CITY OF SAN MATEO

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Agenda Report

Agenda Number: {{item.number}} Section Name: {{section.name}} File ID: {{item.tracking_number}}

TO: City Council

FROM: Alex Khojikian, City Manager

PREPARED BY: Finance Department

MEETING DATE: April 21, 2025

SUBJECT:
General Fund 2025-26 Operating Budget – Preview

RECOMMENDATION:
Receive the General Fund 2024-25 operating budget preview.

BACKGROUND:
On February 18, 2025, staff presented a mid-year budget update to Council on the City's financial status. The General Fund budget deficit for fiscal year (FY) 2024-25 is projected at $6.4 million, an improvement from the original $10.6 million shortfall. This reflects better-than-expected investment earnings and charge for services, as well as budget savings from vacancies. Despite the projected deficit, the General Fund balance is expected to remain strong at year-end, with an estimated $112 million.

On April 7, 2025, Council reviewed the existing General Fund Reserve Policy. Staff proposed revisions to clarify reserve usage, establish replenishment requirements, and adjust reserve targets to align with best practice and the City's unique fiscal needs. Under Council direction, the revised policy will be incorporated into the FY 2025-26 proposed budget. The policy framework will keep roughly $77 million in General Fund reserves and $10 million in unassigned fund balance at the end the current fiscal year, and set aside $25 million in a Capital Investment Reserve for critical infrastructure projects.

The 2025-26 budget is being developed to align with Council priorities, meet operational needs, and support City's commitment to fiscal sustainability. While staff continue to finalize the proposed operating budget, this report provides the Council with an early preview of the General Fund budget outlook.

Two key concerns continue to shape the City's budget planning:

- Elevated interest rates, which have cooled the housing market and slowed growth in both property tax and real property transfer tax revenues in recent years.
- Property Tax In-Lieu of Vehicle License Fee (VLF) shortfalls, which remain a long-term financial risk.

Added to these challenges is the uncertainty in the broader economy. Rapid shifts in U.S. trade policies have contributed to market volatility and raised concerns of a potential economic downturn. The sections that follow provide an overview of current economic conditions and staff's budget forecast for FY 2025-26 General Fund revenue and expenditures.

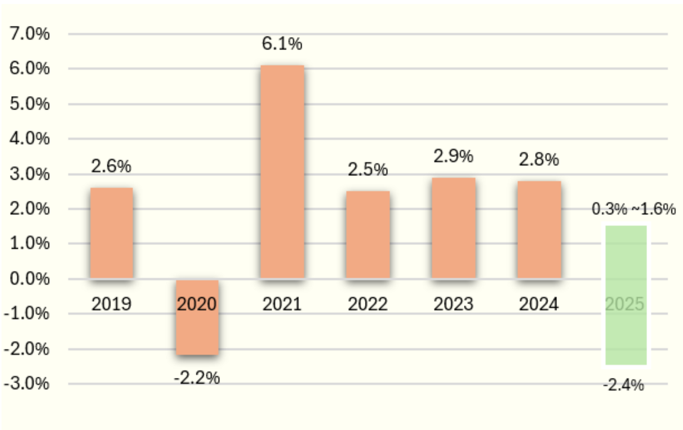
General Economic Conditions

- **Economic Growth:** U.S. real GDP grew 2.8% in 2024 (Chart 1). Early data from January and February 2025 showed continued solid performance. However, in March and April, significant shifts in U.S. trade policy and escalating trade conflicts have raised concerns about a potential economic slowdown. Many forecasters now revised their 2025 GDP growth projections downward to a range of 0.3% to 1.6%, with some forecasting negative growth. This wide range reflects a high degree of uncertainty we face. It is becoming increasingly difficult to navigate the current environment, as the situation continues to evolve, and the duration and severity of this potential downturn remain unclear.

- **Inflation:** Inflation showed encouraging signs early in the year, with the Personal Consumption Expenditure (PCE) Price Index dropping to 2.4%, close to the Federal Reserve (Fed)'s long-term target of 2%. That said, recent developments, including broad-based tariffs, are expected to put pressure on prices. As of this report's preparation, the administration has implemented a 25% tariff on all imported steel and aluminum products, a 25% tariff on all imported cars and auto parts scheduled to begin on May 3, 2025, and 10% tariff on other imported goods with some exceptions.

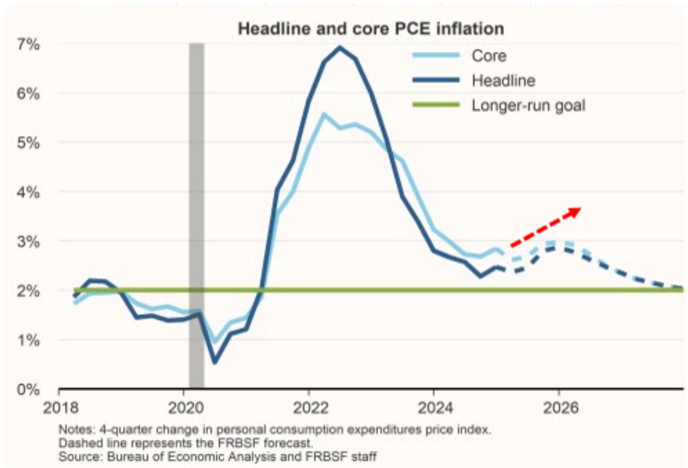
  While the full impact may not be felt immediately, some forecasts estimate inflation could rise to 3% ~ 4% over the next 12 months. These projections are subject to change due to the evolving situation. Elevated inflation is expected to affect the City's budget by increasing personnel costs, capital project costs, and the funds required for vehicle and major equipment replacements. Staff will continue to monitor economic conditions and adjust forecasts as necessary.

Chart 1 – U.S. Real GDP Growth



Data Source: historical data per BEA.gov / various forecasters

Chart 2 – Inflation – PCE Index

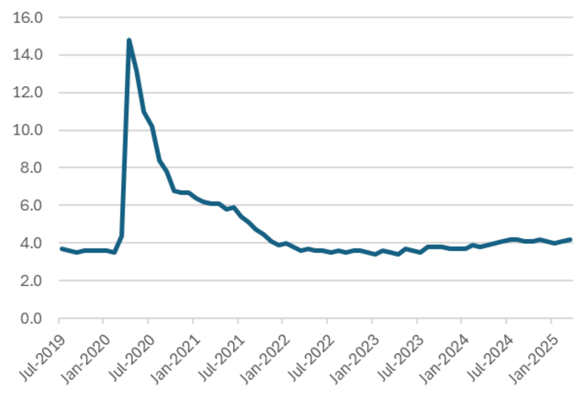


- **Interest Rates:** The Fed kept interest rates unchanged at its March 2025 meeting, emphasizing that it is well-positioned to adjust rates in either direction. While markets are expecting two rate cuts this year, the Fed has maintained a cautious "wait-and-see" stance. Policymakers have indicated they will closely monitor both hard and soft economic data and may delay rate cuts until gaining clearer economic signals.

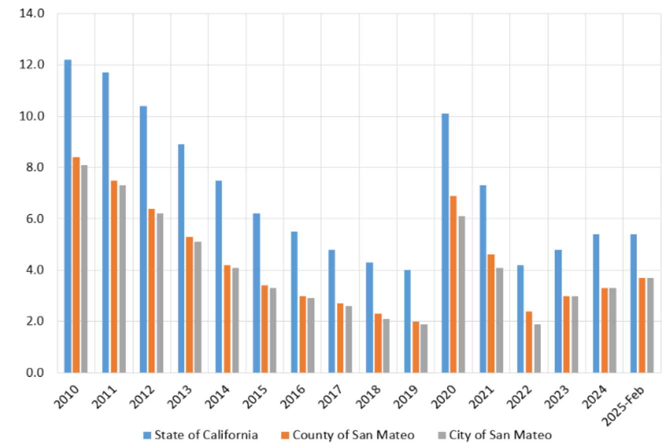
- **Labor Market:** The labor market remains stable, with the national unemployment rate at 4.2%, slightly above the prior year's 4.0%. California's unemployment rate is higher at 5.4%, while San Mateo County continues to outperform both the state and national averages, maintaining a low rate at 3.7% (Charts 3 and 4). Amid all this, there are growing concerns about a weakening labor market, particularly in more vulnerable sectors. However, the Bay Area is positioned as a talent hub for technology and innovation and is expected to support a more stable local job market.

Chart 3 – National Unemployment Rate

Chart 4 – State and Local Unemployment Rates



Data Source: BEA.gov



Data source: EDD

- **Consumer Confidence:** Consumer sentiment has declined sharply in recent months. According to preliminary April 2025 data, the University of Michigan's Consumer Sentiment Index declined to 50.8, a 30% drop from 74 in December 2024 and the lowest since June 2022. This decline reflects consumers' growing concerns about the economic outlook.
- **Business and Investor Sentiment**: Business and investor confidence has weakened in response to recent policy and market developments. Many companies are pausing long-term investment decisions and re-assessing hiring plans. Small businesses tied to global trade have been particularly impacted. In April, financial markets experienced unusual volatility, marked by simultaneous sell-offs in both equity and bond markets -- a rare occurrence that underscores elevated uncertainty and declining investor confidence.

These broader economic indicators, especially those related to interest rates, inflation, the labor market, and consumer and investor sentiment, have direct implications for the City's revenue projections and fiscal outlook. Due to the degree of uncertainty, staff have taken a conservative approach in developing the FY 2025-26 budget.

General Fund Budget Preview

The FY 2025-26 General Fund budget preview reflects a cautious approach in response to both external economic conditions and internal operational needs. Budget assumptions were thoroughly reviewed and updated to reflect the best estimates available. These assumptions are summarized in **Attachment 1** for Council review.

General Fund Revenues

General Fund revenues for FY 2025-26 are projected to be $172.4 million, a decrease of $1.5 million (0.9%) from the FY 2024-25 mid-year projections. The decrease is primarily due to a projected reduction in real property transfer tax (RPTT), which will be budgeted at its baseline level for FY 2025-26. RPTT is highly volatile and closely tied to real estate market activity. In 2024-25, the City benefited from strong Measure CC revenues driven by several major commercial property sales – many were one-time revenues. Reflecting a conservative approach, RPTT is budgeted at a more modest level for the upcoming year. All other major revenues are expected to remain relatively flat.

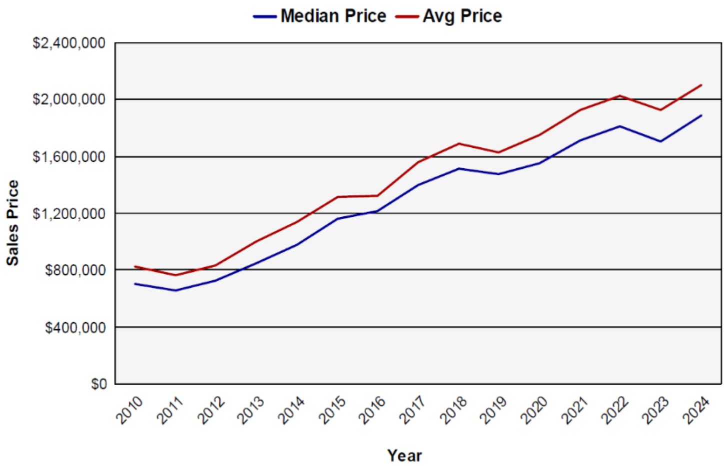
General Fund Revenues (in millions)	2022-23 Actuals	2023-24 Actuals	2024-25 Adopted Budget	2024-25 Mid-Year Projection	2025-26 Budget Preview	Change in $	Change in %
Property Tax	$ 80.6	$ 78.6	$ 84.0	$ 84.0	$ 86.0	$ 2.0	2.4%
Sales Tax	29.6	27.8	30.1	27.9	27.9	-	0.0%
Property Transfer Tax (RPTT)	7.4	8.6	8.0	14.0	8.6	(5.4)	-38.6%
Business License Tax	8.8	8.4	7.8	7.3	8.0	0.7	9.6%
Transient Occupancy Tax (TOT)	6.1	5.3	4.0	4.0	4.0	-	0.0%
Franchises	3.6	3.4	3.4	3.4	3.4	-	0.0%
Golf Fees	3.2	3.7	3.5	3.2	3.3	0.1	3.1%
Recreation Service Charges	3.7	4.0	4.1	4.1	4.7	0.6	14.6%
Permits, Fees, and Fines	8.0	9.4	7.7	7.7	7.7	-	0.0%
Intergovernmental	3.5	3.1	3.4	3.4	3.4	-	0.0%
Interest and Miscellaneous	2.8	11.1	5.0	6.0	6.2	0.2	3.3%
In-Lieu Charges	4.6	4.7	4.9	4.9	5.1	0.2	4.1%
Transfers In from other funds	4.0	4.0	4.1	4.0	4.1	0.1	2.5%
Total General Fund Revenues	**$ 165.9**	**$ 172.1**	**$ 170.0**	**173.9**	**$ 172.4**	**$ (1.5)**	**-0.9%**

Property Tax

Property Tax is the largest revenue source for the General Fund, accounting for approximately 50% of total revenues. For FY 2025-26, property tax revenue is projected at $86 million, an increase of $2 million (2.4%) compared to the 2024-25 mid-year projection. Currently, the local real estate market remains relatively stable. Unlike during the 2008 Great Recession, the housing market is more resilient due to regulatory changes, limited supply, and mortgage refinancing that allowed many homeowners to lock in historically low interest rates.

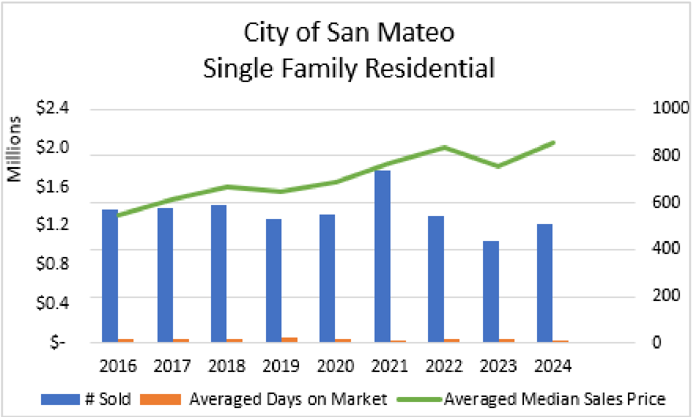
Secured property taxes, which make up over 60% of total property tax revenues, are anticipated to increase 4.0% based on the County Assessor's Office estimated tax roll. Approximately 75% of San Mateo's secured property tax base is residential. As shown in Charts 5 and 6, despite declining sales volume in recent years, home prices in San Mateo remain steady.

Chart 5 – City of San Mateo
Single Family Residential Full Value Sales (2010 - 2024)



Data Source: HdL Coren and Cone / San Mateo County Recorder

Chart 6 – Single Family Residential



Data Source: San Mateo County Association of Realtors
(Note: The Federal Reserve began increasing interest rates in March 2022.)

Two main risk factors continue to impact property tax growth:

(1) **Elevated interest rates** - From FY 2012 through FY 2024, assessed values (AV) grew on average 6.7% annually. Due to high interest rates, AV growth has slowed down in recent years. FY 2023-24 AV growth dropped to 5.5% and followed by 4.8% in FY 2024-25. For FY 2025-26, AV growth is projected to be 4.0%. Despite this slowdown, San

Mateo's central location on the Bay Area peninsula continues to make it a highly desirable place to live and work. Once interest rates begin to ease, market activity is expected to rebound.

(2) **Property tax in-lieu of Vehicle License Fee (VLF) Shortfalls** - As explained in Attachment 2, San Mateo County's VLF shortfalls continue to grow as more school districts are shifting from non-basic-aid to basic-aid status. In FY 2025-26, the City's VLF entitlement is projected to be $17.0 million, of which $7.1 million lacks a funding source, resulting in a projected VLF shortfall. If the State commits to funding its obligations to backfill the shortfall, the City will typically receive this VLF shortfall funding two years later in FY 2027-28 – that's the best-case scenario.

San Mateo County and its cities are actively advocating for the State to backfill the FY 2023-24 VLF shortfalls, of which the City's share is $6.6 million. Due to federal funding cuts and ongoing economic uncertainty, it is becoming less clear the State will backfill the VLF shortfalls. Given this uncertainty, staff has conservatively included 50% of the FY 2023-24 shortfall -- $3.3 million out of the City's $6.6 million shortfall -- in the FY 2025-26 budget. Staff will continue to monitor VLF developments and adjust projections as needed.

Sales Tax
Sales tax is projected to remain flat at $27.9 million, comprising of $20.5 million from the local 1% Bradley-Burns sales tax, $0.4 million from Proposition 172, and $7.0 million from the local ¼% Measure S transaction and use tax. Ongoing inflation, high interest rates, and trade conflicts continue to weigh on consumer spending. While tariffs may trigger a short-term spending surge, the long-term outlook remains uncertain.

San Mateo's sales tax base is relatively diversified, reducing the City's exposure to high-volatility sectors such as auto sales. While the City does not experience rapid growth in sales tax revenue during economic booms, unlike cities with major auto dealership or retail hubs, the City's sales tax tends to be more stable during a downturn.

Real Property Transfer Tax (RPTT)
San Mateo's RPTT is set at 0.5% on sale or transfer value of any property within the City. Voters-approved Measure CC increases the rate to 1.5% on properties sales or transfers of property with a value of $10 million or more. For FY 2025-26, RPTT is projected to be $8.6 million, including $8 million baseline budget and an estimated $0.6 million from Measure CC.

In summary, given the ongoing economic uncertainty, General Fund revenues are expected to remain flat or experience a certain degree of slowing down. The good news is that San Mateo's revenue remains resilient, supported by stable property tax. This provides the City with certain insulation during economic downturns. In addition, the City's strong General Fund reserves place us in a solid position, providing a runway to address the structural deficit.

General Fund Expenditures
Total General Fund expenditures for FY 2025-26 are expected to reach $187.6 million**,** an increase of $7.2 million (4.0%) compared to the prior year's adopted budget.

General Fund Revenues (in millions)	2022-23 Actuals	2023-24 Actuals	2024-25 Adopted Budget	2025-26 Budget Preview	Change in $	Change in %
Personnel Costs:						
Salaries and Wages	$ 48.3	$ 52.8	$ 56.1	$ 57.2	$ 1.1	2.0%
Benefits	19.4	21.0	23.5	24.0	0.5	2.1%
Pension Unfunded Liability (UAL)	11.7	11.4	13.0	13.4	0.4	3.1%
Non-Personnel Operating Expenses	34.8	37.0	40.1	43.0	2.9	7.2%
SMC Fire and Legacy Costs	32.8	34.2	36.1	38.8	2.7	7.5%
Transfers Out	12.5	15.7	11.6	11.2	(0.4)	-3.4%
Total General Fund Expenditures	**$ 159.5**	**$ 172.1**	**$ 180.4**	**$ 187.6**	**$ 7.2**	**4.0%**

Personnel Costs

Personnel costs are projected at $94.7 million, consisting of salaries, benefits, and pension unfunded liability payments. This reflects a 2.3% increase over the prior year and accounts for approximately half of the General Fund budget. When including SMC Fire's personnel and legacy costs, total personnel-related costs represent 70% of the General Fund budget.

For FY 2025-26, staff adopted a conservative approach to planning the personnel budget. In addition to incorporating salary adjustments based on negotiated labor contracts and scheduled step increases, staff applied tailored vacancy assumptions to support a leaner budget model. Other budget-balancing measures include reducing the set-aside for the City's self-insured Workers' Compensation Program by $1.5 million, drawing down on excess fund balance from the Workers' Compensation Fund, and monitoring CIP staff time chargebacks to reduce General Fund burden by $1 million. Without these measures, the General Fund personnel budget would have shown close to 5.0% increase instead.

Recent market volatility also affected the investment performance of the CalPERS pension system. As of April 11, 2025, preliminary data showed CalPERS' year-to-date investment return at 2.9%, raising concerns that it may fall short of its long-term return rate of 6.8%. If CalPERS misses its earnings target, the City's unfunded pension liabilities will increase, along with future annual pension contribution requirements. This will not affect the FY 2025-26 pension costs, but it could place additional pressure on the City's long-term financial outlook.

Other Operating Expenditures

- Non-personnel operating expenditure is projected to be $43.0 million, increased by $2.9 million (7.2%). This reflects preliminary baseline budget projections, with inflation adjustments, and increases in insurance premiums.
- Transfers out, anticipated to be $11.2 million, comprising of $7.7 million contributions to Capital Project Funds for CIP projects, $3.0 million for debt service, and $0.4 million annual contribution to the Equipment and Vehicle Replacement Fund for major building component replacement.

Budget Deficit and Financial Sustainability Plan

With projected revenues at $172.4 million and expenditures at $187.6 million, General Fund is facing a $15.2 million budget deficit in FY 2025-26.

To address this gap, staff are actively working on a Financial Sustainability Plan with measurable actions to reduce the deficit and improve the City's long-term financial health. The following are actions that have been implemented or are underway as part of the initial phase of the Financial Sustainability Plan:

- **Grant Funding Strategy:** Engaged a citywide grant writing consultant and established a cross-departmental grant management team to proactively pursue and manage grant funding opportunities.
- **Reserve Policy Review:** Completed a comprehensive review of the General Fund Reserve Policy to improve structure, better align with best practices, and create a dedicated Capital Investment Reserve for future infrastructure needs.
- **Cost Recovery Enhancements:**
  - Completed a cost recovery study for the Recreation Division and updated the Parks & Recreation fee schedule, effective FY 2025-26.
  - Monitored capital project (CIP) staff time chargebacks, aiming to reduce General Fund burden by an estimated $1 million in FY 2025-26.
- **Use Excess Set-Aside Fund for Budget Stabilization:** The City is self-insured for its Workers' Compensation Insurance Program. A recent review of the Workers' Comp Fund identified approximately $6 million in excess reserves. These funds are being used to temporarily reduce internal charge to city operating funds over the next three years, resulting in an estimated $1.5 million savings for the General Fund in FY 2025-26. This is a short-term strategy to support budget stability but does not address the underlying structural deficit issue.
- **Economic Development Work Plan/Action Plan**: A new Economic Development Work Plan/Action Plan is in

development and will be presented to Council soon in late summer or fall. This plan is to attract and retain businesses and build a strong economic base for San Mateo.

- **Contingency Planning**: Staff are working on a contingency plan -- initial steps include reducing non-essential discretionary spending and implementing a hiring freeze on non-essential positions. The goal is to minimize disruption to city services. If conditions worsen, further actions such as service level reductions and deferring capital projects may be needed.
- **Exploration of 2026 Revenue Measure options:** To fund city services at the current levels and continue investing in infrastructures and city facilities, the City will need to explore potential 2026 revenue measure options. A sustainable and reliable revenue source will be critical to support the City's ongoing service delivery.

While General Fund reserves remain strong, long-term forecasts show that costs, particularly staffing costs and capital improvement needs, are rising faster than revenues. To address funding issues, the City will need to find ways to grow its revenues and continue making thoughtful spending decisions to sustain services and maintain the City's long-term financial health.

NEXT STEP:

Any feedback and direction received from the Council as a result of this report and supporting presentation will be incorporated into the FY 2025-26 proposed budget and corresponding long-term financial plan. Staff anticipate delivering the budget to the City Council with a public hearing and budget adoption in June.

BUDGET IMPACT:

There is no direct budgetary impact resulting from this report. The financial status of the General Fund will continue to be monitored. Updated final estimates will be incorporated into the proposed 2025-26 operating budget.

ENVIRONMENTAL DETERMINATION:

This report is not a project subject to CEQA, because it is a government fiscal activity which does not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment. (CEQA Guidelines Section 15378(b)(4).)

NOTICE PROVIDED

All meeting noticing requirements were met.

ATTACHMENTS

Att 1 – FY 2025-26 General Fund Budget Assumptions
Att 2 – Conceptual Overview of the VLF shortfall in San Mateo County

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