/18</td>
<td>118,000</td>
</tr>
</tbody>
</table>

New home construction has struggled to advance since the recession, with permit levels that remain well below the long-run average, mainly because of a very slow rebound in single family home construction. Through the first half of the year, total housing permits declined by 2.0%, with a 10.6% decline in multi-family activity nearly offset by a much welcome 9.0% increase in single-family activity.
Hdl Companies
1340 Valley Vista Drive, Suite 200
Diamond Bar, California 91765
Telephone: 909.861.4335 • 888.861.0220
Fax: 909.861.7726

California’s allocation data trails actual sales activity by three to six months. Hdl compensates for the lack of current information by reviewing the latest reports, statistics and perspectives from fifty or more economists, analysts and trade associations to reach a consensus on probable trends for coming quarters. The forecast is used to help project revenues based on statewide formulas and for reference in tailoring sales tax estimates appropriate to each client’s specific demographics, tax base and regional trends.

"Good information leads to good decisions."

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Beacon Economics, LLC has proven to be one of the most thorough and accurate, economic research/analytical forecasters in the country. They regularly provide national, state, regional, and sub-regional economic analysis/forecasting to clients ranging from the State of California to private hedge funds to major universities. Their evaluation of the key drivers impacting local economies and tax revenues provides additional perspective to Hdl’s quarterly consensus updates. The collaboration and sharing of information between Beacon Economics and Hdl helps both companies enhance the accuracy of the work that they perform for their respective clients.