

Special Report
April 21, 2020

Navigating the Impact of the COVID-19 Pandemic on Berkeley's Finances



BERKELEY CITY AUDITOR

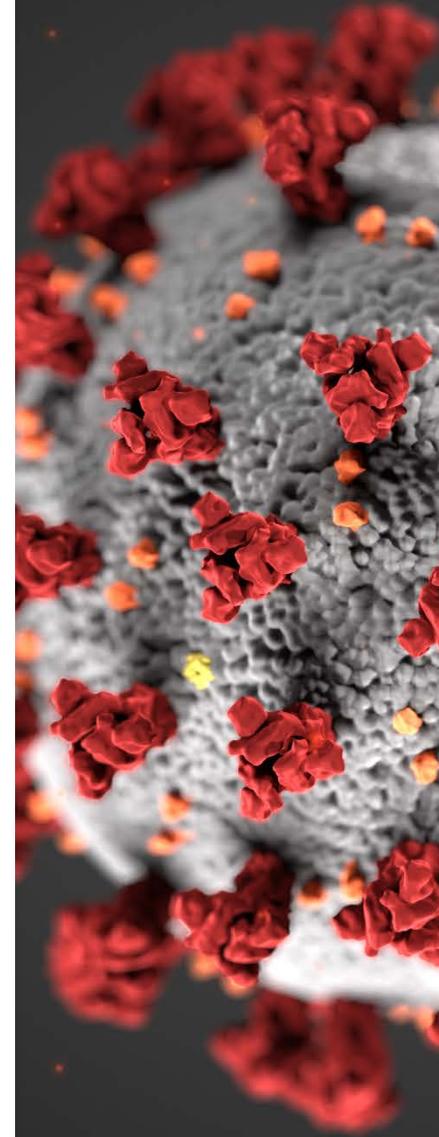


Image: Center for Disease Control

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Report Highlights



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The COVID-19 pandemic is a public health crisis with social and economic impacts that may last for years.

Impact on Berkeley's Economy

- With residents sheltering in place except for essential activities, Berkeley's businesses, arts organizations, and community service agencies are under tremendous financial pressure.
- Shelter-in-place orders will impact at least 30,000 Berkeley jobs, possibly more.
- About 27 percent of workers who live in Berkeley are at high risk of unemployment or have already become unemployed.
- This pandemic-induced economic shock is unprecedented because the public health risk is driving its severity and duration.
- The City is in a relatively strong fiscal position, but will face difficult decisions about tradeoffs in order to weather the economic downturn.

Impact on Berkeley's Revenues

- Berkeley's revenues from sales and use tax, property transfer tax, and hotel occupancy tax will decline in the short term.
- Berkeley will see impact on property tax and business license tax revenues over the next one to two fiscal years.
- Federal and state financial assistance may help cover some costs of the COVID-19 response, but will not make up for all lost revenues.

Impact on Berkeley's Expenditures

- Costs to respond to the COVID-19 pandemic are rising as revenues are decreasing.
- Costs to provide employee health insurance and retirement contributions are expected to increase due to the pandemic.

The City will need to balance its pandemic response with long-term financial planning as revenues decline and some expenditures increase.

Experts recommend the City:

Ensure social equity by evaluating the need to support Berkeley's residents, businesses, and community agencies together, rather than on a one-at-a-time basis, so that city resources are distributed fairly and in proportion to the level of need.

Reduce expenditures to focus on essential activities that prioritize public health and safety, as well as community value.

Leverage current and potential federal and state assistance in a comprehensive approach to addressing community needs.

Coordinate use of Berkeley's resources to provide support in areas that are not supported by federal and state funding.

Take a long-term view to spending reserves to make sure that enough funds are available to pull the City through a potentially long economic downturn.

Navigating the Impact of the COVID-19 Pandemic on Berkeley's Finances

Background and Purpose

The COVID-19 pandemic is a public health crisis with devastating social and economic impacts. Unemployment is skyrocketing as consumer confidence and retail sales are plummeting. With residents sheltering in place and the closure of UC Berkeley and non-essential activities, Berkeley's community service agencies, restaurants, hotels, retail businesses, arts organizations, and other small businesses are under tremendous financial pressure. The economic shock is hitting our most vulnerable residents the hardest and demand for city services may increase at a time when city revenues are certain to shrink.¹

The City Manager and department heads are working diligently to address a myriad of issues that stem from the COVID-19 pandemic. The Mayor and City Council acted quickly to set up a relief fund for small businesses, arts and cultural organizations, and renters. The Berkeley Health Officer has been at the forefront of protecting our residents by issuing the nation's first shelter-in-place order. Staff throughout the City are working in the Emergency Operations Center to address this pandemic that local, state, and federal officials declared as an emergency.

While the public health crisis has demanded the immediate attention of city staff, our office consulted with the City's Budget Division and Finance Department, to review how the crisis will impact the City's budget and ability to provide essential city services.

This economic downturn is severe and may last for years. It is critical that decision makers and the public understand the various financial impacts so that the City can continue to meet the needs of city residents, small businesses, and arts organizations in a time of declining revenue.

Berkeley is fortunate to have a reserve fund. The City Council established a stronger reserve policy at the recommendation of the City Auditor in 2016. The fund, currently at \$36 million or 17 percent of the City's General Fund, gives city decision makers more flexibility to respond to the crisis. For the reserve fund and other city funds to best meet the needs of city residents, they need to be managed with a long-term view of a potentially prolonged economic crisis.

Response to this economic downturn will require a marathon approach rather than a sprint.

¹ The City of Berkeley's adopted budget projections of \$489.4 million in revenues in fiscal year 2020 and \$495.9 million in fiscal year 2021 will need to be adjusted.

This special report provides information to assist Berkeley's leaders in navigating the financial challenges ahead. We conducted interviews and reviewed data from government finance and budget officials to compile the following information:

- Estimates of how the COVID-19 pandemic will affect the local economy and Berkeley's revenues and expenditures; and
- Considerations from government finance and budget officials for the City Manager and Council to inform decisions about how to manage resources as revenues decline and expenditures increase.

Scope and Methodology

The COVID-19 pandemic continues to affect many important aspects of community life in Berkeley. To provide information that is timely and complementary to the work of other city departments, we focused this report on the pandemic's impact on the local economy and city revenues and expenditures through fiscal year 2021. We present a high-level overview of a range of considerations for mitigating the impact of COVID-19 in Berkeley, but do not provide detailed analysis or audit recommendations.

To develop a comprehensive set of best practices for Berkeley leaders to consider in navigating this economic downturn, we interviewed and gathered information from officials at the following organizations, professional associations, and local governments:

Brookings Institution	San Francisco, CA
California Budget and Policy Center	Oakland, CA
California Legislative Analyst's Office	San Jose, CA
California State Assembly	Hayward, CA
California Public Employees Retirement System	Seattle, WA
Center on Policy and Budget Priorities	Kansas City, MO
Downtown Berkeley Association	Johnson County, KS
U.S. Government Accountability Office	Colorado Springs, CO
League of California Cities	
Moody's Analytics	
Pew Charitable Trust	
Public Policy Institute of California	
University of California, Berkeley	
Urban Institute	

Information Subject to Change

The COVID-19 pandemic is unprecedented, and information about health outcomes and economic impacts is rapidly changing. All figures in this report reflect estimates based on the information available as of April 21, 2020 and are subject to change.

Impact on Berkeley's Economy

As Berkeley's economy faces sudden business closures, low income residents, small businesses, hotels, and community organizations are most impacted.

More than 30,000 jobs in Berkeley might be impacted and 27 percent² of workers who live in Berkeley are at high risk of losing their jobs. The California Budget and Policy Center suggests that this pandemic may impact nearly 1.2 million non-farm jobs in the Oakland-Hayward-Berkeley Metro Division. The jobs hardest hit by social distancing measures are in the tourism, hospitality, and retail industries, which make up an estimated 23 percent of the region's private sector jobs. Based on this data, we estimate that Berkeley's share of jobs impacted relative to its population is roughly 31,000 jobs out of Berkeley's total 70,000 jobs. However, that number could be higher due to the relatively high concentration of jobs in Berkeley, including more than 23,000 jobs at the University of California, Berkeley (UC Berkeley).

The closure of UC Berkeley will significantly impact the local economy. UC Berkeley employs over 23,000 people and brings about 43,000 students to Berkeley during the academic year. University staff and students contribute significantly to the local economy. UC Berkeley has cancelled in-person classes starting March 10 and extending through the summer. As of April 10, about 6,000 or 86 percent of students in residence halls have moved out, and more students in non-university housing have also left Berkeley. If the pandemic requires closures to continue into the next academic year, businesses that count on income from university students and staff could suffer and sales and use tax revenue will decrease. As of April 21, 2020, enrollment numbers for the 2020-2021 academic year are still uncertain.

The pandemic is disproportionately impacting low income workers and vulnerable populations. The California Budget and Policy Center estimates that lower paid

KEY TAKEAWAYS

Shelter-in-place orders will have most impact on low income residents, small businesses, hotels, and community organizations.

- In Berkeley, business closures may affect roughly 30,000 jobs and unemployment may reach 27 percent or more.
- The pandemic is disproportionately impacting low income workers and vulnerable populations.
- Berkeley's cultural identity is at risk as businesses and arts organizations struggle financially.

This unprecedented downturn is different from the Great Recession.

- This economic downturn is more volatile because it is tied to the COVID-19 public health risk.

Impact to federal and state economies may reduce funding to Berkeley.

- Without federal aid, state and local governments will be stretched to address unmet needs.
- Many California workers most impacted are in lower paid occupations.

² Based on an analysis in a April 2020 report by Economic Roundtable: <https://economicrt.org/wp-content/uploads/2020/04/In-Harms-Way.pdf?referringSource=articleShare>

occupations are hit hardest, having a greater financial impact on low income Californians with little to no savings. Others estimate that the negative financial and health effects will hit hardest for people of color, undocumented workers, seniors, unhoused residents, people in abusive households, and frontline workers in healthcare, transit, delivery, and grocery services.

The pandemic puts Berkeley's cultural identity at risk as businesses and arts organizations struggle financially. The small businesses, restaurants, arts and culture organizations, and nonprofits that make up Berkeley's cultural identity may lack the financial resources to continue to employ staff or operate during and after the shelter-in-place order. About one in five small businesses and nonprofits in Berkeley applied for aid from the Berkeley Relief Fund, illustrating the intense level of need. The Berkeley Downtown Association predicts that ongoing need for social distancing even after the shelter-in-place order is lifted will greatly impact arts and other community organizations whose work includes bringing people together.

The City of Berkeley is in a better fiscal condition to weather a recession than it was during the Great Recession. The City created a reserve, which currently has a balance of about \$36 million. The City is also sufficiently liquid in terms of its investments. According to the Finance Director, if the City manages its revenues and expenditures prudently, which will require making some difficult decisions about tradeoffs, it should be able to weather the impacts of the economic downturn.

Despite impact to many local businesses, Berkeley's diverse economic base is an advantage. Employers in Berkeley represent a diverse range of industries, including manufacturing, healthcare, higher education, research, and retail. Not all will experience the same consequences or severity of setbacks. This will aid Berkeley's local economy in weathering and recovering from the pandemic.

This unprecedented economic downturn is different from the Great Recession.

This situation is more volatile because the public health risk is driving when and how the economy will reopen. The severity of economic impact from the COVID-19 pandemic is still unknown, but unlike the Great Recession, virus transmission risk will determine when and how long businesses need to stay closed to promote social distancing, ensure adequate healthcare system capacity, and save lives. Public health experts say this pandemic may have multiple waves and require ongoing shelter-in-place orders and social distancing until an effective vaccine is developed. Governor Gavin Newsom has stated that the decision to lift the shelter-in-place order will be determined by California's ability to prevent additional outbreaks and mitigate the impact on vulnerable populations, among other public health measures.

California may face revenue reductions 1.5 times greater than during the Great Recession. Moody's Analytics estimates that state revenue losses could exceed losses during

the Great Recession, and in a shorter timeframe.

The combination of economic impact and public health risk increases overall risk for vulnerable populations. Past policy decisions at the state level resulted in greater reserves and stronger public programs to help residents. However, many residents are still vulnerable to health and economic impacts, particularly those who are uninsured or will not receive economic benefits from the federal relief bills.

There is no unified federal leadership on the nation's healthcare response. Public health responses vary by state and city. To the extent that other regions become hotspots of infection and travel remains unrestricted, regional efforts to contain the virus may be hampered. Governor Newsom is coordinating with other western states to mitigate this risk.

This economic shock is expected to hit the service, retail, and hospitality industries harder than it did in the Great Recession. These sectors are seeing immediate impacts as businesses in the service, retail, and hospitality industries close to comply with the shelter-in-place orders.

The spike in unemployment is more abrupt and spread across different employment sectors. As of April 21, 3.1 million California residents have filed new claims for unemployment insurance since the Governor issued a shelter-in-place order on March 19. This far exceeds the totals during the Great Recession, when most retail and restaurants were not affected as quickly or severely. To put these numbers in perspective, more people have filed for unemployment claims in the last four weeks nationwide than the total number of jobs created since the Great Recession, and these numbers will most surely continue to increase.

Impact to federal and state economies may reduce funding to Berkeley.

The U.S. economy is headed toward a recession or even a depression, which will affect state and local revenues. While much is still uncertain, economists agree that the U.S. will experience a recession, or even a depression.³ As of April 20, nearly all Americans are ordered to stay at home except to address essential needs. Business closures are expected to continue in many parts of the country through much of May, possibly longer. March 2020 saw the worst stock market performance since the Great Recession. Unemployment has increased rapidly with a record-breaking 20 million people filing for unemployment insurance in four weeks. The week ending in April 4 saw the highest unemployment rate on record.

Federal lawmakers passed a COVID-19 response bill that appropriated significant

³ A *recession* is a downtrend in the economy that can affect production and employment, and produce lower household income and spending. The effects of a *depression* are much more severe, characterized by widespread unemployment and major pauses in economic activity. Recessions can also be more localized while depressions can have global reach. Source: Merriam-Webster

funding for individuals and small businesses. However, many workers are not eligible for these benefits, including recent college graduates with no earnings history, newly self-employed workers who have not filed their taxes, and undocumented workers. Similarly, some small businesses have reported barriers in applying for the special relief loans included in the bill, and the New York Times reported that businesses owned by people of color may face disproportionate barriers in securing loans due to systemic disparities in banking relationships. Further complicating things, as of April 16, the small business loan fund is now exhausted and no more loans will be forthcoming without additional congressional authorization. Sufficient funds for small businesses could be a continual problem over time, depending on the direction of future federal action.

California is in a relatively strong position to face a recession, but the cost of protecting public health will put significant pressure on the state's budget. The California Legislative Analyst stated that California's recession has begun and that demand for government services is increasing as revenues are falling. State legislators authorized the use of \$1.1 billion from the general fund to pay for public health expenses and to assist homeless residents and other vulnerable populations in preventing illness. The state's Department of Finance has forecasted that COVID-19 will require California to spend an additional \$7 billion, and that the fiscal effects of the pandemic will be immediate and last into fiscal year 2021. Moody's Analytics conducted a stress test on state budgets to determine states' capacity to absorb the economic shock resulting from the pandemic. The stress test found that California may face revenue reductions of about 19 to 23 percent depending on the duration of the state's shelter-in-place order.⁴ California is listed among 12 states that have most, but not all, of the reserves they need to handle a recession. California has \$21 billion in reserves and rainy day funds, but the state's budget shortfall will likely exceed reserves. State law requires California to pass a budget with no deficit, so budget cuts will be necessary to pass the budget in June 2020. These cuts will likely result in cuts to funding for local governments to provide services unless additional federal aid becomes available.

Unless future federal relief includes individuals excluded from previous aid bills, it may fall to state and local governments to address their unmet needs. To address this issue, the U.S. House of Representatives introduced a new federal relief bill with provisions to allocate \$250 billion in direct federal aid to local governments with a population of less than 500,000 as they face the mounting challenges related to the pandemic. Whether the bill will pass and whether the funds will be allocated to state and local governments remains to be seen. As of April 20, that bill is still pending, and city staff will monitor its status.

Many California workers most impacted are in lower paid occupations. As of April 15, California saw an unprecedented 2.7 million new unemployment insurance claims in the previous four weeks. The Legislative Analyst's Office stated that unemployment statewide has

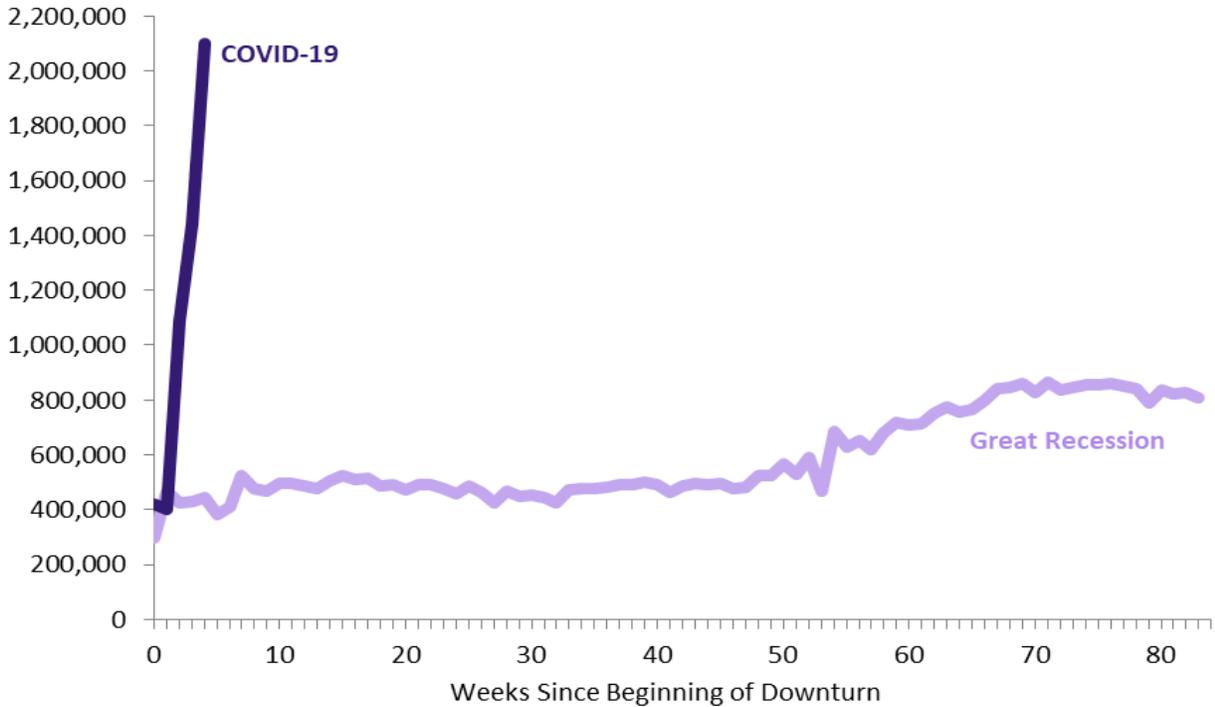
⁴ The estimated revenue reductions assume that the state will experience moderate stress in the form of a deep recession in the first half of 2020 followed by modest rebound and a peak jobless rate of 13 percent in the second quarter of 2020. There is a possibility of a more severe economic stress scenario if travel and business restrictions last into the third quarter of 2020 and the jobless rate reaches 17 percent.

already far exceeded peak unemployment during the Great Recession (see Figure 1). Many of these job losses will be in sectors hardest hit by the closures to comply with shelter-in-place orders, including restaurants, hotels, transportation, retail, and hospitality.

Figure 1. California's Unemployment caseload indicates unprecedented unemployment statewide.

Unemployment Caseload Now More than Double the Worst of the Great Recession

Total number of workers with active claims for unemployment benefits



Source: Legislative Analyst's Office report: <https://lao.ca.gov/LAOEconTax/Article/Detail/452>

Impact on Berkeley's Revenues

The economic shock will affect many of Berkeley's revenue streams, but the total impact is uncertain.

The City's main sources of revenue are expected to decrease, including sales and use tax, business license tax, transient occupancy tax, property tax, parking fines, and property transfer tax. Berkeley budgeted for revenues of \$489.4 million in fiscal year 2020 and \$495.9 million in fiscal year 2021. In the short-term, sales and use tax is likely to decline significantly due to the sudden and extended closure or limited operation of restaurants and retail businesses (see Table 1). Many businesses, especially restaurants, are at risk of closing permanently, which would affect sales and use tax revenue over time. Berkeley may feel this impact more deeply than other California cities because restaurants make up 25 percent of the sales and use tax base compared to 16 percent statewide. However, Berkeley's diverse sales and use tax base may buffer the City from more severe impact as not all businesses are experiencing the same decline in sales.

Any impact the pandemic may have on real estate values will affect property taxes and property transfer taxes. Some analysts estimate that impacts on property values may mirror the Great Recession to some extent. Due to local real estate value assessment practices, property taxes reflect values from one or more years before the taxes are collected. Consequently, Berkeley will experience any impacts on property taxes in future years depending on the severity of the downturn. Impact on property transfer taxes will be more immediate. Table 1 highlights a selection of revenue sources likely to be most affected by the economic downturn. These revenue sources account for more than two thirds of Berkeley's budgeted general fund revenues.

Some funding to support unhoused residents may be affected, but not right away. Berkeley voters passed measures P, O, and U1 to fund affordable housing, provide services to homeless adults and youth, and assist in housing retention and rapid rehousing for unhoused residents, respectively. Measure U1 is tied to business license taxes, and may see changes in funding to the extent that the pandemic

KEY TAKEAWAYS

The economic shock will affect many of Berkeley's revenue streams, but the total impact is uncertain.

- The City's main sources of revenue are expected to decrease, including sales and use tax, business license tax, transient occupancy tax, property tax, parking fines, and property transfer tax.
- Berkeley will see impact on property tax and business license tax revenues over the next one to two fiscal years.

Federal and state funding will cover some COVID-19 response but will likely not completely make up for lost revenue.

- This situation is more volatile because economic activity is tied to the COVID-19 transmission rate.

Financial experts suggest that cities use multiple scenarios to forecast revenue losses.

- Without additional federal aid, state and local governments will be stretched to address residents' unmet needs.

affects rental income for owners of five or more residential rental units. Measure P is tied to property transfer taxes, and revenues may be impacted to the extent that the pandemic affects property values and sales. Measure O is funded through municipal bonds and the City's Finance Director does not foresee an impact to those funds at this time.

Table 1. Selected Revenues Most Impacted by COVID-19, Fiscal Year 2020

Revenue Source	% of General Fund	Potential Impact ⁵	Estimated First Impact ⁶
Property Tax (Real and Unsecured)	34%	This revenue was relatively stable during the Great Recession, and is likely to change to the extent that COVID-19 affects the housing market and property values. This impact will likely be moderate rather than severe.	12+ months
Sales and Use Tax	10%	Berkeley's sales and use tax will decline significantly with restaurants and many other businesses closed or scaled back. This impact will be multiplied if COVID-19 forces UC Berkeley to extend online classes into the fall and staff, faculty, and students are not spending money at Berkeley businesses. However, sales tax revenue is able to recover more quickly than other taxes.	Immediately
Business License Tax	10%	Business licenses are taxed based on a percentage of the previous year's gross receipts. Businesses that close permanently or take in less money this year due to closure required by public health officials will pay less taxes in the following fiscal year. This revenue will likely decrease by about 10-15 percent over the next 2 fiscal years.	12+ months
Property Transfer Tax ⁷	6%	During the Great Recession, property transfer taxes declined by 51% between 2007 and 2009, and did not return to pre-recession totals until 2016. This revenue will likely not be lost, but deferred until real estate sales resume after the shelter-in-place order is lifted.	Immediately
Transient Occupancy Tax	4%	Hotel Tax revenue remained relatively flat during the Great Recession. However, tax revenue will decline now as the shelter-in-place order affects occupancy.	Immediately
Parking and Moving Violations	4%	Berkeley has relaxed parking enforcement to promote social distancing. Revenue is likely to decline as a result.	Immediately

Sources: The City of Berkeley's Adopted Budget Book for Fiscal Years 2020 and 2021, auditor analysis, and estimates by the League of California Cities

Projected revenue from taxes that increase based on growth in the consumer price index (CPI)⁸ may now be overestimated. Berkeley's budget for fiscal years 2020 and 2021 assumes that revenues for the following taxes will reflect an increase in CPI: Emergency Services

⁵ Auditor analysis based on estimates by the League of California Cities.

⁶ "Immediately" refers to the April-May-June quarter of 2020.

⁷ Tax on the sale of real estate property.

⁸ The U.S. Bureau of Labor Statistics defines CPI as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."

for the Disabled Tax, Library Tax, Parks Tax, and the Measure GG Fire Services and Disaster Preparedness Tax. The City budgeted for a CPI increase of 3.32 percent annually over the next five years, but that may now change. CPI decreased to about 0.8 percent in 2009 during the Great Recession. Depending on the length and severity of this economic downturn, CPI could hold steady or decline in 2021 resulting in less revenue from these tax funds than previously estimated.

Federal and state funding will not completely cover the anticipated revenue shortfall. Berkeley receives about \$34 million in grant funding, and about half of Berkeley's public health funding in fiscal year 2019 came from government grants. Researchers at Moody's Analytics estimate that California may face revenue reductions of approximately 19 to 23 percent compared to 10 percent during the Great Recession. Such severe budget shortfalls may affect availability of funding to Berkeley to provide services unless additional federal aid becomes available.

Some actions the City has taken to assist small businesses and residents will also affect revenue. The City has allowed customers of commercial refuse services to reduce or temporarily stop service and allowed businesses that have loans with the City to defer loan payments. Additionally, revenue from parking fees and enforcement will decrease as the City has stopped charging fees at parking meters and has stopped parking enforcement except for violations with safety risks.

Revenue reductions could put more pressure on the ongoing Marina Fund deficit. Prior to COVID-19, the costs to operate the Berkeley Marina exceeded berth rentals and lease revenue by about \$1 million. The City's most recent budget noted that without revenue and expenditure balancing measures, the Marina Fund would exhaust its reserves by 2021. Any increases to personnel costs and decreases in revenue due to COVID-19 will further deplete reserves and increase the deficit.

Federal and state funding will cover some COVID-19 response costs but will likely not completely make up for lost revenue.

Some funding from the \$2 trillion COVID-19 relief bill is allocated to assist states in responding to the crisis, but it will be up to states whether to disburse any of those funds to local governments. The bill will allocate about \$10 billion in block grants to California, and Governor Newsom stated that \$4.5 billion would go directly to local governments. There are no details yet about when that will happen or how much Berkeley will receive. The bill allows jurisdictions with populations over 500,000 people to receive aid, but Berkeley's population falls short. Federal legislators are currently considering an additional relief bill that would include provisions to dedicate aid specifically for local governments. It is unclear if cities will be allowed to use those funds to make up for lost revenue. Government finance experts we interviewed stated that the total aid Berkeley receives is unlikely to completely cover the cost of responding to COVID-19 and other lost revenue.

The City of Berkeley is eligible for reimbursement for some COVID-19 response activities. Reimbursable activities include increased disinfecting of public spaces, responding to medical calls, providing overflow capacity to overwhelmed hospitals, and communicating health guidance to residents. Funding may also reimburse some staff costs associated with the response to the COVID-19 pandemic, distribution of personal protective equipment and supplies, and increased security and law enforcement. The largest amount of funding is likely to come from the Federal Emergency Management Agency's Public Assistance program. At this time, there is no funding dedicated to reimburse cities for reduced revenues due to shelter-in-place orders.

California has granted \$100 million to help protect the health and safety of people experiencing homelessness during the COVID-19 pandemic.⁹ Berkeley is likely to receive some portion of this funding as reimbursement for costs to provide COVID-19-related services to unhoused people. Other funding from state agencies directed to Berkeley's costs to respond to COVID-19 have not been released.

Financial experts suggest that cities use multiple scenarios to forecast revenue losses.

This pandemic-induced economic downturn is unprecedented, and its duration and severity are uncertain. Finance and government experts we interviewed stated that, at this early point in time, the closest cities can come to forecasting how the COVID-19 pandemic may impact local revenues is to plan for moderate and severe revenue shortfalls and moderate or long economic recoveries. Those models can be updated as more information about public health risk becomes available and federal and state policies respond to the pandemic. Some examples of scenarios that may be useful for Berkeley to consider include the following types of economic impact:

- "V-shaped" deep decline and relatively faster recovery--prior epidemics have caused "V-shaped" impact, but COVID-19 is a larger global pandemic and has affected more of the global economy
- "U-shaped" deep decline and relatively longer recovery
- "L-shaped" deep decline and longer recovery
- "W-shaped" decline and recovery followed by second decline if there is a second wave of COVID-19

City staff are working to develop revenue loss projections, but those numbers are not yet available. It is especially challenging to project revenue shortfalls because many factors, such as the duration of the shelter-in-place order and the availability of federal and state funding, are subject to change depending on the severity of the COVID-19 outbreak. Providing updates regularly with revised projections can help with planning and adjustments to the plan.

⁹ Alameda County has been allocated \$1.4 million. These funds will be available to the county once it depletes its current emergency budget.

Impact on Berkeley's Expenditures

The COVID-19 outbreak may increase demand for city services in the short- or long-term, leading some expenditures to increase even as the overall budget decreases.

Some expenditures will increase depending on the severity of the COVID-19 outbreak. The costs of running emergency operations and protecting public health will continue to increase in proportion to the rate of transmission in Berkeley and the Bay Area. In addition to safeguarding the community, the City can take comprehensive action now to contain the virus and reduce transmission, and maintain those measures until the virus is contained.

Berkeley is facing some immediate increases in costs to protect public health and welfare. These costs include city actions to communicate safety guidelines to the public, distribute supplies, assist unhoused residents, and increase sanitation measures. The total cost of these interventions will be directly related to the duration and severity of public health risk. Other immediate expenditures include relief to small businesses, community organizations, and renters. City Council established the Berkeley Relief Fund and allocated \$3 million for emergency relief grants to small businesses, nonprofit arts organizations, and residential tenants that are hardest hit by the COVID-19 pandemic. This fund provides grants to small businesses up to \$10,000, which will provide some relief. However, if COVID-19

Berkeley has taken immediate action to protect the community from COVID-19 including, but not limited to:

- Setting up a COVID-19 testing site for vulnerable community members, including those without access to health care as well as firefighters, nurses, police officers, and other essential City employees
- Convening a task force of staff from Berkeley Fire and Public Health to help skilled nursing and long term care facilities to limit the spread of COVID-19 and prepare for an outbreak
- Placing unhoused residents living in shelters into hotel rooms
- Increasing sanitation capacity at homeless encampments

KEY TAKEAWAYS

The COVID-19 outbreak may increase demand for city services in the short- or long-term, leading some expenditures to increase even as the overall budget decreases.

- Some expenditures will increase depending on the severity of the COVID-19 outbreak.
- COVID-19 will likely increase the cost to provide health insurance and retirement contributions for city employees.

Finance and budget experts we consulted recommend best practices for making decisions about reducing expenditures.

- Prioritize public health and safety, as well as community value in making decisions about cuts.

Proper planning is crucial in using reserves to make up for lost revenue.

- Berkeley is fortunate to have a reserve fund, giving the City more flexibility during economic downturns.

risks persist for many months, a year, or more, the needs of these businesses and organizations will outstrip the fund's resources.

COVID-19 will likely increase the cost to insure city employees. Covered California estimates that healthcare costs directly related to COVID-19 may cause 2021 health insurance premiums to increase by up to 40 percent nationwide. To recoup those costs, insurers will likely pass on this increase to employers, who may pass those costs to employees. Before COVID-19, Berkeley budgeted for a projected rate increase of only 12 percent in fiscal year 2021.

Potential longer term expenditure increases include contributions to employee retirement benefits. The City of Berkeley and its employees pay into the California Pension Employees Retirement System (CalPERS), which lost \$69 billion of its \$404 billion fund balance due to the economic downturn in March. City and employee contributions may increase in the future to make up for the lost value, as they did following the Great Recession. This increase is in addition to an existing \$665 million in unfunded liabilities related to employee retirement benefits.¹⁰ CalPERS may recover some of this value as stock market values rebound. Moody's Investors Service estimates that the U.S. pension systems are on track to see investment losses of about 21 percent for fiscal year 2020. However, this is only one estimate and the impact could vary depending on the severity and duration of the economic downturn.

Berkeley is taking steps to reduce expenditures and prioritize essential services. The City Manager asked department directors to look at budgets to identify non-essential and non-urgent expenditures that can be reduced or deferred. As of writing, city management is developing a balanced budget which incorporates the impacts of the COVID-19 pandemic to ensure the City can meet essential community needs and mitigate the effect of reduced revenue.

Finance and budget experts we consulted recommend considering the following in making decisions about reducing expenditures.

The considerations below summarize considerations we gathered from finance experts and government officials. We offer these practices and concepts that may be useful for Berkeley to consider in navigating the financial challenges of COVID-19. We suggest that this work be done quickly but thoroughly to yield maximum savings. Other cities in the Bay Area and across the state are already experiencing severe economic consequences and are considering or taking some of the steps listed below. Please note that these considerations do not constitute specific audit recommendations.

¹⁰ *Unfunded liabilities* are financial obligations for which an organization does not have sufficient resources to cover if all obligations were immediately due. According to a March 2019 Council report, Berkeley also has about \$786 million in unfunded liabilities related to infrastructure.

General

- Prioritize public health and safety, as well as community value, in making decisions about cuts rather than applying cuts across the board.
- Ensure social equity in decisions about using city resources to support the community by considering the full range of needs, from small businesses, to residential renters, to community service agencies that provide critical services to the City's most vulnerable residents. Evaluate the need to address community needs comprehensively, rather than on a one-at-a-time basis, so that city resources are distributed fairly and in proportion to the level of need.
- Federal and state funding will help Berkeley pay for activities to protect public health and respond to the COVID-19 pandemic. It will be important to monitor emerging funding opportunities and leverage government membership associations to collectively advocate for increased federal and state aid.
- It is also important to plan for total federal and state aid to fall short of Berkeley's overall need. It will be necessary to coordinate use of Berkeley's resources to provide support in areas that are not supported by federal and state funding. The City will need to consider supporting not only small businesses, but also Berkeley's community agencies. These organizations serve as safety nets for our most vulnerable residents by connecting them to food, healthcare, housing, and other essential resources critical to staying safe during a pandemic.
- It is important to consider both short-term expenditures to protect public health and provide essential services, and longer-term expenditures that may be needed to prepare Berkeley for swift economic recovery.
- Managing the influx of reimbursement programs and other possible future funding opportunities from the federal and state government can be challenging and resource-intensive. Much of this will require Berkeley to recover these costs from the federal and state sources. Investing in adequate staffing to manage the processes and maintain fiscal accountability requirements is a key consideration for reducing Berkeley's personnel expenditures.
- Conduct an assessment of all expenditures to determine whether they can continue, including an assessment of whether deferment is possible for new and ongoing projects that are not essential at this time.

Personnel

- Make every effort to avoid layoffs to prevent further unemployment.
- Implement a hiring freeze with a process for exceptions and flexibility for essential service roles.
- Consider approaches that would allow flexibility to defer wage increases if revenues fall short of a certain threshold.
- Consider the need for administrative support for the City's disaster cost recovery efforts when making any changes to staffing.

- Consider increased technology and operational costs for remote work if the shelter-in-place order continues into the future.
- Estimate the increase of healthcare costs associated with the continued response to the COVID-19 pandemic.
- In the event that the budgetary impact is so severe that furloughs and layoffs are considered necessary, prioritize community needs in deciding which positions to cut rather than across-the-board staff reductions. This could include a community needs assessment that evaluates the community value of positions at all levels. It could also include implementing voluntary separations for non-essential staff based on the outcomes of the community needs assessment.
- Consider maintaining the administrative support needed to monitor and manage services provided to the community, including support to community agencies.

Capital development and outlay

- For new capital projects, assess which ones may be deferred with minimal impact on community wellbeing. Remember that for affordable housing development and other projects funded by property taxes, these funding streams may not be affected in the next one to two fiscal years.
- Assess which large purchases can be deferred and which equipment and vehicles may be replaced when funding is more stable.

Proper planning is crucial in using reserves to make up for lost revenue.

Berkeley is fortunate to have a reserve fund, giving the City more flexibility during economic downturns. Experts we spoke with advised taking a long-term, multi-year view to spending reserves so that funds are available for the duration of the economic downturn. Berkeley's General Fund Reserve Policy provides some guidance but is limited on specific details on how to use the reserves. The reserves are made up of the Stability Reserves and the Catastrophic Reserves and cannot be used for new programs or projects. Stability Reserves are to be used to maintain fiscal stability to address unexpected shortfalls, while Catastrophic Reserves are for maintaining operations in the case of a public emergency.

Experts we spoke with advised taking a long-term view in spending reserves so that funds will be available for the duration of the downturn. The following points reflect other best practices for considering when and how to use reserves in an economic downturn.

- **It is most beneficial to use reserves as part of a plan with defined end dates and a specific goal.** The COVID-19 pandemic may come in multiple waves and require repeated shelter-in-place orders to control transmission and protect public health. Without a reliable estimate of when or how the economy will begin to recover, Berkeley

should be cautious about how much to spend to make sure there are enough reserves to pull the City through a protracted economic downturn.

- **Do not rely solely on reserves, but use them in combination with other measures to reduce expenditures and mitigate revenue loss.** As part of having a reserves plan, diversifying the response to revenue shortfalls rather than depleting reserves may put Berkeley in a better financial position to weather a protracted downturn and recover after the pandemic. A first step is to assess the funding needed for essential services. A second step is to make critical decisions about what needs to be reduced that is not critical. Reserves can then be used to offset the funding gap to maintain core responsibilities of preserving life, safety, and health of Berkeley residents, protecting our most vulnerable residents, and maintaining the character of our community.
- **It can be helpful to develop multiple scenarios with specific criteria for when and how much of the reserves can be used.** For example, if revenues fall below a certain threshold for a certain amount of time, and other identified revenue sources are exhausted, the City will use a specified amount of general funds and the reserves to cover essential costs. In addition, the City has not set a limit for using its reserves unlike the state's policy of only being able to use 50 percent of the reserves during the first year of a declared budget emergency. The City can consider a similar approach if it estimates the economic impacts to be lengthy and will need the reserves to last over a longer period of time.

Corrections

The report was revised to reflect two corrections:

- *Measure U1 revenue is tied to business license taxes, not property taxes.*
- *The City will likely first feel the impact of property transfer tax revenue reductions immediately, not in 12+ months.*

Mission Statement

Promoting transparency and accountability in Berkeley government.

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To: Honorable Mayor and Members of the City Council

From: Jenny Wong, City Auditor *zw*

Subject: Navigating the Impact of the COVID-19 Pandemic on Berkeley's Finances

RECOMMENDATION

Consider this framework when making budget decisions about managing revenues and expenditures impacted by the COVID-19 pandemic, as well as using reserve funds. This high level report includes three sections: impact on economy, revenues, and expenditures. Government finance experts offer key considerations for managing expenditures including: reducing expenditures; focusing on essential activities that prioritize public health and community value; and long-term planning when spending reserves to make sure that enough funds are available to pull the City through a potentially long economic downturn. See full report for more information.

FISCAL IMPACTS OF RECOMMENDATION

The COVID-19 pandemic is causing a severe economic downturn that may last for years. The decisions the City makes in this time of declining revenues and rising expenditures can have a lasting effect on its ability to provide essential services to meet community needs, especially for our most vulnerable residents. Considering this framework when making those decisions may help the City mitigate the economic impacts of COVID-19.

CURRENT SITUATION AND ITS EFFECTS

This report provides high level information about how the COVID-19 pandemic may impact Berkeley's economy as well as city revenues and expenditures.

Impact on Economy: With residents sheltering in place except for essential activities, Berkeley's businesses, arts organizations, and community service agencies are under tremendous financial pressure. Based on research data, shelter-in-place orders may impact at least 30,000 Berkeley jobs, and about 27 percent of workers who live in Berkeley are at high risk of unemployment or are already unemployed. This pandemic-induced economic shock is unprecedented because the public health risk will determine its severity and duration. The City is in a relatively strong fiscal position, but will face difficult decisions about tradeoffs in order to weather the economic downturn.

Impact on Revenues: The City relies on tax revenue from sales and use, business licenses, property, property transfers, and hotel occupancy to fund many of its services. With many local businesses closed and a 12-month sales tax deferral for small businesses statewide, the City's sales and hotel tax revenues are plummeting. The City will feel these decreased revenues almost immediately. Due to the timing of tax assessment and collection, Berkeley will first feel

the impact on revenue from property taxes and business license taxes in about a year or more. Federal and state financial assistance may help cover some of the costs of the City's COVID-19 response, but will not make up for all of the lost revenues.

Impact on Expenditures: Meanwhile, the increased need for city services is causing some expenditures to rise. Necessary measures to protect public health and support social distancing—especially among unhoused residents—will increase city expenditures. Federal and state aid may mitigate some of the financial impacts for Berkeley residents and small businesses. But for those who are not eligible for federal or state aid, Berkeley may see increased demand for services and support. Additionally, the impact of COVID-19 on insurance markets and retirement funds are likely to result in increased expenditures for employee health insurance and retirement contributions.

Government finance experts we interviewed recommended that Berkeley consider long-term strategies as revenues decline and expenditures increase. We suggest that this work be conducted quickly but thoroughly to yield maximum savings:

- Reduce expenditures to focus on essential activities that prioritize public health and safety, as well as community value.
- Leverage current and potential federal and state assistance in a comprehensive approach to addressing community needs.
- Coordinate use of Berkeley's resources to provide support in areas that are not supported by federal and state funding.
- Ensure social equity by evaluating the need to support Berkeley's residents, businesses, and community agencies comprehensively, rather than on a one-at-a-time basis, so that city resources are distributed fairly and in proportion to the level of need.
- Formulate a plan that takes a long-term view to spending reserves to make sure that enough funds are available to pull the city through a potentially long economic downturn.

The City is promptly taking steps to ensure it can continue meeting the community's needs by reducing or delaying non-essential and non-urgent expenditures. Additionally, federal and state funding may cover some of the COVID-19 response costs or provide reimbursement. However, the duration of the downturn is unknown and financial impact for the City and its residents is likely to outstrip available relief funding.

BACKGROUND

The COVID-19 pandemic is a public health crisis that has altered Berkeley's community life and economy. The Berkeley Health Officer has been at the forefront of protecting our residents by issuing the nation's first shelter-in-place order. With residents staying home except for essential

activities, Berkeley's restaurants, hotels, local retailers, arts and sports venues, and other small businesses that make up the City's unique cultural and economic fabric have had to scale back or close.

While the public health crisis has demanded the immediate attention of city staff, our office initiated this special report, consulting with the City's Budget Division and Finance Department, to review how the crisis will impact the City's budget and ability to provide essential city services for months and years to come. City officials also expressed interest in learning about best practices that could be adapted to Berkeley. In addition, we developed considerations on how to use the \$36 million in reserves the City has built over the years to weather financial instability.¹ To develop a comprehensive framework, we reached out to officials at leading finance and government organizations, as well as professional associations and other local governments.

ENVIRONMENTAL SUSTAINABILITY

Our office manages and stores audit workpapers and other documents electronically to significantly reduce our use of paper and ink.

RATIONALE FOR RECOMMENDATION

COVID-19 pandemic is a public health crisis with social and economic impacts that may last for years. This framework can assist city leaders in balancing the need for short-term action with long-term financial planning as revenues decline and expenditures increase.

CONTACT PERSON

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Attachments:

1: Report: Navigating the Impact of the COVID-19 Pandemic on Berkeley's Finances.

¹ The City Council established a stronger reserve policy at the recommendation of the City Auditor in 2016.