

MEMORANDUM

Office of the City Manager



DATE: March 20, 2020

TO: Mayor and Councilmembers

FROM: Steve McHarris, Interim City Manager *Steve McHarris*

SUBJECT: Preliminary projected Fiscal Impact for FY 2019-20 and FY 2020-21 due to the COVID-19 Pandemic

Background

On March 13, the President of the United States declared a National Emergency concerning the Novel Coronavirus Disease (COVID-19) Outbreak. On Monday, March 16, 2020, the County of Santa Clara, and six of the most populous counties in the region, announced a shelter-in-place order in light of the increased number of cases of COVID-19 that have been confirmed in Santa Clara County. The shelter-in-place order went into effect at 12:01 am on Tuesday, March 17 and will be in effect through Tuesday, April 7. On March 19, Governor Newsom issued a statewide shelter-in-place order.

On March 12, I, as the City's Emergency Services Director, signed the Milpitas Emergency Proclamation, which the City Council ratified on March 17, 2020. Based on the actions taken at various levels of government, the City closed down non-essential services.

The regional, national and global efforts to contain the pandemic, mostly through restrictions on travel and movement of people have had and will have a significant impact on the regional, national and global economies. Locally, the Great Mall closed down this week and business travel generating overnight hotel stays has decreased substantially. In response, central banks and governments worldwide unleashed unprecedented monetary and fiscal stimuli to prop up the faltering economies and, hopefully, prevent the global economy from sliding into recession. However, the economic news from China, the country first hit by the virus, is not hopeful as China expects a 6% contraction of its economy in the first quarter of 2020.

Analysis

At this time, it is very difficult to predict the impact the COVID-19 pandemic will have on our local economy and General Fund tax revenues because little data is available. Regardless, as soon as our Finance Department staff transitioned to their home office set-up due to the Shelter-in-Place order, they modelled the tax revenue impact related to the pandemic based on the Great Recession.

The Great Recession

The last recession, referred to as the Great Recession, our nation experienced started in December 2007 and ended 18 months later in June 2009. The underlying cause of the Great Recession was the so-called "subprime mortgage¹ crisis."

Although the triggers for the past recession and the current economic crisis are different, the immediate impacts are similar. In both cases, business travel decreased affecting Transient Occupancy Tax (TOT) receipts and consumers and businesses slowed spending affecting sales tax and development services

¹ Subprime mortgages are home loans granted to borrowers with poor credit histories.

related revenue. Secondly, due to the subprime mortgages, a significant number of homeowners defaulted on their mortgages, which depressed real estate markets and subsequently property tax proceeds. At this time, economists are not predicting a significant real estate market impact.

The table below shows the percent changes of the General Fund’s major revenue sources over four fiscal years from FY 2006/07 to FY 2010/11, which includes the fiscal years impacted by the contraction of economic activity and the start of the recovery from the recession. Property Tax, TOT, Sales Tax, and Licenses and Permits (fee revenue generated by the Planning, Fire Prevention, and Building Safety functions) were immediately impacted by the economic downturn. These major revenue sources comprise 81% of the General Fund’s revenues in FY 2019-20.

Major Tax Revenue Changes – Great Recession

Revenue	Percent Change from FY 2006-07 to FY 2007-08	Percent Change from FY 2007-08 to FY 2008-09	Percent Change from FY 2008-09 to FY 2009-10	Percent Change from FY 2009-10 to FY 2010-11
Licenses and Permits	-13.7%	-26.6%	-32.1%	34.4%
Property Tax	-5.6%	5.6%	-3.4%	-2.9%
Sales Tax	-3.5%	0.5%	-6.1%	11.3%
Transient Occupancy Tax	39.6%	-22.9%	-4.6%	15.6%

The recession officially started in the middle of FY 2007-08, which resulted in a reduction of major tax and fee revenues and continued for two more fiscal years. The recovery started three years later in FY 2010-11. In response to the tax and fee revenue declines, the City reduced approximately 31 positions between FY 2006-07 and FY 2009-10 and employee groups agreed to wage and benefit concessions to balance the budgets.

Fiscal Year 2019-2020 Projected Impact

Given anecdotal evidence from local hotels and the news, the travel market is severely impacted. Further, consumers and businesses have slowed spending due to shelter-in-place orders and supply chain interruptions; although consumer spending has shifted to online purchases. Therefore, staff expects immediate impacts to TOT, License and Permits, and Sales Tax revenues. Additionally, as part of the closure of non-essential services while paying part-time employees the Council approved temporary emergency pay, the City is incurring additional costs and forgoing revenue generating services. For the remainder of FY 2019-20, these impacts are expected to result in \$4 to \$6 million loss in revenues in comparison to the revenue estimates presented to the Council on February 18 as part of the FY 2019-20 Mid-Year budget review and unexpected some additional costs. It is important to note that at the Mid-Year Budget review staff projected that the General Fund will end with a surplus of \$2.5 million. Staff expects that the revenue shortfall between \$4 to \$6 million can be offset with the projected General Fund surplus and expenditure savings, and that the General Fund will still end with a modest budget surplus. Staff will recommend budget adjustments for City Council consideration to rebalance the FY 2019-20 Amended Budget as part of the Third Quarter Financial Status Report scheduled for May 5, 2020. The projected FY 2019-20 General Fund surplus will assist us in addressing next fiscal year's anticipated budget shortfall further described below. To maximize the current year General Fund surplus, I will institute a hiring and expenditure freeze except for essential functions and for activities in response to the COVID-19 pandemic.

Fiscal Year 2020-2021 Projected Impact

At the January 28 Preliminary FY 2020-21 Budget Study Session, staff projected \$123.5 million in revenues and \$122.3 million in expenditures with a FY 2020-21 General Fund Base Budget surplus of \$1.2 million. The forecast model using revenue impacts from the last recession projects a revenue decrease between \$12 to \$14 million in comparison to the January 2020 Forecast resulting in a deficit in the General Fund between \$11 to \$13 million. The decrease in revenue estimates assumes that travel restrictions will not be lifted and consumers will hold back on spending until the end of the first quarter of FY 2020-21. Thereafter, the model assumes that economic activity will return mostly by Summer 2021 leading to a substantial recovery of monthly TOT, Licenses and Permits, and Sales Tax proceeds by the end of FY 2020-21. At this time, staff expects a shorter-lived recession due to the massive monetary and fiscal stimuli enacted and deliberated at the federal and state levels.

To address this unexpected revenue shortfall, Finance started to review projected expenditures for FY 2020-21 and expects to reduce them by \$3 to \$5 million in comparison to the preliminary base budget presented on January 28, 2020. Further, the FY 2020-21 Proposed Budget will only contain minimal expenditure increases above the base budget addressing Council priorities and/or legally required service level changes. As discussed during the March 17 City Council meeting, the organization is currently focused solely on continuing operations and service delivery to our residents within the confines of the COVID-19 pandemic. Due to the focus on the pandemic, the City doesn't have the capacity to review all department functions and identify service delivery cuts with the least impacts to our residents. Further, due to the unprecedented stimulus packages, staff wants to be judicious and hold off on reducing staffing and therefore service levels at this time. Therefore, I am considering recommending to the City Council the use of budget surplus from FY 2019-20 and the Budget Stabilization Reserve (BSR) to assist with balancing the FY 2020-21 Proposed Budget. The BSR per the Council approved Reserve Policies shall be used to provide budget stability when there are fluctuations that result in lower than projected revenues and or higher than projected expenditures that cannot be re/balanced within existing budget resources in any given fiscal year. This reserve is intended to provide a buffer, or bridge funding, to protect against reducing service levels when these fluctuations occur. The BSR is currently funded at \$9.5 million.

Next Steps

In the next few days, I will institute a hiring and expenditure freeze except for activities in response to the COVID-19 pandemic and other essential activities in order to maximize the current year General Fund surplus.

During the next few weeks, staff will monitor economic data as it becomes available and make further adjustments to revenue projections. Please note that the rapidly changing economic conditions may not allow us to incorporate the latest available information in the FY 2020-21 Proposed Budget scheduled for release on May 4, 2020. Therefore, as we move through the budget adoption process, I may have to bring forward amendments to the FY 2020-21 Proposed Budget to ensure that the Council adopts a balanced budget.