



City of Palo Alto

City Council Staff Report

(ID # 11315)

Report Type: Action Items

Meeting Date: 5/4/2020

Summary Title: Potential Financial Scenarios due to the Current COVID-19 Emergency

Title: Review of the Potential Financial Scenarios due to the Current COVID-19 Emergency and Direction to Staff on the Continued Development of the FY 2021 Budget

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends that the City Council select a financial scenario to be used for planning and issuance of the FY 2021 revised operating and capital budgets to be considered by the City Council during their budget deliberations beginning May 11, 2020.

Background

In light of the disruptions caused by novel coronavirus (COVID-19), staff has been working with the City Council on a modified budget process for the development of the FY 2021 proposed operating and capital budgets. Based on the approved action by the City Council on March 23, 2020, [CMR #11208](#), and in accordance with the City Charter, staff provided a baseline budget on April 20, 2020 for both the operating and capital budgets. At the time of the development of the FY 2021 budget, the world is grappling with COVID-19, a global pandemic. The financial implications of this public health emergency are significant, with regional, national and global impacts on economies in response to shelter in place orders required by the State of California and the County of Santa Clara and related social distancing restrictions.

On March 12, 2020 the City Manager, acting as the Director of Emergency Services, issued a Proclamation of Local Emergency regarding the presence and community spread of COVID-19 in Santa Clara County and our region. On Sunday, March 15, 2020, the City Manager activated the Emergency Operations Center (EOC) and since that time, the City has managed the EOC virtually through a cross-functional multi-departmental team. On March 16, 2020, the City Council ratified the Proclamation of Local Emergency.

The proposed budgets released in April reflect the cost of current service levels recalculated to FY 2021 rates and limited adjustments and were in response to City Council direction to be used

as baseline for further Council deliberations. The capital budget was updated with current cost estimates of projects based on engineering designs and only adds limited new projects for urgent health and safety needs. Despite reflecting most recent figures, the release of the proposed budgets revenue estimates contained in these budgets were released knowing that the revenue estimates would need to be revised and additional work would be needed to balance the budgets reflecting the current public health emergency.

Discussion

While mindful of the unprecedented circumstances in front of us as a City, this staff report provides additional details to inform the City Council and to gain further direction for staff to return with revised proposed budgets for consideration beginning on May 11. The scenarios outlined in this staff report reflect the tough budget decisions ahead of us.

Depending on the length and depth of this current public health emergency, the severity of the financial ramifications remain unknown. In the General Fund, staff provided an estimate that major General Fund taxes would decline at minimum by \$20.0 million in FY 2021 compared to the estimates carried in the baseline budget. Based on revised information, potential timelines and State criteria developed for the lifting of the shelter in place order, staff has provided two scenarios for the City Council to discuss and provide guidance to staff on which scenario to use to prepare the FY 2021 Proposed Budget. Inevitably, the scenario chosen will directly correlate with the level of service impacts that may be felt. Ultimately it is estimated that the City may face between a \$20 million and \$39 million loss in major tax revenues during the next fiscal year. Staff anticipates revenues will fall somewhere between these two scenarios. As federal, state, and local agencies gain more clarity of the financial implications of this public health emergency, staff will update Council and recommend additional options or adjustments, as needed.

High-level Scenarios

Scenario A: This scenario originally looked at what a natural disaster may look like, what some refer to as a “V” economic recovery where there is a precipitous reduction due to typically physical event such as a hurricane, and once the event has passed, a quick recovery is seen. This scenario has been removed as an option to consider at this point as the shelter in place period continues to be extended and this is unlikely to be a viable model.

Scenario B: This scenario assumes a shelter in place order through this spring/early summer, with an economic recessionary period slowing growth once the order is lifted. This scenario also reflects impacts related to longer term social distancing requirements to continue.

Scenario C: This scenario assumes a shelter in place order through the winter, with an economic recessionary period dampening the growth once the order is lifted. This reflects a much slower recovery as the lifting of the shelter in place order is approached in phases through the calendar year.

Major Tax Revenue Assumptions and Related Financial Scenario Impacts

The table below provides a summary of major tax revenue for the City of Palo Alto including both historical and projected collections. Of note, the FY 2020 modified budget reflects the revenue estimates as approved by the City Council in the FY 2020 Mid-Year Budget Review, approved on March 2, 2020, and reflects revenue estimates prior to the COVID-19 emergency. Staff expects the FY 2020 General Fund budget to see significant losses, projecting a deficit of \$20 million in the General Fund in FY 2020. The FY 2021 Proposed Budget reflects the baseline revenue estimates published in the April 20, 2020 budget documents. These, as discussed earlier, reflect estimates prior to the COVID-19 emergency and are provided to assist in articulating the magnitude of the estimated revenue losses and specifically the impact on the FY 2021 budget proceedings that the Council will continue on May 11, 2020. Details on the revenue assumptions behind these scenarios follows the table.

The table also highlights staff assumptions related to tax revenue based on Scenario B and Scenario C impacts. Scenario B includes a \$20 million shortfall with an additional \$4.3 million impact to the General Fund CIP due to TOT losses. Scenario C includes a \$38.7 million shortfall with an additional \$9.2 million impact to the General Fund CIP due to TOT losses.

	FY 2018 Actuals	FY 2019 Actuals	FY 2020		FY 2021 Proposed 4/20/2020	Scenario B			Scenario C		
			Modified Budget 2/20/2020	FY 2021 Proposed 4/20/2020		FY 2021 Scenario B	chn ^g vs FY20	chn ^g vs FY21	FY 2021 Scenario C	chn ^g vs FY20	chn ^g vs FY21
Property Taxes	\$ 42,839,330	\$ 47,327,394	\$ 50,576,000	\$ 52,863,000	\$ 52,600,000	4%	0%	\$ 52,000,000	3%	-2%	
Sales Taxes	\$ 31,091,158	\$ 36,507,728	\$ 36,085,000	\$ 37,605,000	\$ 26,500,000	-27%	-30%	\$ 20,500,000	-43%	-45%	
Transient Occupancy Tax	\$ 24,937,066	\$ 25,648,696	\$ 26,554,853	\$ 29,689,000	\$ 23,800,000	-10%	-20%	\$ 14,900,000	-44%	-50%	
Utility Users Tax	\$ 15,414,275	\$ 16,402,044	\$ 17,572,071	\$ 17,553,000	\$ 16,000,000	-9%	-9%	\$ 15,100,000	-14%	-14%	
Documentary Transfer Tax	\$ 9,228,905	\$ 6,922,609	\$ 8,100,292	\$ 8,016,000	\$ 5,600,000	-31%	-30%	\$ 4,700,000	-42%	-41%	
Return on Investments	\$ 1,436,979	\$ 2,018,018	\$ 1,388,100	\$ 1,367,700	\$ 1,300,000	-6%	-5%	\$ 1,100,000	-21%	-20%	
Subtotal Major Tax Revenues	\$ 124,947,713	\$ 134,826,488	\$ 140,276,316	\$ 147,093,700	\$ 125,800,000	-10%	-14%	\$ 108,300,000	-23%	-26%	
Change from FY 2021 Proposed					\$ (21,293,700)			\$ (38,793,700)			
Estimated Impact to General Fund CIP due to TOT loss					\$ (4,539,000)			\$ (8,455,000)			

Scenario B assumes a shelter in place order through this spring/early summer, with an economic recessionary period dampening the growth once the order is lifted. As such, it is expected in this scenario, once the shelter in place order lifted, that as soon as June, businesses would be able to re-open and movement within society would be able to begin at some level. People would be able to return to economic engines such as the downtown core, California Avenue, and Stanford Shopping Center to support local restaurants and retail establishments. Both limited business and visitor travel would resume to some level allowing for increased activity in our hotel occupancy levels, restaurants, and retail. These activities, although sluggish compared to levels prior to COVID-19, would allow for some revenue collection through Sales Tax and Transient Occupancy Taxes during the beginning of FY 2021, with continued slow growth through the end of FY 2021. Due to the timing of property tax assessments and the tax cycle, a delay in impacts to the City's revenues are expected and assumed in this scenario.

Scenario C assumes a shelter in place order with a very slow phased lifting of that order through the calendar year. This would result in continued restrictions on travel and other related

impacts as a result of social distancing, continued closure of populous locations and local economic engines such as the downtown core, California Avenue, and Stanford Shopping Center and other related business activities remain significantly impacted during this timeframe. Once the shelter in place order is eventually lifted halfway through the year, following in 2021, recessionary levels of activity would continue with long-term constrains on discretionary spending of both businesses and consumers alike. This scenario is a very pessimistic protracted shelter in place and would result in significant extended closure of many “non-essential” businesses. This is likely too pessimistic and should be considered as an extreme level of impact. This is evidenced by the recent news as of April 29, 2020, referenced later in this report, where the County is beginning to ease some restrictions already.

Not included in either of these scenarios are the additional factors that may have both a positive or negative impact on these scenarios. For example, these do not assume changes in licenses and fees for services from recreation and educational classes, to regulatory fees for activities such as construction. Staff expects to monitor these cost recovery activities and adjust both revenues and expenses to maintain cost recovery levels depending on the activity levels. With the recent April 29, 2020 announcement by the Santa Clara County Public Health Officer easing certain economic restrictions associated with the revised Shelter in Place Order beginning on May 4, it is anticipated that construction will begin to rebound quicker than the current assumptions outlined in both Scenario B and C. Lastly, preliminary figures from CalPERS reflect that original expected investment returns will not be met this year. CalPERS is currently hovering around -1 percent to +1 percent in investment earnings. It is expected that the impacts to CalPERS’ investment portfolio will materialize in the City's FY 2022-2023 retirement rates and continue through a 20-year period.

Budget Balancing Options for Consideration

In conclusion, the City Council has several options to consider on how to continue to address the financial impacts of COVID-19 and proactively plan for a shelter in place order extension and other impacts, and a recessionary recovery, while maintaining flexibility due to the significant number of unknowns still before us. Below are a few options to consider as direction to the staff regarding potential FY 2021 budget balancing actions:

- 1) Build a FY 2021 proposed budget assuming Scenario B
- 2) Build a FY 2021 proposed budget assuming Scenario B with a Tier 2 plan that balances no less than 50% of Scenario C
- 3) Build a FY 2021 proposed budget assuming Scenario C

The significant unknowns that the City is facing in terms of the duration and type of shelter in place continues to be a moving target, as noted above with the recent easing of County Shelter in Place restrictions which could have a positive impact on the City’s economy in the shorter term. The changes continue to be swift and being able to react in a nimble way, while prioritizing our ability to reengage services and serve this community continues to be a high priority.

Based on Council direction today, staff will return with budget proposals that respond to the severity of the financial ramifications before us, recognizing the City Council's adopted [Budget Principles as approved in the FY 2021–2030 General Fund Long Range Financial Forecast](#), and including new Budget and Fiscal Recovery Priorities to help guide our work to balance this significant change and continue to evolve through these uncertain times.

These priorities include supporting economic recovery through changes to our policies and programs; focusing on resiliency over the long term, while making service reductions and changes; ensuring that any services eliminated can be restored in future years; seeking new ways to conduct our work through efficiencies and a learning environment; applying citywide approaches to reductions where possible, and using temporary solutions to bridge extreme revenue losses expected in the short term.

Timeline

This is the next step in the multi-step process for review of the FY 2021 budget. Next, the Finance Committee will review the Electric and Gas utility rates for FY 2021 and the financial forecasts for those utilities on May 5, 2020. Staff will return to the full City Council May 11-13, 2020 for budget discussions surrounding the action necessary to balance the FY 2021 budget with these revised assumptions, including service reductions and department specific budget proposals. Final balancing actions will be reviewed on May 26, 2020 with the full Council and ultimately FY 2021 Budget adoption is scheduled for June 22, 2020, as required by the City's Charter. The City's new fiscal year begins on July 1, 2020.

Stakeholder Engagement

Staff continues to bring incremental steps to the City Council for continued check-ins and engagement on the financial outlook for the City in both FY 2020 and FY 2021. Based on the timeline outlined above, staff is also planning to inform and engage the public and the workforce during the month of May to solicit feedback and ideas on the proposed budget balancing solutions and prioritization efforts that will be required. This is expected to be completed in phases beginning next week with gaining input on prioritization of service areas, with more in depth engagement planned towards the end of May on specific balancing solutions proposed and the service impacts that would result for FY 2021 and beyond. Staff is also sharing budget details through various communications channels including a dedicated webpage at www.cityofpaloalto.org/budget

Resource Impact

Although no recommendation in this report specifically has an impact on the City's financials, ultimately, the discussion and recommendation by the City Council on which assumptions to use in our future financial planning will have significant impacts on the FY 2021 financial landscape and ultimately the services and investments that the City makes as it prioritizes its constrained resources.

Environmental Review

This report is not a project for the purposes of the California Environmental Quality Act (CEQA).