Déjà vu, all over again?

Risks to and Solutions for San Jose's Delivery of Core Services
Response to Mayor Liccardo's Budget Message, March 9, 2019

Citizens for Fiscal Responsibility

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Citizens for Fiscal Responsibility

Fiscal Sustainability in San Jose through Common Sense Government

Citizens for Fiscal Responsibility (CFR) was founded in January 2011 by community-minded San Jose residents. While working together on various community service projects, we realized that even though we have diverse social philosophies and political views, we share two strongly held common values.

First, we share a quest for more effective and responsible government. Government officials, both elected and non-elected, must be responsible stewards of the money citizens entrust to them through the taxes and fees we pay.

Second, citizen involvement and action to improve our future must be ongoing. It is incumbent upon all who may be affected by San Jose's ability to deliver core services to get involved. Voters need to educate themselves and elect representatives who will work tirelessly to protect and improve city services while being fiscally responsible.

CFR is a non-partisan organization. Our members have diverse professional, philosophical, religious and political backgrounds and beliefs. Our shared focus is on fiscal responsibility in government, and actively working for a brighter future for San Jose and Santa Clara County.

Find out more at www.cfr-sj.org

Summary

"This Budget Message triggers the foghorn to prepare for the dangers in the misty months ahead."
– Mayor Liccardo's Budget Message

San Jose is in a precarious financial position. This paper identifies the reasons why, after over ten years of economic prosperity and several reform initiatives, our City's ability to deliver core services residents deserve remains doubtful.

Three significant factors have created the problem, as follows:

1. Despite pension reforms, the unfunded liability has tripled to $3 billion since the Great Recession in 2008. Taxpayers will have to pay $3,000 per year for every man, woman and child residing in San Jose just to cover this liability.
2. While the City's contribution to the pension funds continues increasing, reducing an overly optimistic discount rate will significantly raise the unfunded liability and further increase required payments into the pension funds.
3. San Jose has been building reserves in anticipation of the upcoming downturn, but the City Manager's "Recession Scenario" forecast indicates that budget shortfalls may exceed $150 million.

Mayor Liccardo has called for convening a committee of key stakeholders "to calmly explore options that will both protect the benefits that our employees have earned, and protect" the City's delivery of core services. Citizens for Fiscal Responsibility (CFR) supports the Mayor's goals. To accomplish these goals, CFR recommends the following:

1. Make Core Services a priority over other services for budgeting purposes when staff is being hired or cuts are being made.
2. Hire the next City Manager from outside San Jose city government.
3. Bring in an outside consultant to review our City's cost structure.
4. Create a culture of accountability and systems that reinforce that culture.
5. Improve pension reform.

Elected officials need to hold those city employees who are responsible for driving efficiencies accountable for their budgets, staffing, and activities. City employees should recognize that they are most directly affected by cuts in city services and should do everything possible to insure that San Jose avoids a repeat of the drastic reductions following the Great Recession.

Current Situation

"The recently revised General Fund Forecast illustrates an uncertain fiscal future over the next few years…"

– Mayor Liccardo's Budget Message

The Mayor's not so hidden message…we are facing some significant challenges. San Jose once again serves as the canary in the coal mine of California's pension problem. Surrounding cities, which participate in CalPERS, and school districts, which participate in CalSTRS, are just now feeling the consequences of the overly generous pension promises of the past and facing the same struggles that San Jose suffered in the aftermath of the Great Recession.

From 2008 to 2016, the City led the way in dealing with unsustainable pension promises by implementing a second-tier pension plan for new employees and other voter approved reforms, eliminating "thirteenth checks," and reducing the rate of return target for the invested assets of the pension funds. San Jose also nearly quintupled annual payments into the pension funds to reduce its unfunded liability, which exceeded $1 billion at the time.

Much has transpired since the Great Recession that triggered San Jose's pension woes. We are entering the 11th year of an historically long economic recovery. Voters consistently and overwhelmingly supported pension reform measures (Table I) and passed ballot initiatives for over $80 million in additional annual taxes for city government (Table II). Payments into the City's three major pension funds increased by 35% between 2014 and 2018, exceeding $350 million in total contributions (across all city funds) in 2018, roughly five times the amount being paid prior to 2008. The City also increased the financial acumen of the pension funds' governing boards.

Table I: Pension Reform Ballot Measures

Year	Measure	Action	Yes Vote %
2010	V	Repeal Binding Arbitration	66.41
2010	W	Remove payment & retirement age from City Charter	72.14
2012	B	Major pension reforms	69.02
2014	F	Approve pension modification agreement	61.14

Table II: Recent Tax Measures

Year	Measure	Tax	$M Raised/Year	Yes Vote %
2014	B	Library Parcel Tax	$8	81.47
2016	B	General Sales Tax	$38	61.41
2016	G	Business Tax Increase	$12	65.59
2018	T	Public Safety & Infrastructure Bond	$34	70.95

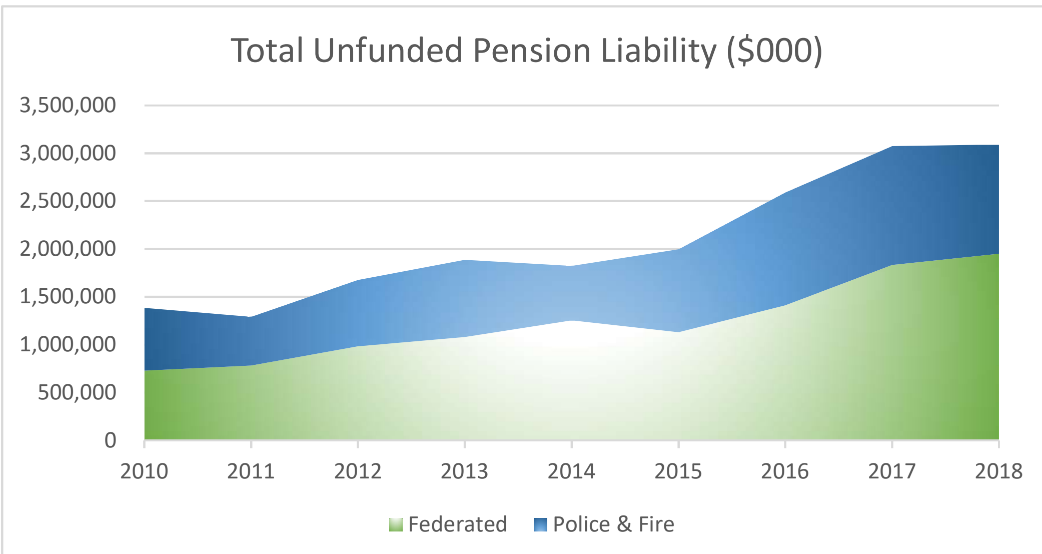
Pensions Over-burden General Fund

"Absent corrective actions, we will once again see retirement costs undermine our collective efforts to serve our residents."

– Mayor Liccardo's Budget Message

In 2008, an unfunded pension liability of $1 billion for the Federated and Police & Fire Plans triggered Mayor Reed's efforts at pension reform. After ten years of positive economic growth, a strong stock market, pension reforms, and increased retirement benefit funding, the unfunded liability has ballooned to $3 billion (Chart I). This is roughly $3,000 per person (every man, woman and child) in San Jose per year. Taxpayers will be required to make good on these pension promises, although the bulk of the burden of paying for this unfunded liability will fall on the roughly 55% of residents between the ages of 25 and 65.

Chart I: Total Unfunded Pension Liability



Yet, we have heard almost nothing lately about this increased exposure, nor of plans to deal with it, other than it's going to take time for things to change: "five year projections show the retirement plans' costs slowing their ascent by FY2020-21, and moderating to more sustainable increases on the order of 2% to 3% annually thereafter until 2027, when they begin dropping substantially," according to Mayor Liccardo's message. We must wait another 8 years until pension payments begin declining, assuming the actuarial assumptions hold true. However, at least one assumption is destined to change. "Retirement board experts have – with good reason – continued to advise the boards to reduce their discount rates even further," the Mayor notes, increasing annual costs "by several tens of millions of dollars, cutting spending on everything from police to parks and potholes."

Despite years of historic economic performance, years of battling for pension reform, and millions of dollars in increased taxes, the need for increased retirement benefit funding is likely to once again crowd out spending on core services. The Mayor's budget message identifies several issues driving this phenomenon:

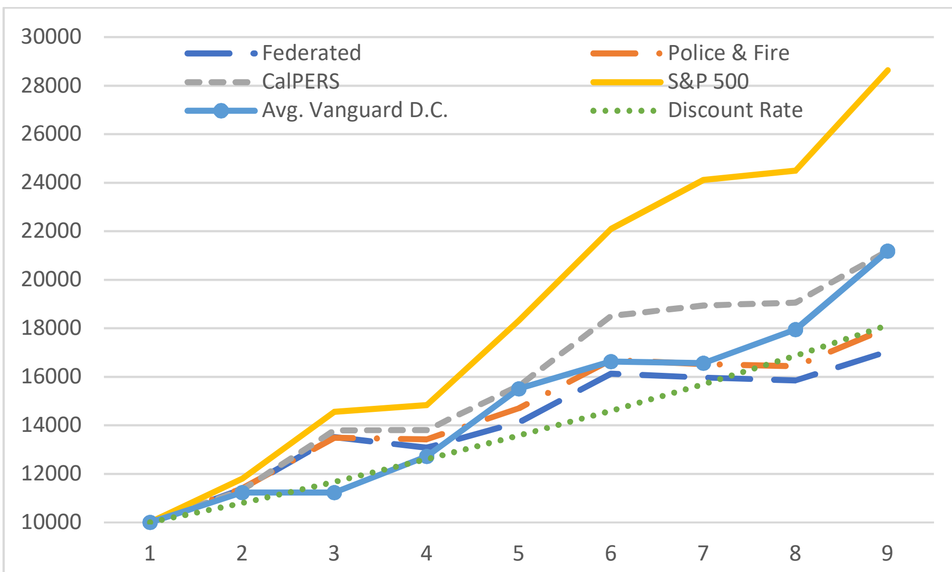
1. The cost of financing unfunded liabilities
2. Inadequate returns on invested pension assets

3. An excessive amount of uninvested assets (cash)
4. Incorrectly optimistic actuarial assumptions

We agree with his assessment. It is a given, the unfunded liabilities exist. Regardless of one's opinion of the generosity of San Jose's retirement benefits, the benefits were earned in good faith by employees, and the City's taxpayers have an obligation to make good on those promises. The City's methodology pays down the unfunded liability over many years if the actuarial assumptions and returns meet expectations. However, if the return on invested pension assets falls below the target rate of return (6.75% next fiscal year and alternatively called the discount rate) or if actuarial assumptions (such as retiree life span) are not conservative enough, the unfunded liability increases. One or the other happens frequently.

Portfolio returns have proven a significant part of the problem; they have failed to meet the target rate in five of the last ten years. Returns consistently fall short of the S&P 500 index with dividends reinvested, not to mention CalPERS annual returns (Chart II). Another relevant benchmark is the average return on the millions of direct contribution retirement accounts held at the Vanguard Group, which also exceeds the returns of San Jose's major pension funds since 2010 (see Chart II).

Chart II: Comparison of the Value of $10,000 at Various Rates of Return



Pension returns are fiscal years for FY2009/10 forward. Vanguard numbers are calendar year average returns beginning in 2010. Investors had more than 4 million direct contribution accounts at the Vanguard Group in CY2017.

San Jose pension funds suffer from poor investment management. CalPERS, which has its own, larger unfunded liability problem, is doing a better job of managing its portfolio. The millions of participants in the Vanguard Group's direct contribution plans are collectively doing a better job than the professional managers of the San Jose plans, and nearly as well as CalPERS.

Worse, the portfolio's investments aren't structured to attain the targeted discount rate. A Stanford Institute for Economic Policy Research study[1] calculated that "the projected returns for the two plans are each approximately 4.8%, based on the projected returns for the various constituent asset classes and target asset allocation." Per the report, a one percentage point reduction in the discount rate

[1] "Analysis of City of San Jose Retirement Plans Investment Portfolios," Working Paper N. 17-039, 11/20/17

increases the unfunded liability (as of 6/30/16) by over $1 billion. Amortizing this additional shortfall over 30 years would increase the City's required retirement benefit payments by over $70 million per year, which is almost as much as the entire Parks, Recreation & Neighborhood Services budget for fiscal year 2018-2019.

Recommendations

"Here is the challenge: this will get worse."
– Mayor Liccardo's Budget Message

In his Budget Memo, the Mayor directs the City Manager to place $3.2 million of the forecast $3.5 million budget surplus into a Reserve for Future Deficit Reduction. The Mayor is "trigger[ing] the foghorn to prepare for the dangers in the misty months ahead."

That Reserve for Future Deficit Reduction, along with several other similar reserves, are but fingers in the dike holding back the budgetary effects of any significant recession. According to a "Recession Scenario" prepared by the City Manager, a typical economic downturn would push forecasted shortfalls to in excess of $150 million. "Most importantly, though, the forecast projections do not account for likely changes in the City's annual obligations for its long-term retirement debt," warns the Mayor.

It's helpful to be able to draw on reserves to level out the ups and downs of the business cycle. But much more work is needed to protect San Jose's ability to deliver core services during downturns. Citizens for Fiscal Responsibility recommends the following actions.

Improve Pension Reform

"To the extent possible we must also limit expenditures within the General Fund to one-time sources of funding that will not require ongoing, multiple-year obligations that cannot be credibly sustained."
– Mayor Liccardo's Budget Message

Incremental progress in protecting and improving the City's ability to deliver core services will come with difficulty. There are no doubt efficiencies to be gained in City operations. Multiple analyses, from IBM consultants, the City Auditor, and Citizens for Fiscal Responsibility, have identified millions of dollars of potential savings. The biggest road block to significant cost reductions is the "California Rule," which precludes reducing future pensions without offsetting compensation to the employees.[2] Lacking action by the California Supreme Court, San Jose, like every other public entity in California, has a potentially devastating fiscal exposure driven by their pension systems' unfunded liabilities.

Because of the California Rule, there is no easy solution to San Jose's looming pension problem. Solving the issue (absent a repeal of the California Rule) will require a team effort. In the recent past the City has proven that changes to pension plans are possible but require engaging with the unions to be successful. For starters, a way to mitigate the effects of lowering the discount rate to a more reasonable level needs to be found. History has shown that the current rate is too high, and as more workers retire, the risk profile of the investments will have to be lowered, further compounding the problem.

[2] For more on the California Rule, please see Addendum II.

Facilitate Stakeholders Working Together

"Now is the time to convene key stakeholders…to calmly explore options that will both protect the benefits that our employees have earned, and protect the City's ability to provide basic services through the next recession."

– Mayor Liccardo's Budget Message

We agree, the Mayor's task force is a solid idea and CFR would happily participate. Only by working together can we avoid another disastrous reduction in San Jose's ability to deliver the core services residents deserve. Residents, elected officials, and government workers must work together to avoid the kind of fiscal disaster that forced drastic reductions in core services after the Great Recession. Everyone must do something to avoid another slashing of a work force that has yet to recover from the cuts of the last economic downturn.

Residents must pay attention to the risk facing our City's budget. Failure to address the underlying issues will take us back ten years, bringing devastating reductions in city services. We need to make informed decisions regarding how much we are willing to tolerate in service cuts in the face of the next inevitable economic downturn. This requires that voters take time to fully understand the nature of the problem, and not just rely on media sound bites or the opinions of those who don't live in San Jose. Electing fiscally responsible representatives is key to resolving this issue.

The San Jose City Council has an obligation to be transparent and honest with its constituents. Further, elected officials must engage city employees and union leadership now to begin developing a strategy that protects our City's delivery of core services. This is the only way to address the problem without recreating the toxic environment that followed the Great Recession.

San Jose employees need to understand the issues facing our City's budget. The risks are much larger for city employees, whose livelihoods depend on San Jose's ability to maintain service levels, than for residents. Over 2,000 city jobs disappeared during the last recession. We are only now beginning to increase police department and other staffing to the levels that existed when San Jose was the safest big city in the United States. It would be a shame if we had to start cutting again. Avoiding that fate will require creativity.

Focus on Core Services

San Jose faces a myriad of challenges but has prioritized the importance of issues it faces as written in core services directive. It is imperative that the City continue to focus limited resources first and foremost on the core services, i.e., the more broadly defined 3Ps; public safety, parks, and pavement. A city's survival and wellbeing depends primarily on these priorities. However, San Jose has been distracted by small yet vocal special interest groups, diluting its effectiveness in these areas. City departments are hiring and expanding non-core services far and beyond what budget availability should allow. Exceeding budget allotments forces reductions in core services such as public safety (which leads to increased response time and increased crime) as well as closure of parks and libraries. This unchecked spending puts the city in jeopardy of relying on successfully passing tax and bond measures by the voters to fund core services

For example, no one would argue San Jose's need for additional affordable housing. However, giving priority and additional budget at the expense of providing core services is a losing proposition. Over the past three years, San Jose's Housing Department has swollen from 50 FTE to 63 FTE to provide everything from: home repair, down payment assistance, and monitoring rentals to the development of multi-family housing. Their fees have more than tripled and will continue to increase as they add even more staff to fund areas that are not city core services. The Housing Department is working towards its goals, but are these the right goals given the city's challenges with providing enough resources for core services? In addition, tax payers should ask, with 24% increase in staff, triple budget usage, and multiple overages, where is the new housing that will alleviate our shortage?

Housing is just one example. Given the fiscal uncertainty being created by unfunded pension liability, San Jose needs to look at all city departments and be diligent about ensuring spending is adequate for providing core city services first and other services second. Keeping on budget is critical to our City's growth and sustainability. All departments and every activity should be focused on providing the core services residents require before providing other non-core endeavors.

Bring in Consulting Expertise

Inefficiencies exist within any large organization, and often it takes fresh eyes to drive operational improvement. We believe that it is time for San Jose to bring in a group with experience in improving the cost structure of municipalities to once more identify ways to improve delivery of core services. Past studies have shown that significant opportunities exist for channeling existing tax dollars into activities providing better core service delivery. In 2012, IBM's Global Business Services delivered an analysis that "rigorously appl[ied] analytics to ensure that limited resources maximize policy outcomes" for local government [3]. Looking at 3 major departments (Police, Fire and PRNS), the study identified $145-$181 million dollars of opportunities for "value creation." A 2014 analysis by CFR identified $147 million of "free money alternatives."[4] San Jose's own internal auditor routinely finds savings opportunities; as of December, 2018 there were $10 million in potential budget savings recommendations awaiting implementation.[5]

Next City Manager Should Come from Outside

Between them, the past four city managers had over 100 years of experience working for the City of San Jose prior to being appointed. The last time San Jose hired a city manager with no San Jose experience was nearly 20 years ago. We greatly respect the people who devote themselves to working for our City but find it hard to believe that San Jose is the sole source of the best minds in municipal management. CFR believes that the next city manager should bring a fresh set of eyes to our government to drive new, more efficient methods for delivering the core services that residents deserve.

Establish Accountability

Our government needs to engage in the tough task of figuring out how to hold itself accountable for improving its ability to deliver core services.

CFR believes that a lack of accountability is the primary obstacle to serious efforts at improving the cost effectiveness of our government. First, employee compensation is based on seniority rather than merit; the longer that employees work for the City, the more they are paid, assuming they meet minimum job requirements. Secondly, there is little incentive for exceeding performance standards for the rank and file worker. Third, as in most governments, management stature depends to a large degree on budget and staff size…bigger is better. There is little incentive to create efficiencies if it reduces staff size. Fourth, compensation for employee suggestions is capped, reducing the incentive

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[3] "City of San Jose Operations Efficiency Diagnostic," 2/28/122

[4] "Finding $147M in San Jose's Finances," www.cfr-sj.org/reports.html

[5] "Status of Open Audit Recommendations as of December 31, 3029," Report to the City Council, www.sanjoseca.gov/DocumentCenter/View/83286

value of creative problem solving. At the very least, the Council needs to increase the maximum payout for the employee suggestion program to something more in the line of 10% of realized savings. Finally, there is relatively little follow up by the Council, as there is much on their plates. There is more of a focus on the issue of the day than on the mundane business of creating an organization capable of delivering core services efficiently. The Council needs to develop a robust method for tracking staff commitments to ensure that directives are fulfilled in a timely manner.

Conclusion

San Jose struggled to get its financial house in order after the 2008-2009 recession. After an historically long economic expansion, we remain ill prepared to continue delivering necessary core services during the next downturn. In fact, our City may be in a worse position, as money that may have once been diverted from “lower priority” core services such as (sorry to say) library hours or street paving is now protected in funds devoted to those purposes. Or, worse, funds are being diverted to expanding departments that are non-core city services. This, combined with the certainty of the need to increase pension contributions, paints a very bleak future for our City. CFR fears that we once again face the predicament of choosing between shoring up our pension funds and delivering services to the community.

It is imperative that work begin right now to avoid a repeat of the years of service cuts and turmoil following the Great Recession.

Appendix

Addendum I: Pension Oversight

"Indeed, it has been the historic failure of the Boards prior to 2008…that has irresponsibly created false optimism about the financial status of pension funds that obscured billions in unfunded liabilities."

– Mayor Liccardo's Budget Message

Who is accountable for the investment returns of the San Jose pension funds? Each pension fund is overseen by a Retirement System Board, which meets once per month, excepting July. The Federated Retirement System Board consists of 7 members: two participating employees, one retiree, three members of the public appointed by the City Council and one public member selected by those six. Each public member must live within fifty miles of San Jose City Hall and is required to have a degree in "finance, actuarial science, law, economics, business or other relevant field," along with at least 12 years' of relevant experience. The Police and Fire Plan Board consists of nine members: two city employees, two retirees, four public members with relevant experience and one public member selected by the other eight.

These boards manage both the investments (or delegate such management) and the discount rate, among other actuarial parameters. In 2008, the discount rate for the Federated Plan was 8.25%, while Police & Fire was 8.00%. Since then, the rates have been reduced to 6.75%. More reductions are likely, as retirement experts "advise the boards to reduce their discount rates even further." Hence the Mayor's concern about likely future core services cuts due to increased payments required to pay down the increased unfunded pension liability.

Both pension funds have frequently underperformed various benchmarks, including their discount rate, as show below. Years where the funds failed to realize their discount rate or more are indicated in red in the chart below.

Fiscal Year	Federated Return	P&F Return	CalPERS Return	S&P 500 Return
09-10	13.7	14.0	13.3	18.0
10-11	18.8	18.3	21.7	23.4
11-12	-3.2	-0.5	0.1	1.9
12-13	8.0	9.6	13.2	23.5
13-14	14.2	13.5	18.4	20.6
14-15	-1.0	-1.0	2.4	9.1
15-16	-0.7	-0.6	0.6	1.6
16-17	7.5	9.7	11.2	16.9
17-18	5.9	6.9	8.6	15.6

Addendum II: The California Rule

The California Rule stems from a 1955 case, Allen v. City of Long Beach. The Court declared that "reasonable" modifications to employees' vested pension rights may be made to "maintain the integrity of the system," as long as "changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages." This not only applies to previously earned benefits, it applies to all future earnings. The pension at the time of hire sets a base that can never be reduced, and should the pension later be enriched, that forms a new base below which the program may not be reduced without "comparable new advantages." Subsequent case law has upheld that future pension benefits are subject to the commensurate benefit requirement (Abbott v. City of San Diego, 1958 and Wisley v. City of San Diego, 1961).