Council Agenda Report

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Subject: Fiscal Impact of the COVID-19 Pandemic, Adjusted Budget Process, and Exacerbated Undermining of the City's Long-term Fiscal Sustainability

Date: March 27, 2020

Facts

1. The Coronavirus (COVID-19) pandemic has had significant impacts to the National, State and City's economy and revenues.
2. The City's three largest General Fund revenue sources are sales tax, property taxes, and transient occupancy taxes (TOT). Collectively, they comprise roughly 75% of the City's General Fund revenues.
3. Fees for services, including fees for Recreation classes, planning services, and building plan check and inspections also contribute the General Fund, but at lesser amounts.
4. On February 20, 2020, the City Council received the mid-year FY 2019-20 budget report. That report projected sales tax revenues to be $15.7 million, property tax revenues to be $11.6 million, and TOT revenues to be $6.7 million.
5. On March 18, 2020, the County of San Luis Obispo issued a "shelter-in-home" mandate, halting all non-essential work in the workplace, in order to slow the spread of the virus. The following day, Governor Newsom issued a similar mandate state-wide.
6. The shelter-in-home mandate will have significant and immediate impacts on sales taxes, TOT taxes, and fees for services. It could potentially impact property tax revenues over the next year or so, depending on trickle down effects of non-essential businesses needing to stop operations.
7. The City Council is required to adopt a comprehensive operating and capital expenditure budget in order to authorize the receipt of revenues and to authorize, guide and direct City activities no later than June 30, each year.
8. For the past four fiscal years, the City has adopted a detailed two-year budget. By developing a two-year budget, the City can link long-term strategic plans with the financial planning process. Additionally, it reduces work hours dedicated to budget development.
9. However, in order to develop a two-year budget, long-term planning is a crucial aspect. The economic impacts from COVID-19 are not known at this time nor will we know for some time. Given the time depends on staff and the Council, devoting the normal resources to the budget development and approval process is also not feasible.
10. As a result, developing a two-year budget overview is not appropriate.

Analysis and Conclusions

Fiscal Impact of COVID-19 Pandemic. During this unprecedented public health crisis, COVID-19 has already had a significant and immediate impact to the City's local economy. Tourism has become an increasingly important industry within the City. The City is home to a number of special events attracting visitors from all over the state, nation, and worldwide. Such events include the Wine Festival, Zinfandel Festival, Paderewski Festival, Pioneer Day, Vine Street Victorian Showcase, Concerts in the Park, California Mid-State Fair, Firestone Walker Invitational Beer Festival, and the Garagiste Festival (for small wineries). More new events are added each year. The local wine industry continues to receive world recognition for its premium wines and local breweries, cideries, and distilleries are also garnering acclaim.

As a result, transient occupancy tax (TOT) collections, viewed as an indicator of tourism success, is the City's third highest General Fund revenue source and comprises 17% of the City's General Fund revenue. During the 2018-19 fiscal year, the City received $6.2 million in transient occupancy tax revenue, an increase of 11% over the 2017-18 fiscal year and 47% over the last five fiscal years combined. Currently, there are over 2,000 additional hotel rooms that are either in the planning entitlement, plan check, or construction phase.

Prior to the COVID-19 pandemic, the City's FY 2019-20 TOT revenues were tracking to be approximately 9% more than in the previous fiscal year, for a total $6.8 million. As a result of the COVID-19 pandemic, it is anticipated that tourism-related revenues will decrease by 75% over the next couple of months, with general tourism declining for the rest of 2020 according to Oxford Economics key findings. As such, the City's preliminary analysis of TOT revenue predicts that COVID-19 will have a $1.6 million decline in tourism revenues for FY 2019-20 (with just over three months remaining in the fiscal year). Should the pandemic last until September 2020, an additional $800,000 decline is projected for FY 2020-21. It is very possible that the pandemic is prolonged and tourism-related revenues decline beyond 2020. As it stands today, total tourism revenues are projected to decline by 31% when calendar year 2020 is compared to calendar year 2019. These projections are preliminary and may change as additional data becomes available.

Similar effects are going to be felt by the City's largest revenue source--sales tax. Sales tax revenue generates approximately $15.9 million of revenue to the City's General Fund and represents 41% of the total General Fund revenue. Preliminary estimates show a decline in revenues of approximately $1.3 million for FY 2019-20 and $1.7 million for the 2020-21 fiscal year. These projections are preliminary and may change as additional data becomes available.

Like TOT revenues, the restaurant and hotel industries will see the biggest decline—projected at approximately 40% in the second quarter of 2020—due to events being cancelled and consumers shifting their food spending to groceries. This could also have a long-term impact if dining habits change. The restaurant industry may also be the most vulnerable to closures given the already increasing tight operating margins and staff costs placing pressure prior to COVID-19.

The fuel and service industry are experiencing a unique situation with a combination of a decrease in demand for automobile and jet fuel coupled with an increase in supply of oil by OPEC and Russia. These factors have pushed the price of crude oil back to 2002 lows. It is anticipated that fuel prices in California will drop for the remainder of 2020 and into the first quarter of 2021. Although it is anticipated to increase thereafter, oversupply may keep gas prices relatively low and moderate potential sales tax growth.

The auto and transportation industry will undoubtedly be impacted. Auto sales had already started to decline prior to the COVID-19 outbreak, with rising vehicle prices propping up sales tax receipts. New and used vehicle acquisitions will experience dramatic declines into the spring months. In response to the sudden and significant slowdown of the economy, it is anticipated that many auto dealers will ramp up incentives and decrease prices to move inventory. Longer term growth rates are attributed to a comparison with dramatic near-term declines and the probability of lower interest rates available to elongate the stimulus to the economy.

The City will also see extensive impacts to expenditures. No estimate of that is yet available.

<u>Adjusting the Budget Process</u>. At the onset of the COVID-19 pandemic, the City was in the midst of compiling information needed for the two-year budget to cover the 2020-21 and 2021-22 fiscal years. A key component to budget development was long-range fiscal sustainability. Without full knowledge of the duration of the pandemic or its full fiscal impacts, it is not possible to produce accurate long-range fiscal

models. As a result, staff is recommending modifying its initial plan to include adopting a budget by June 30th for the 2020-21 fiscal year only. The budget plan will include only essential, non-discretionary expenditures as well as staff's best estimate of revenue shortfalls. The City is fortunate to have healthy reserve balances of approximately 40% of General Fund revenues as well as additional monies in the City's Section 115 Trust Pension Fund that can be utilized to offset the likely increases in pension costs. A combination of all reserve sources will help mitigate and minimizes the impacts of COVID-19. Additionally, all discretionary capital improvement projects will need to be reviewed, analyzed, and possibly delayed or eliminated until the economy and revenues come back to original levels.

A significant portion of the City's budget is related to personnel because the City is a service-oriented business. As a result, staffing needs to be reviewed carefully and only essential vacancies will be filled. The long-term impacts of the pandemic on the CalPERS (California's Public Employee Retirement System) pension system are still unknown. The latest information has shown that CalPERS investments have declined by 17% over the past month. If accurate, this results in the City's funded status decreasing from 73% to 62%. In order to increase the funded status, annual increases over and above those previously anticipated will likely need to occur.

<u>Exacerbated Undermining of the City's Long-term Fiscal Sustainability</u>. The COVID-19 pandemic dramatically increases the challenge of maintaining the City's long-term fiscal sustainability. Since the Great Recession that started in 2008, the City's revenue base has been severely impacted by both revenue reductions (in inflation-adjusted dollars) and increasing expenditure demands. The revenue decline has been exacerbated further by four major challenges including: pensions, tax shifts, aging infrastructure, and an overall increase in operational costs. These four main reasons are expanded further:

- CalPERS imposed significant financial requirements for local jurisdictions to backfill the pension shortfalls when CalPERS lost significant investments during the Great Recession.
- Changing consumer patterns such as the increase in online sales caused substantial loss of sales tax, and there have been reductions in gas tax due to more fuel-efficient vehicles.
- Aging infrastructure and outdated equipment require significant investments into City's capital assets such as streets, Fire Stations, Library, Community Center, and City Hall which are growing increasingly challenging to make over time.
- Cost increases due to core higher operational costs (which include services like Police, Fire, parks, and recreation).

Increasing service demands will also make it more challenging for the City to maintain the current service level with existing resources. For example, Police calls for service have increased by 40% over the last 5 years, with no increase in population. Fire and Emergency Services calls for service have seen similar increases.

The City has undertaken essentially all steps it can to address its funding shortfall without cutting back on services that residents have told us in surveys over the last three years that they need. These steps include, among others: economic development; fee updates; grants (homeless, transportation, fire staffing, police equipment and DWI campaigns); cash management (higher investment income); effective labor negotiations and hiring chills; police retention incentive program (to retain trained officers and avoid the high costs of recruitment and training new officers); compensation triggers based on City revenue receipts; and others.

The long-term fiscal impacts of the pandemic cannot yet be projected. It is crucial, however, that the City analyze and monitor these impacts, and take the needed corrective actions, if our residents are going to continue to receive the nature and scope of services they need and demand.

Fiscal Impact
While the COVID-19 pandemic and City response will have fiscal impacts that are outlined in the report and that will continue to change over time, receipt of this report has no fiscal impact.

Recommendation
Receive and file the report, providing any desired direction to staff.