

City Manager's Message

FY 2023 City Manager's Budget Letter

Dear Mayor and Members of the City Council,

During Fiscal Year 2022, we entered the third year of battling the negative effects of the COVID-19 pandemic on the lives of Santa Cruz residents, the livelihood of our businesses, and the operations and fiscal health of the City. While we are seeing steady improvements across all of these areas, our recovery is ongoing, and there is much work to be done to ensure the City remains on solid financial footing for the years to come.

We began our budgeting process for Fiscal Year 2023 with the theme "Recover. Rebuild. Refocus." Our **Recovery** efforts will build on our Re-Envision Santa Cruz recovery plans and continue the great work already underway aimed at helping the community and local economy recover from the pandemic. This year, we have seen encouraging revenue growth, but the economy is still volatile and unpredictable. Departments made reductions of nearly \$2.5 million in their Fiscal Year 2023 budget proposals as another way to support our continued recovery.

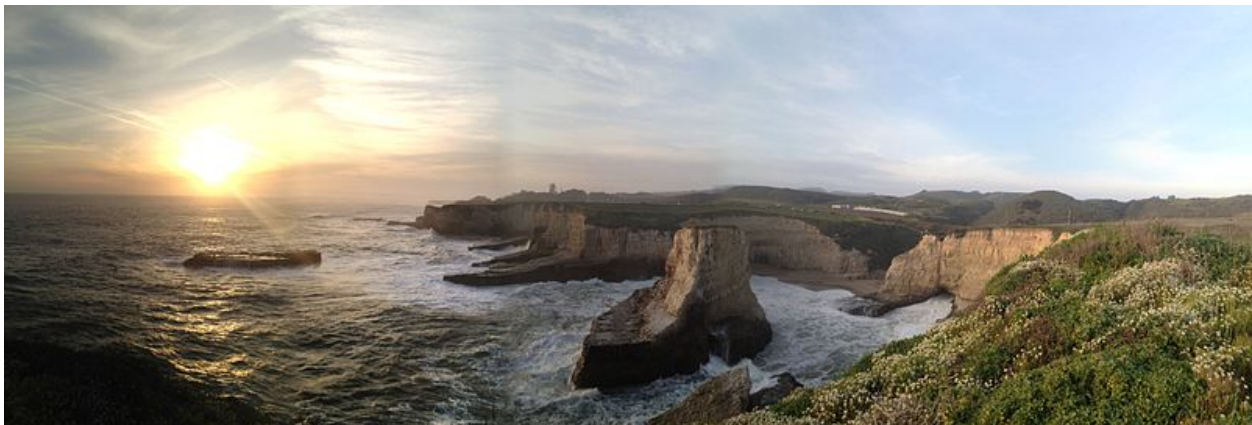
This will also be a **Rebuilding** year as we work to bolster organizational capacity so that each of our smart, dedicated employees feel supported and that as an organization we can continue to lead important work on many fronts. The rebuilding efforts include filling key leadership and department head positions, restarting our employee engagement program and looking for opportunities to operate more efficiently and effectively as a city. Finally, **refocusing** means we are rebuilding intentional work plans that align with Council priorities to have a clear citywide road map for the work ahead.

However, this forward-looking work is occurring against the backdrop of a host of uncertain factors in the nationwide economy. Current inflation rates are over 8%, and we are all feeling the squeeze. Fuel prices are at an all-time high, and supply chain issues are increasing costs for new vehicles, housing, and general consumer goods. The City's purchasing power has weakened. To manage inflationary effects, the Federal Reserve has begun increasing interest rates, thereby increasing the cost to borrow and setting into motion a range of impacts that could ultimately slow down the economy. The high unemployment we saw during the pandemic has largely subsided — in March the rate was 3.6% nationally and 5.2% in Santa Cruz County. However, now we face a shrinking labor force due to Baby Boomer retirements and other employment factors, with retail and service industries taking the biggest hit.

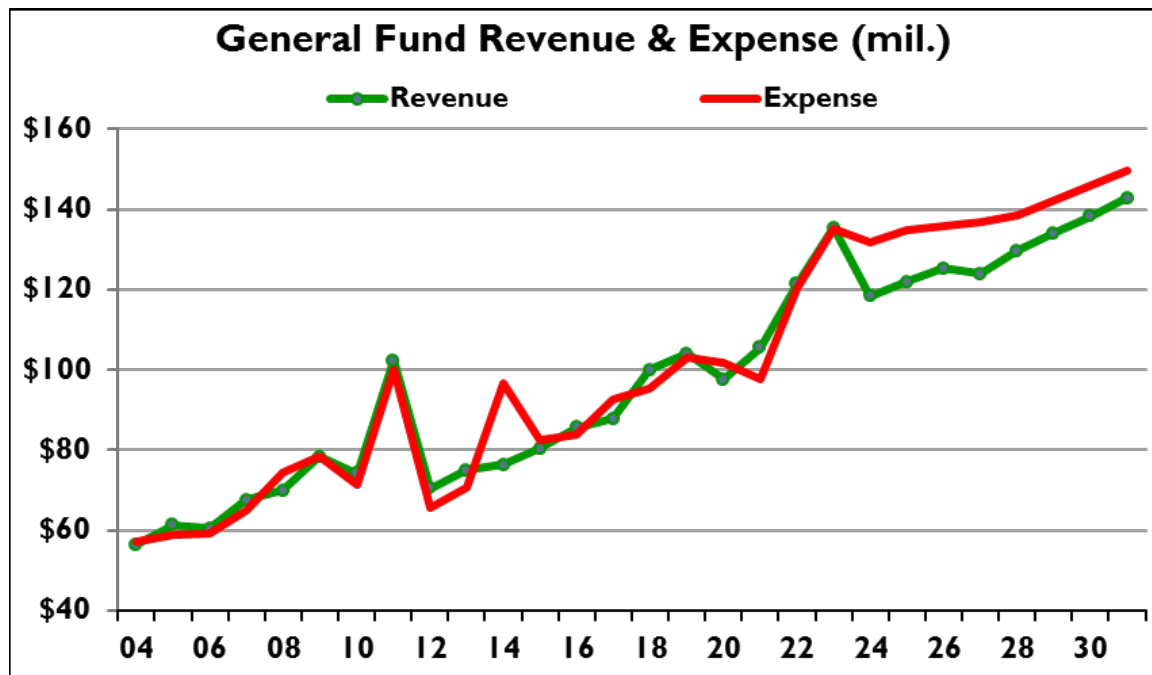
With respect to the General Fund, the City estimated a loss of \$11 million for Fiscal Year 2021. In Fiscal Year 2022, projections indicate the City will end the year about 7% above Fiscal Year 2019 levels. However, while Santa Cruz is recovering to pre-pandemic levels in many areas of revenue, the City is not experiencing this as “real growth” when these figures are adjusted to account for one of the highest rates of inflation that we have experienced in more than 40 years. Tourism/visitor-related revenues have slowly been returning to pre-pandemic levels. Transient Occupancy Tax revenue is projected to increase 25% by the end of this fiscal year compared to FY 2021 and is projected to grow 8% in FY 2023. Admission Tax revenue is estimated to increase by 20% in FY 2023 compared to FY 2022 estimated actuals. Overall, the General Fund is projected to increase 9% for Fiscal Year 2023.

With respect to Enterprise Funds, the Parking Fund continues to lag in recovery efforts as garage and parking permit fees were significantly discounted to encourage visitors to our Downtown. FY 2023 shows the Parking Fund estimated fund balance in a \$3.7M deficit. Parking rates have since been raised to pre-pandemic rates and are expected to help with recovery efforts to this fund.

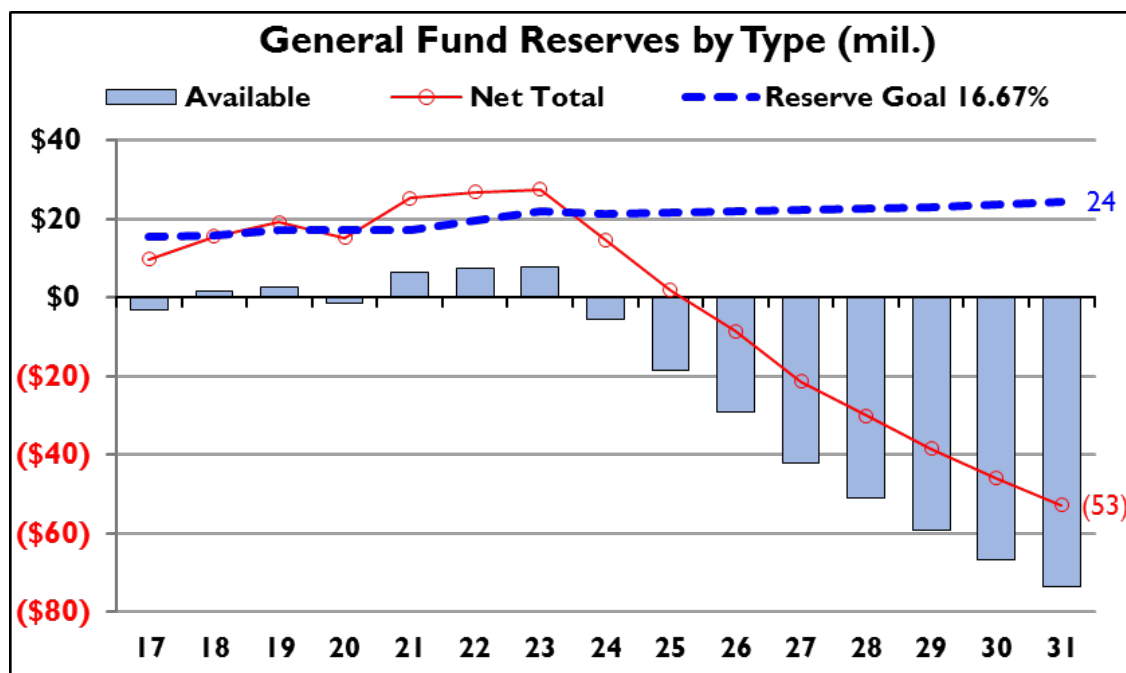
In Fiscal Year 2022, through the advocacy efforts of then-Mayor Donna Meyers, City staff, and the support of Senator John Laird and Assemblymember Mark Stone, the City received a one-time \$14 million payment to support establishing a proactive approach to managing homelessness issues within the City. A citywide team came together to develop the new [Homelessness Response Action Plan](#), which focuses on balancing individual needs and community impacts from prevention to exit. It will guide the City through the next three years of homelessness response. Key to the plan is the City taking a more active role in providing individuals with emergency shelter and case management to help them secure permanent housing. We are also collaborating more closely with the County to achieve better outcomes. Importantly, most of our homelessness response efforts are funded by one-time state and federal dollars, requiring that we continue to explore and secure additional funding streams to sustain these critical programs over the long term.



Despite positive recovery trends, the City continues to face structural deficits that outpace revenue recovery. The graph below shows the General Fund projected deficits if new revenue sources are not secured to meet projected demands.



One-time revenue from the American Rescue Plan Act (ARPA) and California State funding for homelessness response have helped the City bridge the fiscal crises brought on by the pandemic and the economy. However, without other sources, City revenues are depleted by FY 2025 as shown in the graph below.



Looking ahead to Fiscal Year 2023, we must balance the reality of the City's existing structural deficit with continuing to seek opportunities to ensure the City's vibrancy and stability in the future. We will be making significant investments in our Homelessness Response Action Plan, including building an organizational framework to implement the plan. With a significant backlog of capital and infrastructure projects, we are also committing to greater investment each year in our Capital Investment Program to attempt to address a greater percentage of deferred maintenance that could threaten the City's resiliency. Taking a longer view of the City's financial trajectory, we will also undertake the development of a long-term financial plan that will provide a framework for evaluating investment strategies and pension cost financing, as well as a plan for citywide capital needs, prioritization, and financing. Fortunately, we will gain additional interim stability from the second and final installment of funding from the American Rescue Plan Act of \$7.1 million. Still, we will need to secure alternative ongoing revenue sources to achieve long-term fiscal sustainability.

The most significant opportunity to ensure long-term stability on our horizon is Measure F. In March, to address community needs, including homelessness programs and other essential city services, the City Council voted unanimously to place Measure F, a local half-cent sales tax measure, on the upcoming June 7 ballot. This additional sales tax would add 5 cents to a \$10 purchase. If passed, current projections show the measure would generate revenues of approximately \$8 million annually. While we are hopeful for the community's support of Measure F, we are not standing still in seeking new forms of revenue. The City Council's Budget and Revenue Ad Hoc Committee continues to explore new revenue resources, and staff are working on a citywide fee study to address greater cost recovery across the organization.

We are also mindful of the significant expenditures on the horizon, such as expected increases in insurance costs and the need to invest in and address capital infrastructure projects, particularly given the inflationary impacts on construction costs in recent months. In addition, we will work to support our employees as we negotiate with five bargaining units on new contracts in Fiscal Year 2023 and seek to ensure competitive compensation plans for all of our dedicated employees. Our Enterprise Resource Planning (ERP) system – the integrated software that supports all aspects of our day-to-day operations – is scheduled to sunset in 2027. Current replacement costs for the ERP system are estimated to be \$8–\$10 million, with multiple years of staff time needed to implement the new system.

We are coming to the close of Re-Envision Santa Cruz, the interim recovery plan that has carried us through the past 18 months. Throughout the plan, we worked to execute a bold vision that centered on the priorities of long-term fiscal sustainability, Downtown and business revitalization and building out much-needed infrastructure. We worked to find ways to inject our local economy with new jobs, green businesses, affordable housing, and resilient green infrastructure. We worked to bolster what makes Santa Cruz special by supporting our businesses, advocating for new and improved funding sources, and reinvesting in the Downtown and infrastructure, from roads and water to parks, facilities, and open spaces. We made significant achievements across the 18 months that are too numerous to mention. But I invite you to learn more at cityofsantacruz.com/recovery.

I would like to thank our entire budget team, including our Interim Finance Director Bobby Magee and Budget Manager Lupita Alamos. We are fortunate for this team's incredible leadership during an extremely volatile time. I also want to thank the executive leadership and the more than 800 City of Santa Cruz employees. You have demonstrated your unwavering dedication to serving the community, and I am proud to call you my colleagues.

I continue to be impressed with the dedication of our City of Santa Cruz team, and I am excited about what's to come.

Matt Huffaker

