File No. 230320

Committee Item No. ______
Board Item No. 40

COMMITTEE/BOARD OF SUPERVISORS

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Prepared by: Lisa Lew **Date:** March 31, 2023
Prepared by: ______ **Date:** ______

FILE NO. 230320 RESOLUTION NO.

[Urging Governor Gavin Newsom to Overhaul the California Employment Development Department]

Resolution urging Governor Gavin Newsom to overhaul and increase the useability of the California Employment Development Department.

WHEREAS, In California, Unemployment Insurance is dispersed by the Employment Development Division (EDD); and

WHEREAS, California's Unemployment Insurance provides weekly temporary wage replacement to unemployed workers who lose their job through no fault of their own; and

WHEREAS, The Unemployment Insurance was established as part of the Social Security Act of 1935, offering an economic line of defense against the effects of unemployment; and

WHEREAS, Unemployment Insurance is one of the most important economic safeguards, allowing workers to continue to support their families and contribute to the economy; and

WHEREAS, During the COVID-19 pandemic, when there was a dramatic uptick in job loss, EDD did not have the infrastructure to keep pace with the surge of workers seeking Unemployment Insurance Claims, leaving workers without benefits for weeks or months at a time; and

WHEREAS, Getting through to EDD on the phone lines was nearly impossible, In April 2020, EDD answered less than 1% of the calls received, and each field office had over 450 pounds of unprocessed mail, individuals experienced severe challenges getting through to an agent, as many found themselves waiting on hold for hours each day; and

WHEREAS, Since March 2020, the EDD has seen 29 million claims, and at its height there was a backlog of 1.7 million claims, growing by 10,000 claims a day; and

WHEREAS, Many out-of-work Californians waited weeks or month for their money to arrive, severely impacting their capacity to pay their bills and keep up with their rent; and

WHEREAS, A report produced by the California Legislative Analyst's Office found that EDD had deep structural deficiencies as a result of a focus on reducing costs and detecting fraud, rather than making it easier for workers to receive their benefits; and

WHEREAS, An audit by the State of California in January 2021, found that the Unemployment Insurance program was at a higher risk due to using "uninformed and disjointed" techniques to detect fraud, and the EDD did not take the substantive action to improve security until months into the pandemic; and

WHEREAS, EDD paid out some $20 billion in fraudulent claims after being repeatedly warned by the Federal Government that the system was at a severe security risk; and

WHEREAS, According to a report published by the San Francisco Budget and Legislative Analyst's Office (BLA), on file with the Clerk of the Board of Supervisors in File No. 230302, which is hereby declared to be a part of this Resolution as if set forth fully herein, workers in San Francisco's retail and food services have been most impacted by job loss; and

WHEREAS, California must support the frontline workers most impacted by the COVID-19 pandemic by ensuring that they can receive their entitled Unemployment Insurance Benefits; and

WHEREAS, The Hospitality, food service, and retail workers and their families are a vital part of the economy should not be penalized as a result of a malfunctioning Unemployment Insurance system; and

WHEREAS, While the pandemic is winding down, the problems that EDD faces, persist; and

WHEREAS, As layoffs in the technology sector increase, the economy in San Francisco and around California are reliant on individuals receiving the unemployment insurance they are entitled to; now, therefore, be it

RESOLVED, That the San Francisco Board of Supervisors calls on California Governor Gavin Newsom to take the necessary efforts to overhaul and increase the usability of the Employment Development Department; and, be it

FURTHER RESOLVED, That the Board of Supervisors hereby directs the Clerk of the Board of Supervisors to transmit a copy of this Resolution to Governor Gavin Newsom, and Nancy Farias, Director of the California Employment Development Department.

CITY AND COUNTY OF SAN FRANCISCO
BOARD OF SUPERVISORS

BUDGET AND LEGISLATIVE ANALYST

1390 Market Street, Suite 1150, San Francisco, CA 94102

PHONE (415) 552-9292 FAX (415) 252-0461

Policy Analysis Report

To:	Supervisor Connie Chan
From:	Budget and Legislative Analyst's Office
Re:	Options for Addressing Economic and Tax Revenue Trends in Downtown San Francisco
Date:	February 24, 2023

Summary of Requested Action

Your office requested that the Budget and Legislative Analyst conduct an analysis of the Covid-19 pandemic's economic impact on Downtown San Francisco, implications for tax revenues, and possible strategies for addressing associated challenges.

For further information about this report, contact Fred Brousseau, Director of Policy Analysis, at the Budget and Legislative Analyst's Office.

Executive Summary

- Downtown San Francisco has undergone dramatic changes in recent years, due largely to the pandemic, but also due to changes in the retail industry and the growth of online shopping. Pandemic-related impacts include the shift to remote working that has resulted in our estimate of 147,303 fewer office workers Downtown each workday. Working remotely is a development that some experts believe will be permanent for a significant portion of office workers who were present Downtown prior to the onset of the pandemic in March 2020.

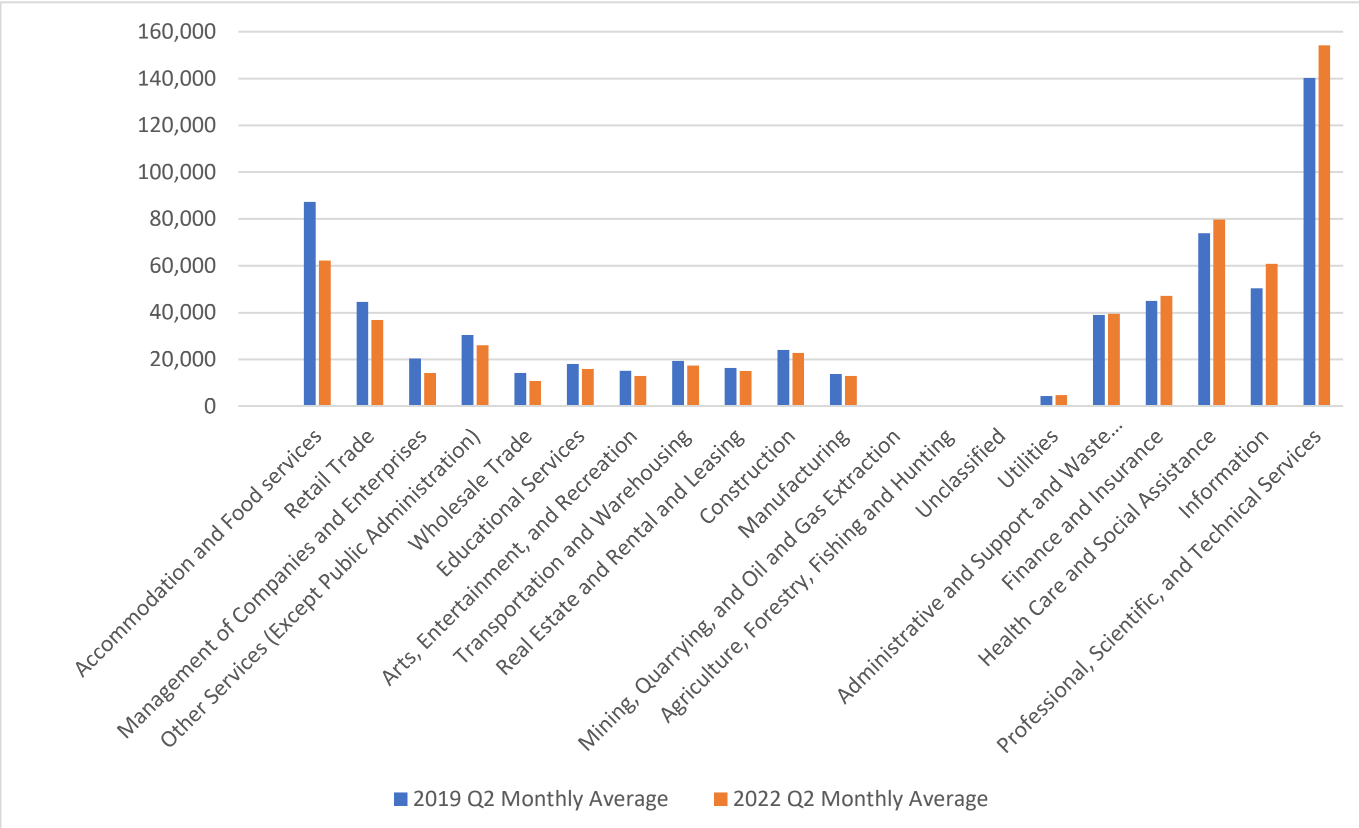
- Starting in March 2020, some of the Downtown businesses that support office workers, such as restaurants, had to curtail their operations due to public health mandates and/or the absence of the office workers who made up their customer base.

- Other pandemic-related impacts included a sharp decline in tourism and convention business, affecting one of San Francisco's main industries as hotels, restaurants, and tourist attractions closed or diminished their operations.

- The net effect of these pandemic shifts was a dramatic reduction in workers and activity Downtown, resulting in major and ongoing impacts on City and County of San Francisco tax revenues. Between the second quarter of 2019 and the second quarter of 2022, there was a net decrease of 22,837 total private sector jobs across the City, from 656,303 to 633,466.

- As shown in Exhibit A, job losses were not spread evenly among industries. The most significant reductions were in Accommodations and Food Services and Retail jobs (-24,977 and -7,711, respectively). Increases were reported in Professional. Scientific and Technical services and Information jobs (+13,906 and +10,560, respectively), among others.

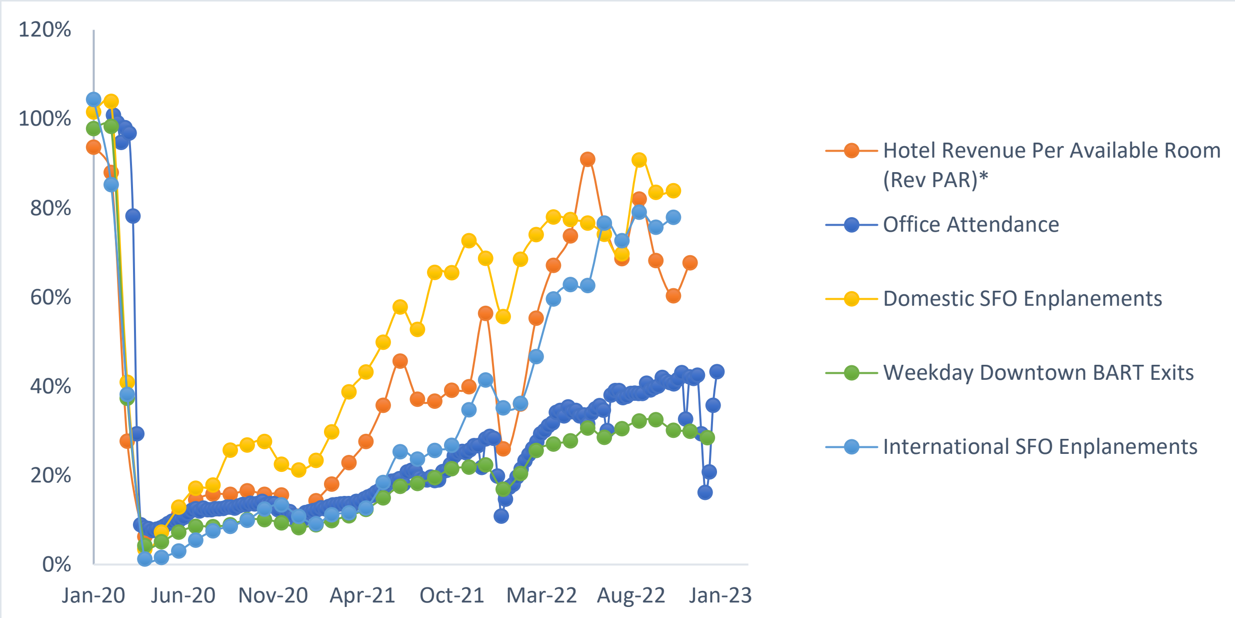
Exhibit A: Changes in San Francisco Private Sector Jobs by Selected Industries, 2019 Q2 vs. 2022 Q2



Source: Quarterly Census of Employment and Wages, U.S. Bureau of Labor Statistics

- While not back to pre-pandemic levels, there are indicators of some improvement in tourism since 2020 measured in airplane enplanements and hotel revenue per available room. Office attendance Downtown, however, remains well below pre-pandemic levels as demonstrated by office attendance rates and weekday BART exits at Downtown stations. These measures are shown in Exhibit B.

Exhibit B: Select Indicators as a Percentage of Pre-Pandemic Baselines



Source: BLA Analysis of data from Kastle Systems, STR, San Francisco International Airport and Bay Area Rapid Transit, provided by the San Francisco Controller's Office (Office of Economic Analysis)
Note: Hotel Revenue Per Available Room data covers 32 cities in San Francisco, San Mateo and Marin counties, but San Francisco accounts for approximately 65 percent of the supply of hotel rooms, according to the hospitality industry analytics firm STR, which compiles the data.

- Assuming approximately 245,505 *office* jobs in Downtown San Francisco pre-pandemic in 2019 (based on an assumed average of 238 square feet per worker) and applying an office attendance rate of approximately 40 percent, there are approximately 147,303 fewer office workers Downtown due primarily to remote work.[1]
- One notable academic study from 2021 concluded that remote and hybrid work arrangements with fewer days in the office are here to stay, based on the national Survey of Working Arrangements and Attitudes and applying decision making theory to business enterprises.[2]
- The same study estimated that workers in San Francisco spent an average of $168 per week near their workplaces, prior to the pandemic. This means that expenditures Downtown by office workers alone would be reduced by approximately $1.2 billion per year if the 40 percent office attendance rate holds into the future.

[1] This excludes changes in the base number of Downtown jobs, such as reductions due to layoffs and business closures.
[2] "Why Working from Home will Stick", Barrero, J, Bloom, N., and Davis, S. Hoover Institution, 2021

- In a comparison of activity measured by cell phone activity in the downtowns of 62 U.S. and Canadian cities during the pandemic, the Institute of Governmental Studies (IGS) at U.C. Berkeley found that San Francisco had the lowest rate of recovery to pre-pandemic levels of downtown activity, with a "recovery quotient" of 31 percent.
- The IGS study found a correlation between San Francisco's recovery quotient and the highest percentage of jobs in Professional, Scientific, and Management services Downtown (also 31 percent) compared to the 61 other cities analyzed. Jobs in these fields are considered very compatible with working remotely. For comparison, downtown Austin, Texas has fewer jobs in Professional, Scientific, and Management services at 13 percent and a downtown recovery quotient of pre-pandemic activity at 58 percent, much higher than San Francisco's 31 percent. New York City was reported as having only 18 percent of its downtown jobs in Professional, Scientific and Management services and a much higher downtown recovery quotient of 74 percent.
- One of the key impacts of changing work patterns in Downtown San Francisco between 2019 and 2022 has been significant increases in office vacancies in the primary office markets Downtown, as shown in Exhibit C.

Exhibit C: Changes in Office Total Vacancy Rates by Area, 2019 and 2022

	2019 Q4	2022 Q4
North Financial District	5.5%	24.6%
South Financial District	5.2%	20.6%
Mid-Market	7.3%	32.4%
Union Square	7.1%	21.1%
Total: Greater Downtown[3]	5.2%	25.1%

Source: JLL San Francisco Office Insight, Q4 2019 and Q4 2022.

- Tourism has made a comeback in San Francisco compared to the early days of the pandemic but is still not back to its pre-pandemic levels. There were 17.1 million tourists in 2021, still down from 26.3 million in 2019, but more than the low of 11.8 million in 2020. The mix of tourists has changed, however, with domestic and day visitors making up a greater share of all visitors and international tourists making up a reduced share, as of 2021. The impact of

[3] The greater Downtown area is composed of the City's primary office submarkets as designated by JLL in their regular reports on San Francisco's commercial real estate: North Financial District, South Financial District, Mid-Market, Union Square, Jackson Square, Mission Bay/China Basin, North Waterfront, Showplace Square, South of Market, and the Van Ness Corridor.

these changes has been a reduction in average expenditures from $365 in 2019 to $211 per visitor in 2021. These changes have negatively affected the City's hotel tax revenues.

City revenue impacts of changes in working arrangements, jobs, and tourism Downtown

Property tax

- In the January 2023 Five Year Financial Plan prepared by the Controller, Mayor's Office, and our office, General Fund property tax revenues are projected to increase in FY 2022-23 to $2.4 billion, or slightly higher than the $2.3 billion in actual property tax revenue for FY 2021-22.[4] However, the forecast projects these revenues will decrease annually from FY 2023-24 through FY 2026-27, with projected revenues not reaching their FY 2022-23 level again until FY 2027-28. While this projected reduction in property tax revenue between FYs 2023-24 and 2026-27 represents a net reduction of only approximately $61 million, the comparison to what was forecast for property tax in prior years is more striking.

- Compared to projections published in January 2022, General Fund property tax revenue for Fiscal Years 2022-23 through 2025-26 is projected to be $327.3 million less, or $81.8 million per year on average based on more recent January 2023 projections. This reflects changes in economic conditions and decreases in Downtown office property values due to continuing remote work and a reduced demand for Downtown office space. Besides remote working, recent layoffs in the technology industry could further reduce demand for office space, though this may be a more cyclical phenomenon than remote working.

- Separate from City forecasts, a 2022 analysis from the Institute on Taxation and Economic Policy (ITEP), a nonprofit, nonpartisan tax policy organization, projects a 27 to 43 percent decrease in San Francisco's commercial real estate prices related to the increase in remote work. If all office properties were reassessed at their market value at the same time to reflect losses in value assumed by the study and applying the standard 1 percent property tax rate, this would translate to estimated property tax revenue losses for all funds of between $186 million and $297 million annually from Downtown commercial properties alone, as shown in Exhibit D below.

- While our projections indicate the potential magnitude of the property tax revenue impacts of the ITEP study's estimated change in property values, California property tax laws and typical real estate turnover that triggers reassessments of property values to market rate would likely preclude a loss of this magnitude all at one time. Over time, however, these impacts would change the City's financial position.

[4] Actual property tax revenue is from the Six-Month Budget Status Report from the Controller's Office, dated February 15, 2023.

Exhibit D: Annual Effects of Decreased Downtown Office Property Values due to Loss in Market Value Projected by Institute on Taxation and Economic Policy (millions)

	27% loss	43% loss
Current assessed value, Downtown commercial	$69,000	$69,000
Current property tax revenue (@1%)	$690.0	$690.0
Projected property tax revenue (w/ loss)	$503.7	$393.3
Reduction in property tax revenue	**$186.3**	**$296.7**

Source: BLA Analysis of San Francisco Office of the Assessor-Recorder data

Business tax

- Reduced office attendance Downtown has and will continue to affect City business tax revenue. More than half of the City's business tax obligations comes from businesses located Downtown,[5] according to the Office of Economic Analysis of the San Francisco Controller's Office.[6] Among these businesses, business tax obligations declined by an estimated $144 million between Calendar Years 2019 and 2021 from $862 to $718 million, as shown in Exhibit E. By contrast, total business tax obligations for other businesses increased by approximately $14 million during the same period, resulting in a Citywide net decrease of $130 million. The reduction in obligations for Downtown only businesses was 16.7 percent, greater than the 9.5 percent reduction for all businesses Citywide.

[5] These businesses include some entities with one location and others with multiple locations, as long as all locations are Downtown; they do not include businesses with locations both Downtown and elsewhere.
[6] In the analysis used in this section, the Office of Economic Analysis defined Downtown as comprising the following zip codes: 94102, 94103, 94104, 94105, 94107, 94108, 94109, 94111, 94133, and 94158.

Exhibit E: Business Tax Obligations: Downtown and Citywide, 2019 and 2021 (millions)[7]

Calendar Year	Business Tax Owed (Businesses Located Only Downtown)	Business Tax Owed (All Businesses)	% of All Business Tax Owed
2019	$862	$1,368	63%
2021	$718	$1,238	58%
Change	-$144	-$130	
% Change	-16.7%	-9.5%	

Source: Office of Economic Analysis, San Francisco Controller's Office

- The January 2023 five-year revenue projections issued jointly by the Controller, Mayor's Office, and our office show Citywide business tax projections between FY 2022-23 and FY 2025-26 that increase each year over the baseline $831.1 million projected for FY 2022-23. However, compared to what was projected for FY 2022-23 through FY 2025-26 in January 2022, total business tax revenues over that period are forecast to be $555.2 million less than forecast, or $138.8 million annually on average.
- Business taxes include not only gross receipts taxes, which are tied to the work location of employees, but also business registration fees and the administrative office tax. The gross receipts tax component will be most affected by the extent of the ongoing shift to remote work started during the pandemic as well as due to changes in the City's population.
- The January 2023 five-year business tax revenue projections assume a 40 percent reduction in taxable gross receipts due to the increase in telecommuting from outside the City.

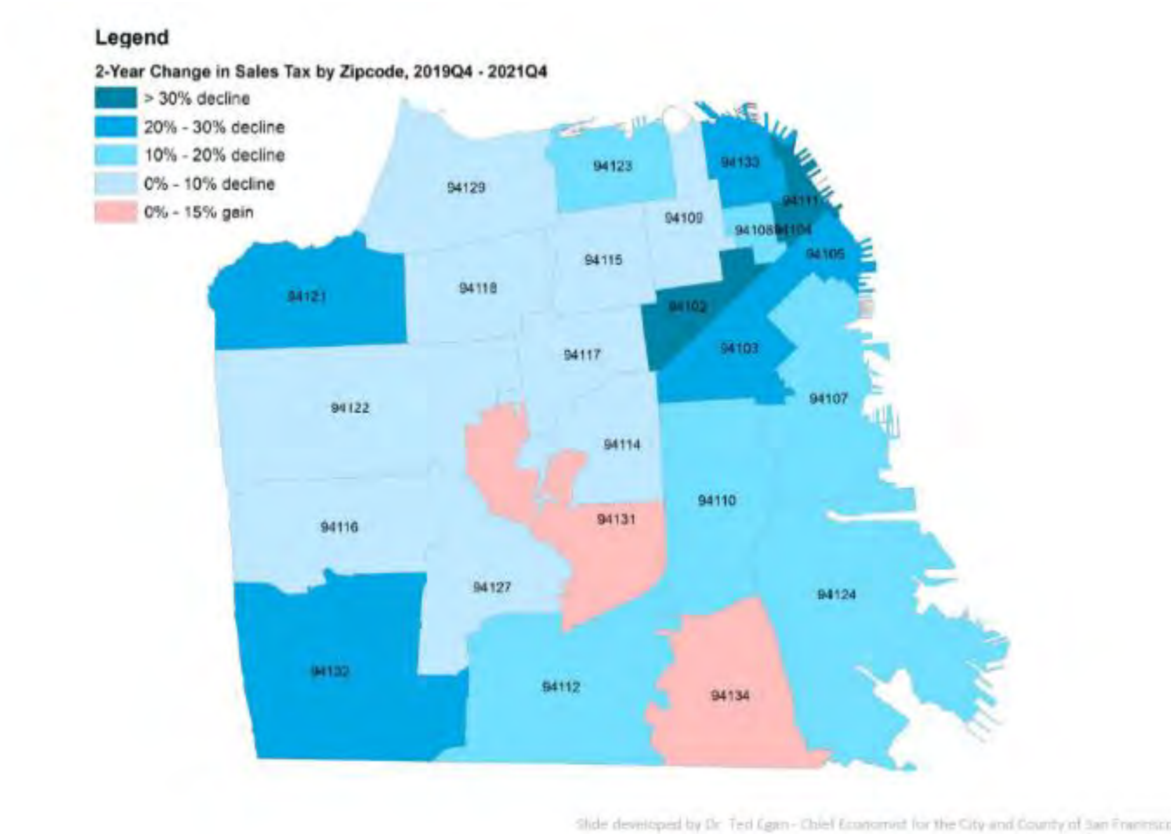
Sales tax

- Sales tax revenue provides an additional indicator of economic activity Downtown generated by office workers, business travelers, tourists, and other customers. Citywide sales tax General Fund revenue was $171.2 million in 2021, of which $34.7 million, or 20 percent, was generated in the Financial District/South Beach and SOMA.
- Neighborhood-level sales tax data shows a steeper drop in sales tax revenue Downtown between 2019 and 2021 compared to most neighborhoods, as shown in Exhibit F. Comparing all of 2019 to all of 2021, revenues generated in the Financial District/South Beach neighborhoods (zip codes 94111, 94114, 94105), declined by 38.6 percent, more than the

[7] 2014 totals consist of Payroll and Gross Receipts tax obligations; 2019 totals consist of Gross Receipts, Homelessness Gross Receipts, Payroll, Commercial Rents, Administrative Office Tax (AOT), and Homelessness AOT tax obligations; 2021 totals consist of Gross Receipts, Homelessness Gross Receipts, Commercial Rents, AOT, Homelessness AOT tax obligations. Dollar amounts are rounded to the nearest million.

Citywide reduction of 20.7 percent. The loss Citywide between 2019 and 2021 was $44.6 million, of which the Financial District/South Beach and SOMA areas were responsible for $19.9 million of that loss.

Exhibit F: Change in Sales Tax Revenue by Neighborhood, 2019 - 2021



Hotel Tax

- As shown in Exhibit G below, hotel tax revenue decreased significantly following the onset of the pandemic. Due to a rebound of tourism, General Fund hotel tax revenue is currently projected to increase to $264.9 million in FY 2022-23, an increase over the prior year. Even with such an increase, it will remain below the FY 2018-19 pre-pandemic level. Although SF Travel projects that the average daily room rate for hotels – calculated by dividing room revenue by the number of room nights sold – will surpass 2019 rates by 2024, it does not anticipate hotel occupancy matching 2019 levels until 2025.

Exhibit G: General Fund Hotel Tax Revenue, FY 2016-17 through FY 2022-23

Fiscal Year	Hotel Room Tax Revenue (millions)
2016-17	$370.3
2017-18	$382.2
2018-19	$392.3
2019-20	$252.2
2020-21	$33.2
2021-22	$158.2
2022-23	$264.9 (Projected)

Source: Six-Month Budget Status Reports, FY 2016-17 through FY 2022-23, San Francisco Controller's Office

Policy Considerations

We present the following strategies and policy options for consideration by the Board of Supervisors to address challenges related to the current and future state of downtown San Francisco.

Based on our analysis presented in this report, we conclude that there is no one solution to address the impacts of changes that have occurred in the use of Downtown since the onset of the Covid-19 pandemic. While conditions can change in unforeseen ways, waiting for the market to correct itself in terms of the demand for office space may be a very long-term prospect and may not ever result in a return to pre-pandemic conditions. For these reasons, we present a multi-pronged approach to policy interventions for consideration by the Board of Supervisors that we conclude could improve the use of and level of activity Downtown. However, the absence of an estimated 147,303 office workers who were Downtown every workday will be difficult to offset in terms of activity levels and City revenue at least in the short run.

Challenge 1: *The Rise of Remote Work Carries Risk for Citywide Tax Revenue*

Strategy 1: Prepare for an uncertain tax revenue environment.

Policy Option 1.1: The Board of Supervisors could prepare for possible shortfalls created by decreases in Downtown tax revenues, including by considering tax code changes, identifying areas for budget savings, and/or advocating for increased state relief. Hearings could be held beyond the standard annual budget review to cover these topics and/or a work group of City staff and community representatives could be convened for this purpose.

***Challenge 2**: Decreased Downtown visitors and foot traffic is hurting small businesses and neighborhood vitality.*

Strategy 2: Support interventions designed to increase visitors and Downtown foot traffic.

Policy Option 2.1: Request that OEWD and SF Travel report to the Board of Supervisors on initial results of programmatic interventions designed to improve Downtown public spaces and increase business and leisure tourism, and work with OEWD and SF Travel to ensure promising interventions are sufficiently resourced.

Policy Option 2.2: Request that the San Francisco Municipal Transportation Agency report on ways the City can help improve the Citywide and regional transit experience for commuters from other jurisdictions.

***Challenge 3:** Vacant commercial space, particularly on the ground floor, reflects missed opportunities to boost street vibrancy and restrictive allowable uses of second and third floors in retail zones limits opportunities for more varied businesses*

Strategy 3: Explore additional strategies for reducing commercial vacancies through programmatic interventions.

Policy Option 3.1: The Board of Supervisors could solicit feedback from the Office of Economic and Workforce Development on the prospect of programs incentivizing creative leasing arrangements, such as co-location and short-term subleasing, that reduce risks for commercial landlords and tenants alike.

***Challenge 4:** The City's economy is heavily concentrated in a small number of industries*

Strategy 4: Build on efforts to diversify the City's industrial mix.

Policy Option 4.1: Request that the Planning Department and the Office of Economic and Workforce Development report on ongoing and possible future efforts to diversify the industrial mix of Downtown's workforce, such as efforts to market the City and recruit target industries and/or eliminate Planning Code restrictions that may pose barriers for certain businesses and nonprofit organizations that might otherwise be interested in operating Downtown.

***Challenge 5**: A limited housing supply in the core areas of Downtown compounds challenges to economic recovery, particularly outside of business hours*

Strategy 5: Pursue new ways of incentivizing office conversion and housing construction downtown.

Policy Option 5.1: Request that the Planning Department, the Mayor's Office of Housing and Community Development, and the Office of Economic and Workforce Development report on existing efforts and future options for increasing housing construction Downtown including specific legislative proposals to streamline housing construction and commercial property conversions in certain areas of Downtown, to include creating a ministerial path for awarding permits to certain types of conversion, for consideration by the Board of Supervisors.

Project Staff: Fred Brousseau, Adam Sege

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Trends Affecting Downtown Economic Activity

While definitions vary, Downtown San Francisco generally refers to the City's Financial District and adjacent commercial areas. This part of the City is characterized by its heavy concentration of office buildings and small businesses supporting the office occupants, and it also includes the George R. Moscone Convention Center, the Yerba Buena Center for the Arts, and the San Francisco Museum of Modern Art, as well as numerous restaurants, hotels, and retailers. A hub for local and regional transit, it includes the Ferry Building, the Salesforce Transit Center, four Bay Area Rapid Transit stations and a car-free stretch of Market Street that serves as a central artery for Muni buses and trains and for cyclists. The greater Downtown area includes most of the City's office submarkets, which are depicted in the map below, created by real estate brokerage firm Cushman and Wakefield.

For the purposes of this report, unless otherwise indicated, we are defining Downtown as the Financial District north of Market Street (North Financial District), the Financial District south of Market Street (South Financial District), Union Square and the Mid-Market area.

Relative to its size, Downtown has historically generated a disproportionate amount of the City's economic activity. It was particularly hard hit by the pandemic, which caused hundreds of thousands of workers to abandon the area. Office workers to a great extent were able to hold their jobs but began working from home or remotely in great numbers. Tourism plummeted and those in businesses that served office workers and the tourist industry in businesses Downtown such as restaurants, retail, and hotels reduced their presence and employment as their businesses closed or reduced hours.

Exhibit 1: San Francisco's Primary Office Submarkets

Source: MarketBeat San Francisco: Office Q3 2022, Cushman & Wakefield

Exhibit 2 shows changes in the number of jobs by industry between the second quarters of 2019 and 2022, as recorded by the U.S. Bureau of Labor Statistics. As can be seen, job losses during the pandemic were not equally allocated. The total number of jobs in San Francisco decreased by 22,837 between the second quarter of 2019 and the second quarter of 2022, but the Accommodation and Food Services and Retail sectors lost 24,977 and 7,711 jobs, respectively, while other fields that make up San Francisco's office workforce either added jobs or decreased by relatively smaller amounts.

The differences in job losses between industries during the pandemic in San Francisco help explain the current situation Downtown. Many office-using workers Downtown began working remotely when the pandemic shutdown commenced, found the advantages of doing so largely outweighed the drawbacks, and have continued to work remotely even as the virus has subsided. Their absence

Downtown, combined with the loss of tourism, reduced the customer base and employment prospects for workers in Accommodation and Food Services and Retail businesses, many of whom are no longer working Downtown or in the City at all. While similar trends have occurred in cities across the country and around the world, the impacts have been higher and longer term in San Francisco due to the concentration of jobs that lend themselves to working remotely and due to the City's dependence on tourism.

Exhibit 2: San Francisco Private Sector Jobs by Industry, 2019 and 2022

Industry	2019 Q2 Monthly Average	2022 Q2 Monthly Average	Change
Accommodation and Food Services	87,248	62,271	-24,977
Retail Trade	44,564	36,854	-7,711
Management of Companies and Enterprises	20,387	14,091	-6,296
Other Services (Except Public Administration)	30,335	25,912	-4,423
Wholesale Trade	14,210	10,849	-3,361
Educational Services	18,078	15,792	-2,286
Arts, Entertainment, and Recreation	15,237	13,041	-2,196
Transportation and Warehousing	19,371	17,411	-1,960
Real Estate and Rental and Leasing	16,425	15,018	-1,407
Construction	23,999	22,862	-1,137
Manufacturing	13,653	12,967	-685
Mining, Quarrying, and Oil and Gas Extraction	10	27	17
Agriculture, Forestry, Fishing and Hunting	194	255	61
Unclassified	1	78	77
Utilities	4,246	4,607	362
Administrative and Support and Waste Management and Remediation Services	39,001	39,581	579
Finance and Insurance	44,984	47,219	2,235
Health Care and Social Assistance	73,879	79,683	5,804
Information	50,272	60,832	10,560
Professional, Scientific, and Technical Services	140,209	154,115	13,906
Total	**656,303**	**633,466**	**-22,837**

Source: Quarterly Census of Employment and Wages, U.S. Bureau of Labor Statistics

A number of federal, state, and local programs were established during the pandemic to assist those who had lost their jobs temporarily and permanently and to assist businesses affected by the loss of their customer bases. The assistance was needed and distributed across the City but, for Downtown, the loss in the customer base has been pronounced because both leisure and business tourists have been slow to return, and office workers have not returned in the numbers present prior to the pandemic.

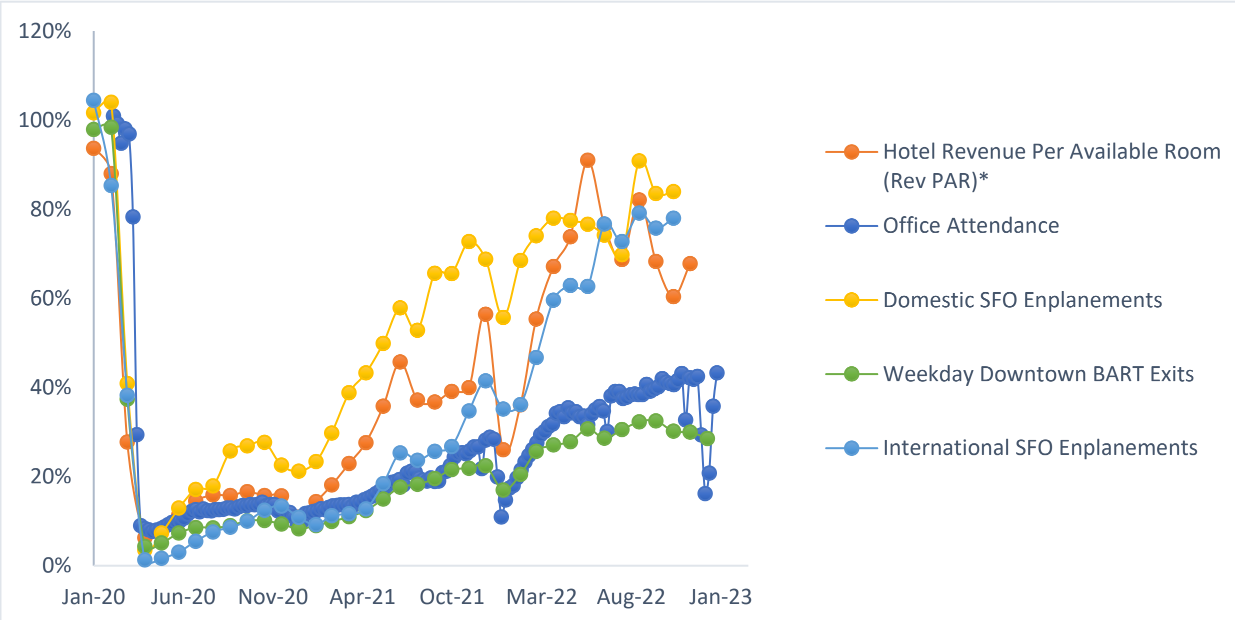
The changes in the Downtown economy during the pandemic have affected City and County of San Francisco revenues, as detailed below. A key difference going forward, however, is that tourism has been making a comeback, and though it still hasn't returned to its pre-pandemic levels as of the preparation of this report, it is projected to do so in the future. By contrast, it appears that reduced office attendance patterns for many Downtown workers may continue for some time or may be permanent, with corresponding ongoing reductions in economic activity. According to a 2022 study published by the Institute of Governmental Studies at U.C. Berkeley, cell phone activity recording the presence and movement of office workers, visitors and residents in Downtown San Francisco stood at 31 percent of pre-pandemic levels during September – November 2022.[8] This covers all activity, but a good share of that before the pandemic was based on office workers and tourists as well as City and local Bay Area residents visiting Downtown to work, shop, dine, visit cultural institutions, attend medical appointments, and other activities.

Exhibit 3 presents key metrics representing the number of office workers Downtown and business and leisure visitors before and after the onset of the pandemic. As can be seen, daily office occupancy was approximately 40 percent of pre-pandemic baselines as of January 2023, according to data from Kastle Systems. Representing visitors to the City, enplanements and hotel revenue per available room are now closer to pre-pandemic baselines than to the lows while stay-at-home orders were in effect, though reaching baseline levels will still take time. As of August 2022, the San Francisco Travel Association (SF Travel), the City's travel and convention marketing organization, projects that global visitor volume and hotel revenue per available room (RevPAR) will not reach 2019 levels until 2025.[9]

[8] Karen Chapple, Michael Leong, Daniel Huang, Hannah Moore, Laura Schmahmann, Joy Wang *Death of Downtown? Pandemic Recovery Trajectories across 62 North American Cities*", Institute of Governmental Studies, U.C. Berkeley. June 2022. See downtownrecovery.com for most current data.

[9] San Francisco Travel. San Francisco Tourism Rebounds in 2022. August 2022.

Exhibit 3: Select Indicators as a Percentage of Pre-Pandemic Baselines



Source: BLA Analysis of data from Kastle Systems, STR, San Francisco International Airport and Bay Area Rapid Transit, provided by the San Francisco Controller's Office (Office of Economic Analysis)
Note: Hotel Revenue Per Available Room data covers 32 cities in San Francisco, San Mateo and Marin counties, but San Francisco accounts for approximately 65 percent of the supply of hotel rooms, according to the hospitality industry analytics firm STR, which compiles the data.

Office Attendance

The implications of the reduction in office attendance rates and BART exits shown in Exhibit 3 are significant. Assuming approximately 245,505 office jobs in Downtown San Francisco pre-pandemic in 2019 and applying an office attendance rate of approximately 40 percent,[10] there are approximately 147,303 fewer office workers Downtown due primarily to remote work.[11] Whatever estimation methods are used to derive this number, we conclude that office attendance has increased compared to earlier in the pandemic but is still far below pre-pandemic rates.

The extent to which remote work remains the common practice in the future is still to be determined. However, many experts and observers of workplace trends have concluded that remote work will be

[10] The number of estimated office jobs is based on that standard of 238 square feet of office space per worker established by Keyser Marston Associates, Inc. in their May 2019 *Jobs Housing Nexus Analysis* prepared for the City and County of San Francisco. This standard was applied to an office inventory of approximately 61.9 million square feet in the North Financial District, South Financial District, Mid-Market and Union Square areas, as reported by JLL, less approximately 3.5 million square feet to account for vacancies, as reported by JLL for the third quarter of 2019.
[11] This excludes changes in the base number of Downtown jobs, such as reductions due to layoffs and business closures.

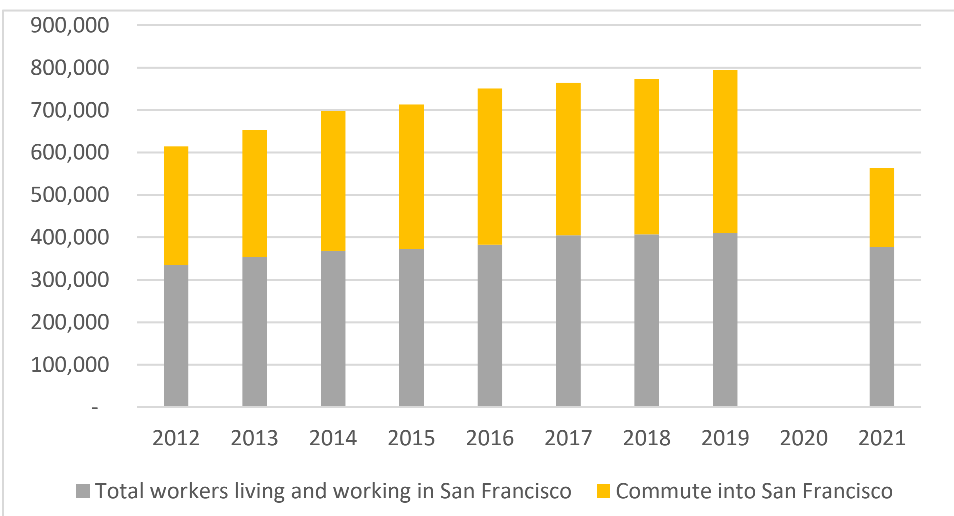
a long-term, or permanent arrangement for many professions. At least one academic study from 2021 concluded that remote and hybrid work arrangements with fewer days in the office is here to stay based on the national Survey of Working Arrangements and Attitudes and applying decision making theory to business enterprises.[12]

The same study estimated that workers in San Francisco spent an average of $168 per week near their workplaces, prior to the pandemic. This means that expenditures Downtown by office workers alone would be reduced by approximately $1.2 billion per year if an office attendance rate of approximately 40 percent holds into the future. These reductions affect small businesses Downtown that have lost a substantial portion of their customer base and will also flow through to City sales tax revenues, which in fact declined between 2019 and 2021.

Of course, many Downtown workers reside in the City and, in theory, may be making more daily expenditures in their residential neighborhoods instead of Downtown when they work remotely, but it is possible that they are not spending at the same level in the absence of the social aspect of going out to lunch or after work with coworkers. Sales tax data, presented below, shows a decline in revenue in most neighborhoods throughout the City.

Census data shows that commuters from other jurisdictions made up 48 percent of San Francisco's total daily workforce in 2019, but that percentage dropped to 33 percent in 2021, as shown in Exhibit 4 below. While this data is Citywide, it is reasonable to assume that many of those jobs were Downtown and the reduction reflects an across-the-board loss in worker expenditures for the City.

Exhibit 4: San Francisco Daytime Working Population



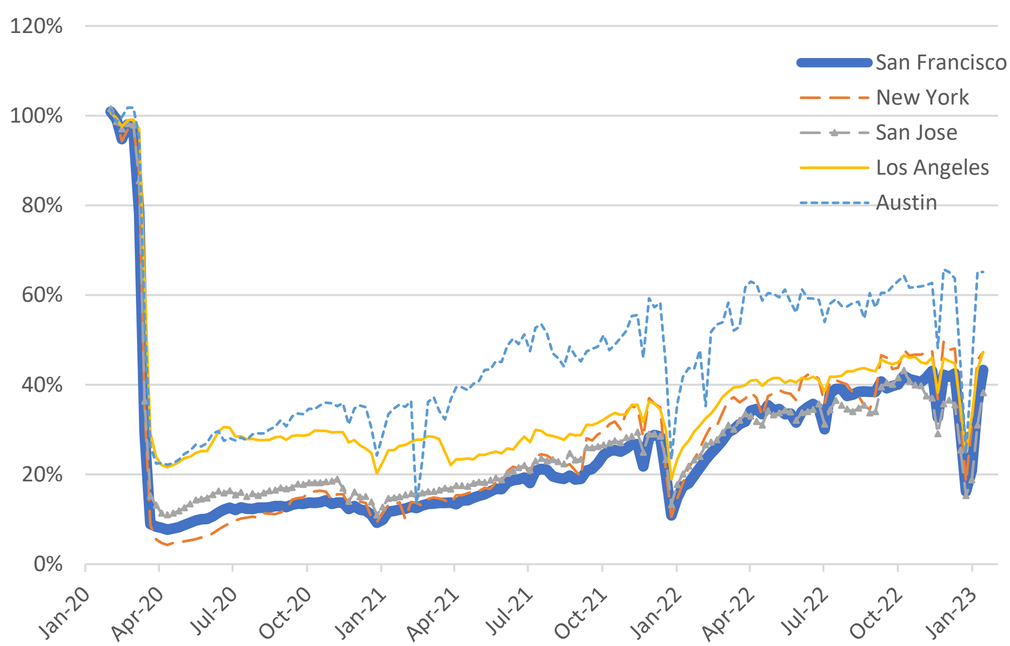
Source: BLA analysis of data from the U.S. Census Bureau, based on American Community Survey
Note: The Census Bureau did not release standard 1-year data from the American Community Survey for 2020, including the data referenced above, due to data collection disruptions caused by the Covid-19 pandemic.

[12] "Why Working from Home will Stick", Barrero, J, Bloom, N., and Davis, S. Hoover Institution, 2021

Besides the impact of reduced employee expenditures, some employers that rent office space Downtown will need less space if their employees don't return to work in the office or even if they do return but only a few days a week, as is the case now for many "hybrid" office work regimes.

As in other cities, the percentage rebound in weekly office attendance in San Francisco continues to significantly lag rebounds in tourism indicators. Since the spring of 2022, the Office of Economic Analysis of the San Francisco Controller's office reports that office attendance has hovered between 30 and 45 percent of pre-pandemic levels, as shown in Exhibit 5. As of mid-January 2023, the City's office attendance rate of 43.3% relative to pre-pandemic levels lagged that of Austin (65.1%), and to a lesser extent Los Angeles (47.3%) and New York City (47.2%). While this office attendance data covers all of San Francisco, 78 percent of San Francisco's office space lies in the Financial District, Union Square and Mid-Market neighborhoods.[13]

Exhibit 5: Weekly Office Attendance in San Francisco and Other Metro Areas



Source: Kastle Systems data, provided by the Office of Economic Analysis, San Francisco Controller's Office

Composition of Downtown Workforce

In addition to comparing downtown activity across 62 cities in the U.S. and Canada during the pandemic, the Institute of Governmental Studies study referenced above sought to identify possible drivers of decreased activity during the pandemic. To do this, researchers gathered data from the cities in their sample on 43 possible explanatory variables, from resident demographics to the

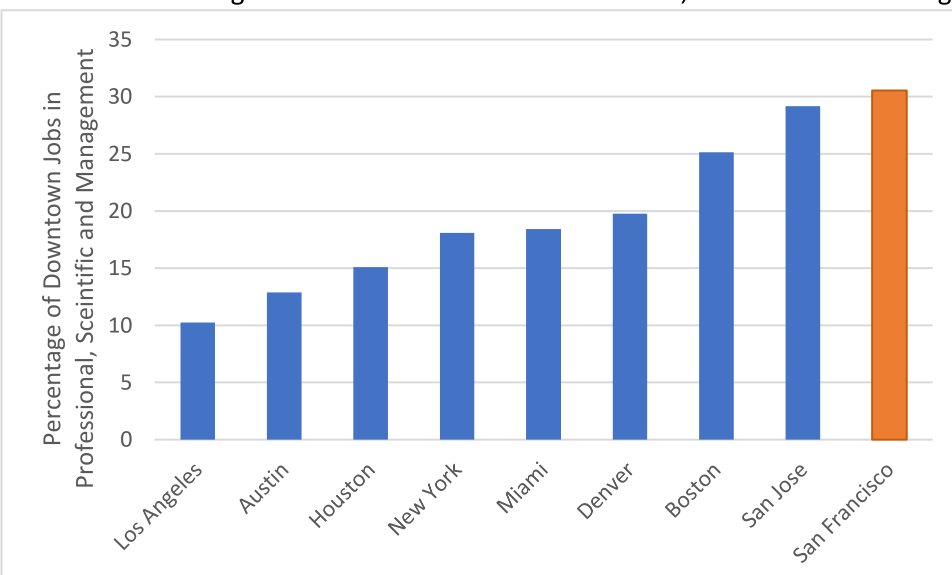
[13] San Francisco Office Insight. JLL. Q4 2022.

percentage of workers in various industries. They then analyzed the relationship between each of these variables and cell phone activity, a proxy for downtown activity.

Among the four strongest correlations was the relationship between cell phone activity and the concentration of jobs classified as Professional, Scientific, and Management services, many of which can easily be performed remotely.[14] The study used U.S. Census employment data by zip code, categorized by the North American Industry Classification System, an industry breakdown used by the federal government. Of all cities in the sample, San Francisco had the highest percent of downtown jobs in this sector (30.5%), and it also had the lowest downtown recovery quotient (31%), or indicator of activity Downtown.[15]

Exhibit 6 compares the percentage of downtown jobs in Professional, Scientific and Management services in San Francisco and several other cities analyzed in the study.[16]

Exhibit 6: Percentage of Downtown Jobs in Professional, Scientific and Management Sectors, 2022



Source: BLA Analysis of Institute of Governmental Studies, University of California, Berkeley data published online in conjunction with "Death of Downtown" policy brief, June 2022. Link.

Exhibit 7 shows the percentage distribution of Downtown San Francisco jobs by industry, as reported in data published online by the Institute of Governmental Studies study's authors.

[14] "Death of Downtown? Pandemic Recovery Trajectories across 62 North American Cities", *Institute of Governmental Studies, U.C. Berkeley*, June 2022, page 7, Link.
[15] "Explanatory Variables," Institute of Governmental Studies, U.C. Berkeley, accessed November 21, 2022. Link
[16] These job classifications may not exactly match those used by the California Employment Development Department though the proportions are similar.

Exhibit 7: Composition of Downtown San Francisco Workforce September 2022 – November 2022

Sector	Jobs, as Percentage of All Downtown Jobs
Professional, Scientific and Management	30.5%
Finance and Insurance	12.2
Information	9.3
Administrative Support and Waste Management	8.4
Accommodation and Food Services	7.5
Management	5.7
Retail Trade	4.0
Transportation and Warehousing	3.3
Utilities	2.5
Real Estate	2.5
Healthcare and Social Assistance	2.4
Educational Services	1.9
Wholesale Trade	1.8
Construction	1.8
Manufacturing	1.3
Arts, Entertainment and Recreation	1.2
Public Administration	1.2
Agriculture, Forestry, Fishing and Hunting	0.0
Mining, Quarrying, Oil and Gas	0.0
Other	2.5
Total	**100.0%**

Source: Data published in connection with the policy brief "The Death of Downtown? Pandemic Recovery Trajectories across 62 North American Cities," published by the Institute of Governmental Studies (IGS) at the University of California, Berkeley and the School of Cities at the University of Toronto, updated January 2023.[17] Accessed Feb. 17, 2023. Link.

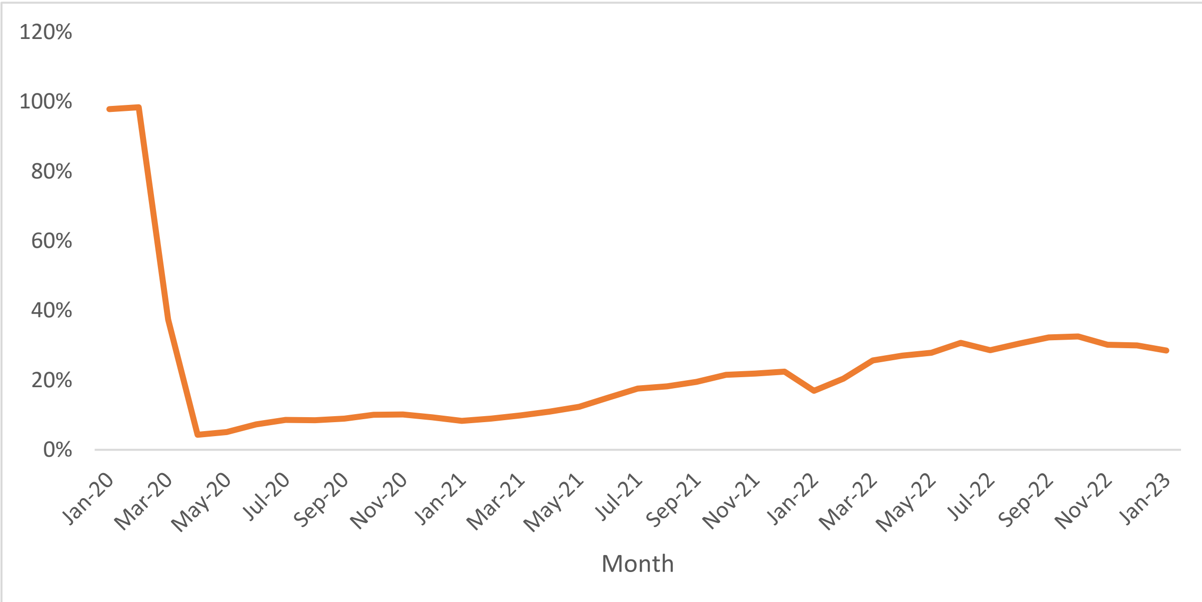
Weekday Transit

Weekday travel data suggests a stronger rebound in driving commutes than in public transit usage. Monthly Bay Bridge crossings, one indicator of driving commutes, surpassed 90 percent of 2019 baselines in March of 2021 and have remained at or above 90 percent for most months since then. By contrast, average weekday exits at four downtown BART stations – Embarcadero, Montgomery, Powell, and Civic Center – did not surpass 30% of 2019 levels until June of 2022 and stood at 29 percent of baselines in January of 2023. MUNI usage trends are in between BART and driving

[17] IGS defines Downtown San Francisco as consisting of the zip codes 94104, 94105, 94111 which covers an area composed of the North and South Financial Districts.

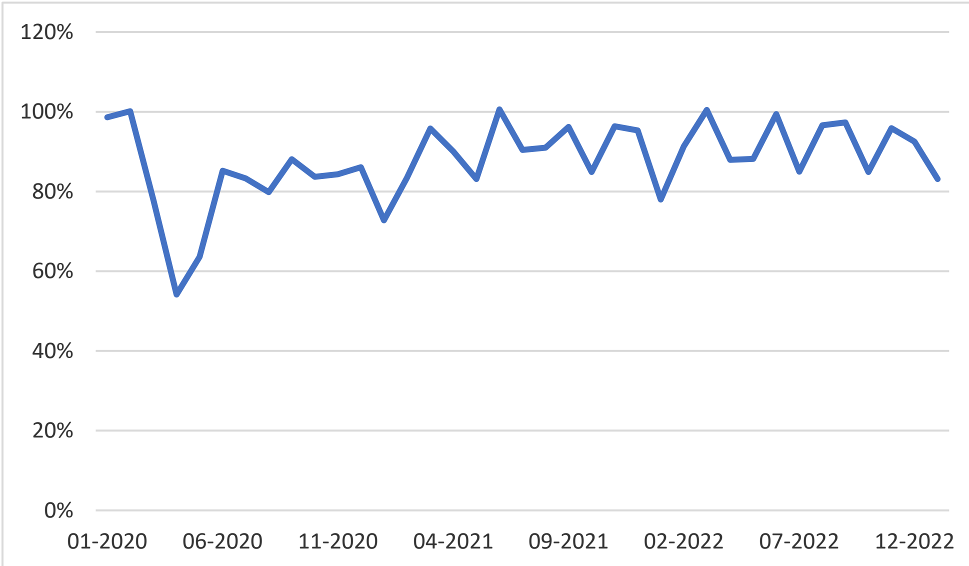
indicators: Citywide, weekday trolley bus, motor bus and light rail usage stood at 69, 63, and 40 percent of baselines, respectively, as of January 2023. Bridge crossings measure all vehicles regardless of their destination. These vehicles could be travelling to other San Francisco neighborhoods besides Downtown or to other cities.

Exhibit 8: Weekday BART Exits at Downtown San Francisco Stations, as a Percentage of the Same Month in 2019



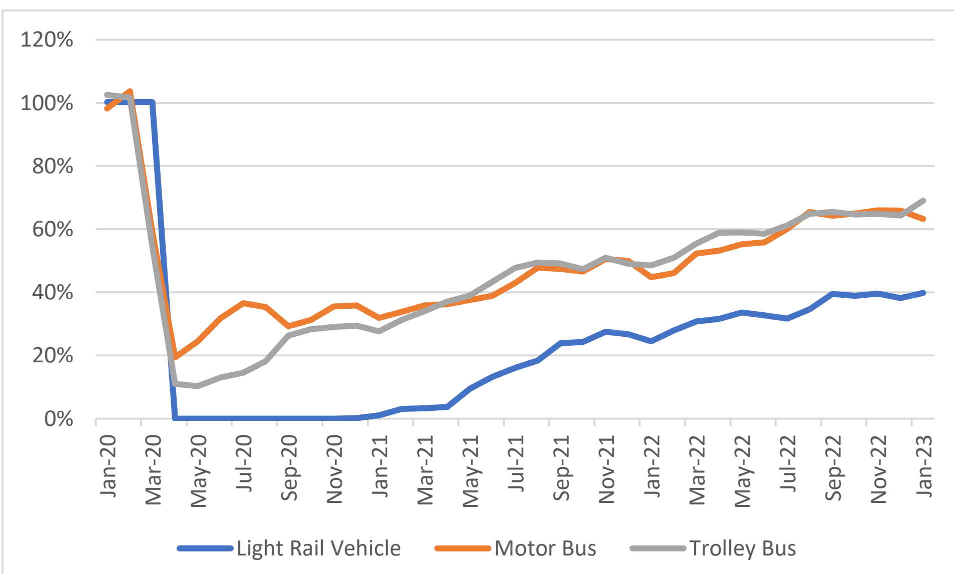
Source: BLA Analysis of Bay Area Rapid Transit Monthly Ridership Reports data.

Exhibit 9: Weekday Bay Bridge Crossings, Compared to the Same Month of 2019



Source: BLA Analysis of Bay Area Toll Authority data

Exhibit 10: MUNI Ridership for Select Modes of Transit, Compared to the Same Month of 2019

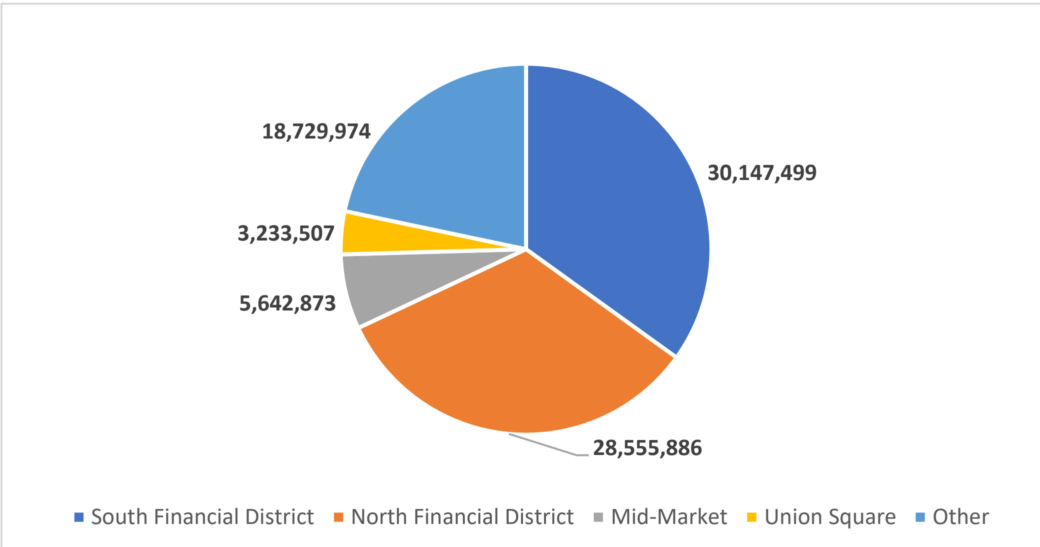


Source: BLA Analysis of San Francisco Municipal Transportation Agency data

Office Inventory and Vacancies

Of the 86.3 million square feet of office space reported by real estate brokerage firm JLL in San Francisco for the fourth quarter of 2022, 67.6 million square feet, or approximately 78 percent, is in the North and South Financial Districts, Mid-Market, and Union Square areas, as shown in Exhibit 11.

Exhibit 11: Total Office Inventory in Select Downtown Neighborhoods, 2022 Quarter 4 (Square Feet)



Source: JLL San Francisco Office Insight, Q4 2022.

Reflecting the reduction in demand for office space due to the shift in working arrangements for many office workers, Downtown areas with significant office space experienced increases in vacancy rates between 2019 and 2022, as shown in Exhibit 12.

Exhibit 12: Changes in Office Total Vacancy Rates by Area, 2019 and 2022

	2019 Q4	2022 Q4
North Financial District	5.5%	24.6%
South Financial District	5.2%	20.6%
Mid-Market	7.3%	32.4%
Union Square	7.1%	21.1%
Total: Greater Downtown[18]	5.2%	25.1%

Source: JLL San Francisco Office Insight, Q4 2019 and Q4 2022.

To the extent remote working continues and the demand for Downtown office space is permanently reduced, City revenues will be affected due to reductions in building values, potentially affecting property tax revenue, and reduced work being performed in San Francisco, affecting City business tax revenue. The absence of workers Downtown will also affect sales tax revenue. These impacts are discussed further subsequently in this report.

Tourism: Air Travel and Hotel Revenue

Tourism is a major industry in San Francisco, with visitors spending an estimated $9.6 billion in 2019. While overnight visitors stay in lodging and visit attractions throughout the City, there is a concentration of hotels Downtown, as well as restaurants, cultural and recreational attractions, and businesses supported by tourists. With the onset of the pandemic, the number of visitors to the City declined from an estimated 26.3 million in 2019 to 11.8 million in 2020, then increased to 17.1 million in 2021, still resulting in a 35 percent reduction compared to 2019.[19] This visitor data is presented in Exhibit 13.

[18] The greater Downtown area is composed of the City's primary office submarkets as designated by JLL in their regular reports on San Francisco's commercial real estate: North Financial District, South Financial District, Mid-Market, Union Square, Jackson Square, Mission Bay/China Basin, North Waterfront, Showplace Square, South of Market, and the Van Ness Corridor.

[19] *Visitor Volume and Direct Spending Estimates, 2021*. SF Travel, August 2022

Exhibit 13: Visitors to San Francisco, by Type 2018 – 2021 (millions)

Type	2018	2019	2020	2021
Domestic Overnight	7.4	7.5	2.4	4.0
International Overnight	2.9	3	0.5	0.6
Day Visitors	15.5	15.8	8.9	12.5
Total	**25.8**	**26.3**	**11.8**	**17.1**
Distribution of Number of Visitors				
Domestic Overnight	28.7%	28.5%	20.3%	23.4%
International Overnight	11.2%	11.4%	4.2%	3.5%
Day Visitors	60.1%	60.1%	75.4%	73.1%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Visitor Volume and Direct Spending Estimates, 2021. SF Travel, August 2022

As shown in Exhibit 14 below, tourist spending decreased to $3.6 billion in 2021, or by 62 percent, from $9.56 billion in 2019. This amount represented an increase in spending above the 2020 level but is still well below pre-pandemic spending levels. As discussed further below, these changes in tourism are captured in the City's hotel tax revenues, which declined significantly with the onset of the pandemic and have since increased but not to the level received prior to the pandemic.

Exhibit 14: Visitor Spending, by Type of Visitor, 2018 – 2021 (Billions)

Type	2018	2019	2020	2021
Domestic Overnight	$3.1	$3.2	$1.0	$1.4
International Overnight	5.0	5.1	1.0	1.2
Day Visitors	1.2	1.3	0.6	1.0
Total	$9.3	$9.6	$2.6	$3.6
Distribution of Visitor Spending				
Domestic Overnight	33.3%	33.3%	38.5%	38.9%
International Overnight	53.8%	53.1%	38.5%	33.3%
Day Visitors	12.9%	13.5%	23.1%	27.8%
Total	100.0%	100.0%	100.0%	100.0%
Average spending/visitor[1]	$360	$365	$220	$211

Source: Visitor Volume and Direct Spending Estimates, 2021. SF Travel, August 2022
[1] Not in billions.

As shown in Exhibits 13 and 14, the distribution of tourists shifted during the pandemic, with a higher proportion of day visitors and lower shares of international and domestic overnight travelers. Day visitors contribute to the City's economy but for the most part do not stay in hotels and contribute to the hotel industry and the City's hotel tax revenues. The lower level of spending per visitor is reflected in average expenditures per visitor, shown in Exhibit 14. As can be seen, average spending per visitor was $211 in 2021, down from $365 in 2019. This shift in the makeup of visitors is part of the explanation of changes in the City's hotel and sales tax revenue, details of which are provided in the next section.

As other measures of changes in tourism, domestic and international enplanements at San Francisco International Airport stood at 84 and 78 percent of 2019 baselines in November of 2022, the most recent month for which data is available. These figures were lower than those at New York City's John F. Kennedy International Airport and Seattle-Tacoma International Airport, but slightly higher than those at Los Angeles International Airport.[20] For the San Francisco metro area, which as noted above includes 32 cities in San Francisco, San Mateo and Marin counties, hotel revenue per available room (Rev PAR) of $99 stood at 68 percent of 2019 levels in December of 2022, according to data from the hospitality industry analytics firm STR.[21] This was lower than the corresponding percentages in Los Angeles, New York, San Diego and Seattle.[22]

[20] Office of Economic Analysis, San Francisco Controller's Office.

[21] Hotel revenue per available room (Rev PAR) is a measure of demand for hotel rooms, calculated by dividing total revenue generated during a specific time period by the number of rooms available for reservation. Rev PAR data for the San Francisco metro area covers 32 cities in the area, but San Francisco accounts for approximately 65 percent of the supply of hotel rooms, according to STR.

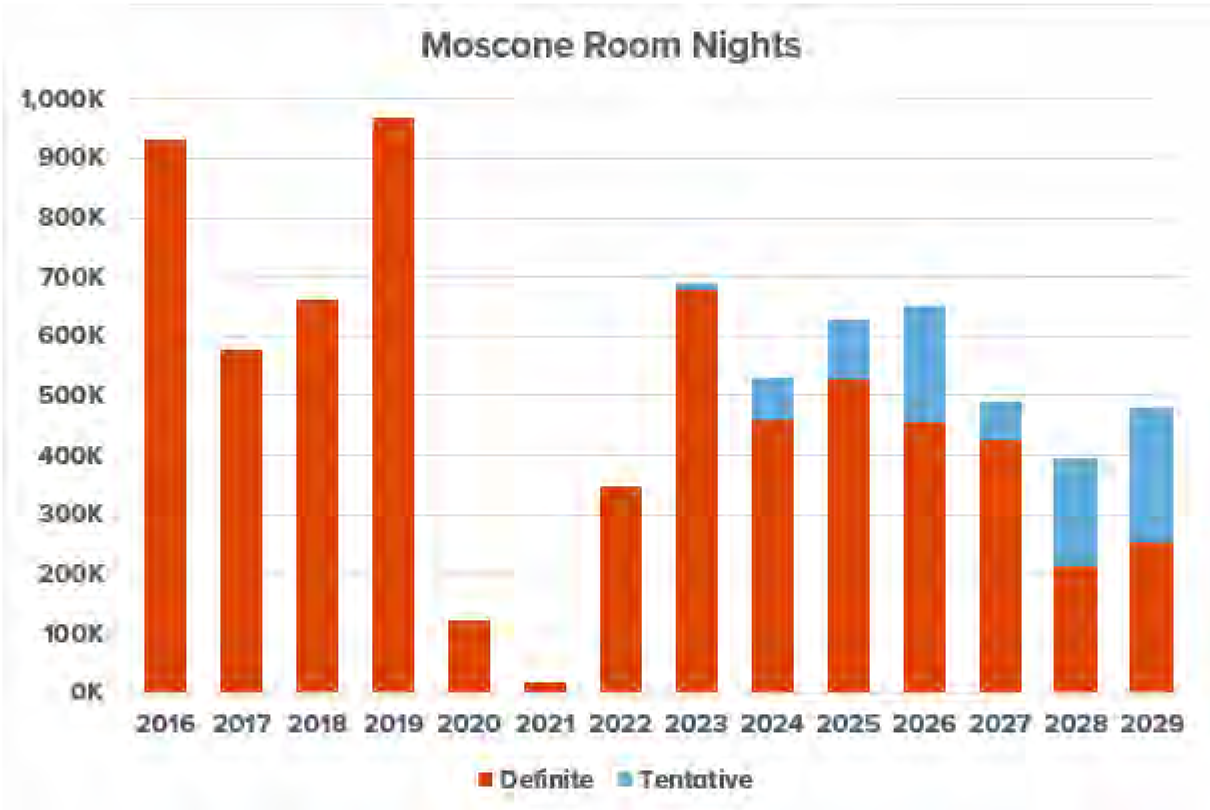
[22] STR data compiled by the Office of Economic Analysis, San Francisco Controller's Office.

Tourism: Convention Business

The convention business in San Francisco supports Downtown businesses and contributes directly to City hotel and sales tax revenue. As one measure of convention activity, SF Travel tracks Moscone Convention Center room nights: these refer to hotel rooms blocked for guests attending events at the Moscone Convention Center, with each night of a reservation representing one room night. (For past events, data generally reflects only those rooms and nights that are ultimately reserved by event guests, while for future events, data includes blocked rooms that have not yet been reserved, according to SF Travel.) As shown in Exhibit 15, Moscone Center room nights plummeted with the onset of the pandemic, but rebounded in 2022. While projected to continue improving in the out years, Moscone Center room nights will still be below their pre-pandemic level as presently forecast. Confirmed Moscone Center room nights for 2022 totalled 35 percent of 2019's total, an increase over the corresponding figures for 2020 and 2021.[23] Definite and tentative bookings for 2023 total 66 percent of 2019's total.

[23] For past events, data generally reflects only those rooms and nights that are ultimately reserved by event guests, while for future events, data includes blocked rooms that have not yet been reserved, according to SF Travel.

Exhibit 15: Definite and Tentative Moscone Convention Center Room Nights, As of January 2023



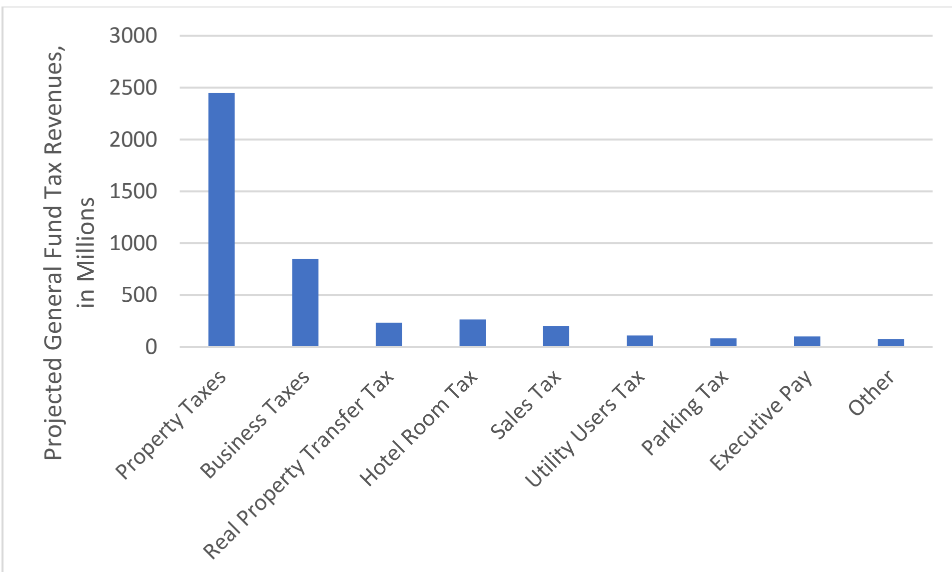
Source: S.F. Travel. Data as of Jan. 31, 2023.

Trends in Downtown Tax Revenue

Background

Local tax revenues account for 67.8% of projected Citywide total General Fund revenues and transfers in for FY 2022-23, according to February 2023 projections from the Controller's Office.[24] Other revenues include charges for services, licenses, fines, interest, rent, and payments from the state and federal governments. Among General Fund local tax revenues, property tax revenue is projected to contribute 56.2% of revenues, followed by business tax revenue, hotel room tax revenue, property transfer tax revenue, and sales and use tax revenue, among other tax revenue sources, as shown in Exhibits 16 and 17. This section will discuss four leading sources of tax revenue, all of which are dependent on Downtown: property, business, hotel, and sales taxes.[25]

Exhibit 16: Projected Citywide General Fund Tax Revenue Sources by Type, FY 2022-23



Source: San Francisco Controller, *Six-Month Budget Status Report.* February 2023.

[24] Projections are from the Six-Month Budget Status Report from the Controller's Office, dated February 15, 2023.

[25] This report does not analyze in detail property transfer tax revenue, which is relatively volatile, as explained here.

Exhibit 17: Projected Citywide General Fund Tax Revenue Sources by Type, FY 2022-23

Tax Revenue Category	Projected FY 2022-3 General Fund Tax Revenue (Millions)	% Total
Property Tax	$2,449.2	56.2%
Business Tax	848.9	19.5%
Real Property Transfer Tax	233.8	5.4%
Hotel Room Tax	264.9	6.1%
Sales Tax	201.4	4.6%
Utility Users Tax	108.2	2.5%
Parking Tax	80.2	1.8%
Executive Pay	100	2.3%
Other	74.70	1.7%
Total	$4,361.30	100.0%

Source: San Francisco Controller, *Six-Month Budget Status Report.* February 2023.
Notes: "Other" includes Access Line Tax, Sugar Sweetened Beverage Tax and Stadium Admission Tax.

Property Tax

As of September 16, 2022, Downtown properties made up 33 percent (approximately $106.1 billion) of the City's total assessed value of $319 billion (before exemptions), according to the Assessor's Office.[26] Downtown commercial space accounts for nearly two thirds of this value, or 22 percent (approximately $69 billion) of the City's total property tax roll. However, this total valuation could decrease in the coming years because of market conditions, including reduced demand for office space associated with the rise in remote work and related reductions in prices when these buildings are sold.

A 2021 analysis from the Institute on Taxation and Economic Policy (ITEP), a nonprofit, nonpartisan tax policy organization, projects a 27 to 43 percent decrease in San Francisco's commercial real estate prices related to the increase in remote work.[27] (The authors' model also factors in job losses between December of 2019 and December of 2020). If all properties were reassessed at their market value at the same time to reflect such losses and applying the standard 1 percent property tax rate, this would translate to estimated property tax revenue losses for all funds of between $186 million and $297 million annually from Downtown commercial properties alone, as shown in Exhibit 18 below (this includes San Francisco property tax revenue that would be apportioned to other entities such as San Francisco Unified School District).

[26] In this context, "Downtown" refers to the Financial District, Union Square, Embarcadero, and SOMA neighborhoods, as reflected in Assessor volumes 2, 3, and 25

[27] Howard Chernick, David Copeland, and David Merriman, "*The Impact of Work From Home on Commercial Property Values and the Property Tax in U.S. Cities*," Institute on Taxation and Economic Policy, November 2021, Link

Because of the way properties are assessed under California state law, any declines in assessed value will likely be smaller than declines in market value.[28] Thus, in each of these scenarios (a 27 percent decrease and 43 percent decrease), the City's actual property tax revenue reductions Downtown would likely be somewhat smaller than the potential property tax revenue reductions estimated above. There is also a lag between changes in value, market prices, building sales, assessed value and property tax revenue.[29] Our estimates of value at risk are broadly consistent with recent projections from the Office of Economic Analysis showing that a downturn in the Downtown commercial real estate market could result in annual property tax reductions of $100 million to $200 million by 2028.[30]

The exact timeline and magnitude of the effects of market changes on property tax revenues is unclear, as a lag exists between changes in value, market prices, building sales, and property tax revenue.

Exhibit 18 Effects of Decreased Downtown Office Property Values if Assessed Values were Reduced Consistent with Loss in Market Value Estimated in 2021 ITEP Study (millions)

	27% loss	43% loss
Assessed value, Downtown commercial	$69,000	$69,000
Current property tax revenue	$690.0	$690.0
Projected property tax revenue	$503.7	$393.3
Reduction in property tax revenue	$186.3	$296.7

Source: BLA Analysis of San Francisco Office of the Assessor-Recorder data, applying estimates of reduced property values prepared by Chernick, et al. in Institute of Taxation and Economic Policy study (2021).

[28] "Remote Work and the San Francisco Office Market: Potential Property Tax Implications," San Francisco Controller's Office, November 16, 2022, Link. Discussed at Board of Supervisors Budget and Finance Committee Hearing, November 16, 2022, clip begins 2:12:47, Link.

[29] Other than the up to 2 percent increase in assessed valuations allowed each year under California state law, assessed valuations can be changed only upon sale or modification of a building, as a result of a property owner's assessment appeal being approved by the City's Assessment Appeals Board, or if the Assessor authorizes such a reduction under the terms of Proposition 8, which can only occur depends on a property's value decreasing below its base value, set when it was last sold. All of these mechanisms provide the possibility of decreases in assessed value and property tax revenue for San Francisco's commercial Downtown properties but also limit the extent of decreases at any one time.

[30] "Remote Work and the San Francisco Office Market: Potential Property Tax Implications," San Francisco Controller's Office, November 16, 2022, Link. Discussed at Board of Supervisors Budget and Finance Committee Hearing, November 16, 2022, clip begins 2:12:47, Link

Numerous commercial properties have appealed their assessed value for Fiscal Year 2022-23.[31] The Assessor's Office reported an increase from 372 to 559 appeals on commercial properties between FY 2019-20 and 2020-21. Although these appeals can result in lower assessments and thus lower property tax obligations, the San Francisco's Assessment Appeals Board has up to two years from the filing of an appeal to issue a decision following a hearing.[32]

In the January 2023 Five Year Financial Plan prepared by the Controller, Mayor's Office, and our office, General Fund property tax revenues are projected to increase in FY 2022-23 to $2.4 billion, up slightly from the $2.3 and $2.1 billion projected in January 2022 and January 2021, respectively. The forecast projects, however, that these revenues will decrease annually from FY 2023-24 through FY 2026-27 and that projected revenues will not reach their FY 2022-23 level again until FY 2027-28. The projected revenue reduction during the four-year period from FY 2023-24 through FY 2026-27 is $61 million, or an average of approximately $15.3 million per year.

The most recent forecast published in January 2023 projects decreases in property tax revenue compared to previous five-year forecasts based on more current information about assessment appeals, changes in the value of office and other properties in San Francisco, and other factors. For FYs 2022-23 through 2025-26, the January 2023 forecast amounts to approximately $327.3 million less than the forecast in January 2022 for the same four-year period, or an average of $81.8 million per year.

While this projected reduction doesn't mean a drop of $327.3 million in property tax revenue from current year revenue, it does represent a loss in resources available compared to what was expected just a year ago to meet future expenditures. Increased assessment appeal payouts resulting from reduced property values are one factor contributing to this reduction. However, even if the ITEP study projections of a 27 to 43 percent reduction in commercial property prices are borne out, the California property tax system and the market for commercial properties in San Francisco would mean that the impact of such a change would be blunted over multiple years.

Business Tax

More than half of the City's business tax obligations comes from businesses located only Downtown,[33] according to the Office of Economic Analysis of the San Francisco Controller's Office.[34] Among these businesses, business tax obligations declined by approximately $144 million between Calendar Years 2019 and 2021 from $862 to $718 million, as shown in Exhibit 19. By contrast, total business tax

[31] Kevin Truong, "The Owners of Iconic SF Buildings Are Looking to Slash Their Property Values," the San Francisco Standard. Link

[32] "Filing a Formal Appeal." Assessment Appeals Board. Link

[33] These businesses include some entities with one location and others with multiple locations, as long as all locations are Downtown; they do not include businesses with locations both Downtown and elsewhere.

[34] In the analysis used in this section, the Office of Economic Analysis defined Downtown as comprising the following zip codes: 94102, 94103, 94104, 94105, 94107, 94108, 94109, 94111, 94133, and 94158.

obligations for other businesses increased by a net of approximately $14 million during the same period, resulting in a Citywide net decrease of $130 million. The reduction in obligations for Downtown only businesses was 16.7 percent, greater than the 9.5 percent reduction for all businesses Citywide.

Remote work performed outside San Francisco is a factor in the reduction of business tax obligations among businesses located only Downtown. Under the City's gross receipts tax, the centerpiece of the city's business tax structure, one factor in a company's tax obligations is the proportion of work performed within San Francisco. Remote work performed outside the City can therefore lower a firm's business tax obligations.

Exhibit 19: Business Tax Obligations, 2019 and 2021 (millions)[35]

Calendar Year	Business Tax Owed (Businesses Located Only Downtown)	Business Tax Owed (All Businesses)	% of All Business Tax Owed
2019	$862	$1,368	63%
2021	$718	$1,238	58%
Change	-$144	-$130	
% Change	-16.7%	-9.5%	

Source: Office of Economic Analysis, San Francisco Controller's Office

The January 2023 revenue projections issued in January 2023 jointly by the Controller, Mayor's Office, and our office show Citywide business tax projections between FY 2022-23 and FY 2025-26 are $138.8 million lower per year, on average, than what had been projected in January 2022. These latest projections assume a 40 percent reduction in taxable gross receipts due to the increase in telecommuting from outside the City.

Sales Tax

Sales tax revenue provides an additional indicator of economic activity Downtown generated by office workers, business travelers, tourists, and other customers. Citywide sales tax General Fund revenue was $171.2 million in 2021, of which $34.7 million, or 20 percent, was generated in the Financial

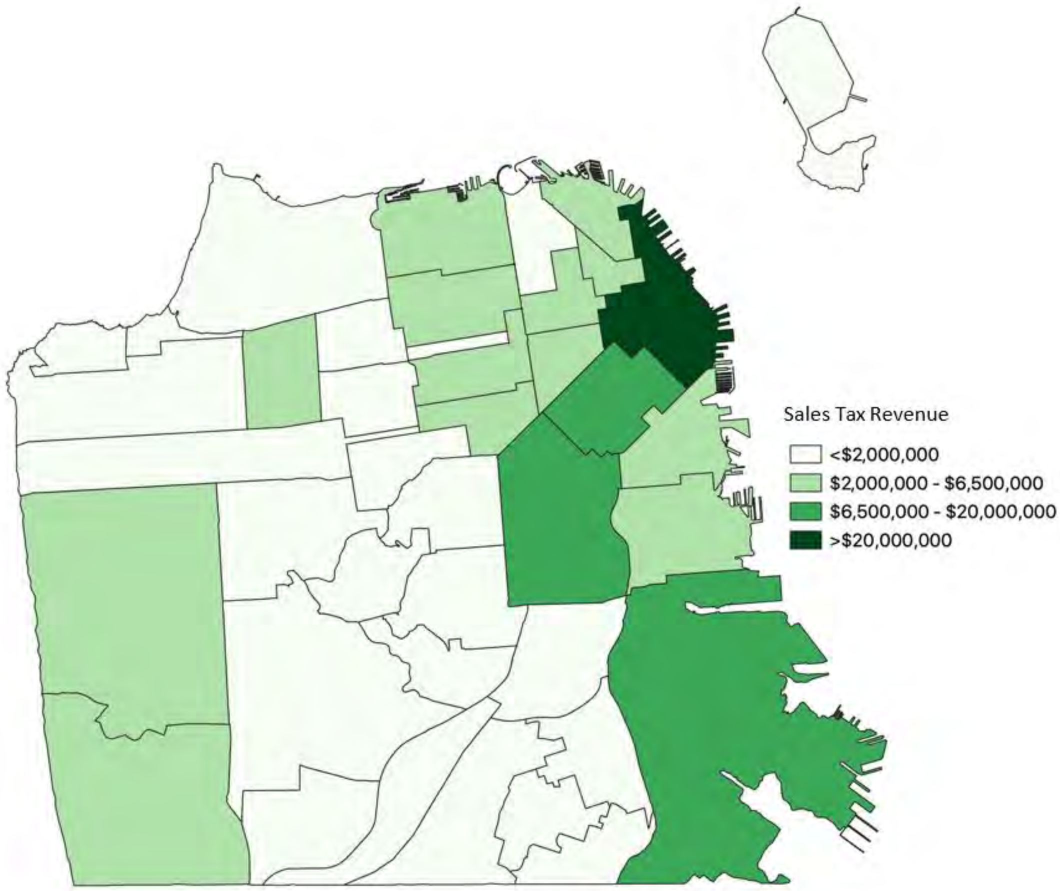
[35] 2014 totals consist of Payroll and Gross Receipts tax obligations; 2019 totals consist of Gross Receipts, Homelessness Gross Receipts, Payroll, Commercial Rents, Administrative Office Tax (AOT), and Homelessness AOT tax obligations; 2021 totals consist of Gross Receipts, Homelessness Gross Receipts, Commercial Rents, AOT, Homelessness AOT tax obligations.

District/South Beach and SOMA.[36][37] As shown in Exhibit 20, the Financial District – South Beach neighborhood, which makes up the majority of Downtown's office space, generated the highest sales tax revenue of any neighborhood in 2021.

[36] Sales tax revenue from a data set shared by the San Francisco Controller's Office titled *San Francisco: Sales Tax Revenues by Geographic Area*. The subareas delineated by the Controller's Office when breaking down sales tax differ somewhat from the submarkets used by commercial estate firms cited elsewhere in this report.

[37] According to the San Francisco Controller's Office, if a company has multiple locations in the City, their total sales tax is divided equally among all locations. Sales tax totals for specific areas are therefore approximations.

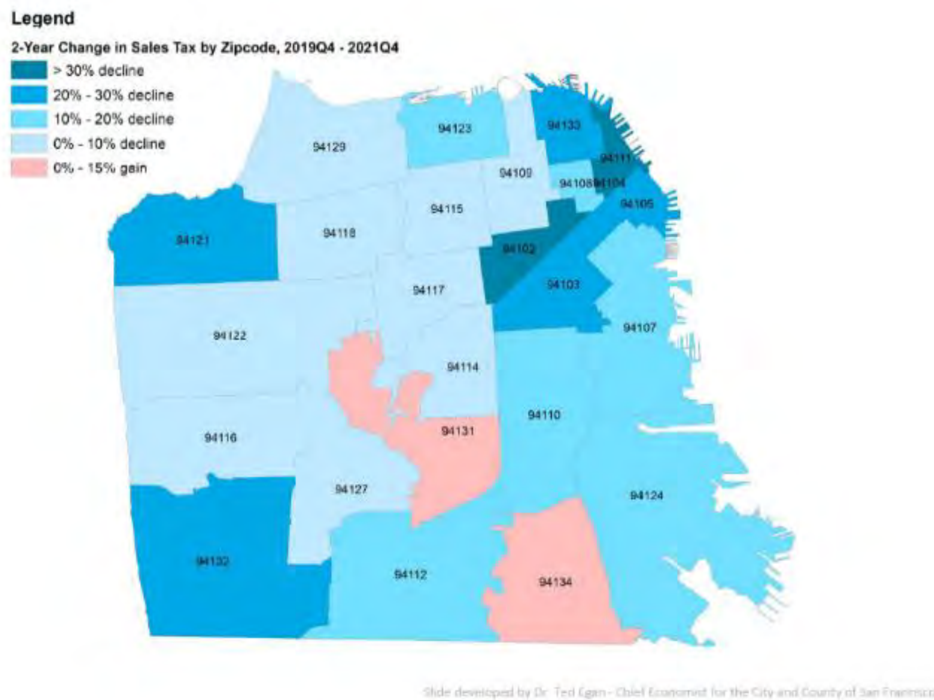
Exhibit 20: Sales Tax General Fund Revenue by Neighborhood, 2021



Source: BLA Analysis of *City of San Francisco: Sales Tax Revenues by Geographic Area,* shared by San Francisco Controller's Office

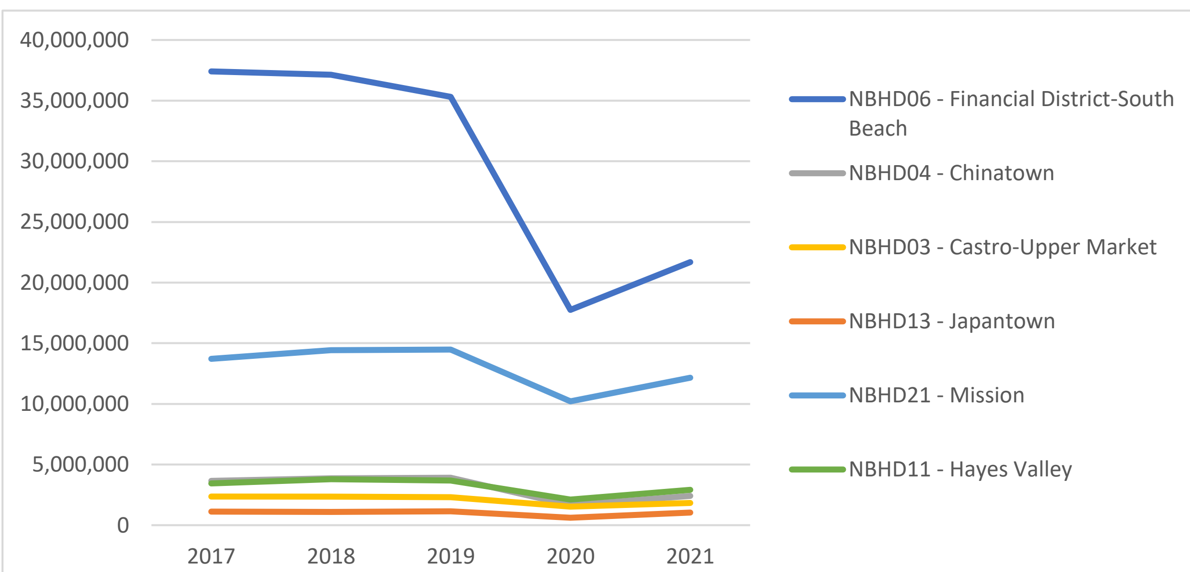
Neighborhood-level sales tax data shows a steeper drop in sales tax revenue Downtown between 2019 and 2021 as compared to most neighborhoods, as shown in Exhibit 21. Comparing all of 2019 and all of 2021, the 38.6 percent reduction in the Financial District/South Beach neighborhood was greater than the Citywide reduction of 20.7 percent. The loss Citywide between 2019 and 2021 was $44.6 million, of which the Financial District/South Beach area was responsible for $13.6 million of that loss and SOMA $6.2 million. Additionally, while Downtown saw an increase between 2020 and 2021, sales tax revenue remained approximately $13.6 million below what it had been in 2019.

Exhibit 21: Change in Sales Tax Revenue by Neighborhood, 2019 - 2021



Source: Chief Economist for the City and County of San Francisco

Exhibit 22: Sales Tax General Fund Revenue in Selected Neighborhoods, 2017 - 2021



Source: BLA Analysis of *City of San Francisco: Sales Tax Revenues by Geographic Area*, shared by San Francisco Controller's Office

Hotel Tax

As shown in Exhibit 23 below, hotel tax revenue decreased significantly following the onset of the pandemic. Due to a rebound of tourism, General Fund hotel tax revenue is currently projected to increase to $264.9 million in FY 2022-23, an increase over the prior year. Even with such an increase, it will remain below the FY 2018-19 level. Although SF Travel projects that the average daily room rate for hotels – calculated by dividing room revenue by the number of room nights sold – will surpass 2019 rates by 2024, it does not anticipate hotel occupancy matching 2019 levels until 2025.

Exhibit 23: General Fund Hotel Tax Revenue, FY 2016-17 through FY 2022-23

Fiscal Year	Hotel Room Tax Revenue (millions)
2016-17	$370.3
2017-18	$382.2
2018-19	$392.3
2019-20	$252.2
2020-21	$33.2
2021-22	$158.2
2022-23	$264.9 (Projected)

Source: Six-Month Budget Status Reports, FY 2016-17 through FY 2022-23, San Francisco Controller’s Office

Policy Considerations

The trends presented above suggest San Francisco faces a number of interconnected challenges associated with the economic effects of Covid-19 on Downtown. This section identifies five interconnected challenges: Citywide tax revenue risks, reduced visitors and foot traffic, commercial vacancies, an economy dominated by a few industries, and a scarcity of housing. For each challenge, we propose one or more intervention strategies and specific areas for policy intervention.

Based on our analysis presented in this report, we conclude that there is no one solution to address the impacts of changes that have occurred in the use of Downtown since the onset of the Covid-19 pandemic. While conditions can change in unforeseen ways, waiting for the market to correct itself in terms of the demand for office space may be a very long-term prospect and may not ever result in a return to pre-pandemic conditions. For these reasons, we present a multi-pronged approach to policy interventions for consideration by the Board of Supervisors that we conclude could improve the use of and level of activity Downtown. However, the absence of an estimated 147,303 office workers who were Downtown every workday will be difficult to offset in terms of activity levels and City revenue at least in the short run.

Challenge 1: The Rise of Remote Work Carries Risk for Citywide Tax Revenue

Even as the pandemic subsides, a return to 100 percent in-person work among office workers is unlikely, according to many experts. The January 2023 Five-Year Financial Plan prepared by the Controller, Mayor's Office and our office shows less General Fund property and business tax revenue compared to forecasts from the prior two years.

Separately, national survey data for those who can work remotely shows employee and employer preferences are converging around a hybrid model of work weeks split roughly evenly between the office and remote locations.[38] Preferences among both groups now average between two and three days of remote work per week.[39] Given the high number of jobs in San Francisco that can be performed remotely and the high cost of living, the City – and Downtown specifically – are likely to see a higher rate of remote work than many cities.

Because the gross receipt tax factors in whether work is performed within the boundaries of San Francisco, this rise in hybrid and remote work carries direct implications for business tax revenue. As discussed above, business tax revenue obligations from Downtown-only businesses were $144 million lower in 2021 than in 2019, and future business tax revenues will hinge to a significant degree on the extent of hybrid and remote work. Although the Controller's Office has factored current trends into future projections published in the most recent five-year revenue projections, these projections can shift and indeed already have: as of January 2023, business tax projections for FY 2022-23 through FY 2025-26 are $555.2 million, or $138.8 million lower per year on average, than what had been projected in the January 2022 five-year forecast, driven largely by an increased estimate of long-term telecommuting rates among office workers and reductions in the City's population.

As discussed in this report, a lasting shift away from in-person work could also result in decreased property tax revenue from downtown commercial real estate.
If Downtown commercial real estate prices decrease between 27 to 43 percent, as projected in a policy study by the Institute of Taxation and Economic, this could theoretically translate to potential annual property tax revenue losses of up to between $186 million and $297 million annually from Downtown commercial properties alone. These estimates of value at risk are broadly consistent with recent projections from the City's Office of Economic Analysis showing that a downturn in the Downtown commercial real estate market could result in annual property tax revenue reductions of $100 million to $200 million by 2028. In the January 2023 Five Year Financial Plan prepared by the Controller, Mayor's Office, and our office, Citywide General Fund property tax revenues are projected to decrease annually from FY 2023-24 through FY 2026-27, with projected revenues not reaching their FY 2022-23 level again until FY 2027-28. Other City tax revenues affected by pandemic-induced

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[38] Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731. Cited in "The Economic Context for Development in Post-COVID San Francisco," a presentation by the San Francisco Controller's Office. June 2022.

[39] Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731.

changes in activity and behavior Downtown have declined since 2020. Specifically, business tax, hotel tax, and sales tax revenue allocated to the General Fund were all lower than their FY 2018-19 levels through FY 2021-22 and, while improving, none of these three sources is projected to exceed its pre-pandemic FY 2018-19 levels in FY 2022-23. Hotel tax revenue plummeted dramatically in FY 2020-21 from $252.2 million the prior fiscal year to $33.2 million. It increased to $158.2 million in FY 2021-22, still down substantially from its pre-pandemic level.

In addition to working to minimize tax revenue impacts (including through Strategies 2-5 below), the Board of Supervisors can prepare now for the likelihood of such impacts and consider ways to respond.

Strategy 1: Prepare for an uncertain tax revenue environment.

Policy Option 1.1: Prepare for possible shortfalls created by decreases in Downtown tax revenues, including by considering tax code changes, identifying areas for budget savings and/or advocating for increased state relief.

Already, members of the Board of Supervisors receive regular updates from the Controller's Office forecasting future revenues and identifying the current state of revenues and expenditures. Board members have recently requested detailed analyses and input from City officials on revenue impacts to property taxes and business taxes associated with office vacancies, telecommuting, and other factors.[40] As the Board of Supervisors review these analyses, it could consider possible tax code changes to help address any revenue shortfalls and request input from City departments through hearings in addition to the annual budget review process to identify areas of potential multi-year revenue enhancements or expenditure reductions that would have the least impact on City services. These might include one-time capital or other projects that have not yet commenced and could be deferred or other areas of expenditure where reductions would have minimal impact on services.

The Board of Supervisors could work with the Mayor's Office of Legislative and Government Affairs to advocate for increased state relief, particularly given the disproportionate tax revenue impact on cities, and San Francisco specifically, of changes to the commercial real estate market. In conjunction with other cities, for instance, San Francisco could call for a shift in state aid toward cities and away from suburban areas that have experienced housing market growth during the pandemic, as researchers at the Institute on Taxation and Economic Policy have called for based on their projections of declining commercial real estate values in cities.[41]

[40] San Francisco Chronicle. "How much will downtown S.F.'s struggles hurt the city budget? Supervisors want to know." Sept. 13, 2022.

[41] Chernick, Howard, David Copeland and David Merriman, 2021. "The Impact of Work From Home on Commercial Property Values and the Property Tax in U.S. Cities," Institute on Taxation and Economic Policy.

Challenge 2: Decreased Downtown visitors and foot traffic is hurting small businesses and neighborhood vitality.

Multiple indicators make clear the decrease in daily activity Downtown. As cited in this report, a study tracking smartphone data found that Downtown activity is less than a third of what it was before the pandemic. Much of this decrease is due to the drop in daily commuters, with Citywide office attendance estimated to be approximately 40 percent of what it was prior to the pandemic. While tourism indicators have rebounded to some extent, they too remain below pre-pandemic baselines.

These changes have upended business as usual for restaurants, bars and retail outlets Downtown, many of which have closed (creating ground floor vacancies, discussed further below). These challenges compound each other: With fewer establishments drawing them Downtown, commuters and tourists alike have fewer reasons to visit; with fewer visitors, businesses have fewer potential customers and may struggle to remain open. Although addressing vacancies directly is an important part of the equation and is discussed below, investments in public space are also necessary to draw commuters and visitors back Downtown in greater numbers.

Strategy 2: Support interventions designed to increase visitors and Downtown foot traffic.

Policy Option 2.1: Request that OEWD and SF Travel report to the Board of Supervisors on initial results of programmatic interventions designed to improve Downtown public spaces and increase business and leisure tourism, and work with OEWD and SF Travel to ensure promising interventions are sufficiently resourced.

Multiple City departments and SF Travel have initiatives under way designed to improve experiences in public spaces Downtown. So do community benefits districts, such as Downtown SF Partnership, the Yerba Buena Community Benefit District and the East Cut Community Benefit District. Ongoing efforts include:

- Ambassador programs to mitigate qualify of life issues (OEWD, SF Travel, community benefit districts)
- Enhanced street cleaning (Department of Public Works, community benefit districts)
- The S.F. Shines program, which reimburses businesses for qualifying storefront improvements (OEWD)
- Rental incentives to lower the cost of holding events at Moscone Center (City Administrator's Office and SF Travel)
- Public space activations and live events (OEWD)
- Planned marketing initiative targeting select out-of-state markets (SF Travel)

Other possible interventions are laid out in the Public Realm Action Plan created by the Downtown SF Partnership and include restricting vehicle traffic on selected streets, improving Downtown's bikeway network, creating new public spaces, planting trees and other vegetation, enhancing privately owned public open spaces, and holding regularly occurring activations.[42]

Reports to the Board of Supervisors on the results of these and other initiatives should include numbers of attendees or visitors to the events and change in activity levels Downtown to help determine if additional investments are warranted to further attract visitors. Marketing efforts undertaken by SF Travel and other organizations to promote tourism should be reviewed by the Board of Supervisors to assess results and determine if further funding may be appropriate to further bolster tourism.

Policy Option 2.2: Request that the San Francisco Municipal Transportation Agency report on ways the City can help improve the Citywide and regional transit experience for commuters from other jurisdictions.

Weekday Downtown BART exits remain lower than tourism, weekday driving commute, and weekday MUNI ridership indicators. For at least some of those workers commuting into San Francisco from outside the City – an estimated 383,427 people each workday prior to the pandemic[43] – improvements to ridership experiences could also increase willingness to commute into Downtown. Although regional transit agencies are separate from the City and County, there may be opportunities for San Francisco to partner with agencies on specific initiatives, including on actions laid out in the Bay Area Transit Transformation Plan. These include actions aimed at improving real-time mapping and scheduling information, coordination among transit networks, and travel times.

Challenge 3: Vacant commercial space, particularly on the ground floor, reflects missed opportunities to boost street vibrancy.

Across Downtown, vacant commercial spaces stymie other efforts to support economic recovery. Ground floor vacancies are a particular concern, as they are most visible to passerby – and thus represent missed opportunities to most visibly increase street vibrancy. Upper floor vacancies also affect street life, by contributing to reduced numbers of commuters.

OEWD has several strategies in place already to address vacancies, including the creation of a position dedicated solely to addressing this issue and the Vacant to Vibrant initiative, which is facilitating pop-up businesses in ground floor retail locations. As part of Citywide efforts to keep existing businesses in place, the City has also provided direct grant support to small businesses and has worked to provide flexibility to ground floor businesses through the Shared Spaces program, which provides permits for use of outdoor spaces such as sidewalks and parking lanes for outdoor dining and other uses. Other

[42] "Public Realm Action Plan," *Downtown S.F. Partnership,* July 2022, Link
[43] U.S. Census Bureau

City efforts to reduce some of the burdens facing small businesses include the new Permit Center, created to be a one-stop hub for obtaining permits from various City departments. As part of its Public Realm Action Plan, Downtown S.F. Partnership has also outlined strategies for filling ground-floor spaces, including through targeted incentives and pilot pop-ups.

Strategy 3: Explore additional strategies for reducing commercial vacancies through programmatic interventions.

Policy Option 3.1: The Board of Supervisors could solicit feedback from the Office of Economic and Workforce Development on the prospect of programs incentivizing creative leasing arrangements, such as co-location and short-term subleasing, that reduce risks for commercial landlords and tenants alike.

Besides some zoning restrictions particularly in the Union Square area, market conditions appear to be driving Downtown vacancies, with commercial property owners and would-be tenants far apart on what rent would be acceptable. Creative leasing arrangements can help fill this gap, and they can also attract specific types of tenants that could bring vitality to Downtown spaces but face challenges. Small businesses and nonprofit community organizations, for instance, often have limited credit histories, and they may be unable to commit to yearlong leases or entire ground-floor spaces. One model for addressing these obstacles is having a Community Development Corporation or foundation obtain a lease and then sublet the leased space to small businesses or nonprofit organizations for shorter time periods. Another option is co-location, in which multiple businesses share a single retail space, often on the ground floor.[44] The Board of Supervisors could ask OEWD staff to report on programmatic options for incentivizing such arrangements.

Co-location and short-term commercial sublet arrangements do not require Planning Code changes, according to Planning Department staff. For the Union Square area (C-3-R zone), the Board of Supervisors could advocate for less restrictive requirements in the Planning Code, particularly for uses of second and third floors which are restricted or require conditional use approval for non-retail uses.

Challenge 4: The City's economy is heavily concentrated in a small number of industries

Relative to the recoveries in other city centers, Downtown San Francisco's economic recovery appears to be limited by a disproportionate share of jobs that can be performed remotely concentrated in a small number of industries. In the Institute of Governmental Studies report cited in this report, the return to daily activity in Downtown San Francisco ranked last among 62 North American downtowns studied, at 31 percent of its pre-pandemic rate as of September – November 2022, according to cell phone data.[45] In looking at 43 variables potentially tied to recovery rates, the research team found

[44] Central Business District Washington D.C.: Strategies for Recovery and Economic Resilience, 2020. Urban Land Institute.

[45] "*Death of Downtown? Pandemic Recovery Trajectories across 62 North American Cities*", Institute of Governmental Studies, U.C. Berkeley. June 2022.

that San Francisco differed most from other comparable cities in its mix of industries, with 31 percent of the City's downtown workforce employed in Professional, Scientific and Management services. By contrast, this sector employs 18 percent of downtown New York City's workforce and 13 percent of downtown Austin's. Relatedly, while 18 percent of downtown Seattle's workforce works in health care and social assistance – a sector less conducive to remote work – this sector employs just two percent of downtown San Francisco's workforce.

Downtown zoning is relatively permissive, with few restrictions about what types of businesses can operate. Still, there are certain restrictions for particular zoning districts within Downtown that could be revisited, including specific regulations related to hotels and laboratories. Already, the Planning Department is considering whether relaxing any of these restrictions would lead to new business formations Downtown or help diversify the area's industrial mix, including nonprofit organizations. The City has also commissioned an independent study of Downtown's economic recovery, which will include recommendations for recruiting underrepresented sectors that can help diversify San Francisco's industrial mix.[46]

Strategy 4: Build on efforts to diversify the City's industrial mix.

Policy Option 4.1: Request that the Planning Department and the Office of Economic and Workforce Development report on ongoing and possible future efforts to diversify the industrial mix of Downtown's workforce, such as efforts to market the City and recruit target industries and/or eliminate Planning Code restrictions that may pose barriers for certain businesses and nonprofit organizations that might otherwise be interested in operating Downtown.

In addition to acting on the recommendations of the independent study of Downtown's economic recovery commissioned by the City,[47] the Board of Supervisors could request that the Planning Department and the Office of Economic and Workforce Development report back on current initiatives and future options for attracting underrepresented industries and nonprofit organizations to Downtown. Planning Department staff are researching possible modifications to the Planning Code, for instance, to facilitate laboratory uses, particularly in places where offices are already permitted. Other efforts could specifically incentivize the conversion of commercial space for other commercial uses.

Across the Bay Area, more than 600,000 square feet of office space were being converted to laboratories during the first quarter of 2022,[48] demonstrating the potential feasibility of such projects. The Board could also request that Planning Department staff provide insight on

[46] *Next Steps for Our Downtown.* Mayor London Breed, September 6, 2022, Medium, Link.

[47] *Roadmap to Downtown San Francisco's Future.* (Relevant section: *Attract and retain a diverse range of industries and employers.*) City and County of San Francisco, February 9, 2023. Link.

[48] *San Francisco Bay Area Second Largest Percentage Gain in Life Sciences Conversions,* CBRE, May 6, 2022, Link

encouraging the development of new clusters or corridors for target sectors, to complement the life sciences neighborhood in Mission Bay.

Challenge 5: A limited housing supply in the core areas of Downtown compounds challenges to economic recovery, particularly outside of business hours

Much of the new housing construction in San Francisco has taken place in or near Downtown over the past three decades,[49] and the greater Downtown area is home to thousands of residential units. However, these units are not spread evenly throughout Downtown, and the housing supply in parts of the area remains limited. The Downtown S.F. Community Benefit District, which includes the North Financial District and Jackson Square, is home to only approximately 350 units of housing.[50]

City staff caution that determining the correct mix of housing and office space within Downtown is complex, as is determining the precise locations where new residential construction could be viable. Families, for example, need convenient access to schools and parks, and residents of all ages need access to groceries and other neighborhood services. The pandemic's lasting effects on demand for Downtown living also remain unclear, further complicating project viability. Converting office stock into housing also carries long-term opportunity costs, as office space (when occupied) can generate significant economic activity and higher contributions to City tax revenue.

Still, the pandemic has made clear that there are risks to the current heavy reliance on office workers concentrated in a few industries and tourists to generate Downtown's economic activity. Facilitating new housing options Downtown could help mitigate these risks by increasing neighborhood activity outside of business hours and contributing to a diversification of the neighborhood's economy.

One option for increasing residential units is adaptive reuse, in which buildings constructed for one purpose, such as offices, are modified for another purpose, such as residential.[51] Such conversions, however, are often as expensive as new construction and more technically complicated. This is particularly true for Class A commercial office properties, which generally have wider footprints and thus less natural light per floor; these properties also bring in higher rents per square foot as offices, raising the opportunity costs of conversion. The financial landscape can be somewhat more conducive to conversion among Class B and C properties, though high construction costs may still make conversion financially unviable.

As of Quarter 4 of 2022, JLL reports a total of 15.9 million square feet of Class B and C office space in the North and South Financial Districts, Mid-Market, and Union Square.[52] Conversion of even a fraction of this space could result in thousands of residential units. A RAND study of conversion

[49] *Next Steps for Our Downtown.* Mayor London Breed, September 6, 2022, Medium, Link.

[50] DiFeliciantonio, Chase. "Downtown S.F. keeps adding housing units, but does anyone actually want to live there?" San Francisco Chronicle, July 6, 2022. Link

[51] Our office issued a report on this topic, *Repurposing Commercial Real Estate for Residential Use,* to Supervisor Gordon Mar, on January 6, 2023. The report can be accessed here.

[52] JLL San Francisco Office Insight, Q4 2022.

opportunities in the Los Angeles area estimated that 13.19 million square feet of underutilized office space represented the potential for between 12,565 and 26,387 residential units.[53] An estimated 12,000 residential units have already been built through adaptive reuse in Downtown Los Angeles since 2000, encouraged by the City of Los Angeles's adoption of its Adaptive Reuse Ordinance in 1999, which streamlined the development project approval process. Conversions of Class B and C properties in Lower Manhattan have also produced more than 25,000 units of housing in recent decades.[54]

The San Francisco Business Times reported 11,090 new apartments converted nationwide from office uses in 2020 and 2021, 43 percent more than in the previous two-year period, primarily in older cities with older building stock such as Philadelphia and Chicago. While San Francisco shares some of the characteristics of older East Coast cities, office to housing conversions have not yet taken hold.

The approximately 15.9 million square feet of Class B and C office buildings in the North and South Financial Districts, Mid-Market and Union Square represents the potential for up to 15,862 housing units based on 800 square feet per unit (less 20 percent of the gross square footage for common space and exterior walls). Given the benefits of a 24-hour presence of people committed to the neighborhood's vitality, even a small number of conversions – or conversions that take years to materialize – could represent significant steps toward ensuring long-term stability Downtown. City staff note that there would be tradeoffs associated with decreasing available Class B and Class C office space. For instance, Class B and Class C office space generally rents at a lower rate than Class A inventory, so decreasing available Class B and Class C inventory could make it more difficult to attract categories of businesses that face more barriers in accessing capital, such as women- and minority-owned enterprises. Based on the experience in other cities, we do not assume that anywhere close to all Class B and C space would be converted to housing. Even if the City adopts incentive programs, there would still be many buildings for which such conversion would not be structurally or financially feasible.

Strategy 5: Pursue new ways of incentivizing office conversion to housing and new housing construction Downtown.

Policy Option 5.1: Request that the Planning Department, the Mayor's Office of Housing and Community Development, and the Office of Economic and Workforce Development report on existing efforts and future options for increasing housing construction Downtown, including specific legislative proposals and possible changes to the Charter to streamline housing construction of all or certain types of housing and commercial property conversions in certain areas of Downtown for consideration by the Board of Supervisors.

[53] Ward, Jason M. and Daniel Schwam. "Can Adaptive Reuse of Commercial Real Estate Address the Housing Crisis in Los Angeles?" RAND Corporation. 2022.

[54] The Real Estate Board of New York. *Testimony to New York State Assembly Standing Committee on Housing Regarding Repurposing Vacant and Underutilized Real Estate for Affordable Housing Development.* December 2020.

Staff in the Planning Department, Mayor's Office of Housing and Community Development, and Office of Economic and Workforce Development are working on multiple fronts to facilitate housing construction in and near Downtown. In addition to MOHCD's ongoing investment in the development of new affordable housing, the Planning Department is leading a cross-department initiative focused on identifying barriers in the Building Code and Planning Code to building housing. The Planning Department is also working with City departments and external partners to identify possible opportunities, for both new housing construction and conversion of existing buildings, among other current efforts.[55]

Staff could also provide insight and legislative proposals for consideration by the Board of Supervisors to streamline the City's development project review processes and lower the costs for certain types of conversions of commercial buildings to residential use, such as affordable and mixed income housing through creation of a ministerial approval pathway for qualified projects, eliminating the need for CEQA review and/or specific discretionary approval processes and public hearings for qualified projects. As we have recommended in our January 2023 report on repurposing commercial real estate for residential use, areas to be considered for modification could include development impact fees, permitting processes, and below market rate housing requirements. To the extent that the current permitting process impedes housing development or conversion of commercial buildings to housing, the Board of Supervisors could advocate for or initiate necessary changes in the City Charter and codes.

The Board of Supervisors could also request that staff advise on other possible interventions, including:

- **Reducing or eliminating certain City requirements on specific types of housing construction and conversions of office or other commercial uses Downtown to residential, including by**:[56]

  a. Reducing or removing Below Market Rate requirements for qualified projects,

  b. Exempting qualified projects from density and other development limitations, or relaxing existing limitations,

  c. Temporarily delaying the collection of impact fees, or reducing or eliminating impact fees for qualified projects,

  d. Updating sections of the Building Code to facilitate adaptive reuse in conjunction with the review underway headed by the Planning Department,

  e. Streamlining review of qualified projects where possible through legislative and administrative action, to include exemptions from Discretionary Review hearings by

[55] "Next Steps for Our Downtown," Mayor London Breed, Medium, September 6, 2022, Link

[56] These recommendations are also presented in our office's January 6, 2023 report *"Repurposing Commercial Real Estate for Residential Use"*, prepared for Supervisor Gordon Mar. Link

the Planning Commission and possible elimination or reduction of conditional use requirements, and

f. Setting hard time limits on determining when applications are complete and processing applications for certain types of projects, including consideration of any additional staffing resources needed to achieve this change.

- **Leveraging State incentives for adaptive reuse – and advocating for additional State investment**. Current incentives include a new State of California adaptive reuse program that will allocate up to $400 million over two years for grants incentivizing adaptive reuse for affordable housing construction, particularly in infill areas.[57] In addition to seeking ways to tap into existing funding, the City and County could also advocate for additional State spending to further assist cities in incentivizing conversions.

- **Offering new local incentives for adaptive reuse**. A recent Gensler analysis, commissioned by the San Francisco Bay Area Planning and Urban Research Association (SPUR), analyzed 36 Downtown buildings and determined that 12 of them were strong candidates for conversion.[58] The analysis's findings could help Planning Department staff determine the extent to which adaptive reuse projects are feasible Downtown and how the Department could help facilitate such projects. Possible models for incentives include Chicago, where local officials are offering tax incentives for adaptive reuse of buildings within a specific downtown corridor;[59] Los Angeles,[60] where Planning Department staff have recommended expanding incentives for adaptive reuse projects beyond those included in that city's Adaptive Reuse Ordinance adopted in 1999; Washington, D.C., where Mayor Muriel Bowser has proposed a tax break as an incentive for converting downtown commercial space into housing that includes affordable units;[61] and the Canadian city of Calgary, where as of October 2022 five office-to-housing conversion projects have been approved since the launch of an incentive program in 2021.[62] [63] [64]

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[57] "The 2022-23 California Spending Plan: Housing and Homelessness," *Legislative Analyst's Office,* September 16, 2022, Link

[58] Amy Campbell, Holly Arnold, and Doug Zucker, "How Office-to-Residential Conversions Could Revitalize Downtown San Francisco," Gensler, February 16, 2023, Link

[59] "LaSalle Street Reimagined," *City of Chicago*, accessed November 18, 2022, Link

[60] "Downtown Community Plan: CPC Recommendation Draft Summer 2022," *Los Angeles City Planning,* Summer 2022, Link

[61] Marisa M. Kashino, "Should DC's Empty Office Buildings Get Turned Into Apartments?," *Washingtonian*, July 28, 2022, Link

[62] Noah Arroyo, "Yes, S.F. could turn empty downtown offices into housing. Here's what it would take," *San Francisco Chronicle*, Oct. 17, 2022, Link

[63] Jason Herring, "Three downtown Calgary office buildings converting to residential," *Calgary Herald*, June 19, 2022, Link

[64] Kate Marino, "Cities push to convert deserted office buildings into housing," *Axios,* September 28, 2022, Link

- **Creating a task force of housing experts and community representatives focused on adaptive reuse:** In January of 2022, New York City enacted legislation creating an office conversions task force, subsequently named the Office Adaptive Reuse Task Force, which will report recommendations within two years. In San Francisco, a similar panel could explore options specific to Downtown.

- **Identifying and addressing barriers to factory built residential components,** which involves constructing components of buildings in factory-controlled settings before assembling them on-site. Although this construction method carries potential cost benefits, regulatory, political and logistics barriers may be reducing the feasibility of such projects in San Francisco, including Downtown.[65]

Separately, the Board of Supervisors could convene a working group that includes private sector leaders and community representatives to discuss additional opportunities to attracting new businesses Downtown.

[65] "Mitigating the Housing Crisis: Accessory Dwelling Units and Modular Housing," *San Francisco Civil Grand Jury,* July 5, 2018, pages 12-13, Link

Employment Development Department

Significant Weaknesses in EDD's Approach to Fraud Prevention Have Led to Billions of Dollars in Improper Benefit Payments

January 2021

REPORT 2020-628.2

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Elaine M. Howle *State Auditor*

January 28, 2021
2020-628.2

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, CA 95814

Dear Governor and Legislative Leaders:

As authorized by state law, my office presents the results of our high risk audit concerning the Employment Development Department's (EDD) management of federal funds related to the COVID-19 pandemic. EDD administers California's unemployment insurance (UI) program and received a significant amount of federal funding in response to the COVID-19 pandemic and related federal expansion of UI benefits. The following report details our conclusion that significant weaknesses in EDD's approach to fraud prevention have led to billions of dollars in improper benefit payments.

EDD did not take substantive action to bolster its fraud detection efforts for its UI program until months into the pandemic, resulting in payments of about $10.4 billion for claims that it has since determined may be fraudulent because it cannot verify the claimants' identities. Specifically, EDD waited about four months to automate a key anti-fraud measure, took incomplete action against claims filed from suspicious addresses, and removed a key safeguard against improper payments without fully understanding the significance of the safeguard.

Further, EDD's lack of preparation left it unable to manage two important fraud-related situations that arose during its 2020 pandemic response. In September 2020, because of fraud concerns, EDD directed Bank of America to freeze 344,000 debit cards (accounts) that it used to provide benefit payments to claimants. However, EDD did not have a plan in place to ensure that it could unfreeze those accounts found to belong to legitimate claimants, and it has been slow to acknowledge its role in freezing these accounts. EDD was also unprepared to prevent payment of fraudulent claims filed under the names of incarcerated individuals, the total of which is an estimated $810 million. Because it had not developed the capacity to regularly match data from its claims system with data from state and local correctional facilities, EDD did not detect fraudulent claims until after it had paid them.

EDD has put its UI program at higher risk for such fraudulent payments by relying on uninformed and disjointed techniques to prevent and detect impostor fraud. For example, EDD has not established a centralized unit that is responsible for managing its fraud prevention and detection efforts, and it does not monitor or assess its numerous fraud prevention and detection tools to determine whether they are successful. Consequently, EDD may be using ineffective fraud prevention and detection techniques, which can delay payments to legitimate claimants while it puts their claims through additional and unmerited review.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
California State Auditor

Selected Abbreviations Used in This Report

CARES	Coronavirus Aid, Relief, and Economic Security
CDCR	California Department of Corrections and Rehabilitation
EDD	Employment Development Department
GAO	Government Accountability Office
PUA	Pandemic unemployment assistance
SSNs	Social Security numbers
UI	Unemployment insurance

CONTENTS

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SUMMARY

The Employment Development Department (EDD) is responsible for administering the State's unemployment insurance (UI) program, which provides partial wage replacement benefits to eligible Californians who have become unemployed, including those affected by the COVID-19 pandemic (pandemic). Since the surge in pandemic-related California unemployment claims began in March 2020, individuals, news organizations, and law enforcement officials have reported many cases of potential and actual UI fraud. Not surprisingly, the pandemic conditions increased EDD's UI workloads and also resulted in changes to federal UI benefit programs, both of which have created a greater risk of fraud. We assessed EDD's response to increased fraud risk during the pandemic—such as allegations of impostor fraud, which occurs when a perpetrator uses someone else's personal information to fraudulently collect benefits—and evaluated its overall efforts to detect fraud. This report draws the following conclusions:

EDD's Fraud Prevention Approach During the Pandemic Was Marked by Significant Missteps and Inaction

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EDD did not take action to bolster its fraud detection efforts until months into the pandemic. As a result, its data show that it paid about $10.4 billion in claims that it has since determined may be fraudulent. Even as late as December 2020, EDD was allowing claimants to continue to collect benefits using suspicious addresses because it did not establish payment blocks for their claims. Further, $1 billion of the $10.4 billion paid for suspicious claims was the result of EDD's decision to remove a key safeguard against payment to claimants whose identities it had not confirmed. EDD staff misunderstood the importance of that particular safeguard and, from April to August 2020, made payments to claimants despite concerns about the legitimacy of their identities.

EDD's Lack of Preparation Left it Unable to Effectively Address Two High-Profile Situations

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Because of fraud concerns, EDD directed Bank of America to freeze 344,000 debit cards (accounts) that it uses to provide claimants with benefit payments. However, EDD did not have a plan to ensure that it could selectively unfreeze accounts belonging to legitimate claimants, has been slow to provide clear information about its role in freezing these accounts, and does not have a full understanding of which accounts are frozen. Additionally, EDD was unprepared to prevent payment for fraudulent claims filed under the names of incarcerated individuals—which it estimated to total about $810 million. EDD had told the Legislature for years that it was considering adopting a cross-match between claim and incarceration data. However, because it had not developed the capacity to match data between its claims system and the data from state and local correctional facilities, it did not detect these fraudulent claims until after the fact.

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EDD Has Relied on Uninformed and Disjointed Techniques to Prevent Impostor Fraud

EDD has not established a centralized unit that is responsible for managing its fraud detection efforts, and it does not reliably track potential fraudulent activity from detection to resolution. As a result, EDD's UI program is at a higher risk for fraud. Further, it does not monitor or assess its numerous fraud prevention and detection tools to determine whether they are successful in mitigating fraud. Consequently, EDD may well be using ineffective fraud prevention and detection techniques and delaying payments to legitimate claimants while it puts their claims through additional and unmerited review.

Summary of Recommendations

Legislature

To protect against fraudulent UI claims, the Legislature should amend state law to require EDD to regularly cross-match its claims against data from state and local correctional facilities.

To ensure that EDD effectively protects the integrity of the UI program, the Legislature should amend state law to require EDD to, by January 2022, and biannually thereafter, assess the effectiveness of its fraud prevention and detection tools, eliminate those that are not effective, and reduce duplication in its efforts.

EDD

To ensure that it does not suspend critical safeguards, EDD should plan in advance which UI fraud prevention and detection mechanisms it can adjust during recessions to effectively balance timely payment with fraud prevention.

To provide timely access to benefits for legitimate UI claimants with frozen accounts, EDD should immediately obtain and review a comprehensive listing of benefit accounts that are frozen and, by March 2021, begin the process of unfreezing legitimate accounts.

To ensure that it can approach UI fraud prevention in a comprehensive and coordinated manner, EDD should do the following:

- By March 2021, establish a central unit responsible for coordinating all fraud prevention and detection efforts.

- By May 2021, develop a plan for how it will assess the effectiveness of its fraud prevention and detection tools.

Agency Comments

EDD stated that it undeniably struggled to timely distribute benefits to the millions of newly unemployed Californians and simultaneously prevent fraudulent claims. It agreed with all of our recommendations and indicated that it will implement them all.

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INTRODUCTION

Background

The Employment Development Department (EDD) is responsible for administering the State's unemployment insurance (UI) program, which provides partial wage replacement benefits to eligible Californians who have become unemployed. In general, individuals who claim these monetary benefits (claimants) must meet certain requirements, such as being unemployed through no fault of their own and being able and available to work. Claimants must also provide certain information, such as their Social Security numbers (SSNs) and information about their previous employment, including their estimated earnings, which can help EDD ensure that it issues proper benefit payments to the correct individuals.

The benefit payments that EDD administers are subject to two main types of potential fraud: benefit fraud and impostor fraud. Benefit fraud can occur when individuals misreport their earnings or employment information under their own identity. For example, individuals may establish legitimate UI claims using their own personal information but then fail to report that they returned to work, fraudulently continuing to collect UI benefits. EDD has several methods for detecting benefit fraud and, in general, this type of fraud is easiest to trace to a specific individual because the person filing the fraudulent claim benefits from it. As we detailed in an earlier report about EDD, in March 2020 it indefinitely postponed most of its required UI eligibility determinations, which has likely increased the UI program's vulnerability to benefit fraud during the COVID-19 pandemic (pandemic).[1] As we discuss later in the Introduction, the pandemic-related benefits also increased EDD's risk of the second type of fraud: impostor fraud, which occurs when a perpetrator uses someone else's personal information to collect UI benefits.

EDD Has Several Divisions and Offices That Undertake Fraud Detection Efforts

- Investigation Division, Criminal Intelligence Unit: Manages fraud reports submitted by UI staff, by the public, by law enforcement, by state and federal agencies, by the Governor or Legislature, and by others; oversees EDD's fraud hotline.
- Investigation Division, Enforcement Operations Units: Investigate egregious and costly cases of fraud and may pursue criminal charges against impostors.
- UI Support Division, Integrity and Legislation Unit: Manages a fraud report mailbox and initiates the identity verification process for certain claims.
- UI Integrity and Accounting Division, Identity Verification and Technical Support Section: Verifies claimant identities when potential fraud or other identity issues have been detected.
- UI Integrity and Accounting Division, Benefit Overpayment Section: Performs daily, weekly, and quarterly matches between employer data and UI benefit claims to detect improper payments and potential fraud.
- UI Integrity and Accounting Division, Benefit Claims Section: Assigns new unique identifiers to potentially fraudulent claims to reduce the impact on the true owners of compromised SSNs.
- Information Technology (IT) Branch: Facilitates fraud detection efforts through EDD's technical systems, including as directed by other responsible parties.
- Local field offices: Report potential fraud and suspicious claims to the fraud report mailbox and initiate the identity verification process for certain claims.

Source: Analysis of EDD roles and responsibilities, EDD documentation, and interviews with EDD staff.

EDD's Fraud Detection Processes

A number of divisions and offices within EDD play a role in its efforts to detect UI fraud, as the text box describes. According to EDD's June 2020 report to the

1 *EDD's Poor Planning and Ineffective Management Left It Unprepared to Assist Californians Unemployed by COVID-19 Shutdowns,* Report 2020-128/628.1, January 2021.

Legislature on fraud deterrence and detection activities, in 2019 EDD investigated 61 ongoing and new UI fraud cases representing potential fraud payments of around $24.4 million, including 14 cases of UI impostor fraud representing more than $5.5 million paid in fraudulent benefits. EDD also reported more than 110,000 UI overpayments due to fraud—or payments that EDD expected claimants to return to EDD—totaling $116.8 million in UI benefits paid in 2019. EDD further reported that this $116.8 million represented only 2.3 percent of its $4.9 billion benefit payments made in 2019.

One of the key ways that EDD attempts to prevent impostor fraud is by verifying the identities of prospective claimants as a condition to providing benefits, as federal law requires. Historically, this process has included basic automated verifications to ensure that the information that claimants submit to EDD, such as SSNs and driver's license numbers, match the information retained by the U.S. Social Security Administration and California Department of Motor Vehicles. If these verifications detect discrepancies, EDD activates a manual identity verification process to confirm whether the claimant is the true owner of the identity. When it activates the manual identity verification process, EDD's system suspends or stops payments to the affected claim while EDD attempts to verify the claimant's identity. EDD will pay eligible claimants whose identities it confirms for the weeks their payments were paused. This process does not block the claimants' access to UI benefit payments that EDD has already issued. However, in October 2020, EDD introduced a new online identity verification tool, ID.me, as part of its efforts to process claims faster while preventing impostor fraud at the onset of a claim. EDD has indicated that ID.me makes it easier for claimants to verify their identities, reduces the amount of manual work by EDD staff necessary to process claims, and includes more robust protections against impostor fraud.

Reported Cases of UI Fraud During the COVID-19 Pandemic

Since the pandemic began affecting California unemployment rates in March 2020, individuals, news organizations, and law enforcement officials have reported many cases of potential and actual UI impostor fraud. For example, the Beverly Hills Police Department announced in September 2020 that it had arrested 44 individuals responsible for identity theft and EDD fraud and had recovered EDD debit cards containing more than $2.5 million in fraudulently obtained UI benefits. Moreover, in November 2020, we reported that many individuals had received mail from EDD that was addressed to other people, and that this mail may have been the result of attempts to fraudulently collect UI benefits.[2] For example, an individual who had recently moved into a new home reported receiving more than 65 pieces of mail from EDD addressed to at least 15 different people. The significant amount of mail returned to EDD because it was undeliverable suggests that such cases have likely been widespread. Finally, in a November 2020 letter to the Governor, several district attorneys reported that EDD fraud was occurring in prisons across the State. We discuss this inmate‑related fraud later in this report.

Two main factors have made the UI program especially vulnerable to fraud during the pandemic: the sudden and massive increase in UI claims and the significant expansion of eligibility for benefits. After the start of the pandemic and the imposition of the statewide stay‑at‑home order, California's unemployment rate surged from 4.3 percent in February 2020 to 16.2 percent by April 2020, according to EDD's labor market information. This surge in unemployment created a dramatic increase in the number of UI claims individuals submitted: EDD received nearly 2.4 million UI claims in April 2020, about 13 times as many as it received in April 2019. This massive increase in demand for benefits may have made it harder for EDD to carry out typical fraud detection efforts.

In addition, in late March 2020, the federal government enacted the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which expanded UI benefits and relaxed some requirements for receiving those benefits. For instance, the CARES Act extended pandemic unemployment assistance (PUA) to certain individuals who were not eligible for regular unemployment benefits, such as individuals who had been self‑employed and therefore would not have a third‑party employer to report their wages or validate unemployment. Further, the CARES Act added $600 per week to the amount of benefits claimants could otherwise receive under state law between March and July 2020. The U.S. Department of Labor (Department of Labor) has also specified that states must backdate PUA claims to the first week in which claimants became eligible for benefits, which was as early as February 2020—meaning that a larger amount of money was available to claimants because they could receive benefits from many previous weeks before the date that they filed their claims. These factors further contributed to the heightened risk of fraud, since impostors had opportunities to earn more benefits without providing verifiable information about their work histories.

2 *Follow‑Up—Employment Development Department: Since the COVID‑19 Pandemic It Continues to Mail Documents Containing Social Security Numbers and Put Californians at Risk of Identity Theft*, Report 2020‑502, November 2020.

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EDD's Fraud Prevention Approach During the Pandemic Was Marked by Significant Missteps and Inaction

Key Points

- EDD failed to take fast enough action at the beginning of the pandemic to bolster its UI fraud detection efforts. As a result, from March through December 2020, out of $111 billion in UI benefits, EDD paid about $10.4 billion on claims that it later determined might be fraudulent.

- EDD paid $1 billion of the $10.4 billion in part due to a problematic decision to streamline its processes by removing a safeguard against paying individuals with unconfirmed identities. EDD issued payments to those claimants with unconfirmed identities before discovering it had inadvertently removed the safeguard for more than a four-month period.

- EDD faces an impending workload to assist the victims of identity theft whose personal information was used to file fraudulent claims. Given the high levels of potentially fraudulent claims and its processes for addressing them, EDD is underprepared to handle this work.

EDD's Failure to Act Promptly to Reduce Fraud Resulted in About $10.4 Billion in Potentially Fraudulent UI Benefit Payments During the Pandemic

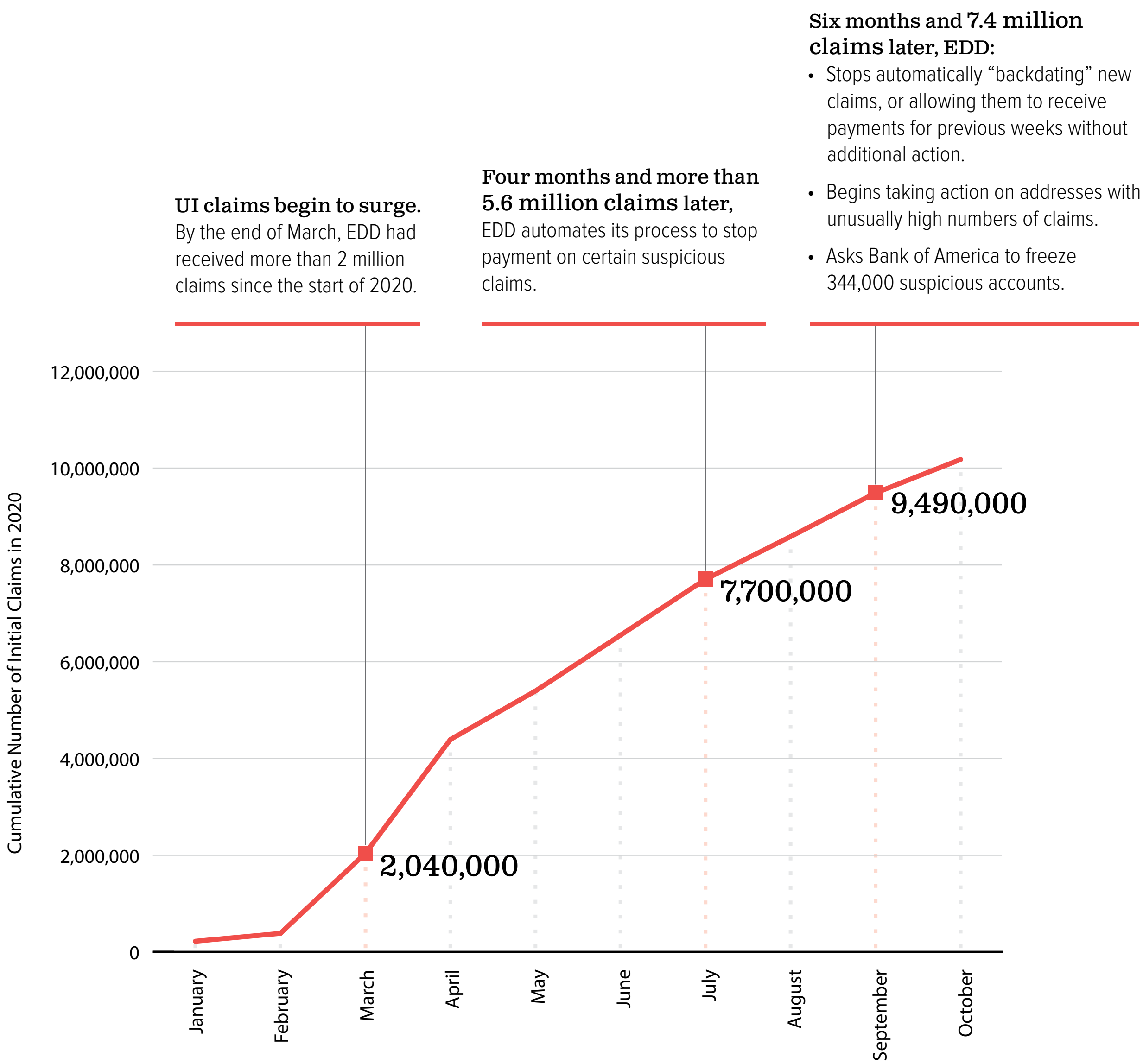
EDD's data show that out of a total $111 billion paid during the pandemic, from March 2020 through December 2020, it paid about $10.4 billion for claims that it has since determined could be fraudulent. These payments happened despite warnings from the U.S. Department of Labor (Department of Labor) to states at least twice in the early months of the pandemic that it had not relaxed its expectations related to fraud prevention in light of the pandemic. First, in its April 2020 instructions for implementing and operating the PUA program, it reminded states that they were required to take reasonable and customary precautions to deter and detect fraud, such as conducting a random audit of a sample of claims. Then, in May 2020, it issued another letter to remind states of their need to ensure the integrity of the UI program. This letter advised that states should perform essential ongoing reviews meant to detect improper payments throughout the UI program, including new benefits that the federal government had established in March 2020. Also in May 2020, when it requested data from EDD to identify fraud trends, the Department of Labor's Office of the Inspector General warned EDD that California was likely to see at least $1.2 billion in potential fraud based on the 2.9 million new claims that EDD had received in March and April 2020.

Despite these repeated warnings, EDD did not take prompt action to enhance safeguards against illegitimate benefit payments. As Figure 1 shows, EDD did not make any substantive changes to its fraud detection practices until late July 2020—four months after the pandemic-related shutdowns led to a surge in UI claims. That July 2020 change automated EDD's process for stopping payment on claims that EDD believed were suspicious. Previously, EDD's staff needed to perform a manual review of daily reports of thousands of possibly fraudulent claims and manually stop payment on each. Because it delayed this automation, EDD likely allowed fraudulent claimants to collect benefits through the first four months of the pandemic. For example, we reviewed the reports from just two days each of April, May, and June 2020 and found that these reports had identified more than 1,000 claims as suspicious or potentially fraudulent on each of these days. EDD asserted that two staff members were responsible for reviewing these reports each day and stopping payment by initiating the identity verification process for all current claims that this report identified as suspicious. However, EDD's reliance on this manual process gave claimants the opportunity to collect UI benefits before staff were able to stop payment on the claims. Given that these reports can contain more than a thousand claims each day, EDD may have allowed many more fraudulent claims to collect payments without impediment before it automated this process.

EDD delayed responding to instances in which an unusually high number of claims under different names were filed from a single address.

Additionally, EDD delayed responding to instances in which an unusually high number of claims under different names were filed from a single address, despite having substantial evidence that fraudsters were using this approach to defraud the UI program during the pandemic. According to EDD, multiple claims from the same address, such as a vacant building or house, can be a sign that fraudsters are trying to intercept or gather the mail associated with this address. However, EDD did not identify suspicious addresses associated with these claims until September 2020. Further, at that time EDD performed two separate analyses of the suspicious address issue, it took action on only a portion of the cases it identified. One of its assessments identified 26,000 suspect addresses that were associated with a total of more than 555,000 claims. However, EDD stated that it did not stop payment on all of these claims because it considered this list informational. Rather, it performed another assessment to determine addresses that may have been associated with fraudulent claims, which identified only 10,000 suspicious addresses associated with 250,000 claims. Most of these 10,000 addresses also appeared on the larger informational list of 26,000 addresses. EDD asserted that it stopped payment on this set of 250,000 claims and required these claimants to verify their identities. The most egregious example from this analysis was a case of more than 1,700 claims going to a single address.

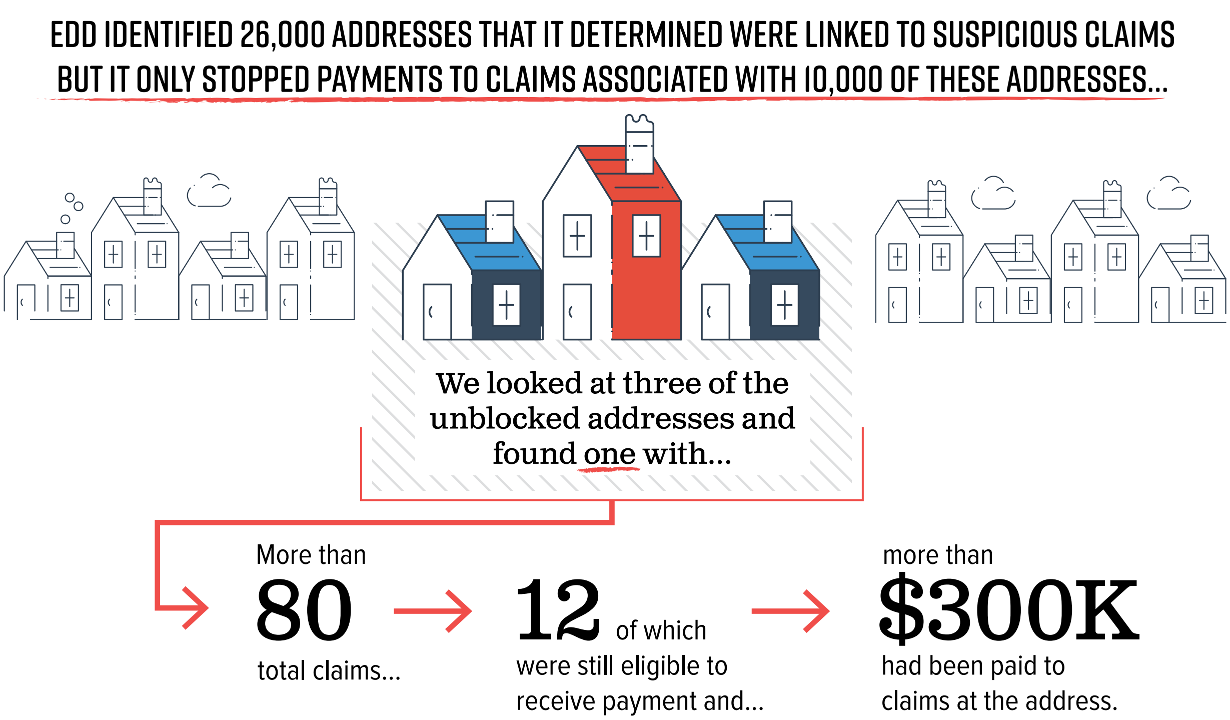
Figure 1
EDD Responded Slowly to Fraud Risks as Claims Surged



Source: Analysis of EDD's claims data and its fraud tools and modifications made during the pandemic.

It is almost certain that because of its lax approach, EDD missed stopping payment on fraudulent claims during the pandemic. As Figure 2 shows, we selected three addresses that appeared only on EDD's list of 26,000 addresses. In other words, EDD identified claims from these three addresses as potentially fraudulent but did not take any action to stop payments on claims from those addresses (unblocked addresses). More than 80 UI claims were filed at one of these unblocked addresses. Moreover, because EDD was unable to verify the identities of claimants for more than 70 of those claims, it is likely that impostors used this address to file fraudulent claims. However, EDD's fraud detection tools failed to detect 12 of the more than 80 claims as suspicious, allowing those 12 claims to remain active. As of mid-December 2020, EDD has paid more than $300,000 in UI benefits related to these 12 active claims. One of the other two unblocked addresses that we reviewed, which had more than 20 claims associated with it, raised similar concerns. Our review illustrates that EDD continues to pay claims despite having evidence that they are very likely fraudulent. After we shared our concerns with EDD, it performed another analysis identifying more than 572,000 claims at more than 30,000 addresses it identified as indicative of fraud. Most of these 30,000 addresses were included on EDD's larger informational list of 26,000 addresses identified in September. EDD asserted that it stopped payment on some of those fraudulent claims in mid-December. However, EDD still had not stopped payments on the claims associated with two of the three unblocked addresses we selected, including the address with 12 active claims. We made other observations about EDD's efforts to address problematic numbers of claims at a single address and, to avoid publishing information that could expose EDD to additional fraud, we shared those observations with EDD's management in a confidential letter.

Figure 2
EDD Has Not Stopped Payments on Claims at Addresses It Identified as Suspicious



Source: Review of EDD's analysis of suspicious addresses and claim information.

EDD took another action that compounded the effect of its slow and inadequate reaction to potential fraud. As part of its temporary COVID-19 procedures, EDD instructed staff to automatically backdate new UI claims to the date the claimant said they became unemployed. In other words, staff were told to enter an effective date for a claim that could be weeks before the date the claimant actually filed, allowing that individual to be paid benefits for those weeks. The Department of Labor provided guidance instructing states to backdate pandemic related claims to the week in which claimants first became unemployed. According to EDD, it automatically backdated new claims to comply with this guidance. EDD asserted that automatically backdating claims reduced the manual workload that would have otherwise been required to pay claimants. However, since early September 2020, in response to suspected fraud in the PUA program, EDD has required claimants to submit a separate request, aside from their UI claim, to obtain backdated payment. Since EDD took that action, claims for PUA have fallen considerably. Although we cannot establish a direct link between EDD's actions and the drop in PUA claims, it is possible that by ceasing its practice of automatic backdating, EDD has deterred fraudulent claims from occurring.

Since early September 2020, EDD has required claimants to submit a separate request, aside from their UI claim, to obtain backdated payment.

A Key Process for Detecting Fraud Has Been Overwhelmed During the Pandemic

Under normal circumstances, some of EDD's benefit fraud detection efforts might have allowed it to detect impostor fraud. Benefit fraud can occur when individuals continue to receive benefits by failing to report that they have returned to work. To detect such fraud, EDD performs daily reviews using California employer data and weekly reviews using nationwide employer data. Because these reviews use SSNs to identify overlap between EDD's benefit data and employer databases, the reviews would detect when impostors filed claims using the identities of people who were earning wages. When an overlap is detected, EDD generates and mails documents to the employers of the claimants whom the system detected as both continuing to work and receiving UI benefits, asking for further information about the claimant. EDD staff must then review the returned documents to assess whether fraud has occurred and take appropriate action.

However, during the pandemic, the amount of work generated by these matches overwhelmed the unit responsible for performing these reviews—the Benefit Overpayment Section within the UI Integrity and Accounting Division. Between March and November 2020, this process generated more than 840,000 matches, illustrating that hundreds of thousands of claimants were either collecting UI benefits while working or had had their identities stolen and impostors were using those identities to collect benefits. These 840,000 reviews generated during the pandemic were quadrupled from the number generated for this section to complete in 2019. This process relies on employers to provide details about whether an employee who matches a claimant in EDD's system is earning wages. EDD staff explained that this process can enable EDD to learn about potential impostor fraud because employers often notify EDD that the employees are continuing to earn wages and have attested to the employer that they are not collecting UI benefits. Complaint data we reviewed indicated that employees tell their employer that they are not receiving UI benefits after being questioned by their employer. However, because of the significant increase in the number of reviews generated, as of the end of November 2020, the section responsible for performing them had completed only 113,000 of the 840,000 reviews generated during the pandemic. This process is entirely paper-based and, as of the end of November 2020, the section was still processing documents received in August 2020. Staff do not stop payment on these claims until they process these documents, meaning that EDD has likely continued to pay on these potentially fraudulent claims, despite having identified them through this process. As a result of these workload challenges, EDD has been unable to effectively leverage this practice of relying on existing cross-match reviews to quickly detect fraud.

…an employment data match process generated more than 840,000 matches, illustrating that hundreds of thousands of claimants were either collecting UI benefits while working or had had their identities stolen…

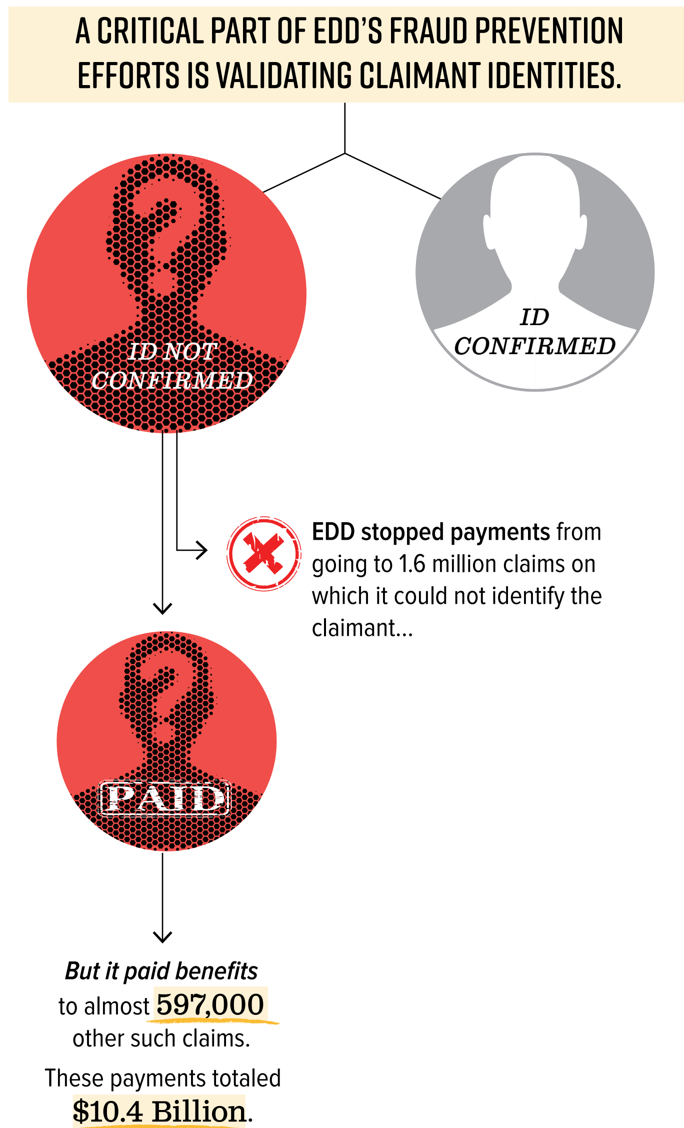
EDD's Slow Response Has Led to About $10.4 Billion in Payments to Suspicious Claims

As of late-December 2020, EDD had more than 2.2 million claims submitted during the pandemic for which it could not confirm the identity of the claimant—24 percent of the 9.5 million claims filed from the time the CARES Act became law in March. EDD issued at least one benefit payment on about 597,000 of those claims before identifying them as potentially fraudulent.[3] In total, EDD paid about $10.4 billion for these claims, as Figure 3 summarizes. Although EDD explained that it is not able to confirm that all of these claims are fraudulent—some of the claimants may have legitimate reasons for ignoring EDD's request for identity information—it does not know how many are legitimate and how many are fraudulent. More than 534,000 of the claims were paid UI benefits in excess of EDD's traditional dollar threshold for pursuing a criminal investigation of an impostor. As we explain in the Introduction, EDD reported that in 2019, its Investigation Division investigated only 14 cases of UI impostor fraud representing more than $5.5 million paid in fraudulent benefits. EDD's Investigation Division told us that as of December 10, 2020, it had opened more than 250 criminal cases related to potentially fraudulent claims filed during the pandemic and estimated an initial loss totaling greater than $30 million on these cases. However, considering that EDD's data show many more potentially fraudulent claims and the difficulty of identifying the perpetrators of the impostor fraud in 2020, it seems highly unlikely that EDD will be able to investigate more than a small fraction of these fraudulent claims, let alone recover a significant portion of the lost funds.

We asked EDD for its perspective on the slow and reactive approach that it took to combating fraud in 2020. EDD asserted that its fraud tools effectively identified and stopped potentially fraudulent claims throughout the pandemic and that it enhanced its existing processes and tools as needed. However, an estimate of the total UI benefit payments EDD prevented through these fraud prevention tools demonstrates that EDD paid almost as much to suspicious claims as it prevented. Using the number of claims associated with individuals with unconfirmed identities to which EDD had not issued payment and an estimated benefit amount based on Department of Labor data for 2020, we estimated that EDD stopped about $12.8 billion in payment to potentially fraudulent claims. Although any amount of fraudulent payment that EDD stops is a benefit to the UI program, a thorough analysis of the effectiveness of EDD's fraud prevention efforts needs to compare the amount of fraud prevented to the amount paid to potentially fraudulent accounts. As we note in the next paragraph, the total amount EDD paid to fraudulent claims is likely to continue growing as it completes upcoming work, further showing that EDD's fraud prevention methods have not been adequate to stop it from paying on fraudulent claims during the pandemic.

[3] This figure does not include approximately 10,000 additional claims for which EDD could not verify the identity of the claimant but issued at least one payment, and for which the claimant has appealed EDD's determination that their identity was unverified.

Figure 3
EDD Paid About $10.4 Billion in Benefits to Claimants With Unconfirmed Identities



Source: EDD data on payments and identity alerts, and Department of Labor estimated fraud rates for UI programs.

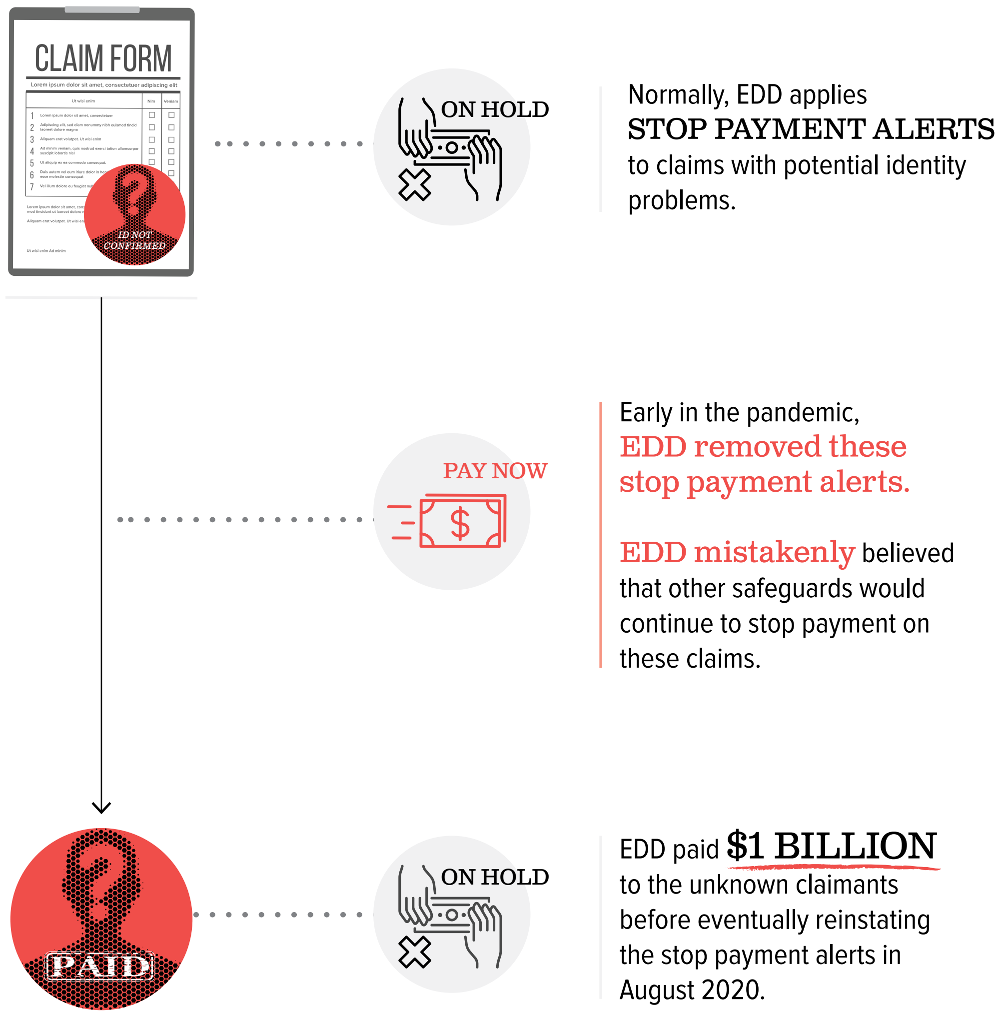
The $10.4 billion is likely not the full amount of improperly paid benefits. As we describe earlier in this section, we observed instances in which EDD continued to pay on suspicious claims that its fraud detection methods had not yet identified. During our audit, the number of claimants for which EDD could not confirm identity grew. Further, EDD's pending reviews of employment data mean it is likely that more claims will be called into question. As of early January 2021, EDD has requested identity information from more than 1.2 million claimants to whom it has already paid $19.5 billion in benefits. It is unlikely that EDD will verify the identity for all of these claimants with pending identity issues. Therefore, it is highly probable that EDD will ultimately determine that it improperly paid significantly more than the $10.4 billion we identify in this report as potentially fraudulent.

EDD Suspended a Critical Fraud Prevention Safeguard During the Pandemic Because of Its Poor Planning

Early in the pandemic, EDD altered a critical fraud prevention mechanism, resulting in it paying more than $1 billion of the $10.4 billion in benefits we discuss in the previous section to suspicious claimants. Figure 4 summarizes this problem. As we describe in the Introduction, EDD stops payment on claims while it verifies claimants' identities, ensuring that it pays benefits only to legitimate and verified claimants. However, early in the pandemic, EDD decided to remove a key safeguard against paying claims for which staff had identity concerns because of the mistaken belief that other safeguards would stop payments on these claims. However, because the EDD leadership who made these decisions did not adequately understand how the stop payments worked, EDD waived the barriers to payment for almost 77,000 claims and paid more than $1 billion on claims that it has determined are potentially fraudulent.

EDD explained that the early months of the pandemic presented challenges in balancing prompt payments for claims against its fraud prevention efforts. In the effort to respond to the overwhelming volume of unemployment claims, EDD leadership decided to identify and remove certain barriers to payment. EDD management asserted that it removed these barriers to streamline its processes. Nevertheless, this decision had significant consequences: EDD incorrectly believed that other safeguards in its claims processing system would stop all payments to claimants with unconfirmed identities. As Figure 4 shows, this incorrect belief was costly. We found that EDD continued to waive this payment barrier into August 2020—meaning it was not until four months after its decision to waive the barrier that EDD reversed its decision and ceased the practice.

Figure 4
EDD Removed a Key Fraud Safeguard and Paid $1 Billion to Individuals With Unconfirmed Identities



Source: Analysis of EDD's claims database and interviews with EDD staff.

The decision to waive this safeguard could have had even more significant consequences. At the time EDD waived the safeguard, it paid an additional 93,000 claims an additional $490 million in benefits before knowing that the claimant identities were confirmed. Although EDD eventually confirmed the identity of these claimants, it did not have that assurance when it issued these payments. Had EDD evaluated the risk of removing barriers to payment, it may have determined the need to streamline other processes in its system that would not have exposed it to so much potential fraud.

EDD paid $1 billion for almost 77,000 claims that it determined may be fraudulent.

We found that the majority of claims with unconfirmed identities for which EDD waived the payment safeguard had future payments prevented by other safeguards. In fact, most of the 77,000 claims received payments only for backdated benefit weeks. For example, one claimant filed a claim on August 3, 2020, but reported having become unemployed due to the pandemic on February 2, 2020—26 weeks prior to filing the claim. EDD immediately stopped payment on the claim on the same day it was filed. However, when it waived the safeguard for this claim, its data show that it paid benefits for the backdated weeks—totaling almost $22,000. Secondary safeguards stopped any future payments on the claim. Subsequently, EDD was unable to confirm this claimant's identity and disqualified the claim from any additional payments.

EDD could have avoided this misstep through more careful planning and preparation. As we explain in more detail in our earlier review of EDD, the department was unprepared for an economic downturn.[4] Its planning deficiencies extend to the area of fraud prevention. As shown by the decision we describe above to remove a claim payment safeguard, EDD leadership made a critical misstep because it had an inadequate understanding of its fraud prevention mechanisms—a gap in understanding that is more easily discovered and dealt with when planning in advance of a crisis moment. In addition to the key features of sound recession planning that we identified in our previous report, EDD's recession planning must include descriptions of the available adjustments to fraud prevention practices that EDD could make while continuing to best mitigate risk. Identifying the types of tasks it determines it is able to stop or delay during a recession while maintaining acceptable fraud detection and prevention efforts would minimize the need for less informed steps like the decision we describe above.

In the Near Future, EDD Will Likely Need to Dedicate Considerable Resources to Assisting Victims of Identity Theft

EDD will likely face a significant workload in the future to support the many individuals whose identities were stolen by impostors who filed fraudulent claims during the pandemic. Between March 2020

4 *EDD's Poor Planning and Ineffective Management Left It Unprepared to Assist Californians Unemployed by COVID-19 Shutdowns,* Report 2020-128 / 2020-628.1, January 2021.

and early January 2021, more than 2.2 million claimants did not satisfactorily answer EDD's request that they provide identity documentation. According to EDD, fraudsters are often not able to provide documents to confirm identity; therefore, EDD considers claims that are disqualified due to nonresponse as evidence that it has effectively deterred fraud. Although not every one of these 2.2 million claims made it far enough in the process to be paid, EDD's data indicate that it paid benefits totaling about $10.4 billion on almost 597,000 of these claims, suggesting that these individuals may have obtained benefits fraudulently. However, these are only the cases EDD has identified; the actual number of claims filed with other people's personal information may be higher because people who have not yet learned that they were victims of identity theft have not yet reported it to EDD. Further, we do not believe that EDD's fraud detection tools have yet detected every fraudulent claim filed during the pandemic.

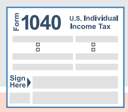
When EDD pays benefits on claims involving stolen identities, the victims of that identity theft may be asked to pay taxes on the benefits or to pay back the benefits. A victim's interactions with EDD to resolve the theft will depend upon the circumstances under which the fraud is discovered, as we show in Figure 5. For example, victims of identity theft may not know they are victims until they receive a tax form notifying them to report income from benefits, are contacted by EDD, or try to collect UI benefits themselves. In each of these cases, the work EDD will need to perform to assist these identity theft victims represents a potentially significant increase in its workload.

EDD's main process for addressing complaints of identity theft has been overwhelmed during the pandemic. If individuals discover that their identity has been used to file a fraudulent claim with EDD, they can notify EDD through its online fraud reporting portal or through its telephone hotline. EDD's data show that by July 1, 2020, EDD was receiving hundreds of these reports each day, growing to consistently receiving more than 1,000 a day in September 2020 and peaking at more than 1,800 reports on a single day that month. By comparison, EDD only received 6,000 UI fraud reports in all of calendar year 2019. EDD has dedicated only a single staff position to receive and assess these reports, and that position became vacant in July 2020. As a result, from April through October 2020, EDD responded to less than 2 percent of the UI fraud reports it received through its online portal. Further, it had yet to address more than 77,000 fraud reports as of November 2020. Many of these reports likely involve victims of identity theft who will need EDD's help to resolve their situations.

Figure 5
EDD Will Likely Need to Assist Victims of Identity Theft in Several Ways

TAXES DUE

Victims may be asked to pay taxes on benefits they did not receive or request.



EDD would need to determine the legitimacy of a complaint and coordinate with the IRS.

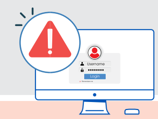
REPAYMENT DEMANDED

EDD may request money back from victims that the victims did not receive.

EDD would need to perform a manual identity verification process to remove any repayment.

CLAIM COMPLICATIONS

Victims may attempt to collect benefits on their own UI claims and realize fraudulent claims exist.



EDD would need to perform a manual identity verification process, stop payment on the fraudulent claim, and assign the claim a unique identifier that indicates it was fraudulent.

Source: Analysis of EDD's data, workload, and fraudulent claims processes.

To successfully resolve each case of suspected identity theft, EDD must first investigate the complaint to determine whether it can substantiate that identity theft has likely occurred. Once it completes that analysis, EDD can perform the work necessary to clear the reported income from the victim's name. According to data EDD provided, as of mid‑December 2020, it had performed this work for about 21,000 victims of identity theft for claims that had been filed from March through November 2020. This process will prevent the victims of identity theft from receiving incorrect tax forms. However, if EDD did not complete this process for an identity theft victim before reporting income to the IRS—a likely outcome given the volume of potentially fraudulent claims and the number of outstanding fraud reports that EDD has received but not yet addressed—the victims will need to contact EDD to resolve their cases. EDD will need to respond to fraud reports as identity theft victims submit them. EDD anticipates these submissions will represent a large workload in the future.

EDD could be better situated if it modified its existing practices to handle this upcoming work. Specifically, instead of continuing to receive complaints of identity theft through its regular fraud report mechanisms, EDD would provide faster and better service to identity theft victims by setting up a dedicated communication channel for those individuals. Further, to better understand the level of work it needs to accomplish, EDD should establish a working group specifically to coordinate the work needed to resolve each complaint of identity theft and make decisions about staffing levels necessary to accomplish that work. Without a concentrated focus, EDD risks unnecessarily delaying assistance to victims of identity theft, who will remain in precarious tax situations until EDD completes its work.

Recommendations

To ensure that its recession planning encompasses its fraud prevention efforts, EDD should identify the fraud prevention and detection efforts it can adjust during periods of high demand for UI benefits. It should ensure that it accounts for all probable consequences of the adjustments and design procedures that appropriately balance the need to provide prompt payment during a recession with the need to guard against fraud in the UI program.

To prepare to respond to victims of identity theft who receive incorrect tax forms, EDD should, by mid-February 2021, provide information on its website and set up a separate email box for such individuals to contact EDD and receive prompt resolution.

To ensure that it provides appropriate assistance to victims of identity theft who report fraud through its online fraud reporting portal, EDD should, by March 2021, establish a working group to coordinate the work needed to resolve each complaint of identity theft, make decisions about staffing levels necessary, and add staffing to accomplish the work.

EDD's Lack of Preparation Left it Unable to Effectively Address Two High-Profile Situations

Key Points

- In September 2020, EDD directed Bank of America to freeze 344,000 debit cards (accounts) because of concerns about UI fraud. Since then, EDD has not acknowledged its responsibility for this action, and it did not have a plan or take action to ensure that it could unfreeze those accounts belonging to legitimate claimants.

- EDD left itself especially vulnerable to UI fraud associated with incarcerated individuals—which it estimates has reached about $810 million—because it has not had a system to regularly cross-match UI claims with information from state and local correctional facilities.

When EDD Directed the Freezing of Accounts for 344,000 Claims, It Did Not Take Sufficient Action to Help Legitimate Claimants

EDD's reactive response to its discovery of potentially fraudulent activity appears to have harmed legitimate claimants. Bank of America—the State's vendor for distributing UI benefit payments—identified more than 309,000 of its UI accounts that it believed to be fraudulent and notified EDD of its plans to freeze—or shut down to prevent cardholders from accessing the funds—these accounts in mid to late September 2020. EDD reviewed the accounts the bank identified and confirmed that Bank of America should freeze 271,000 of the accounts. EDD also directed Bank of America to freeze another set of 73,000 accounts that Bank of America had not identified as accounts it planned to freeze. Therefore, in late September 2020, EDD directed Bank of America to freeze about 344,000 benefit accounts, which Bank of America did, effectively stopping anyone in possession of the debit cards aligned with these accounts from spending the benefit payments deposited into them. Bank of America froze 53,000 additional benefit accounts in the same week because the accounts exhibited certain fraud indicators established by Bank of America. However, because those fraud indicators differed from EDD's fraud criteria, Bank of America quickly unfroze the majority of these accounts in early October 2020 in an effort to align its fraud efforts with EDD's. Figure 6 summarizes key exchanges between EDD and Bank of America.

Several elements of EDD's role in these events are troubling. First, EDD did not initiate the request to freeze these potentially fraudulent accounts on its own, indicating that its fraud detection and prevention methods were not functioning optimally. Second, EDD mishandled the aftermath of this incident. Following public outcry in early October 2020 from legitimate claimants who could not access their benefits, EDD requested that Bank of America unfreeze all 344,000 accounts it had originally directed the bank to freeze—including the 73,000 claims it had independently identified as potentially fraudulent. In effect, EDD's response was to permit potentially fraudulent activity to continue to ensure that legitimate claimants received their benefits. However, it had no analysis supporting its decision to make such a swift change to its previous direction. In the end, Bank of America disregarded EDD's request to unfreeze the accounts. In a subsequent letter to the Legislature, Bank of America cited its obligation to prevent fraud under federal law as its reason for freezing accounts without EDD's approval. This series of events reveals flaws in EDD's response to fraud: it erred in its initial analysis and request that Bank of America freeze the 344,000 accounts, and it reacted poorly once it realized that accounts of legitimate claimants had been frozen.

Figure 6
EDD and Bank of America Have Repeatedly Corresponded About Fraudulent Accounts

2020

- **9/18** — Bank of America sends EDD a list of more than 309,000 accounts that it believes are fraudulent.
- **9/23-25** — EDD directs Bank of America to freeze 344,000 accounts, which Bank of America does.
- **9/29-10/1** — Bank of America freezes 53,000 additional accounts demonstrating indications of fraud, in addition to those on EDD's list.
- **10/3** — EDD's director issues a memo to Bank of America directing it to unfreeze the accounts that do not meet EDD's fraud criteria.
- **10/4** — Bank of America only unfreezes 51,000 of the accounts that it originally froze.
- **10/5** — EDD requests that Bank of America unfreeze the 344,000 frozen accounts it directed the bank to freeze.
- **10/31** — EDD sends a list of 2,270 verified accounts to Bank of America to unfreeze.
- **11/3** — Bank of America sends EDD a list of 104,000 suspicious accounts to review.
- **11/17** — EDD sends another list of 2,280 verified accounts to Bank of America to unfreeze.
- **12/2** — EDD sends another list of 3,000 verified accounts to Bank of America to unfreeze.
- **12/7** — Bank of America notifies the Legislature that it has identified more than 640,000 potentially fraudulent accounts.
- **12/10** — EDD informs Bank of America that it already stopped payment on 99,000 accounts of the 104,000 suspicious accounts that Bank of America sent in November.

Source: Analysis of EDD's correspondence records with Bank of America and public documents.

In addition, EDD's lack of transparency throughout this exchange damages the public's trust in its statements. When it became apparent that legitimate claimants had been included in the listing of frozen accounts—leading to media reports of people being unable to pay their bills or feed their families—EDD was slow to provide information. In fact, we found no public statements that acknowledged that EDD had directed the freezing of the 344,000 accounts. About a week after EDD directed Bank of America to freeze those accounts, the director of EDD testified to the Legislature that EDD and Bank of America were coordinating "additional review" of more than 350,000 suspicious claims. As the text box shows, when one assemblymember asked the director who froze the accounts, the director did not describe EDD's responsibility and identified Bank of America as the responsible party. A letter from 59 members of the Legislature in November 2020 to the chief executive officer of Bank of America shows that the Legislature believed that EDD had far less of a role in freezing accounts than it actually did. The letter indicates that EDD informed the Legislature that frozen accounts were solely the result of Bank of America's efforts. Although it is true that Bank of America froze some accounts without direction from EDD, the department played a significant role in directing that 344,000 accounts be frozen.

EDD's Director Did Not Acknowledge EDD's Role in Freezing 344,000 Accounts

Assemblymember: I know my district office has continued to receive several constituent calls more recently regarding the Bank of America cards that have been suddenly frozen. Can you give us a sense as to why are they being frozen? And whose accounts are being frozen? Is that something that the department directed them to do or is this something that the bank is doing?

EDD Director: This is part of the Bank of America's fraud protection services, I guess. And that's what I mentioned, that B of A and our—EDD and Labor Agency—we're meeting this afternoon to walk through exactly what was going on, what makes sense. And look at that balance again between paying claims versus fighting fraud. So we're aggressively taking a look at that.

Source: Director's testimony at a hearing of the Assembly Budget Subcommittee on State Administration on October 7, 2020.

Subsequent coordination between EDD and Bank of America about potentially fraudulent accounts has also been problematic. First, EDD has been slow to respond to another list of questionable accounts that the bank identified. In early November 2020 Bank of America sent EDD a list of more than 104,000 accounts that it identified as suspicious and requested guidance from EDD about what to do with the accounts. EDD delayed providing direction to Bank of America until one month later, risking that some fraudulent claimants would continue to collect benefits while EDD performed its analysis on those accounts. Further, when it did respond, EDD informed Bank of America that it had already stopped payment to more than 99,000 of the accounts, but failed to provide explicit instructions to Bank of America as to whether it should freeze those accounts. Therefore, EDD did not direct the bank to protect the money that it had already deposited into those accounts. Moreover, EDD neglected to mention what it had determined—if anything—about the remaining 5,000 accounts that Bank of America originally provided for review. EDD explained to us that it was still verifying the identities of the majority of these claimants as of December 10, 2020.

Still more problematic have been difficulties that EDD and Bank of America have had in agreeing how to unfreeze accounts that belong to legitimate claimants. One complicating factor has been that, during our review, EDD did not know which accounts were frozen or needed to be unfrozen. In fact, EDD confirmed that it does not have a centralized process for tracking and monitoring these frozen accounts, making it unclear how many accounts in total were frozen. Therefore, it does not have a systematic way to ensure that it reviews all frozen accounts to determine whether the accounts should be unfrozen and returned to legitimate claimants. Without such a process, any attempt that EDD makes to address the problem of legitimate claimants with frozen accounts may be incomplete and potentially flawed. Further, Bank of America has required EDD to individually verify the identities of the claimants associated with the 344,000 frozen accounts that EDD identified before it will unfreeze the accounts. An external consultant determined that 72,000 of the 344,000 frozen accounts were at low risk of being fraudulent claimants; however, EDD will need to manually verify these claims as legitimate before Bank of America will unfreeze those accounts. As of December 10, 2020, EDD had verified the identities of only about 7,500 affected claimants. Although EDD may find that it disqualifies some of these claimants—potentially from both the low-risk group of 72,000 accounts and the remaining population of the original 344,000 frozen accounts—for failing to respond to its requests for identity documentation, there will likely be a significant number still to be addressed. Therefore, it will be important for EDD to explore using ID.me or another type of expedited identity verification to avoid prolonging the process by which it resolves frozen benefit accounts that belong to legitimate claimants.

When we presented EDD with our concerns about its interactions with Bank of America, EDD explained that it was concerned about correspondence it had received from the bank that predated the September freezing of 344,000 accounts. EDD cited examples of Bank of America contacting EDD with eight lists of problematic accounts from mid-July through mid-September 2020. However, our review shows that EDD also handled some of these cases poorly. Specifically, Bank of America shared a list of almost 66,000 potentially fraudulent accounts with EDD in mid-July 2020 and requested EDD's review of these accounts. However, EDD was unable to provide any correspondence that demonstrated it ever answered Bank of America's request. In August 2020, Bank of America notified EDD that it was freezing approximately 5,700 accounts due to fraudulent activity. Records show that EDD knew about those frozen accounts and no record we reviewed shows that EDD expressed concern that the bank had frozen the accounts without first consulting the department. In early September 2020, Bank of America again sent EDD a list of more than 150,000 accounts that the bank identified as having suspicious activity, requesting EDD to review the accounts and determine if any are fraudulent and should be frozen by Bank of America. Again, EDD was unable to provide any correspondence that demonstrated that it ever answered Bank of America's request. These earlier requests are evidence of yet another warning about potential fraud that EDD does not appear to have comprehensively addressed.

EDD Was Unprepared to Detect and Handle the Hundreds of Millions of Dollars in Fraudulent Claims Associated With Incarcerated Individuals

As we show in Figure 7, EDD left itself especially vulnerable to fraud associated with incarcerated individuals—which law enforcement officials have said has totaled hundreds of millions of dollars in fraudulent payments during the pandemic. In late November 2020, nine county district attorneys signed a letter announcing that the Department of Labor identified roughly 35,000 unemployment claims filed from March 2020 through August 2020 using data that matched individuals incarcerated in state prisons against UI information. According to November 2020 correspondence from the deputy secretary of communications at the California Labor and Workforce Development Agency, 21,000 of these claims received payments that totaled $400 million. EDD later estimated that between January 2020 and November 2020, it paid about $810 million in benefits to roughly 45,000 claimants with information that matched incarcerated individuals, based on both state prison data and a December 2020 analysis by a private vendor that used data from state and local correctional facilities across the country. EDD noted that most of the problematic claims were for PUA; as we note in the Introduction, the CARES Act relaxed some requirements for receiving these benefits, such as extending the benefits to individuals who had been self-employed and therefore would not have had a third-party employer to report their wages. EDD was unprepared to guard against inmate fraud in this program because it lacked a system to cross-match all incoming claims against incarceration data.

EDD estimated it paid $810 million in benefits to 45,000 claimants who were incarcerated.

Figure 7
Because It Delayed Obtaining Critical Information, EDD Was Unprepared for UI Fraud by Incarcerated Individuals

2016

November A national survey shows that UI administrators in 35 states cross-match claims against incarceration data.

2018

June **EDD notifies the Legislature that it is considering adopting a cross-match against incarceration data.**

2019

June **EDD again notifies the Legislature that it is considering adopting a cross-match against incarceration data.**

2020

April EDD begins receiving PUA claims.

June **EDD again notifies the Legislature that it is considering adopting a cross-match against incarceration data.**

July PUA claims begin to spike. EDD's criminal investigators communicate with local law enforcement about specific cases of UI fraud related to incarcerated individuals.

August EDD reaches out to CDCR to request information that would allow it to cross-match data on incarcerated individuals against claim data.

October EDD develops a contract with a private vendor that claims it can provide access to incarceration records, such as data from local jails.

November Nine county district attorneys sign a letter announcing UI fraud involving tens of thousands of inmates and hundreds of millions of dollars.

December EDD and CDCR sign a data sharing agreement for CDCR to provide EDD with data on individuals incarcerated in state prisons.

2021

January Based on data from CDCR and the private vendor, EDD estimates it paid about $810 million in claims associated with incarcerated individuals.

Source: Emails from and interviews with staff at EDD, EDD claims data and vendor analysis, EDD's annual fraud reports to the Legislature, a letter from nine district attorneys, EDD's data sharing agreement and contract information, and a national survey of state unemployment programs.

EDD's failure to institute this type of cross-match is of special concern given the wide use of this approach throughout the rest of the country. According to a 2016 report on the results of a survey from the National Association of State Workforce Agencies, 35 states were cross-matching unemployment claims with state prison data and 28 states were cross-matching claims with county jail data at that time. For example, Washington state's Employment Security Department reported in December 2016 that it was cross-matching electronic jail records against its database of unemployment benefits three times per week and that it was examining the feasibility of creating a more robust cross-match using real-time data. In that report, Washington's department noted that since it had begun cross-matching these records, from March 2015 through July 2016 it denied benefits on nearly 1,500 such cases and recovered almost $250,000 in related overpayments.

Given the prevalence and usefulness of the incarceration data cross-match, it is troubling that EDD failed to implement this fraud prevention tool previously. According to EDD's annual report to the Legislature on fraud deterrence from June 2020, it already had processes to cross-match its records against other types of data, such as a monthly cross-match with mortality data and a real-time verification of claimants' SSNs with the Social Security Administration. By contrast, the report noted that EDD was "considering" new options for sharing data, such as incarceration data, with government agencies—language that it had also included in its 2018 and 2019 reports. However, according to the chief of EDD's Investigation Division, since starting his position in April 2016 and until recent conversations on this topic in 2020, he was not part of or aware of discussions with the California Department of Corrections and Rehabilitation (CDCR) about sharing state prison data to cross-match against UI claims. During the pandemic, when EDD became aware that this gap in its safeguards was allowing a substantial amount of fraud to occur, EDD spent months negotiating access to CDCR's state prison data after an EDD investigator initially reached out to CDCR in August 2020 about sharing information to identify potential fraud. CDCR originally took a stance that, except in limited circumstances, it was prohibited from providing the information to EDD, but it indicated that the Attorney General authorized it to provide the inmate information to EDD in early December 2020.

Since it became apparent during the pandemic that its failure to cross-match claims against incarceration data was allowing illegitimate benefits payments, EDD has pursued two solutions to address this gap in its fraud prevention efforts. First, according to EDD's chief information officer, EDD has recently expanded its cross-checking capabilities through a private vendor to cross-reference inmate data from prisons and jails in multiple states.

This vendor provided the December 2020 analysis that contributed to EDD concluding that it had paid about $810 million in benefits associated with incarcerated individuals. A contract between EDD and this vendor with a term of October 2020 through June 2021 includes access to what the vendor calls "real-time incarceration and arrest records." An EDD IT Branch staff member confirmed that, although the vendor's analysis for EDD has largely been retrospective, EDD is considering using the vendor in the future to perform more timely checks of new incoming claims against incarceration records. The chief information officer noted that she had not been in her position before May 2020 and, therefore, could not speak to why EDD had not pursued this option before the pandemic. Second, in early December 2020, EDD and CDCR established a data sharing agreement for CDCR to provide inmate data to EDD's investigators at least monthly for two years. State law authorizes the Office of the Attorney General (Attorney General) to share criminal offender information with EDD when there is a compelling need and allows CDCR to provide this information on the Attorney General's behalf.

Despite these new efforts, the Legislature should take action to help ensure that the State prevents future fraud by inmates. Although EDD has established a data sharing agreement with CDCR and a contract with a private vendor that likely will provide additional local data, such as from county jails, the CDCR partnership is dependent on the Attorney General determining that EDD has a compelling need for the information. Because of EDD's fraud prevention deficiencies that we discuss here and elsewhere in this report, and because EDD must rely on other entities such as CDCR to provide inmate data, legislative action is necessary to ensure that EDD can regularly access and use data from state and local correctional facilities to prevent future fraud. A mandate to share information and use that information to check incoming UI claims for potential fraud related to incarcerated individuals would address what has been a longstanding gap in EDD's fraud prevention approach that allowed significant fraud to occur during the pandemic.

Recommendations

Legislature

To ensure that EDD prevents fraud associated with incarcerated individuals, the Legislature should amend state law to do the following:

- Require EDD to regularly cross-match UI benefit claims against information about individuals incarcerated in state prisons and county jails to ensure that it does not issue payments to people who are ineligible for benefits. The Legislature should specify that EDD perform the cross-matches as quickly as possible after individuals file claims and with as little disruption of legal and eligible claims as possible.

- Require CDCR and any other necessary state or local government entities to securely share information about incarcerated individuals with EDD to enable EDD to prevent fraud.

- Require EDD to include, in its annual report to the Legislature about fraud, an assessment of the effectiveness of its system of cross-matching claims against information about incarcerated individuals. The assessment should include how regularly EDD performs the cross-matches, how successful the cross-matches are in detecting and preventing fraud, and whether the cross-matches negatively affect eligible claimants attempting to legally obtain benefits.

EDD

To ensure that it provides legitimate claimants with benefits but does not pay benefits related to fraudulent claims, EDD should immediately obtain from Bank of America a comprehensive list of claimants' accounts that are frozen. EDD should immediately thereafter evaluate the list—including considering using ID.me to verify claimants' identities—to identify accounts that should be unfrozen. By March 2021, it should direct Bank of America to take action to freeze or unfreeze accounts as appropriate.

To ensure that it reviews each account that Bank of America reports to it as suspicious or potentially fraudulent, by February 2021, EDD should establish a centralized tracking tool that allows it to review and stop payment on claims, as appropriate. EDD should use this tool to monitor its own internal decisions and track whether the claimant responds to its requests for identity information and should, therefore, have their account unfrozen.

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EDD Has Relied on Uninformed and Disjointed Techniques to Prevent Impostor Fraud

Key Points

- EDD's disjointed approach to fraud prevention has placed its UI program at a higher risk for fraudulent activity. It has not established a centralized unit to manage its fraud detection efforts, and it does not reliably track suspicious claims to ensure that it is taking appropriate action to resolve any issues, including those that suggest fraud has occurred.

- Best practices for fraud prevention suggest that government agencies should have a dedicated unit to mitigate the risk of fraud. Until EDD designates such a unit and develops a comprehensive approach to preventing and detecting fraud, it is at a greater risk for paying benefits on fraudulent claims.

- EDD does not measure or monitor any of its fraud prevention or detection tools to determine how effectively each one detects fraud. As a result, it may be using ineffective fraud prevention and detection techniques that fail to prevent fraudulent payments or delay payments to legitimate claimants.

EDD's Approach to Fraud Prevention Is Disjointed and Ineffective

In nonrecessionary years, EDD is responsible for the oversight and administration of a UI program that pays more than $5 billion annually in benefits to Californians who qualify for assistance. An essential element of effective management of such a program is prevention of attempts to receive benefits fraudulently. Not only is maintaining the integrity of the UI program a federal expectation, it is critical to ensuring that it provides assistance only to those who genuinely need it rather than those who misrepresent themselves to obtain money illegally. Given the importance of fraud prevention, we expected that EDD would have a cohesive and centrally managed fraud prevention effort, that it would track potential fraudulent activity from detection to resolution, and that it would ensure coordination between the fraud prevention and detection initiatives it uses. Because these practices are lacking, EDD's UI program is at a higher risk for fraud.[5]

EDD has not assigned responsibility to any single departmental unit for ensuring that its fraud detection efforts operate as intended, contributing to its disjointed approach to stopping fraud. As we note in the Introduction, many different divisions and offices have roles related to detecting fraud. These individual EDD units forward reports or allegations of fraud to one another and—in the process—do not remain involved in the resolution of the allegations. Figure 8 shows key units within EDD and the independent responsibilities they have related to fraud. As the figure shows, EDD's fraud detection approach is highly dependent on a variety of units all coordinating effectively with one another. Separation of responsibilities may be an appropriate way for EDD to divide its labor. However, that separation also increases the risk that units will not coordinate

[5] Federal law requires EDD to perform regular audits of randomly selected claims in an effort to determine its improper payment rate. Those audits also identify the causes for EDD's improper payments. However, those efforts differ from a focused attention on individual claims and are, therefore, only part of the solution to preventing fraud in the UI program.

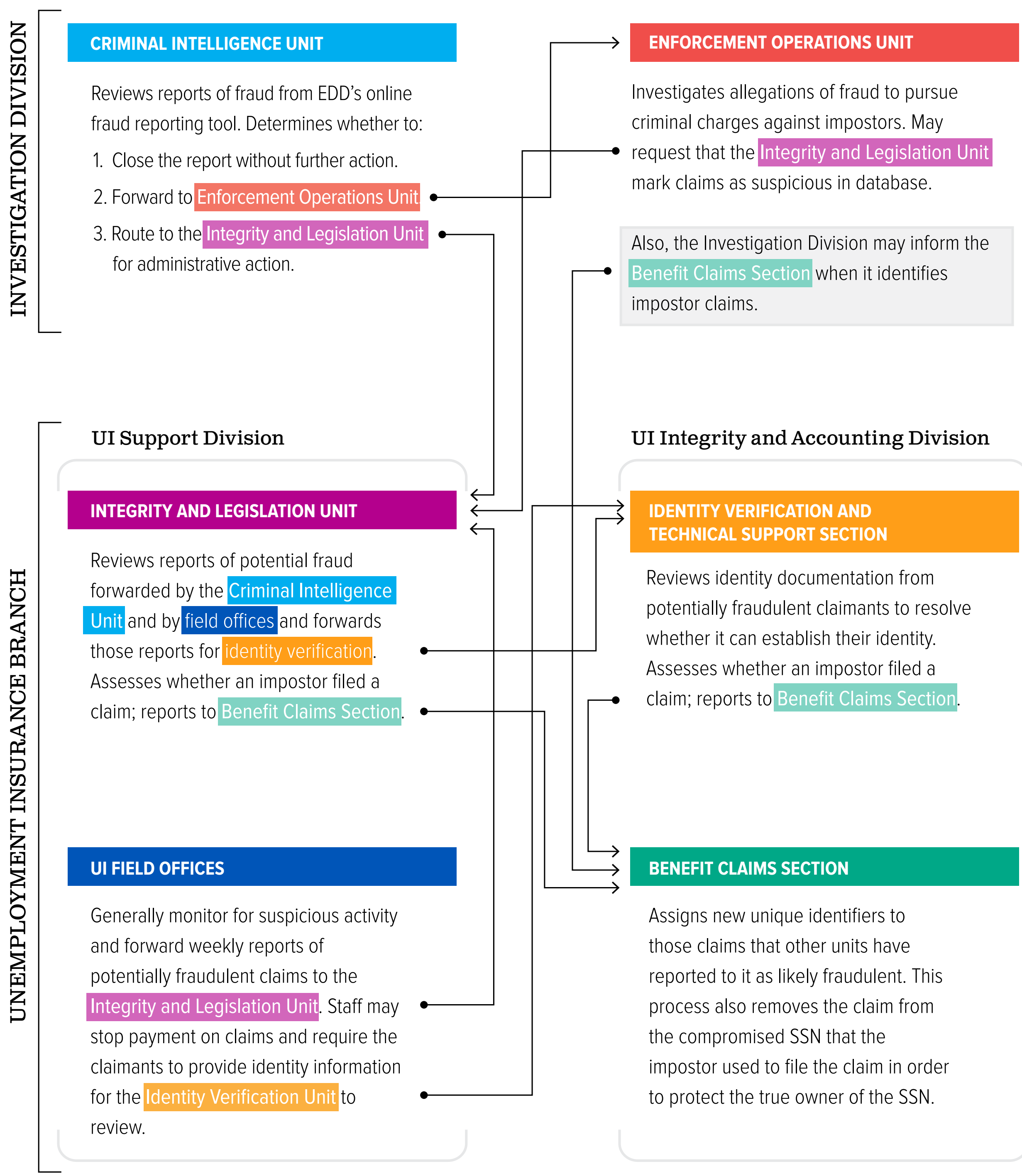
effectively with one another. For example, EDD has assigned primary responsibility for receiving and reviewing fraud allegations to the Criminal Intelligence Unit within its Investigation Division. However, the chief of the Investigation Division stated that the Criminal Intelligence Unit cannot stop payment on claims that it identifies as suspicious. It must refer any potentially fraudulent claims to other units or divisions for further investigation or administrative action. This delay may allow EDD to continue paying UI benefits on fraudulent claims, even after EDD staff have identified them.

We observed that a key mechanism EDD's units use to communicate about potentially fraudulent claims is dedicated email accounts that are managed by multiple staff. Referral and tracking of potential fraud by email increases the risk that EDD will mishandle a fraud report. For example, the Criminal Intelligence Unit's hotline operator monitors and receives reports of fraud from the public. If the hotline operator finds that an allegation has merit, the operator forwards the report to a dedicated email address for the UI Integrity and Legislation Unit. The UI Integrity and Legislation Unit reviews the claim associated with the fraud report and then passes the fraud report to the UI Identity Verification and Technical Support Section for further work. We attempted to follow two fraud reports that the hotline operator emailed to the UI Integrity and Legislation Unit in April and July 2020 to determine what action the unit took. In neither case could the UI Integrity and Legislation Unit locate the original emailed referral from the hotline operator, and the unit could only demonstrate that it had reviewed one of the two fraud reports. These examples demonstrate the gaps in the way EDD manages reports of potential fraud.

Referral and tracking of potential fraud by email increases the risk that EDD will mishandle a fraud report.

In another example, EDD has not coordinated its identity verification efforts, leading to duplicated effort with no discernible benefit. Since its implementation in October 2020, EDD has touted ID.me—an identity verification program that we describe in the Introduction—as one of its primary methods for preventing identity thieves from filing false claims. However, EDD confirmed that it continues to implement fraud detection tools that require claimants to verify their identities even after successfully completing ID.me verification, essentially requiring claimants to verify their identities twice. During a single day in November 2020, for instance, one of its other fraud detection tools flagged 352 claims for identity verification.

Figure 8
EDD Has Convoluted Its Fraud Prevention and Detection Approach by Spreading Key Efforts Among Its Different Units



Source: Review of EDD's organizational chart, EDD's policy and procedure documents, and interviews with EDD staff.

When we asked EDD why it continued to require secondary identity verification even after implementing ID.me, staff asserted that ID.me may have verified an individual's identity, but that individual may have exhibited indicators of fraud that ID.me was not designed to detect. However, as of mid-November 2020, EDD stated that it had not performed any analyses to determine whether this secondary verification step detects fraud that ID.me missed. Further, this secondary verification tool initially requires claimants to provide identity information similar to what they used for ID.me before EDD then further evaluates their eligibility. As such, EDD's secondary tool may delay payments to legitimate claimants by requiring them to verify their identities twice.

During our review, EDD asserted that it was taking steps to improve coordination between the different units that take action to prevent and detect fraud. In mid-November 2020, EDD hired a new deputy director to oversee its Policy, Accountability, and Compliance Branch. This deputy director has been tasked with establishing a fraud working group across the department. However, as of December 30, 2020, this group had not yet held its initial meeting or fully formed a charter to define its purpose. Because best practices for fraud prevention and detection suggest that government agencies should have a dedicated unit to identify fraud risk and determine the activities that the agency will engage in to mitigate that risk, we have concerns that EDD's approach does not seem headed in this direction. The U.S. Government Accountability Office (GAO) recommends that fraud prevention units have sufficient authority, be the central repository for knowledge about the agency's fraud prevention activities, and be the central coordinator of those activities. EDD's new working group may be an improvement to its current approach to preventing fraud, but it would be an even greater improvement for EDD to centralize fraud prevention into a single unit with proper authority to adopt and manage a fraud prevention strategy. Although the scope of our review was limited to fraud prevention practices within the UI program, it would be consistent with GAO guidance and efficient use of resources for EDD to centralize its fraud mitigation efforts in one unit for all of its major programs.

EDD Has Not Determined the Effectiveness of Its Fraud Prevention and Detection Methods

Although EDD employs a variety of tools to prevent and detect potential fraud—such as matching claims against employment records and death records—it has not conducted any analysis of the effectiveness of these tools to determine how well they detect fraud. State law requires EDD's director to periodically review its policies and practices to identify, in part, those that provide little or no value in preventing fraud or abuse in the UI program. However, EDD could not demonstrate that it had performed any such reviews since it reported the results of its first review to the Legislature in 2015. State law also requires EDD to report to the Legislature annually on its fraud detection and deterrence efforts, which it has done. Because of these two requirements, we expected that EDD would measure the effectiveness of each of its fraud prevention and detection tools to ensure that it is balancing its need to provide prompt payments to legitimate claimants with its need to prevent fraudulent payments. Although EDD annually reports on its fraud detection and deterrence efforts to the Legislature, it has not determined how reliably its tools and methods actually detect fraud. EDD's lack of a single unit with the authority to oversee its fraud prevention and detection activities may be one of the reasons that no one at EDD has measured or assessed these tools' effectiveness.

Understanding the effectiveness of its fraud detection tools is paramount to EDD's success at balancing timely payment of benefits with reduced risk of fraud. For example, if EDD knew that most of the claims one tool flagged were indeed fraudulent, it would be reasonable for EDD to continue to rely on that tool. However, if another tool flagged many potentially fraudulent claims that turned out to be legitimate, it would be advisable to alter or remove it since the tool would delay payments to real claimants without detecting actual fraud as well as perhaps wasting valuable EDD resources.

No one at EDD has measured or assessed its fraud detection and prevention tools' effectiveness.

EDD's chief information officer asserted that EDD has collaborated with other departments, such as the California Department of Technology, to assess the effectiveness of EDD's fraud prevention efforts. However, EDD was unable to provide any evidence of such an analysis or of any efforts to comprehensively understand the effectiveness of EDD's fraud prevention and detection efforts. Such an analysis is critical to informing and continuously improving EDD's approach. By evaluating outcomes of UI claims it identifies as having increased fraud risk, as well as identifying claims it did not flag as suspicious but later learned to be fraudulent, EDD can assess the frequency with which individual fraud detection efforts are successful. This will allow the department to update its fraud prevention strategy to prioritize the tools and techniques that prove most effective at stopping fraud and reduce or eliminate those that cause claimants unnecessary delays and yield little benefit.

EDD recently received additional federal funding to bolster its fraud prevention and detection efforts. In September 2020, the Department of Labor awarded EDD $2.4 million in grant funding to prevent and detect fraud in the UI programs implemented in response to the pandemic. Guidance associated with the grant provides examples of uses for these funds, including data mining and analysis. The guidance also suggests the use of the National Association of State Workforce Agencies' Integrity Data Hub, a centralized, multistate data system that allows states to perform cross-matches of claims, provides a national fraud alert system, and supports data analytics on multistate claims. In December 2020, EDD developed a draft spending plan with possible uses for the $2.4 million grant. Regardless of what it decides to do with the newly allocated funds, EDD must ensure that its fraud prevention and detection approach aligns with best practices. Until it does so, it cannot ensure that it appropriately protects the funding intended for qualified unemployed Californians from those who would defraud the State.

As we describe throughout this report, EDD's approach to fraud prevention and detection demonstrates the weaknesses caused by its poor planning and program management. Had it implemented a centralized fraud unit responsible for overseeing its overall fraud approach, it would not have needed to rely on its several units to balance the decision-making process and modifications it made early in the pandemic. It would have already had a dedicated unit responsible for advising it about and implementing those program changes to bolster its approach. Similarly, in nonpandemic times, this unit could likely have ensured that EDD's approach to fraud was informed by evidence of effectiveness, which would provide greater assurances to the public and Legislature that delays in payments to legitimate claimants were appropriate delays. However, because EDD neglected to employ these best practices to mitigate fraud, its weaknesses in detecting and preventing fraud have been exposed during the pandemic. To address these weaknesses, EDD will need to take strategic and urgent steps to coordinate and strengthen its approach moving forward.

Recommendations

Legislature

To ensure that EDD effectively protects the integrity of the UI program, the Legislature should amend state law to require EDD to do the following:

- By January 2022 and biannually thereafter, assess the effectiveness of its fraud prevention and detection tools and determine the degree to which those tools overlap or duplicate one another without providing any additional benefit. EDD should then eliminate any fraud prevention and detection approach for which it lacks clear evidence of effectiveness. It should include this assessment in its annual report to the Legislature on fraud detection and deterrence efforts.

- By July 2021, provide the Legislature with an update on its progress in performing this analysis.

EDD

To ensure that it maintains a robust set of safeguards against fraud, EDD should do the following:

- By March 2021, designate a unit as responsible for coordinating all UI fraud prevention and detection. EDD should assign that unit sufficient authority to carry out its responsibilities and align the unit's duties with the GAO's framework for fraud prevention.

- By May 2021, develop a plan for how it will assess the effectiveness of its fraud prevention and detection tools.

We conducted this performance audit in accordance with generally accepted government auditing standards and under the authority vested in the California State Auditor by Government Code 8543 et seq. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
California State Auditor

January 28, 2021

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APPENDIX

Scope and Methodology

State law authorizes the California State Auditor (State Auditor) to establish a program to audit and issue reports with recommendations to improve any state agency or statewide issue that we identify as being at high risk for the potential of waste, fraud, abuse, and mismanagement or that has major challenges associated with its economy, efficiency, or effectiveness. In August 2020, we issued a report that designated the State's management of federal COVID-19 funds as a high-risk statewide issue in California. Because EDD administers the UI program and specifically the CARES Act federal funding related to COVID-19 unemployment, we performed an audit of EDD's oversight of these funds. The objective of this audit was to evaluate EDD's recent fraud prevention efforts related to its UI program. In conducting this audit, we interviewed staff at EDD, reviewed public and confidential documents related to EDD's efforts to detect benefit and impostor fraud, and collected documentation from EDD pertaining to the steps it has taken to address increased fraud during the pandemic, including fraud issues raised by the public. To assess how EDD communicates reports or allegations of fraud internally, we selected five fraud reports from EDD's fraud reporting portal and evaluated documentation about the resolution of these reports. We also reviewed a selection of claims in EDD's internal database to assess whether the fraud detection tools EDD described to us had effectively detected fraud and stopped payments to those claims. In addition, we reviewed payment information to assess the amount of benefits paid on potentially fraudulent claims as a result of actions taken by EDD. Last, we reviewed guidance and best practices published by the Department of Labor and GAO to inform efforts that EDD should take in developing a comprehensive approach to fraud prevention and detection.

Assessment of Data Reliability

The GAO, whose standards we are obligated to follow, requires us to assess the sufficiency and appropriateness of computer‑processed information that we use to support our findings, conclusions, or recommendations. In performing this audit, we relied on electronic data files that we obtained from EDD's UI and IT branches. To evaluate the data, we reviewed existing information about the data, interviewed staff knowledgeable about the data, and assessed documentation to validate general details about the data. Because we performed only limited testing of the data, we found them to be of undetermined reliability. Although we recognize that this determination may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

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Employment Development Department
State of California

Gavin Newsom, Governor
California Labor and Workforce Development Agency

January 11, 2021

Elaine M. Howle, CPA*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

Thank you for working with our team to complete a thorough review of the challenges EDD has faced since the COVID-19 pandemic. We appreciate the recommendations offered, as this has been a public health and economic event without precedent in American history. EDD is prepared to implement all seven of the fraud recommendations put forward in the audit report.

Like many states, California was unprepared for the impact the COVID-19 pandemic had on both unemployment claims and fraud. California went from record employment rates to record unemployment rates -- seemingly overnight.

The new federal Pandemic Unemployment Assistance (PUA) program presented particular challenges, as it did not have the same safeguards as California's unemployment program. While in a September letter from the Department of Labor acknowledged that the new program is a "target for criminal enterprises and other bad actors deploying advanced technologies, stolen or synthetic identities, and other sophisticated tactics," the Trump Administration provided insufficient support to states to address the aggressive attacks by domestic and international criminal syndicates. 1

In 2010, the worst full year of the Great Recession, EDD paid $22.9 billion in benefits on 3.8 million processed claims. Since March 2020 more than $112 billion in unemployment benefits has been paid on 18.8 million processed claims. Of the 2
$112 billion in benefits paid out, the state has identified $10.4 billion as fraudulent of which approximately 92% of which are PUA claims. EDD has put new 3
safeguards in place flagging an additional $19.5 billion as suspicious, triggering stop payments and outreach to more than 1.2 million claimants to verify identity and over 150,000 to verify other eligibility criteria. In addition, during that same time frame, EDD successfully identified 1.6 million claims as potentially fraudulent

* California State Auditor's comments begin on page 51.

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④ and stopped them from proceeding. Based on an average weekly benefit amount and the average number of weeks of benefits, this represents $7 billion in average fraudulent payment prevented to date, which does not take into account PEUC or Fed-Ed extensions or the Lost Wages Assistance program ($17.4 billion - $10.4 billion)).

In the face of such a drastic increase in claims and unprecedented fraud, EDD undeniably struggled to timely distribute benefits to the millions of newly unemployed Californians and simultaneously prevent fraudulent claims.

This year, EDD took additional steps to detect and prevent fraud including:

⑤
- Stopping 1.6 million fraudulent claims before being paid; identified through EDD's manual identity verification process.
- Stopping the automatic backdating of PUA claims in September 2020 – an action the Trump Administration later advised all states to take.
- Worked with the California Cybersecurity Integration Center to adopt additional cybersecurity protocols.
- Deploying a Strike Team to look at recommendations and solutions to transform the customer experience of applying for and receiving UI benefits with a focus on addressing the backlog of claims.
    - One of the top recommendations of the Strike Team, launched ID.me a third-party identify verification program that helps stop 30% identity fraud at the beginning of the process and helps process claims more quickly compared to the previous manual verification process.

③
- Working with a contractor, initiated additional fraud detection criteria to weed out fraudulent claims which have flagged 1.4 million claimants as high risk for fraud.
- Creating a new task force led by the Governor's Office of Emergency Services (Cal OES) that includes the State's District Attorney's, the US Attorney's Office, the Employment Development Department, the California Department of Corrections and Rehabilitation (CDCR), the California Department of Justice focused on investigating fraud, holding people accountable and identifying resource needs including:

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- Data sharing agreements between EDD and the Departments of Corrections and Rehabilitation and State Hospitals. 6
- $5 million to support and enhance investigative efforts of the regional District Attorney task forces.
- Collaborating with the California Cybersecurity Integration Center to leverage the State cyber security threat intelligence, big data analysis and threat assessment capabilities to support investigative efforts.

- Coordinating with other states through the National Association of State Workforce Agencies (NASWA) for a unified voice in Washington DC and contracting with NASWA's UI Integrity Center to identity, detect and prevent fraud.

EDD will use all seven fraud related recommendations provided by the State Auditor to continue making improvements and strengthening protection of our unemployment system. We look forward to implementing these recommendations, providing updates as requested, and our continued collaboration.

Sincerely,

Rita Saenz

Rita Saenz

Director

Public Release Date: January 28, 2021

CSA Audit: EDD Significant Weaknesses in EDD's Approach to Fraud Prevention Has Led to Billions of Dollars in Improper Benefit Payment

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CSA (JLAC) Recommendations – Fraud Report 2

Recommendation #1

To ensure its recession planning encompasses its fraud prevention efforts, EDD should develop an evaluation of the fraud prevention efforts that it can adjust during periods of high demand for UI benefits. It should ensure that it accounts for all probable consequences of the adjustments, and design procedures that appropriately balance the need to provide prompt payment during a recession and the need to guard against fraud in the UI program.

EDD Response to Recommendation #1:

The EDD agrees with this recommendation.

During the COVID-19 pandemic, EDD has experienced unprecedented attacks on the unemployment programs– including from domestic and international crime rings. These
7 attacks primarily targeted the federal PUA program In response to the significant fraud, the EDD has initiated additional fraud prevention and detection efforts, such as the implementation of ID.me in October 2020 and cross matching CDCR and DSH inmate and patient records, as well as contracting with Thomson Reuters to review EDD data against industry-standards fraud measures in December 2020. EDD will continue to evaluate, monitor, and if needed implement new tools as fraud continues to evolve. It is the goal of the EDD to be proactive and nimble as necessary to stop fraud before claims are paid while also continuing to investigate fraud that has occurred. EDD is also committed to applying lessons learned during the pandemic to the future.

Recommendation #2

To prepare to respond to victims of identity theft who receive incorrect tax forms, EDD should, by mid-February 2021, provide information on its website and set up a separate email box for such individuals to contact EDD and receive prompt resolution.

EDD Response to Recommendation #2:

The EDD agrees with this recommendation and is confident that we will meet the proposed mid-February 2021 date. In preparation for calls related to the tax form that claimants receive (Form 1099G) and mailings related to potential fraud, the department is updating the EDD website and enabling the ability for customers to submit a question online through the public-facing Ask EDD portal and on their UI Online account. The EDD will also temporarily increase staffing in the Integrity and Accounting Division (IAD) contact center by 300 agents by February 1, 2021.

In addition, all UI Contact Center agents will receive training regarding 1099G calls. Any reports of fraud will be identified and analyzed through the Identity Verification process, ID.me and Thomson Reuters tools, or elevated to the Investigations Division. Claims with reported identity theft that are identified and confirmed as imposters will have re-computations completed and an amended 1099G will be provided. Additional hiring is in place to build resources in the Identity Verification and Re-computation areas to meet the increase in workload.

Additionally, the EDD is committed to ensuring victims of identity theft in our benefit programs are provided information and resources to assist them in reporting fraud and dealing with the aftermath of identity theft. Customers who wish to report fraud visit our EDD public website at https://edd.ca.gov/ and select “Report Fraud” under our Ask EDD link.

The EDD is committed to reviewing our online services to improve the customer experience, especially during the unprecedented outbreak of fraud associated with the federal Pandemic Unemployment Assistance program.

Recommendation #3

To ensure that it provides appropriate assistance to victims of identity theft who report fraud through its online fraud reporting portal, EDD should, by March 2021, establish a working group to coordinate the work needed to resolve each complaint of identity theft and make decisions about staffing levels necessary and add staffing to accomplish the work.

EDD Response to Recommendation #3:

EDD agrees with this recommendation. An enterprise Fraud Workgroup has been formed with representation of all benefit program areas of the EDD. The purpose of this workgroup is to document and evaluate current fraud prevention processes and fraud policies, including how individuals can report and resolve identity theft related to a benefit program. As part of the Fraud Workgroup, a subcommittee will be established to evaluate the resources and expertise needed to resolve complaints of identity theft and make recommendations to accomplish the work.

Recommendation #4

To ensure that it provides legitimate claimants with benefits but does not pay benefits related to fraudulent claims, EDD should immediately obtain from Bank of America a comprehensive list of claimants' accounts that are frozen and unfrozen. EDD should immediately thereafter evaluate the list—including considering using ID.me to verify claimants' identities—to identify accounts that should be unfrozen or frozen. By March 2021, it should direct Bank of America to take action to freeze or unfreeze accounts as appropriate.

EDD Response to Recommendation #4:

The EDD agrees with this recommendation. The EDD remains committed to ensuring that legitimate UI claimants timely receive the benefits for which they are eligible.

EDD has been working with Bank of America to determine appropriate actions on lists of frozen accounts received from Bank of America. As the vendor for the prepaid debit cards, Bank of America has its own obligations to prevent fraud. Bank of America has access to cardholders' transactional history data, which is an additional fraud detection tool. Because EDD and Bank of America have different tools and information for identifying fraud, we have engaged in many conversations to understand how to leverage each set of tools to enhance our collective fraud detection efforts. These communications continue.

EDD is in the process of reconciling all of the lists it has received from Bank of America
8 to date. A centralized tracking tool has also been created to track action taken on each of the frozen cards and the status of the account. To ensure accountability and completion in review of these lists, procedures have been documented with specific roles and responsibilities and completion timeframes. EDD is also in the process of contacting claimants whose accounts were flagged for identity verification through a separate data cross-match, to verify their identity through ID.me for any claim filed prior to October 1, 2020, including those who may have a frozen debit card.

Recommendation #5

To ensure it reviews each claim that Bank of America reports to it as suspicious or potentially fraudulent, by February 2021, EDD should establish a centralized tracking tool that allows it to review and stop payment to claims, as appropriate. EDD should use this tool to monitor its own internal decisions and track whether the claimant responds to its requests for identity information and should, therefore, have their account unfrozen.

<u>EDD Response to Recommendation #5:</u>

EDD agrees with this recommendation and in December 2020, the Information 8
Technology Branch created a central repository to store, track and maintain the lists provided to and from the Bank of America. These lists and their status will be updated regularly to enable EDD to track the appropriate action taken on each account and the outcome of each claim. To ensure accountability and completion in review of these lists, procedures have been documented with specific roles and responsibilities and completion timeframes.

Recommendation #6

By March 2021, designate a unit as responsible for ensuring coordination of all UI fraud prevention. EDD should assign that unit sufficient authority to carry out its responsibilities and align the unit's duties with the GAO's framework for fraud prevention.

<u>EDD Response to Recommendation #6:</u>

The EDD agrees with the recommendation in principle and will explore how best to 9
address this recommendation through the Fraud Workgroup. Part of the Fraud Workgroup's charge will be to identify opportunities and provide recommendations to centralize fraud prevention efforts, where appropriate, including the creation of a unit whose duties are aligned with the U.S. Government Accountability Office's framework for fraud prevention.

Recommendation #7

By May 2021, develop a plan for how it will assess the effectiveness of its fraud prevention tools.

<u>EDD Response to Recommendation #7:</u>

The EDD agrees with this recommendation. Despite challenges, the EDD was able to
prevent a significant amount of fraudulent benefits from being paid in 2020. During the 5
year EDD successfully identified 1.6 million claims as potentially fraudulent and stopped 4
them prior to payment which represents an estimated $7 billion in fraudulent payments prevented (using an average of 16.1 weeks and an average benefit amount of $282.39, plus $600 in Federal Pandemic Unemployment Compensation for a third of the weeks, minus the $10.4 billion paid out). Additionally, based on an independent review of all

3 9.7 million unique claims in December 2020, EDD put a stop payment on 1.4 million claims that were flagged for high probability of fraud.

7 Throughout this pandemic EDD has taken additional steps to detect and prevent fraud using a layered approach including:

- Launching ID.me – a third party identity verification tool that helps stop fraud at the front door.
- Contracting with a vendor to assess and apply industry standard fraud criteria to EDD claims.
- Entering into MOUs with CDCR and DSH to share and crossmatch identifying information.

These are new tools initiated in response to the unprecedented fraud seen over the course of the pandemic. EDD is currently evaluating the inventory of these, and other, tools and organizational resources to align our efforts in improving reporting metrics through benchmarking and continual analysis, including historical analysis and trending reports that can provide quantitative analysis of the effectiveness of our fraud prevention tools. Our goal is by May 2021, to have developed a plan on how to assess the effectiveness of our fraud prevention tools.

COMMENTS

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM EDD

To provide clarity and perspective, we are commenting on EDD's response to the audit. The numbers below correspond to the numbers we have placed in the margin of its response.

EDD does not acknowledge earlier warnings about potential fraud and its own failure to respond quickly to those warnings. We note on page 9 how the Department of Labor warned states about fraud in the early months of the pandemic and reminded states to take reasonable and customary precautions to deter and detect fraud. On the same page we also note that in May 2020, the Department of Labor's Office of the Inspector General warned EDD that—based on fraud trends in the UI program—California was likely to see at least $1.2 billion in potential fraud from 2.9 million new claims that EDD had received in March and April 2020. Further, on page 26 we describe how in July 2020 Bank of America shared with EDD a list of almost 66,000 potentially fraudulent accounts. However, because EDD did not take prompt action to enhance its safeguards against fraudulent benefit payments, it paid about $10.4 billion for claims from March through December 2020 that it has since determined could be fraudulent. 1

To clarify, we requested that EDD analyze its data to determine very specific information about the total paid to potentially fraudulent claims. EDD did not attempt to determine this amount until we asked about it. Absent our request, it is not clear whether EDD would have identified this amount. EDD did not provide us with support for its claim that 92 percent of the $10.4 billion was for PUA claims, and therefore we do not opine on that figure. 2

This action is indicative of EDD's slow approach to bolstering its fraud detection efforts during the pandemic. EDD states that it has placed new safeguards in place that have flagged an additional $19.5 billion in claim payments going to over 1 million claimants as suspicious and clarifies later in its response that it identified these claimants by working with a contractor. However, EDD did not take action to identify these claims as potentially fraudulent or stop payment to them until December 2020—almost eight months into the pandemic and four months after EDD asserts it observed an increase in fraudulent PUA claims. That EDD identified so many claimants as potentially fraudulent only after paying them $19.5 billion in benefits is troubling and a sign that EDD's fraud prevention approach was lacking the rigor it needed at the start of the pandemic. 3

4 On the day EDD's response to our draft report was due, it shared its estimate that it had prevented an estimated $7 billion in potential fraud. After reviewing EDD's estimate, we determined that the method we used to develop a $12.8 billion estimate was preferable because it allowed for a direct comparison to the amount EDD paid to potentially fraudulent claims. We shared our estimate with EDD after it submitted its response and it agreed that it should be reflected in the report. Further, we explain on page 17 that we expect the $10.4 billion that EDD has paid to potentially fraudulent claims to continue to grow as EDD performs additional work to verify questionable claimant identities. As we note on page 15, analysis of the effectiveness of EDD's fraud prevention approach should compare the amount paid to potentially fraudulent claims to the amount of improper payments prevented. Accordingly, EDD cannot know at the time whether it stopped more potentially fraudulent payments than it issued because it is still accounting for all potential fraud.

5 Although EDD identified 1.6 million potentially fraudulent claims before paying those claimants, its fraud prevention efforts failed to stop payments totaling $10.4 billion to about 597,000 claims, as we explain on page 15. Further, we state on page 17, and as EDD acknowledges in its response, EDD has flagged an additional 1.2 million claimants to whom it has already paid $19.5 billion in benefits as suspicious. It is unlikely that EDD will verify the identity of all of these claimants. Therefore, although the 1.6 million claims represent some level of success, it cannot yet be compared to the rate at which EDD failed to prevent fraud because it is still verifying the identities of some claimants it has already paid, leaving open the possibility that the number of claimants with unconfirmed identities to whom EDD paid benefits will grow.

6 EDD cites its partnership with CDCR as a positive step it took to combat fraud during the pandemic. However, it is troubling that EDD failed to implement a cross-match between claim data and incarceration data well before the pandemic began. We describe on page 29 how EDD spent months during the pandemic negotiating access to CDCR's state prison data. However, we note a national survey showed that 35 states were cross-matching unemployment claims with state prison data in as early as 2016. Further, EDD has reported to the Legislature that it was "considering" new options for obtaining incarceration data since at least 2018. Finally, as we state on page 30, the CDCR partnership is dependent on the State Attorney General determining that EDD has a compelling need for the information. Because of EDD's fraud prevention deficiencies that we discuss in this report and because EDD must rely on other entities such as CDCR to provide inmate data, legislative action is necessary to ensure that EDD can regularly access and use data from state and local correctional facilities to prevent future fraud.

Had EDD taken action before the pandemic, as many other states had done, this critical safeguard would have already been in place and would have prevented some of the $810 million in fraudulent payments in claims associated with incarcerated individuals.

EDD describes the actions it took to combat the "unprecedented attacks" on the UI program. However, EDD began taking the actions it describes in October 2020, more than six months into the pandemic, despite earlier warnings about this fraud. Further, these steps—though laudable—evidence how unprepared EDD was to combat fraud at the outset of the pandemic as each of these steps would have reasonably benefited EDD in the years before 2020 and better prepared it to respond to the pandemic-related surge in claims. 7

EDD describes actions it is in the process of implementing. We expected that, before our audit began, EDD would have a method for comprehensively tracking the status of benefit accounts that have been frozen. However, as we note on page 26, during our review EDD did not appear to know the status of all of the claimant accounts that have been frozen and confirmed that it did not have a centralized tracking process for the status of these accounts. EDD now asserts that it has established a centralized way to track these matters. We look forward to reviewing its progress as part of our regular recommendation follow up process. 8

EDD indicates that it will use its recently formed work group to explore how to implement our recommendation. EDD should act quickly to address the problems we highlight in Figure 8 on page 35 where we show the fragmented responsibility for fraud prevention at EDD. Because EDD's approach does not align with best practices for fraud prevention, we recommended that it centralize fraud prevention responsibility and authority in a single entity. Moreover, as we note on page 36, the working group had not yet held its initial meeting or fully formed a charter to define its purpose as of December 30, 2020. Therefore, its progress in exploring our recommendation to date has been minimal. We look forward to seeing the progress EDD makes in addressing our recommendation as part of our regular recommendation follow up process. 9

Introduction Form

(by a Member of the Board of Supervisors or the Mayor)

I hereby submit the following item for introduction (select only one):

- ☐ 1. For reference to Committee (Ordinance, Resolution, Motion or Charter Amendment)
- ■ 2. Request for next printed agenda (For Adoption Without Committee Reference)
  (Routine, non-controversial and/or commendatory matters only)
- ☐ 3. Request for Hearing on a subject matter at Committee
- ☐ 4. Request for Letter beginning with "Supervisor [ ] inquires…"
- ☐ 5. City Attorney Request
- ☐ 6. Call File No. [ ] from Committee.
- ☐ 7. Budget and Legislative Analyst Request (attached written Motion)
- ☐ 8. Substitute Legislation File No. [ ]
- ☐ 9. Reactivate File No. [ ]
- ☐ 10. Topic submitted for Mayoral Appearance before the Board on [ ]

The proposed legislation should be forwarded to the following (please check all appropriate boxes):

☐ Small Business Commission ☐ Youth Commission ☐ Ethics Commission

☐ Planning Commission ☐ Building Inspection Commission ☐ Human Resources Department

General Plan Referral sent to the Planning Department (proposed legislation subject to Charter 4.105 & Admin 2A.53):

☐ Yes ☐ No

(Note: For Imperative Agenda items (a Resolution not on the printed agenda), use the Imperative Agenda Form.)

Sponsor(s):

Chan

Subject:

[Urging Governor Gavin Newsom to Overhaul the Employment Development Department]

Long Title or text listed:

Resolution Urging Governor Newsom to Overhaul and Increase the Useability of the Employment Development Department.

Signature of Sponsoring Supervisor: C Chan