

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Norberto Dueñas

**SUBJECT:** 2017-2018 PRELIMINARY GENERAL FUND FORECAST UPDATE  
**DATE:** December 15, 2016

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## INFORMATION

The purpose of this memorandum is to provide a brief and preliminary update on the status of the City's General Fund budget for Fiscal Year 2017-2018. As a reminder, the General Fund 2017-2021 Five-Year Forecast issued in February 2016 projected a shortfall in Fiscal Year 2017-2018 of \$11.1 million followed by small shortfalls ranging from \$4.2 million to \$15.8 million in each of the remaining out years of the Forecast.

While a new Five-Year Forecast will not be released until February 2017, City Council-approved actions as part of the 2016-2017 Adopted Budget, the recent passage of two voter-approved revenue ballot measures, and new information regarding retirement costs (not related to the recent passage of Measure F-San José Pension Modification Agreement) will impact the upcoming forecast and budget process. While expectations for an improved budget outlook are understandably at high levels, based on early information, the General Fund is expected to remain on a very thin margin next fiscal year with either limited resources available or, if conditions worsen, experience a potential General Fund shortfall. This outlook calls for a cautious and conservative approach to the upcoming budget process.

- 2016-2017 Adopted Budget Actions

As part of the 2016-2017 Adopted Budget, the City Council set aside ongoing funding of \$8.0 million (along with \$3.1 million one-time) in a 2017-2018 Future Deficit Reserve to address the forecasted 2017-2018 shortfall. This action, therefore, improved the ongoing General Fund budget condition, leaving only a \$3.1 million ongoing shortfall to be resolved in 2017-2018 or in future budget actions (assuming all other projections in the February 2016 Five-Year Forecast remain unchanged).

It is important to note, however, that the 2016-2017 Adopted Budget included one-time funding for a number of services totaling over \$25 million that are not accounted for in the General Fund Forecast. This includes \$17.7 million that was allocated to pavement maintenance on a one-time basis (funded from the new sales tax ballot measure). If these changes are made ongoing, the \$25 million would need to be budgeted in the upcoming fiscal years.

- Revenue Ballot Measures

Revenue ballot measures approved by the voters in June and November 2016 also improve the General Fund Forecast. The voter-approved Sales Tax ballot measure is projected to generate by \$40 million annually. Of that amount, the City Council allocated \$16.2 million to ongoing uses in the 2016-2017 Adopted Budget to restore a number of key services, including funding to: support the addition of 41 sworn police positions effective late 2017-2018 to improve police response, end the periodic “brown out” of fire companies to improve response times to fire and medical emergencies, double homeless rapid rehousing services, hire an additional 19 Police Department Community Service Officer positions to improve response to burglary and neighborhood crimes, and hire five additional Police Department Crime and Intelligence Analyst positions to work smarter to reduce and solve crimes.

The remaining \$23.8 million of revenue from the sales tax measure, as well as an estimated \$12.0 million in General Fund revenue from the Business Tax Modernization ballot measure approved in November, will be factored into the next Five-Year Forecast and will be available to offset cost increases as described below or that may arise after further analysis of projected General Fund expenditures for 2017-2018, continue services funded with one-time money last year, or support additional spending priorities.

- Retirement Costs

The City’s General Fund Forecast will also be affected by an increase in retirement costs beyond those already included in the General Fund Forecast. As described below, the latest analysis from the Boards’ actuary shows an overall General Fund increase of between \$23.2 million and \$25.6 million in 2017-2018 from the previously forecasted figure provided by the actuary (please note the budgetary impacts will differ). The City makes annual required contributions to the Police and Fire Department Retirement Plan and the Federated City Employees’ Retirement System for pension and retiree healthcare post-employment benefits. Each year, the Boards’ actuary calculates the amount the City should contribute to the plan for post-employment benefits to be fully funded by the end of each plan’s amortization period.

In 2017-2018, the actuary’s estimated cost of the Police and Fire Pension City contribution is expected increase by \$11.4 million in the General Fund from the previously forecasted figure provided by the actuary (the actual budgetary impacts will differ). This number has primarily increased due to recent investment losses and higher than estimated salary increases in the previous fiscal year. These unanticipated events led to an increase in unfunded actuarial liability<sup>1</sup> for the Plan, which requires additional funding to meet the City’s obligation to fully fund the plan. In addition, the Police and Fire Retirement Board is considering a lower discount (earnings) rate (7.00% to 6.875%). The change has the potential to increase the cost to the City by an estimated \$6.3 million

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<sup>1</sup> The unfunded actuarial liability of a retirement plan refers to the difference between the total value of pension benefits owed to current and retired employees based on past years of service and the amount of money a post-employment plan has available to fund the benefits.

in the General Fund. The changes to the Police and Fire Department Retirement Plan are expected to be finalized in January 2017.

The City pension contribution to the Federated City Employees' Retirement System is also anticipated to increase by approximately \$3.1 million in 2017-2018 from the previously forecasted General Fund amount. Much of this increased cost can also be attributed to the recent investment losses in the Plan, which increased the System's unfunded actuarial liability. The Federated Board is also considering lowering the discount rate (7.00% to 6.875% or 6.75%). The change in the discount rate to 6.875% has the potential to increase the cost to the City by an estimated \$2.4 million in the General Fund (\$4.3 million in all funds). The change in the discount rate to 6.75% has the potential to increase the cost to the City by an estimated \$4.8 million in the General Fund (\$8.7 million all funds). The changes to the Federated City Employees' Retirement System are expected to be finalized in January 2017.

It is important to note that these potential changes in the actuary's contribution amounts are solely due to the impact of recent investment performance, higher than estimated salary increases for police and fire, and expected changes in the projected discount rate. They are not attributed to any changes related to Measure F.

There are many elements of the General Fund Forecast that have not yet been updated and will need to be fully evaluated, including the revenue performance in over 450 revenue accounts, all departmental and non-departmental expenditures, and the state of the economy before the release of the February 2017 Forecast.

As stated previously, the early information in this memorandum is intended to provide some preliminary context for the upcoming fiscal year as early indicators appear that the General Fund budgetary position will likely remain on a thin margin. This context will also guide the direction to City departments on developing operating budget proposals for the 2017-2018 Proposed Budget. Fiscal restraint, conservative budgeting, prioritization of the highest service needs, and restructuring/reallocating existing resources will be major themes for the upcoming year, therefore departments will be directed to take a targeted and very limited approach to budget proposal development. This direction memorandum, which is expected to be released this week, will be forwarded to you for reference.

We will continue to provide information to the City Council regarding any other major changes to revenue and expenditures that may impact the General Fund Forecast as appropriate.



Norberto Dueñas  
City Manager