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To: Board of Supervisors, Board of Directors
Department or Agency Name(s): County Administrator's Office
Staff Name and Phone Number: Peter Bruland, 565-8565
Vote Requirement: Informational Only
Supervisorial District(s): Countywide

Title:
Fall 2022 Five-Year Fiscal Forecast and Budget Update

Recommended Action:
Receive an updated five-year General Fund forecast and overview of the FY 2023-24 budget process

Executive Summary:
Each year the County Administrator's Office provides the Board of Supervisors with an updated General Fund Projection and an update on the budget process for the coming year.

Consistent with the approved county Financial Policies <https://sonomacounty.ca.gov/administrative-support-and-fiscal-services/county-administrators-office/budget-and-operations/financial-policies-for-2022-2023>, the Board of Supervisors annually adopts a structurally balanced budget that does not rely on one-time year-end savings to finance operational ongoing costs. Budget development is a months-long process that begins in the fall of each fiscal year. Budget development culminates with Budget Hearings and the adoption of the budget, which are scheduled for June 2023.

A key part of this process is a review of available resources for budgeting. With today's assumptions, the General Fund is projected at a surplus of $7.4 million in FY 2022-23 and a balanced budget in FY 2023-24. This does not include state and federal financed programs and services. Future fiscal years are projected with significant deficits starting with $13.0 million in FY 2024-25. Projections as of this writing are based on a number of assumptions that may prove questionable given the significant economic uncertainties.

Discussion:
<u>**General Fund Projections**</u>

The General Fund's budget includes the primary discretionary general-purpose source of revenue available to the Board of Supervisors. The projections exercise is designed to present a view of the County's General Fund fiscal health and to provide advance views into potential future issues or opportunities. Given the countywide budget is mostly financed with non-discretionary sources, it is important to remark that this General Fund projections only covers about 26% of the county-wide total FY 2022-23 budget. Nonetheless, on a more practical note, the development of General Fund projections during the fall sets the basis for programming discretionary sources in the coming fiscal year, by estimating how much general-purpose revenue will be available in FY 2023-24 for departments that depend on the General Fund to deliver services and programs to our community.

The Five-Year General Fund Fiscal Projections (Attachment A) offer an illustration of where we would expect General Fund sources and uses to come in for the current year and each year from FY 2023-24 through FY 2027-28 by excluding one-time uses and investments and based on current policies aimed at creating structurally balanced budgets. Table 1 shows a summary of these projections. The final surplus or deficit for a given year are based on the single year projections assuming no change in policy. Thus, if the projected $1.6 million surplus in FY 2023-24 were programmed for ongoing costs, the projected deficit in FY 2024-25 would grow. Similarly, if the projected $13 million deficit in FY 2024-25 is addressed, one would expect only about a $1.5 million deficit in FY 2025-26.

Table 1: Projected General Fund Sources (revenues) and Uses (expenditures) in Millions of D

Fiscal Year	FY22-23	FY23-24	FY24-25	FY25-26	FY26-27	FY27-28
Total Genera	$658.5	$609.2	$615.2	$629.4	$645.6	$662.2
Total Genera Expenditures	$651.1	$607.6	$628.2	$643.9	$660.3	$678.2
Total Surplus	$7.4	$1.6	($13.0)	($14.5)	($14.7)	($16.0)

On June 17, 2022, the Board adopted a balanced budget for FY 2022-23. We are now projecting a $7.4 million surplus in the current fiscal year based primarily on improved revenue projections. This is based primarily on $9.8 million of additional property tax revenue that is anticipated based on the final approved Assessor's Roll. Per Board policy, 40% of this increase, or $3.9 million, is to be programmed as an ongoing transfer to the Deferred Maintenance Revenue fund. Additionally, Proposition 172 and Sales Tax revenues are anticipated to come in higher than budgeted by about $3.5 million combined based on the latest projections from HdL, the County's Sales Tax consultants. These increases are partially offset by reduced projections for revenues in Documentary Transfer Tax (down $1.6 million) and Supplemental Property tax ($400,000). These sources are largely dependent on sales of property to generate additional revenue. As interest rates have risen, sales have begun to slow, a trend that is likely to continue.

According to Bankrate, "The Federal Reserve is expected to lift interest rates to the highest level since 2007 in its intense quest to battle the hottest price surge in four decades, according to the nation's top economists." Bankrate is an online publication of mortgage lender profiles and reviews.

The FY 2023-24 projection shows significant decreases to both sources and expenditures. This is as a result of eliminating non-recurring one-time sources (primarily fund balance) that were programmed by the Board of Supervisors during FY 2022-23 budget hearings for one-time or time limited purposes.

Under current assumptions it is anticipated that the County's FY 2023-24 General Fund budget will be structurally balanced, with nominal surplus of $1.6 million (0.3 percent) projected. This projection is based on a number of assumptions that may yet change.

1) Property tax growth is projected to remain robust (4.5%) in FY 2023-24 despite slowing sales. This is due to the fact that the tax rolls for that year are based on changes during the 2022 calendar year. While sales are now slowing, growth based on earlier activity has been included.
2) Further decreases are anticipated in supplemental property tax and documentary transfer tax, in line

with increased interest rates, reduced sales, and potentially flat or reduced median home prices.

3) Other revenue sources, including sales tax and transient occupancy tax, are anticipated to experience only very modest growth, but are not anticipated to decrease.
4) Costs for salaries and benefits are projected to increase by 3.3%, including an increase to total wages expenses of 4% over FY 2022-23 budget. Contracts with all bargaining units are set to expire over the coming year, and so there is no information about what adjustments will occur in the coming fiscal year. In the absence of new information, the projections utilize the floating revenue and CPI formula exclusively for projecting Cost of Living Adjustments (COLA), which is consistent with the approached utilized for the final two years of the current Labor agreements. Based on the rate of inflation and the level of property tax growth, the formula would dictate a COLA of 4% for FY 2023-24. Actual changes will depend on eventual negotiated agreements.
5) Earlier projections showed pension costs increasing significantly in FY 2023-24 due to the change in the discount rate assumed by the Sonoma County Employees' Retirement Association from 7% to 6.75%. Since that time we have received the latest December 31, 2021 actuarial report which suggests that the increase in FY 2023-24 will be more modest due to the strong rate on investment returns the pension fund has experienced through January 1, 2022. Currently the markets suggest that there will be significant losses in 2022. Any losses for calendar 2022 will impact rates beginning in FY 2024-25.
6) As noted above, there were significant one-time expenditures in the FY 2022-23 budget. Except in places where the funding was approved for multiple years, these expenditures are assumed to expire and not be repeated.

A more robust discussion of the uncertainty in the current economic situation and potential impacts on revenue and expenditures appears below in the Economic Conditions section.

Beginning in FY 2024, the General Fund is projected to enter deficit absent policy changes. It is important to note that the model assumes no change to current policies. Changes that either increase revenue (such as raising fees to match costs) or decrease expenditures (such as reducing positions) could change the dynamic. The County Administrator's Office will present a balanced budget to the Board each year. Thus, projected deficits are intended to illustrate that adjustments to address competing needs may be necessary, and not a projection that the County will run a deficit.

The $13.0 million deficit projected in FY 2024-25 is driven primarily by several factors:

1) Growth in property tax is anticipated to slow to 2 percent given the impact of higher interest rates and likely flat or decreasing home prices.
2) Time limited-funding of $3.75 million supporting several programs, including the Sheriff's Helicopter, and the Climate and Resiliency Division of the County Administrator's Office, are set to expire. While one-time costs are dropped, ongoing costs of these programs are not removed from the projections.
3) Wage expenses are anticipated to grow with a 3 percent COLA under the same formula cited above. Actual costs will depend on final labor agreements, but at three percent this outstrips anticipated revenue growth.
4) Pension costs are anticipated to grow by $8.2 million due to anticipated 2022 market losses based on the current S&P 500 20 percent retraction, and due to the expiration of the 3.03 percent employee cost share toward unfunded liability costs that is slated to drop for about 70 percent of the FY 2022-23 budgeted full-time employees.
5) Staffing costs at the planned Behavioral Health Housing unit of the Main Adult Detention Facility are

anticipated to begin in FY 2024-25, however these to not impact the deficit due to the Board's forward-looking decision to set aside $6.6 million in ongoing general-purpose revenue capacity to support these known upcoming costs as part of the FY 2022-23 budget.

6) The above items lead to a total increase in wages and benefits expenses of 5.4%.

Under the current model, deficits are anticipated to continue at a similar rate for the remainder of the five-year window. These deficits are not cumulative, so if the deficit is solved in FY 2024-25, it is anticipated that deficits would be nominal under current assumptions as intended by the Board's structurally balanced budget Financial Policy.

Economic Conditions

The pandemic era has been a very turbulent time for the economy, to say the least. The various indicators continue to paint a mixed picture of the overall state of the economy. The most visible indicator has been a stubbornly persistent rate of inflation that has been well above recent historical averages. The most recent consumer price index for the Bay Area as of the time of writing was from August, which showed a 5.7 percent year-over-year increase (source: US Bureau of Labor Statistics). <https://www.bls.gov/regions/west/news-release/consumerpriceindex_sanfrancisco.htm> This is below the national average of 8.1 percent. In response to the elevated rate of inflation, the Federal Reserve has been increasing interest rates quickly through the year. At the time of writing, rates have increased by 300 basis points (or 3 percentage points), from near zero. It is widely expected that by this board date the Federal Reserve will have raised rates by an additional 75 basis points, and may continue to increase in the future. Likely driven by these impacts, consumer sentiment remains near 30-year lows <https://fred.stlouisfed.org/series/UMCSENT>, while the S&P 500 is down approximately 20% on the year as of writing.

Yet there are other related items that point to a stronger (perhaps overheated) economy. While the increase to interest rates is designed to increase savings, reduce spending, and thus cool inflation (and indirectly slow the economy), to date employment has remained high. An October report from the Bureau of Labor Statistics <https://www.bls.gov/regions/west/summary/blssummary_santarosa.pdf> showed unemployment at 2.8 percent in Sonoma County, down from 5.3 percent a year prior, and below the (still historically low) national average of 3.8 percent. In line with this, consumer spending has also remained strong. Following two quarters of nominal decline, the country's Gross Domestic Product increased in the last quarter. At the moment, a range of outcomes from a relatively benign decrease in the rate of inflation with modest softening of economic activity to a hard recession are possible in the coming months and years. Below is a quick description of how key county general-purpose revenue sources and costs may be impacted by potential outcomes.

Revenues

Property Tax

As noted above, the largest single general purpose revenue source for the General Fund is property tax. Under Proposition 13, a property's assessed value can only increase at the California Consumer Price Index rate, with a cap of 2 percent, unless properties change hands or are improved (in which case only improvements are reassessed, the remaining property value remains at its lower value). Because of this, any growth in the revenue stream above the 2 percent cap is dependent on property sales and new development.

As noted in the prior section, the increase in interest rates to the highest level in 20 years, with 30-year fixed mortgages now averaging more than 7%, home sales are slowing significantly in Sonoma County. Documentary Transfer Tax, which is primarily collected based on property sales and is a leading indicator of property tax growth, is down 27% in FY 2022-23 through October compared to the prior year.

Because of the process with which assessments are made, property tax tends to lag other revenue stream in terms of change. Declining sales and declining home prices will lead to significantly reduced growth in property tax, however unless there is a very sharp decline in home values (or unless the consumer price index goes negative), there is unlikely to be a decrease in property tax revenues. Taxes more directly related to transfers including Supplemental Property Tax and Documentary Transfer Tax are more likely to see decreases.

<u>Sales Taxes</u>
Sales tax makes up less than 5% of total General Fund revenues, but sales have a much greater impact on the overall General Fund county budget. Sales tax impacts the County in four primary ways:

1) **Bradley-Burns Sales Tax:** A 1% share of sales tax collected by the state reverts to the jurisdiction where the sale is generated. This means that Sonoma County gets 1% of the sale price of sales in the unincorporated area of the County (cities receive this share from sales within their city limits). This rate is based on point of sale rather than point of use, so the County does not receive tax related to sales to its residents that initiate outside its jurisdiction but inside the state (e.g., online sales sent from distribution centers outside the county). The FY 2022-23 Adopted Budget includes $25.7 million in this sales tax.
2) **Proposition 172 Public Safety Revenue:** A share of state sales tax also returns to local jurisdictions specifically for use on public safety, based on Proposition 172. The majority of this revenue flows to Counties. The Adopted Budget includes $57.9 million or 62% of all General Fund's Intergovernmental sources in Proposition 172 revenues. Based on board policy, the majority of this (about 83%) supports Sheriff's Office operations, while about 9% goes to the District Attorney's Office and 8% goes to support Fire Services. The distribution formula is based roughly on the rate of sales in a County, but lags actual receipts and thus is impacted both by total revenue growth and relative growth between counties.
3) **Realignment Funding:** Although not included in the enclosed General Fund projection, it is important to remark that the County receives funding for a number of services that were "realigned" from state to counties in two batches: 1991 and 2011. This revenue is made up largely from state sales tax revenues (a smaller share is related to vehicle license fees). Realignment funding plays a significant role in supporting services in the Human Services Department and the Department of Health Services, as well as supporting public safety realignment programs delivered by the county's Justice Services departments. While total amounts for distribution are in part based on overall state sales tax collections, formulas for distribution to counties are based on a variety of criteria such as population, caseload, and success rates, and do not relate to collections within the County. Overall, the FY 2022-23 non-General Fund Adopted Budget includes $121.4 million in sales-tax related realignment revenues, which could be reduced if statewide sales tax declines.
4) **Special Sales Tax:** County departments and related entities receive funding from a number of voter-approved special transaction-and-use taxes. These taxes are Countywide and are designed to support specific programs and services including Ag+Open Space, Regional Parks, and Health Services/Homeless Services. In total the FY 2022-23 Adopted Budget includes $68.4 million for these special taxes outside the General Fund.

The County contracts with HdL Companies <https://www.hdlcompanies.com/> to audit sales tax and to provide forecasts for certain sales tax revenues. So far, these forecasts project revenues to see very little growth for FY 2022-23 and 2023-24, then resume more normal rates of growth, but do not include decreases. Should the state dip into a sharp recession, however, there could be a rapid significant decrease across all areas of sales tax derived revenue streams.

Transient Occupancy Taxes
All transient occupancy taxes assessed by the county are general taxes that could be utilized for any general government purposes. Based on board policy, transient occupancy tax is divided into three buckets. One quarter of total collections flow directly to the General Fund. This constitutes the $6.1 million included in the General Fund Forecast for FY 2022-23 and amounts included in each of the General Fund projection years. One-half flows into the Community Investment Fund Program. The final quarter is related to the 3 percent added under Measure L and flows into a separate Measure L fund. Both the regular Community Investment Fund and Measure L funds are distributed according to Board policy <https://sonomacounty.ca.gov/administrative-support-and-fiscal-services/county-administrators-office/community-investment-fund-program/community-investment-program-policy>. In total, the General Fund adopted budget includes $24.3 million of Transient Occupancy tax. Transient Occupancy tax is highly volatile, depending on the timing, number and price of bookings in unincorporated area establishments. During COVID revenues plummeted by 27.5 percent, only to rebound quickly as hotels reopened. Fiscal Year 2021-22 saw strong numbers; however, it is unclear whether this will be sustained or is a product of a non-recurring pent-up demand and/or surge for travel. First quarter payments for FY 2022-23 were due at the end of October, and so data to update the forecast will not be available until later in the month. In the event of a recession, Transient Occupancy Tax could shrink quickly.

Other Revenues
Beyond tax revenue, the County receives a large amount of state and federal pass throughs that are not directly tied to taxes, as well as various other departmental revenue such as fees and charges for services. There is not a simple explanation for how these will be affected as they are highly contingent on the sources and the nature of an economic downturn.

Other State Revenues
The state of California largely relies on three revenue sources: personal income tax, sales and use tax, and the corporation tax. Together, they make up 95% of General Fund revenues. While one third of the state's FY 2022-23 budget is programmed for Health & Human services and programs. Far and away the largest source of state General Fund revenue is Personal Income Tax. Based on the October Financial Bulletin from the California Department of Finance, income tax is currently underperforming projections by 16.1%, while total general fund revenues are 11.1 percent under projections. Over the past year the State has experience strong growth which has enabled them to increase funding for both ongoing and one-time programs at the local level. Should this decline continue, the County may see reductions to some ongoing programs as well as a significant reduction in one-time funding available for a variety of projects.

Expenditures

Labor

Salaries and Benefits make up 61% of the FY 2022-23 General Fund net expenditures, largest share of total General Fund and non-General Fund County expenditures, and the majority of that cost is direct pay to workers. Labor costs are primarily determined through collective bargaining with the County's eleven (11) unions and, as was mentioned above, all current agreements will expire over the next year. As a note, labor changes associated with unrepresented employees, who are covered under the Salary Resolution, are also anticipated. County leadership recognizes inflation combined with a tight labor market will likely require an investment in our workers. The current forecast assumes a 4 percent COLA in FY 2023-24, a 3 percent COLA in FY 2024-25, and a 2% COLA in FY 2025-26, based on the floating formula from the previous agreement.

<u>Unfunded Liabilities</u>
Reducing unfunded liability costs is a top priority of the Board of Supervisors, which includes a desire to make the pension system fair, equitable and sustainable for taxpayers and employees alike. Currently unfunded liability is over $700 million for both Pension ($543 million), and Retiree Medical or OPEB ($165 million). Operationally, FY 2022-23 General Fund and non-General Fund adopted budget includes $188 million as County-Employer contributions. Over the last several years, your Board has worked to reduce unfunded liability, which helps keep rates from excessive employer and employee rate increases. As of June 2022, the county has made $17.8 million in early payments intended to eliminate or at least mitigate future years' interest costs. However, pension costs are largely dependent on expected returns on the investment of the pension fund, which in a negative return market year could significantly limit the interest cost avoidance benefit in a specific pension year. When actual returns on the investments do not match actuarily interest earning assumptions, the level of the County employer contributions rate increases. As of writing, the S&P 500 is down approximately 20% from its level on January 1, 2022, even after a considerable rally in October. Pension funds do not go up and down simply with the market, but barring a very large late-year increase, it is unlikely that returns on the fund will match the 6.75% discount rate, which will drive up costs to the County in FY 2024-25. Should there be a prolonged downturn this impact could greatly increase.

<u>Other Upcoming Items</u>

This item presents a "status quo" budget. Where future funding demands are already known, and for the most part planned for, as a result of Board direction or existing policies. On the other hand, there are additional ongoing and one-time items that will need attention but that have not been incorporated into the enclosed General Fund projections. Significant items include:

1) **$3.3 million** associated with Time-limited support has been provided for items that are ongoing under policy include the Sheriff's Helicopter, the Climate and Resiliency Division in the County Administrator's Office, as well as term-limited positions at the Clerk-Recorder-Assessor. These items are slated for funding in FY 2023-24, but not beyond that date.
2) **$2.0million** funding for the Mobile Support Team was provided through FY 2022-23. No additional General Fund support or alternative funding source is anticipated beyond this date, but as the final ongoing program is developed additional support may be needed.
3) **$400,000** established during budget hearings. This one-time support was provided to continue operation of Los Guillicos Village. As the homeless services program moves to Health Services, ongoing funding options will be developed for which additional funding support is expected.
4) This item includes only projections for the General Fund. When final labor agreements are entered into, some non-General Fund departments may be unable to pay for increased costs within their revenue streams and may be required to make service reductions, if increased funding is not secured.

This item does not assume any additional support to cover non-General Fund departments' labor costs, which represent 51% of all FY 2022-23 budgeted Salaries and Benefits.

5) In addition to negotiations with the County's bargaining units, the current contracts for In-House Support Services (IHSS) workers will expire at the end of September of 2023. Under a state established formula the state's contribution is capped, which results in the County being obligated to cover the balance of IHSS costs if they increase beyond the cap. The enclosed General Fund projections anticipate only the regular 4% increase in the Maintenance of Effort as is currently established by the state. New agreements may require an increased contribution from the County.
6) **$4.3 million**. Based on a January 2022 report, the new Sonoma County Public Infrastructure (SoCo Pi - formerly Transportation & Public Works) would need to annually increase funding for roads in order to maintain current infrastructure quality levels.
7) **$22.6 million.** There are a number of major capital projects that have significant gaps, including the construction of Roseland Village ($18 million) and the construction of the Behavioral Health Housing Unit (at least $4.6 million).

<u>Fiscal Year 2023-24 Budget Development</u>

The calendar for the FY 2023-24 budget development cycle will be like prior years. Utilizing information from this forecast, staff will distribute General Fund contribution amounts for the coming fiscal year to departments in December. Given the significant uncertainties discussed, the General Fund contribution amounts distributed are likely to be conservative and may not meet full growth needs in departments, which may result in service reductions the Board could consider for restoration during budget hearings. Departments will utilize the General Fund contribution amount to begin working on their budgets for Fiscal Year 2023-24. The next major touch point for the Board of Supervisors will be in March, when the County will hold its annual Consolidated Fee Hearing to set fees and service charges, which for FY 2023-24 represents approximately 16% of all General Fund and non-General Fund funding sources.

As in the last several years, the County will hold budget workshops in advance of budget hearings to give the Board and the public a chance to hear from each of the County's departments and agencies and to ask questions about their recommended budgets. This cycle the budget workshops will occur from April 24-26, 2023, pending final adoption of the Board calendar for 2023. Following the budget workshops, staff will publish the Recommended Budget on May 12, approximately one-month in advance of budget hearings. Budget hearings for the FY 2023-24 budget will be held during the weeks of June 12 and June 19. It is expected that the hearings will take place from June 13-16, with presentations and deliberations on Tuesday, June 13 and Wednesday, June 14, and final adoption on Friday, June 16. As in the past, two weeks are reserved for budget hearings to ensure that the budget can be finalized and adopted before the beginning of the next fiscal year.

Strategic Plan:
N/A

Prior Board Actions:
June 17, 2022 - Adopted Budget

FISCAL SUMMARY
Narrative Explanation of Fiscal Impacts:

There is no fiscal impact for this item.

Staffing Impacts:
None

Narrative Explanation of Staffing Impacts (If Required):
None

Attachments:
- 5-year fiscal projections.
- Presentation

Related Items "On File" with the Clerk of the Board:
None