MEMORANDUM

TO: The Honorable Gavin Newsom
The Honorable Board of Supervisors

FROM: Ben Rosenfield, Controller

DATE: October 31, 2008

SUBJECT: Revised Tax Revenue Projections Given Economic Slowdown

This memo informs the Mayor and Board of Supervisors that the Controller's Office is revising its revenue estimates for the current fiscal year.

The adopted budget for FY 2008-09 assumed continued local economic growth and moderate growth of General Fund tax revenues. Since the adoption of the budget in July, the City's economic outlook has significantly worsened, particularly since the onset of the global financial market upheavals that began in September. The following provides a summary of the Controller's revised General Fund tax revenue outlook given these events, reflecting more recent tax filing information and our revised outlook for the remainder of this fiscal year.

Given this downturn in our local economy, the Controller's Office currently projects General Fund tax revenue shortfalls in the current fiscal year of between $90 million and $125 million versus the adopted budget. This range of projected losses depends on assumptions of the severity of the economic downturn on specific San Francisco industries and the tax revenues those industries generate. While considerable uncertainty remains, it is clear that the budget assumption of moderate tax revenue growth will not occur. Additionally, several major tax revenue sources will drop below levels received in the prior year. The changes in these tax revenues are summarized below:

Property Tax
Property tax is the City's largest single revenue stream and the one least likely to be affected in the current year by the economic downturn. The current year property tax roll, upon which property tax bills and receipts in the current fiscal year are based, has been set. FY 2007-08 revenues benefitted from the effect of a one-time clearance of a backlog of prior year property tax appeals at lower than anticipated assessment reduction levels. This one-time savings will not recur in the current fiscal year. We therefore project approximately $8 million in current year weakness below budget. Additionally, the City has recently seen an increase in the number of appeals of property tax assessments. While the cumulative value of these appeals is still moderate and within assumed levels, our office will monitor and report on appeals activity periodically throughout the year.

Real Property Transfer Tax
Real property transfer tax is the most volatile major tax revenue stream received by the City, and the most affected by the overall economy and availability of credit. Transfer tax receipts grew to record levels in recent fiscal years, with a significant cooling projected in the adopted budget. Accordingly, the budget for the current fiscal year reflects an assumed 24% reduction versus the prior fiscal year's budget. Recent and projected experience, however, leads to larger projected losses during the current fiscal year of between 37% and 48%. This results in projected current year losses of between $40 million and $49 million versus the adopted budget.

Payroll Tax
Since the budget was adopted, the City has seen slowing employment and wage growth, which are the primary drivers of payroll tax revenue. We expect these slowing trends to continue for the remainder of this fiscal year and, in some sectors, to lead to employment declines and reduced salary increases from those originally assumed. Given this experienced and projected weakness, our office currently projects slower growth of this revenue source than the 5.8% assumed in the budget. We currently project weakness of up to $7 million versus the adopted budget, reflecting an assumed annual growth rate of 0.5%.

Sales Taxes
The City receives a number of various allocations of sales tax revenues, some representing local sales tax collections and some a share of statewide sales taxes. The current budget assumed a continuance in locally-generated sales growth rates of 5.0%, consistent with the experience of the last two years. Given the impact of the credit crunch on business and consumer spending, the Controller's Office projects sales tax declines in the current year of between 2.0% and 5.0%, resulting in revenue shortfalls of between $10 million and $14 million. Additionally, state sales tax revenue collections are declining at a more rapid rate, leading to projected health and welfare realignment revenue losses of between $16 million and $20 million (drops of 7.5% to 10.0%) and public safety sales tax of between $7 million and $9 million (drops of 4.5% and 7.1%) versus the adopted budget. Total sales tax-related losses are estimated at $33 million to $43 million.

Hotel Tax
The adopted budget assumes strong, continued growth in hotel taxes of 7.2%. At present, the hotel and tourism sectors have not been significantly affected by the economic downturn, and hotel taxes have met or exceeded budget assumptions during the first quarter of this fiscal year. Occupancy and average daily hotel rates remain high, and the City's convention business is robust. Nonetheless, growth rates have slowed during this period, and the effect of a national recession, a weakening dollar, reduced consumer discretionary spending, and corporate spending reductions will likely result in slowing growth during the remainder of the fiscal year. Given this, we currently project slower growth rates of between 5.0% and 2.0% hotel tax growth for this fiscal year, resulting in General Fund tax losses of between $14 million and $19 million versus the adopted budget.

While uncertainty regarding the severity of the economic downturn remains, the Controller's Office projects that tax revenues losses in the current fiscal year will exceed the balance of the General Fund Reserve. Adjustments to the current year budget – either in the form of reduced expenditures or increased revenues – will be required to balance General Fund expenditures and revenues, as required by the Charter. Until this balance is restored, our office will not be able to certify funds from the General Fund Reserve for other appropriations.

Our office will provide regular updates over the course of the fiscal year on current economic indicators and tax return information. Additionally, we will complete the pre-audit close of last fiscal year in the coming month, and currently anticipate a greater than anticipated balance. Lastly, we will monitor and report on the potential impact of the State's reported $10 billion current year shortfall on the current year City budget as details are known. Please feel free to contact me at (415) 554-7500 should you wish to discuss this information in more detail.

FY 2008-09 Key General Fund Revenue Sources

	Budget	Best Case			Worst Case		
		%	$	Surplus / (Shortfall)	%	$	Surplus / (Shortfall)
Property Tax	1,019	8%	1,010	(8)	8%	1,010	(8)
Property Transfer Tax	94	-37%	54	(40)	-48%	45	(49)
Payroll Tax	385	2.5%	386	1	0.5%	378	(7)
Sales Tax-Related	363	varies	330	(33)	varies	321	(43)
Hotel Room Tax	189	5%	175	(14)	2%	170	(19)
Other Sources	961		965	4		962	1
Total	**3,011**		**2,920**	**(90)**		**2,886**	**(125)**