CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: David Sykes

SUBJECT: **ESTIMATED BUDGET IMPACTS OF COVID-19**

DATE: April 3, 2020

RECOMMENDATION

Accept a report from the City Manager describing estimated budgetary impacts from COVID-19 and the approach for how those impacts will be addressed in Fiscal Years 2019-2020 and 2020-2021.

OUTCOME

This report discusses the Administration's current evaluation of how the COVID-19 pandemic will likely impact the City's budget for 2019-2020 and 2020-2021, and how the Administration will approach the task of maintaining and developing balanced budgets given these very difficult and dynamic circumstances.

BACKGROUND

In compliance with City Charter Section 1204 and the City Council's Adopted Budget process, the Administration published the 2020-2021 City Manager's Budget Request and 2021-2025 Five-Year Forecast (Forecast) on March 2, 2020. The Forecast provided revenue projections for the General Fund and elements of the Capital Improvement Program, and estimated a very small General Fund surplus of $0.5 million for 2020-2021. During the last week of February, as the Forecast publication was being finalized, the initial impacts of COVID-19 were just beginning to be felt, as domestic and global financial markets began their steep drop and major convention and conference cancelations were announced. As noted in the Forecast's transmittal memorandum, the Administration would closely monitor the events associated with COVID-19 to measure their impact as part of the 2020-2021 Proposed Budget process.

On March 6, 2020, the Mayor released the Mayor's March Budget Message for Fiscal Year 2020-2021. Even during the short period between release of the Forecast and the March Budget Message, it was clear that COVID-19 would have a substantial impact on the City's overall budget, especially the City's General Fund. The Mayor outlined a three tier strategy, focusing on fiscal resilience to position the City to better weather a future downturn, the allocation of

Measure E real property transfer tax revenues for affordable housing and homelessness prevention as previously intentioned by the City Council, and a third tier whereby General Funded allocations are contingent upon major improvement from the increasing likely scenario that COVID-19 would negatively impact the City's budgetary outlook in a substantial way. As discussed at the City Council meeting on March 17, 2020 as part of the Mayor's March Budget Message approval, the shelter-in-place order issued by the Public Health Official for the County of Santa Clara that extends through April – and similar measures undertaken by much of the United States and elsewhere around the world – has fundamentally impacted daily economic activity and will have a negative impact on the City's revenues.

Given the unprecedented, dynamic nature of this pandemic and the necessary response to protect community health and safety, estimating its impact on the City's budget is difficult. However, to engage the City Council on the potential impacts and prepare the organization for the coming difficult choices, this report attempts to quantify the budgetary impacts to the City and describe the Administration's approach for addressing those impacts in the budget development process.

Discussion of federal and state disaster relief and stimulus funding are important resources for the City to draw upon, and are discussed in a separate information memorandum scheduled for release prior to the April 7, 2020 City Council meeting. For initial planning purposes, the Administration expects that a majority of the City's direct costs to respond to the COVID-19 will be reimbursed; however, the exact timing and scope of the reimbursements are not yet defined and could cross fiscal years, further complicating budgetary impact analysis. This memorandum discusses the impact of the lost revenue, for which disaster funding is not currently available and the City should be prepared to resolve.

ANALYSIS

Forecast Changes and Revenue Impacts

The spread and global impact of the COVID-19 pandemic accelerated rapidly during March. Though much of this memorandum focuses on direct local impacts, the widespread impacts are affecting the global economy. The County of Santa Clara and much of the Bay Area instituted a shelter-in-place order effective March 17th, followed shortly thereafter by a similar order from the Governor of California. Most of the United States is currently observing some form of suppressed daily activity to limit COVID-19's spread. The County's shelter-in-place order was recently extended to May 3rd, and could continue further. To comply with the order, a significant portion of economic activity is suspended – residents and businesses are impacted, and job losses will likely continue to mount.

Though conditions are evolving, at this moment, the Administration is evaluating the impact to City revenues assuming that the steep decline of economic activity as a result of the COVID-19 pandemic will generally continue through the end of the fiscal year. As restrictions lift toward the end of the fiscal year, the resumption of normal economic activity is anticipated to be slow, resulting in recessionary conditions through at least the first half of 2020-2021.

Reflective of the swift change in economic conditions, Consumer Confidence declined sharply in March. Lynn Franco, Senior Director of Economic Indicators at The Conference Board stated "*March's decline in confidence is more in line with a severe contraction – rather than a temporary shock – and further declines are sure to follow*." Further, as reported by the State of California Employment Development Department, the demand for unemployment benefits in California has reached historic levels due to the impacts of COVID-19 on the State's economy, and reports of unemployment figures and job losses point to near-term steep economic declines. While all signs point to the United States beginning a recession, it is unclear how deep and how long the recession will last. However, the activist role currently being played by the federal government to provide disaster relief and economic assistance is expected to continue, which may help limit the potential for long-lasting and deep recession.

Though based on thoughtful internal analysis and in consultation with other economists and forecasts, the revised revenue estimates described below are still preliminary, will likely change prior to release of the Proposed Budget at the beginning of May, and are based on very little hard data and untested economic models. Whereas normally the Administration can apply existing revenue trends to well-sourced economic models to extrapolate forecasts, the existing revenue trends through February is not representative of current or future conditions, and validated economic models to mimic these conditions do not exist. It is also important to note that detailed information from the City's largest economically sensitive revenue category, Sales Tax, is provided by the State only on a quarterly basis; revenue data for January through March will not be received until May, and revenue data for April through June will not be received until August. As a result, the true fiscal impact of COVID-19 on 2019-2020 will not be known for several months. On a positive note, however, Property Tax revenue (the largest revenue source for San Jose, representing approximately 1/3 of total General Fund revenue) is not anticipated to be significantly impacted in the current fiscal year or 2020-2021, though revenue related to the Education Augmentation Fund (ERAF) will likely be lower. However, the impacts to Property Tax will be felt in the following years beginning in 2021-2022. Property Tax revenue will continue to be monitored and analyzed in conjunction with the County of Santa Clara.

General Fund revenue sources with the largest impact as a result of the COVID-19 pandemic are summarized below in Table 1. As mentioned above, the impacts of the pandemic are fluid and these revenue estimates are continuously being analyzed and revised for both the current fiscal year and 2020-2021. It is important to note that if the shelter-in-place order continues through the summer, or if necessary stimulus efforts are not provided, the revenues forecast described in this memorandum would worsen. Updated information for all General Fund revenue sources will be provided as part of the 2020-2021 Proposed Budget, which will be released in early May.

Table 1 – Significant General Fund Revenue Impacts for 2019-2020 and 2020-2021 ($ Million)

Revenue Category	2019-20 Budgeted Estimate	2019-20 Estimated Revenue Shortfall	% Change From 2018-19 Actuals		2020-21 Feb. Forecast Estimate	2020-21 Estimated Revenue Shortfall	% Change From Revised 2019-20 Estimate
Property Tax	$367.6	$0	11%		$376.3	($3.5)	1%
Revenue Assumptions:	General Secured Property Tax revenue (which makes up over 90% of the category) for 2019-2020 and 2020-2021 are based on property values as of January 1, 2019 and January 1, 2020, respectively. Therefore, any impact the shelter-in-place mandate and the ensuing recession has on the local real estate market will not be significantly felt until 2021-2022. However, a slight loss of revenue ($3.5M) is anticipated in 2020-2021 due to reduced excess ERAF (on top of previously reduced estimates) and lower Unsecured Property Tax receipts.						
Sales Tax	$261.5	($27.0)	(11%)		$267.7	($41.0)	(2%)
Revenue Assumptions:	The shelter-in-place mandate impacts almost all sectors of Sales Tax revenue, including retail sales, construction, transportation, and business-to-business. As the mandate is lifted, recessionary conditions are forecasted and weak revenue collections are anticipated to continue. High unemployment levels will also continue to impact Sales Tax revenue. Year-over-year drop of 11% is anticipated to occur in 2019-2020 and another 2% in 2020-2021. This estimate does not take into account the State's recent actions related to deferral of sales tax payments from small businesses; the Administration is currently evaluating that potential impact.						
Transient Occupancy Tax	$20.2	($7.2)	(37%)		$20.8	($5.8)	15%
Revenue Assumptions:	Cancelled events through the end of the 2019-2020, the shelter-in-place mandate, and declines in business-related travel results in anticipated significant year-over-year declines for 2019-2020 (37%). Activity from mid-March through June is estimated at only 15% occupancy. Activity is anticipated to recover in 2020-2021 with revenues growing to $15 million, but is anticipated to remain well below the estimate assumed in the February Forecast of $20.8 million.						
Business Taxes	$77.0	($6)	(5%)		$77.9	($7)	(0%)
Revenue Assumptions:	Business Tax revenue comprises General Business, Cardroom, Cannabis Business, and Disposal Facility Taxes. During the shelter-in-place, Cardrooms are not open and Cannabis dispensaries have limited operations. In addition, many businesses are being financially affected, which will likely impact the receipt of General Business Tax receipts. In 2019-2020, Business Taxes are anticipated to receive approximately $71 million, compared to the February Forecast of $77 million. In 2020-2021 Cardroom and Cannabis Business Taxes are anticipated to modestly grow from 2019-2020 levels; however, General Business Tax and Disposal Facility Tax revenue remain impacted.						
Utility Tax	$95.3	($2)	(5%)		$96.4	($2.7)	(0%)
Revenue Assumptions:	Utility Tax revenue consist of Electric, Gas, Water, and Telephone Utility Taxes. During the shelter-in-place mandate, a substantial number of businesses are not open, which decreases utility usage; however, more residents are home, which helps increase usage. Estimates for both 2019-2020 and 2020-2021 are approximately $94 million, which are below previous Forecast estimates.						

As of this writing, with the limited amount of information available, the collective revenue shortfall is estimated at $45 million in 2019-2020 and $65 million in 2020-2021. Instead of being viewed as a definitive forecast, these figures should instead be used as a gauge for the level of significance the City will face over the next two years in balancing the budget. While the revenue shortfall could be slightly lower, it could also be substantially higher than the current analysis by tens of millions of dollars. The City will need to engage in thoughtful decision-making to resolve these significant shortfalls during these unprecedented times.

It is also important to note that the shortfall figure does not yet take into any other considerations related to expenditures, including retirement contributions. The Federated and Police and Fire Retirement Boards previously approved contribution rates and amounts for 2020-2021 based on actuarial valuations from 2018-2019. The Administration does not anticipate any changes in contribution levels for 2020-2021, which would be extremely problematic at this late stage, but is prepared to expect large increases for 2021-2022.

Approach to Addressing the General Fund Revenue Shortfall in 2019-2020

Before addressing next year's budget deficit, the City will need to quickly take steps to resolve the anticipated shortfall in the current year. The Administration intends to return later in April to recommend the following actions.

1. ***Reduce or eliminate existing expenditure appropriations***. The Administration issued a memorandum to Senior Staff on March 27, 2020 directing the immediate implementation of a variety of cost control measures, including a hiring freeze on all positions except for Police Department and Fire Department sworn and emergency communications positions, suspension of City-Wide Expenses and General Fund Capital Projects not yet started, and the minimizing of all non-COVID-19-related non-personal/equipment expenditures. The Administration will evaluate the potential cost savings generated by these measures and recommend associated reduction actions to partially offset reduced revenue levels.

2. ***Recognize proceeds from Revenue Capture Agreement with eBay***. Another critical rebalancing tool will be the Revenue Capture Agreement with eBay approved by the City Council on September 24, 2019 that went into effect on October 1, 2020. After analyzing the February disbursement of sales and use tax proceeds from the California Department of Tax and Finance Administration (CDTFA) covering the period of October through December, the Administration has confirmed that the disbursement included sales tax proceeds from eBay and that the revenue can now be considered ongoing. For 2019-2020, net revenues to the City from the agreement with eBay are expected to range from $15 million to $20 million, and are not yet reflected in the table above.

3. ***Evaluate use of reserves***. The Administration continues to assess whether the combination of cost control measures and resources from the Revenue Capture Agreement will address the 2019-2020 revenue shortfall without drawing down the

Budget Stabilization Reserve. However, use of the Budget Stabilization Reserve will likely be necessary as part of 2020-2021 budget balancing actions, and a portion may even be necessary in 2019-2020 to rebalance the current year budget.

Approach to Balancing the Budget in 2020-2021

To balance the 2020-2021 Budget, the Administration will initiate a responsible downsizing that considers a wide range of opportunities and circumstances, minimizes layoffs and reductions to community-facing programs, and acknowledges that a baseline level of strategic support infrastructure is necessary to preserve capacity for service delivery. The strategy will be mindful of organizational impacts associated with position placement and bumping that may result from layoffs. The Administration also recognizes that the impacts of service level reductions result in uneven impacts on our community – considerations of equity will be a necessary component of budgetary decision-making.

Considering the late timing and the City's current focus on maintaining essential services and responding to COVID-19 impacts - as well as the uncertainty as to the length of the recession - the Administration will solve the 2020-2021 anticipated revenue shortfall through a combination of ongoing and one-time means as summarized below.

- ***Pay down debt.*** As described in the Mayor's March Budget Message, as approved by the City Council, the refunding of outstanding City Hall lease-revenue bonds is anticipated to provide reductions in ongoing debt service costs.
- ***Revenue Capture Agreement***. As discussed above, the estimated Sales Tax revenue received by the City from its Revenue Capture Agreement with eBay may be a source of new ongoing revenue. The annual amount of revenue, given the current economic conditions, is still under evaluation.
- ***Implement ongoing service level reductions***. A portion of the shortfall will need to be resolved through the reduction, elimination, and reprioritization of services. While every effort will be taken to avoid layoffs, a certain number of positions will need to be eliminated.
- ***Implement cost containment plans to achieve ongoing savings***. Due to the shortened timeframe and reduced capacity resulting from COVID-19 response, the Administration will likely not be able to identify all the service level reductions necessary to reduce ongoing expenditures. As a result, the City will also likely need to implement cost containment plans that reduce departmental/office budgets through actions such as hiring freezes and non-personal/equipment reductions. The Administration will return to the City Council in August or September to identify the specific ongoing actions necessary, such as position eliminations and service reductions, to achieve the cost containment plans.
- ***Eliminating most 2019-2020 one-time funded items***. The 2019-2020 Adopted Budget included a large amount of one-time funding for services and activities categorized as one-time, even though many of these items could be considered as ongoing due to the fact that they have been funded on a one-time basis for multiple years. It is important to

note that many of these activities will not receive funding in 2020-2021 given the serious revenue shortfall anticipated.

- ***Utilizing the Budget Stabilization Reserve, the 2020-2021 Future Deficit Reserve, and other one-time sources***. The Budget Stabilization Reserve currently stands at $32 million, and the 2020-2021 Future Deficit Reserve stands at $10.9 million. The Administration will recommend using a significant portion of these reserves – as well as other one-time revenue sources that may be available – to offset the level of ongoing service impacts that would otherwise be required.

Special and Capital Fund Impacts

In addition to the General Fund, the economic impacts from COVID-19 will affect a variety of other City revenue streams. The anticipated impacts to several major special fund and capital fund revenues are described below:

- ***Airport Funds.*** Prior to the arrival of COVID-19, Airport passenger and revenue activities were strong. Though March passenger data is not yet available, the Airport anticipates significant reductions and has implemented cost containment measures for 2019-2020 to generate approximately $10.0 million or 11% of operating expenditures savings. Debt payment obligations will not be affected; all debt service payments for this fiscal year have been made. For 2020-2021, Airport staff met with the airlines who agreed to delay the 2020-2021 calculation of Airline Rates and Charges from April 29, 2020 to May 27, 2020 in order to ensure Airport has sufficient time to recalculate and revise revenue and expenditure projections for 2020-2021. Further, the Department will defer $18.6 million or 19% of capital program expenditures until 2020-2021, until such time that the Airport can better evaluate their overall capital improvement program.

  The federal government stimulus package available for the airport sector of the economy includes $10.0 billion to prevent, prepare for, and respond to COVID-19, which could fund the Airport's local share match of Airport Improvement Program (AIP) grant projects currently funded ($500.0 million available) and provide general support of airport operations ($7.4 billion available). An additional allocation of $2.0 billion is available to be distributed through the AIP entitlement formula; these funds may be used to support new additional grant projects not currently awarded. The federal government has also made available $500 billion of direct lending funds as part of the Economic Stabilization for Impacted Sectors to support passenger air carriers ($25.0 billion) and cargo air carriers ($4.0 billion). Receipt of these funds by airports or airlines will be conditioned on the requirement that at least 90% of the recipient's workforce maintain employment.

- ***Transient Occupancy Tax (TOT) Fund, Convention and Cultural Affairs Fund, and the Convention Center Facilities District Revenue (CCFD) Fund***. The City's Transient Occupancy Tax rate is 10%, of which 4% is allocated to the General Fund and 6% is allocated to the TOT Fund, which in turn allocates funding to support the Cultural Grants Program, the Convention and Visitors' Bureau, and Team San Jose's operation and maintenance of the Convention Center and other cultural facilities. Revenues in the TOT Fund are now estimated to decrease by $10.5 million in 2019-2020 and $8.6 million in 2020-2021. These shortfalls will significantly impact cultural art grants and programming, as well as Team San Jose operations and facility capital improvements. Event cancellations at cultural facilities and the Convention Center are additionally projected to increase operations subsidy levels of the management of these facilities, as the losses from operating revenues are anticipated to exceed the near-term capacity to contain and reduce costs during the final quarter of the 2019-2020. The Administration will continue to collaborate closely with Team San Jose and community-based organization stakeholders for cultural grant programs to effectively manage these reductions to available resources. Within the CCFD fund, previously planned capital improvements will be curtailed to allow for continued payment of debt obligations.

- ***Development Fee Program Funds***. Previously contained within the General Fund as a cost recovery program, in 2020-2021 the Development Fee Programs – consisting of Building, Planning, Citywide Planning, Fire, and Public Works – are reallocated into individual special funds for improve transparency and financial and budgetary administration. Given the forecasted economic conditions and shelter-in-place order, activity levels and anticipated fee revenues will experience a significant drop in activity for the remainder of 2019-2020 and remain at lower levels into 2020-2021. Staff is continuing to evaluate the potential revenue shortfalls for the remainder of 2019-2020, and are assuming at least a 30% activity drop in 2020-2021 from previous estimates. Though the programs are cost recovery with no net impact to the General Fund, costs will be closely evaluated and potentially reduced to align with anticipated revenues and reserve levels.

- ***Construction and Conveyance (C&C) Tax Funds***. Over 99% of the total C&C Tax are comprised of conveyance receipts, a tax based on the value of property transfers (sales). Real estate activity is anticipated to drop over the next year, which will directly impact this tax. During the shelter-in-place order, there is anticipated to be little or no movement in the real estate market; and as the restrictions are lifted it is anticipated that the real estate market will be sluggish due to higher unemployment coupled with lower anticipated consumer confidence. C&C receipts are typically received for real estate activity that occurred 30-90 days prior. Due to strong year-to-date performance, it is anticipated that 2019-2020 revenue will meet the current year estimated level of $38 million. However, the impact of the real estate slow-down beginning in March will be felt in the 2020-2021 tax receipts. The original Forecast was built on the assumption that tax receipts would total $36 million in 2020-2021 and remain at that level through 2021-2025, but now receipts are estimated to fall to $30 million, fall again to $26 million in 2021-2022, and rise to $34 million from 2022-2023 through 2024-2025. The lower receipts will significantly impact many of the City's budgeted Capital programs including the Parks and Community Facilities Development, Library, Public Safety, Service Yards and Communications.

- ***Construction Excise Tax.*** The Construction Excise Tax – one of the major revenue streams for the Traffic Capital Program – is imposed upon the construction, alteration, repair or improvement of any building or structure that is for residential or commercial purposes, or is associated with a mobile home. Prior to the increased level of restrictions issued by the County on March 31 and given strong activity year-to-date, it is anticipated that the 2019-2020 revenues of $19 million would fall slightly below the budgeted level of $20 million. However, this revenue drop may need to be revised lower. The original Forecast assumed revenues would remain flat at $20 million annually starting in 2020-2021. Revised assumptions assume a 26% drop in 2020-2021 to $14 million, another 7% drop to $13 million in 2021-2022, and then increasing to $17 million in 2022-2023 and remaining flat.

Community and Employee Engagement

Communication to our community and employees as we engage in difficult budgetary decisions will be both an important focus and challenge. The City is engaged in extraordinary efforts to maintain critical services while appropriately responding to COVID-19 impacts. Our residents and businesses are under enormous financial pressures of their own as we all take actions to slow the virus' spread. The Administration will work to implement a communication plan that takes these challenges into account, including the solicitation of employee and community input, as well as City Council budget study sessions whose formats will need to change. More information regarding these engagement efforts, along with a revised budget development calendar, will be released as soon as possible

EVALUATION AND FOLLOW-UP

The economic and budgetary impacts related to the COVID-19 pandemic are evolving daily, and the Administration will continue to analyze those impacts for both the current fiscal year and 2020-2021. The 2020-2021 Proposed Budget is now anticipated to be released May 8th, approximately a week later than previously anticipated, and will include updated information (as available) related to the revenue impacts resulting from the pandemic, and proposed budget adjustments to address the anticipated revenue shortfall in 2019-2020 and 2020-2021. A revised budget development calendar will be forthcoming.

CLIMATE SMART SAN JOSE

The recommendation in this memo does not have any negative impact on Climate Smart San Jose energy, water, or mobility goals.

PUBLIC OUTREACH

This memorandum will be posted on the City's website for the April 7, 2020, Council agenda.

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

COMMISSION RECOMMENDATION/INPUT

This item does not require any input from a board or commission.

CEQA

Not a Project, File No. PP17-004, Government Funding Mechanism or Fiscal Activity with no commitment to a special project which may result in a potentially significant physical impact on the environment.

David Sykes
City Manager

For questions please contact Jim Shannon, Budget Director, at (408) 535-8142.