BOARD OF SUPERVISORS AGENDA LETTER

Agenda Number:

Clerk of the Board of Supervisors
105 E. Anapamu Street, Suite 407
Santa Barbara, CA 93101
(805) 568-2240

Department Name:	County Executive Office
Department No.:	012
For Agenda Of:	December 7, 2021
Placement:	Departmental
Estimated Time:	1 hour
Continued Item:	No
If Yes, date from:	
Vote Required:	Majority

TO:	Board of Supervisors	
FROM:	Department Director(s)	Mona Miyasato, County Executive Officer
	Contact Info:	Nancy Anderson, Assistant County Executive Officer
SUBJECT:	**Fiscal Year 2022-23 Budget Development Report and Proposed Policies**	

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County Counsel Concurrence
As to form: N/A

Auditor-Controller Concurrence
As to form: N/A

Other Concurrence: N/A

Recommended Actions:

That the Board of Supervisors:

a) Receive and file the Fiscal Year (FY) 2022-23 Budget Development Report that includes a five-year forecast of major budgetary components for the General Fund and other major funds;

b) Adopt the FY 2022-23 Budget Development Policies (Attachment B);

c) Provide staff with any preliminary direction on Board priorities for FY 2022-23, as appropriate; and

d) Determine pursuant to CEQA Guidelines §15378 that the above activity is not a project under the California Environmental Quality Act.

Summary

The County Executive Office (CEO) is commencing the annual budget planning process for FY 2022-23 by preparing budget development policies as a guideline for departments and five-year forecast projections for consideration as the Board deliberates on the County's long-term fiscal plans. This fiscal year, staff has combined this information into one budget development report.

The budget development report includes a five-year forecast for the General Fund of major budgetary components to provide a context for balancing short-term objectives with long-term goals during the upcoming budget development cycle (Attachment A). While the main focus is on the County's General Fund, forecasts of five years of revenue and expenditure projections for other major County operating funds are provided as well. This report also identifies fiscal issues that have the potential to impact demands on County resources during the forecast period. Some are broad issues with countywide impact and others are smaller, specific issues within departments.

The report also includes the budget development policies proposed for FY 2022-23, as they serve as guiding principles for development of the upcoming year's recommended budget, which will be presented to the Board preliminarily during April budget workshops and for final adoption during June budget hearings. The FY 2022-23 proposed policies are similar to those adopted last year, with specific changes to further guide and focus budget development. New additions are explained in this letter, and the policies are presented in full in Attachment B (new additions are presented in bold italicized text).

The FY 2021-22 current year budget was adopted with sufficient discretionary growth, which includes cannabis tax revenue, to cover increases in salary and retirement costs, general liability insurance expenses and several critical department expansion requests. There were also significant one-time resources from cannabis fund balance that the Board was able to allocate towards critical maintenance needs and open space improvements during budget hearings. For FY 2022-23, one-time resources other than funding received through the American Rescue Plan Act will be minimal and discretionary growth mild compared to the previous year. The primary objective for budget development will be maintaining status quo budgets for departments to the extent possible, while funding cost increases related to negotiated labor contracts, increasing pension and general liability insurance costs and additional mandated costs. The proposed budget development policies continue to take into consideration discretionary revenue growth is limited, including cannabis tax revenue, and investments in deferred maintenance, information technology infrastructure and the Northern Branch Jail remain prudent policy commitments.

EXPERT AND STATE OUTLOOK

Early in 2021, the U.S. economy appeared poised for robust growth—economic output was projected to grow substantially as recently-enacted fiscal relief packages were expected to bolster consumer spending and widespread vaccination and declining COVID cases were anticipated to ease social-distancing measures. Since then, however, uneven vaccine rates across the U.S. and the spread of the Delta variant have weighed on consumer confidence and spending and supply constraints have created challenges for businesses.

In its September 2021 Report, the UCLA Anderson Forecast projected "good" and "solid" growth in 2021, 2022, and 2023 but updated its previous forecast to reflect a shift in consumption and investment further into the future by lowering its economic growth projections for 2021 and 2022 and increasing it for 2023 (Table 1). The assumptions underlying these projections include: (1) COVID continues to constrain the economy although its impact on economic activity diminishes through 2023; (2) consumers continue to spend on entertainment, leisure and hospitality, and services but pull back if new variants emerge or cases surge; and (3) the U.S. avoids a self-inflicted recession.

Table 1. Average Annual Gross Domestic Product Growth Forecast

Forecast	2021	2022	2023
September 2021	5.6%	4.1%	3.1%
June 2021	7.1%	5.0%	2.2%

Source: UCLA Anderson Forecast

The UCLA Anderson Forecast identified several risks to its forecast for the U.S. economy: government shutdowns derail the economic recovery; inflation fails to abate over the next 12 months and the Federal Reserve tapers asset purchases and increases interest rates sooner than anticipated in response; and new variants or increased infection rates cause consumers to become more cautious and businesses to delay investments.

The UCLA Anderson Forecast expects California's recovery and expansion to outpace those of the U.S. as a whole. Its economists expect that the state's better public health outcomes—the Delta variant notwithstanding—should lead to a faster return to normalcy and the transition to new ways of work and social interaction will disproportionately benefit the state through its technology sectors. The recovery of the leisure and hospitality sector is projected to lag due to the slow return of domestic consumers and international tourists while the recovery in higher income technical services and residential construction is expected to be faster.

The Legislative Analyst's Office (LAO) November California's Fiscal Outlook for FY 2022-23 indicates a possible $31 billion State budget surplus to allocate next fiscal year. The report suggests a significant portion will be needed to address State Appropriations Limit (SAL) to meet constitutional commitments ($14B) unless the legislature reduces taxes, etc. The LAO also reports that there is likely sufficient capacity for the State to allocate $3 billion to $8 billion towards new commitments, such as spending increases or tax reductions. The Governor's preliminary budget will be issued in January and revised in May 2022.

PRELIMINARY PROJECTIONS FOR FY 2022-23

The forecast for the coming budget year and development of a financial plan for that year are determined based on certain key elements. The primary elements include: 1) State and federal actions that will increase or decrease County costs or revenues; 2) the amount of increase/decrease in the County's assessed valuation impacting property taxes and other major discretionary revenues; 3) the status of the current year's budget and year-end fund balances carried forward to the next fiscal period; and 4) known, quantifiable changes in local program costs and revenues. These elements must be evaluated and carefully monitored before the County can establish a plan for next year's budget. Information relative to these elements is discussed on the following pages, including significant fiscal issues identified by staff that are being monitored and may have potential budgetary impacts.

The CEO has developed forecasts for major budgetary components, provided in Attachment A, that are based on assumptions and key economic factors. Projections will be reassessed and updated for the recommended budget as more current information is obtained. The major budgetary components provided in Attachment A include:

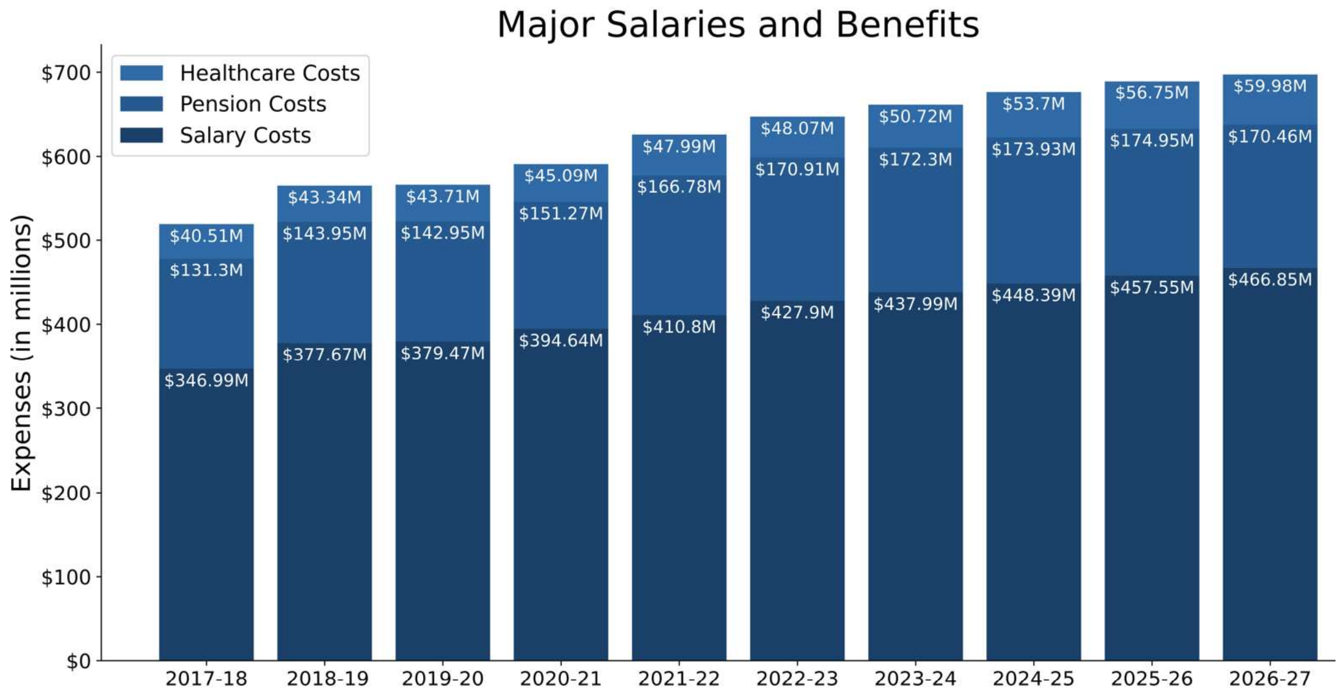
- General Fund discretionary revenue, including property taxes, sales taxes and cannabis revenue
- Changes in salaries and benefit costs
- General Fund reserves (990 Accounts)

Countywide Salary and Benefit Costs

Salary and benefit costs are major budgetary drivers that affect all County operating funds. Several labor contracts have been negotiated recently that are impacting department costs for next fiscal year. Most agreements included a 3% salary increase in the first year, a 2.5% increase in the second, and a 2% increase in the third year. For those MOUs signed in the current fiscal year, this means a 2.5% increase in FY 2022-23, the first year of the forecast period. For those groups currently in negotiations, or with agreements expiring soon, an assumption was made for forecast purposes that salary increases would be the same as recent agreements, with year one of a new contract being FY 2022-23 with a 3% increase. Additionally, an assumption of a change to realign the leadership band was included for the General Fund. Salary costs for all operating funds are estimated to increase $17 million in FY 2022-23 growing to a cumulative increase of $56 million over 5 years. The General Fund portion of the projection is $6.3 million for FY 2022-23 with a cumulative total of $24.7 million by FY 2026-27.

Despite a significant rate of return on investments for SBCERS of 25% at June 30, 2021, the retirement board is considering a reduction of the assumed rate of return from 7% to 6.75% that would partially offset any budgetary savings anticipated for FY 2022-23. Retirement costs are driven by salary increases, pension investment returns, and expectations regarding existing and future retirees. Costs are anticipated to increase nearly 2.5% ($4.1 million) in the first year of the forecast, a fairly modest increase, largely due to the significant returns mentioned above. The impact of both the large investment return, as well as the potential reduction of the assumed rate of return, are smoothed in over a five-year period and will continue to affect future years. The contribution growth flattens to just under 1% in subsequent years of the forecast before seeing an actual *decrease* to contributions in FY 2026-27. This is due to the negative returns of FY 2019-20 being fully smoothed in by FY 2025-26, while the gains of FY 2020-21 are smoothed in for a final year.

The table on the next page shows a ten-year period of Major Salaries and Benefits Costs for the County with 5 years of budget and 5 years of forecast. The forecast for FY 2022-23 assumes growth of $21.3 million, or 3.4% overall. Over the five-year forecast period, steady growth of 2% is assumed each year for a cumulative increase of $71.7 million by FY 2026-27. The detail for major salary and benefit account assumptions can be found in Attachment A page 3. The change in major salary and benefits costs over the five-year forecast period is presented on the financial forecast table for the General Fund on page 8 of this letter.



----------------------Budget----------------------------- ---------------------Forecast-------------------------

<u>General Fund</u>

The General Fund is the main operating fund for the County and a primary focus of budget discussions that relate to discretionary revenue, such as property, sales, transient occupancy and cannabis tax revenues. These major discretionary revenues are distributed to departments as General Fund Contribution (GFC), with nearly 90% allocated to General Fund departments. GFC finances departmental operations and services for which no special or dedicated revenues are available and, in special revenue departments, often serves as local match for State and federal funding. Forecasts for the major budgetary components for the General Fund have been prepared and areas of major impact are discussed below.

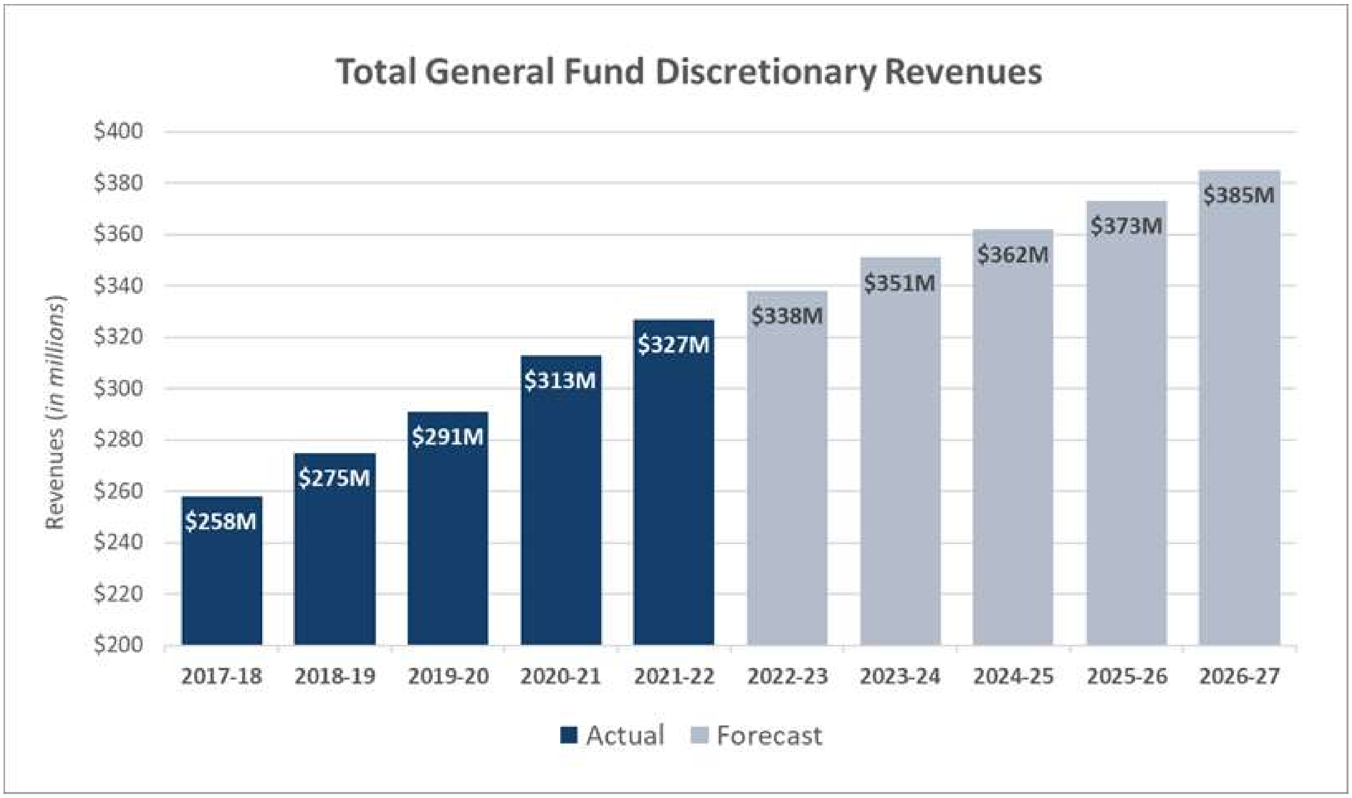
Discretionary Revenue. The primary discretionary General Fund revenue sources are property, sales, transient occupancy and cannabis tax revenues. Growth from these revenue sources are vital to paying for increases in labor and operational costs for many County operations, including most of the public safety function. The forecast for all discretionary revenue is shown on pages 1-2 of Attachment A.

- **Property Taxes**: For budget development purposes and after discussion with the Assessor and Auditor-Controller, an overall increase of 4.7% will be used to provide preliminary projections for next year's property tax revenue estimates. The largest driver of this increase is secured property taxes comprised of residential and commercial properties. Growth in the following years of the forecast assumes that property tax revenue will have mild growth of 3.7% in year two, with growth tapering to 3.3% prospectively. The net impact to the General Fund for property tax revenue for FY 2022-23 is an increase of $7.9 million.

- **Local Sales Tax**: Local sales tax represents the local portion of the retail sales tax collected by the State from sales generated within the unincorporated areas of the County. Despite being impacted early on by the impacts of the pandemic, retail sales in the County have returned to pre-pandemic levels as consumer spending has shifted away from services and back to goods, with an emphasis on e-commerce in particular. With the assistance of Sales and Use Tax consultant, HdL, an increase of 5.4% is projected in FY 2022-23 as the economic recovery continues. Growth is predicted to slow to 3.2% in FY 2023-24 as the economic recovery decelerates, but then increases prospectively to 4% by the final forecast year.

- **Transient Occupancy Tax (TOT):** TOT revenue is highly dependent on tourism and the availability of lodging in the unincorporated areas of the County and was therefore most impacted by the pandemic and the stay-at-home mandates that were implemented statewide. However, TOT revenues have since rebounded to pre-pandemic levels, as the public's desire to travel has surged. An increase of 3.8% has been projected for FY 2022-23 and steady growth of 3.5% is anticipated for the final three years of the forecast.

- **Cannabis Tax**: In a newly implemented and emerging County program, cannabis cultivation and nursery taxes collected have grown substantially year-over-year since program inception in 2018. Based on this historical growth, $19 million was budgeted in the current fiscal year, however, due to oversupply of cannabis product that is beginning to develop statewide and its adverse impacts on pricing, projections for the current year have been adjusted to $15.7 million. FY 2022-23 projects a 7% decrease from the $19 million budgeted in the current fiscal year, or $17.7 million, to reflect the impacts of this oversupply condition. The remaining years of the forecast project positive, steady growth as retail storefront operators and other new cultivators will become licensed and enter the market, thus generating sales and contributing to the tax base, resulting in a final year forecast projection of $21.1 million in tax revenue. The Treasurer-Tax Collector is working on a new cannabis tax compliance monitoring program in coordination with HdL consultants and the County recently began participating in the California Cannabis Authority that may impact future forecasts as accountability is enforced in this industry.



The table above shows a ten-year period of General Fund Discretionary Revenues with 5 years of actual collections and 5 years of forecast. The forecast for FY 2022-23 assumes growth of $10.4 million, or 3.2% overall. Over the five-year forecast period, modest steady growth of 3-4% is assumed each year. The detail for all discretionary revenue account assumptions can be found in Attachment A pages 1-2. The change in discretionary revenue over the five-year forecast period is presented on the financial forecast table for the General Fund on the next page.

Five-Year Financial Forecast. A five-year forecast as it relates to ongoing expenditures funded with ongoing discretionary revenue in the County's General Fund was prepared using the forecast projections for discretionary revenue and salaries and benefits in addition to consideration of prior Board policy commitments and certain anticipated major operational cost increases. The forecast assumes status quo operations and does not include any potential department expansion requests or fiscal issues that are still being determined and monitored. Cannabis tax revenue was excluded as an ongoing source due to the uncertainty of the future growth, which is further discussed as part of a proposed budget development policy later in this report.

FIVE-YEAR FINANCIAL FORECAST
INCREMENTAL CHANGE IN GENERAL FUND ONGOING REVENUE AND COSTS
FISCAL YEARS 2022-23 THROUGH 2026-27

Category	Ongoing Revenue Sources:	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26	FY 2026-27
Forecast	Discretionary Revenue (excludes Cannabis)	11,703,600	12,329,900	9,786,400	10,042,600	11,442,400
	Total Revenue Change	$ 11,703,600	$ 12,329,900	$ 9,786,400	$ 10,042,600	$ 11,442,400
	Ongoing Cost Changes:					
Forecast	Negotiated and Assumed Salary Increases	6,346,800	4,773,700	4,742,100	4,463,000	4,337,700
Forecast	Pension Costs	1,157,500	573,500	555,900	506,900	(330,000)
Forecast	Health Benefits	17,100	757,200	824,100	855,500	906,500
Policy	Strategic Reserve Growth	1,651,400	228,700	87,400	91,500	95,700
Policy	Northern Branch Jail Operations Plan	2,200,000	2,100,000	1,800,000	1,000,000	700,000
Operational	General Liability/Workers Comp Increases (Fund 0001)	1,991,405	1,569,843	540,922	431,619	466,573
Operational	ITS/GS Charges for Services (Fund 0001)	234,450	234,450	234,450	234,450	234,450
Operational	Continuation of Co-Response Program	630,000	470,000			
Operational	DSS CalFresh Local Share Waiver Sunset	807,000				
Operational	IT Department Operations		500,000	250,000	250,000	
Operational	Homelessness Services Costs				5,000,000	
Operational	Project Clean Water Program Costs	900,000				
Fiscal Plan	Board Approved Prior Year Set Aside Offset: GL Increases, labor costs and Co-Response	(3,052,000)				
Fiscal Plan	Previous Year GFC Deficit		1,180,055	57,548		2,790,369
	Total Change in Costs	$ 12,883,655	$ 12,387,448	$ 9,092,420	$ 12,832,969	$ 9,201,292
	Annual (Deficit)/Surplus	**$ (1,180,055)**	**$ (57,548)**	**$ 693,980**	**$ (2,790,369)**	**$ 2,241,108**

The table above is ordered by category type. The forecast line items in the table have been previously discussed in the report. Policy, operational and fiscal plan line items are based on the following assumptions:

- **Policy**
  a) Strategic Reserve Growth: The Board has a current policy of maintaining a prudent reserve at 8% of total General Fund operating revenue (30 days working capital). The forecast assumes the account will be brought current in FY 2022-23 and growth will be set aside each year to maintain the 8% balance for the forecast period.

b) Northern Branch Jail Operations Plan: The Board has a current policy to set aside ongoing funding until the annual jail operations funding equals the incremental annual operating cost of the new facility, which was assumed to occur in FY 2022-23 when the plan was adopted a decade ago. The cumulative set-aside will reach $19.6 million in FY 2022-23, but anticipated operating costs in the Sheriff's Department and maintenance costs in General Services total $22.1 million in the forecast. The assumed increases in the table above are what would be needed to reach parity by FY 2025-26, plus annual cost inflation in FY 2026-27, but a decision will have to made in FY 2022-23 on whether the funding plan should be extended, or if there's another option for covering these costs.

- **Operational**
  a) General Liability/Workers Comp Increases: Risk Management has indicated premium increases for both GL and WC insurance coverage. For FY 2022-23 the GL is increasing by 8% from the previous year and WC is increasing 12%. The Board approved a set aside of $500,000 for potential budgetary impacts related to the anticipated increases.
  b) ITS/General Services Charges for Services: General Services has assumed an 8% annual increase to charges out to Departments for IT services. This is consistent with recent trends in IT costs, and is mostly driven by increasing salaries and benefits costs as well as increasing software and subscription expenses.
  c) Continuation of Co-Response Program: The Co-Response Program has been a priority for the Board for the past several years. Grant funding is anticipated to end partially in next fiscal year and fully by FY 2023-24. The forecast assumes the General Fund will fund the program when the grant funding ends.
  d) DSS Calfresh Local Share Waiver Sunset: Department of Social Services has been anticipating the end to the CalFresh waiver which will increase General Fund contribution in order drawdown additional State and federal funds. The department indicates that the additional drawdowns will be sufficient to offset salary increases as a result of recent labor negotiations.
  e) IT Department Operations: General Services anticipates the establishment of a separate IT Department in FY 2022-23 with full implementation over the next three years. $1 million was set aside in the current year budget with anticipation of some growth over the next three years for full implementation.
  f) Homelessness Services Costs: State grants and ARPA funding have been identified to fund many homeless project operations for the next three years; however, this limited funding ends by FY 2025-26. An estimated $5 million may be needed to continue these programs should alternative funding not be available.
  g) Project Clean Water Program Costs: Project Clean Water has been covering costs in excess of revenue with the use of fund balance, but recent needs in Toro Canyon, as well as additional State stormwater requirements, have rapidly depleted the remaining balance. Staff estimates an ongoing need of roughly $900,000 if other sources of revenue cannot be obtained, to meet State requirements as well as for increased operations and maintenance costs.
- **Fiscal Plan**
  a) Board Approved Prior Year Set Aside Offset: As part of budget development in FY 2021-22, the Board approved the set aside of funding for GL Insurance increases ($500k), labor negotiation increases ($2M) and Co-Response Program ($500k) to plan for these anticipated fiscal impacts.

b) Previous Year GFC Deficit: The five-year forecast shows a deficit of $1.2 million in FY 2022-23, $57k in FY 2023-24 and $2.8 million in FY 2025-26 primarily resulting from the homelessness services costs. The deficits would need to be covered with ongoing resources in the following fiscal year as shown in FY 2023-24, 2024-25 and 2026-27, respectively, if alternative ongoing solutions are not identified and one-time sources are used to bridge the gap.

The forecast reflects a steady consistent growth in revenue with no anticipation of a recession at this time. Revenue growth is helping to offset the corresponding negotiated salary increases recently approved. The County's forecast projects a $1.2 million deficit in FY 2022-23. It is important to note that the forecast assumes status quo operations and no expansion requests or other department fiscal issues are included. While the forecast shows deficits in three of the five years forecasted, the final year of the forecast reflects a surplus of $2.2 million. By law, the Board must adopt a balanced budget. As part of the County's fiscal plan, it will be crucial to mitigate the years of deficit through careful planning of the use of future discretionary revenue growth or consider ongoing expenditure reductions or identification of addition revenue opportunities.

General Fund expenditures are projected to grow throughout the forecast period primarily due to increases in salaries, retirement contributions, and health insurance costs as well as escalating general liability and workers compensation insurance premiums. This growth in expenditures meets or exceeds the projected growth in General Fund revenues with minimal to no remaining ongoing sources for expansion of operations, new projects, or critical needs until FY 2026-27. Estimates will continue to be refined until budget adoption to ensure available funds are appropriated prudently and according to Board priorities. It will be imperative that thoughtful consideration is made related to the extremely limited resources that are available.

Department Fiscal Issues Under Review. As previously noted, department expansion requests and fiscal issues are not included in the General Fund forecast. Departments were asked to submit fiscal issues that were reviewed for significance and will be further considered over the next few months along with budget submittals. Staff will assess the status of the issues identified, timing, and potential service level impacts as part of the budget development review process. If any items are determined critical to address in the FY 2022-23 budget, they will be detailed as part of budget workshops and ultimately the recommended budget. Some of the issues departments have indicated relate to facility conditions and workspace configuration, use of fund balance being used for ongoing operations, and revenue losses related to legislative changes.

Significant fiscal issues are typically $500,000 or greater in ongoing impact related to legislative changes, new statutory mandates, or issues outside the department's control that would result in severe service level impacts or risk to the County. Depending on the certainty of the impact, significant fiscal issues will either be added to the forecast table under the Operational category or noted in this section for monitoring. For FY 2022-23, the following items are being monitored:

- **Probation Department – Legislative Changes**: A variety of State bills continue to eliminate fees or change funding formulas for the Probation Department. The ultimate impact they will have is difficult to determine at this stage, but could be upwards of $1.5 million in a worst-case scenario.

If funding formula changes aren't as drastic, or if backfill is provided, impacts will be less. CEO and Probation staff will monitor during budget development.

- **Deferred Maintenance – Estimated $394M**: Public Works ($304M), Community Services ($75M) and General Services ($15M) continue to address a backlog of deferred maintenance projects. Board policy allocates ongoing funding per the 18% maintenance policy and available one-time funds to these projects based on prioritized needs.

General Fund Unallocated Fund Balances. As part of budget development, the Board considers one-time carry forward fund balances from the previous fiscal year towards one-time expenditures. The unallocated fund balances include those funds carried forward from General Fund departments at June 30, 2021 and unspent funds in the Cannabis Tax Revenue account.

The GF Fund Balance Unallocated (9940 Account) totaled $17.9 million at year-end. Approximately $7.9 million of the balance is Coronavirus Aid, and Economic Security (CARES) Act reimbursement for COVID related expenses incurred in FY 2020-21, with the remainder being FY 2020-21 year-end General Fund surplus. Historically, the funds in this account are used towards one-time budgetary items for the following fiscal year, in this case FY 2022-23. However, two significant items have arisen that require use of the available funding. The Board indicated support for two advance bridge construction projects through Public Works that require temporary cash flow funding through fiscal year 2024-25 totaling $9.98 million. The funding is only temporary and is expected to be repaid to the General Fund. The Public Works Department indicates that the federal infrastructure bill that was recently passed may have alternative funding for the advances, but will not be known for several months. Additionally, the County Executive Office has been advised of potential significant uninsured litigation costs that may impact the current year or next fiscal year budget. The remaining balance of $7.9 million has been earmarked for these unanticipated costs. Staff is still in the process of identifying sources for an additional $10 million needed to cover the significant litigation, which may impact available one-time resources available for budget development and allocation.

GF Fund Balance Unallocated (9940 Account) Adjusted		
Unallocated Carryover from YE 2020-21 (net of FY 2021-22 Appropriations)	$	9,949,000
CARES Act Reimbursement		7,930,300
Total Available Balance July 1, 2021	**$**	**17,879,300**
Less:		
Temporary set aside for PW Advance Bridge Construction (Ends 2024-25)		(9,984,500)
Uninsured Litigation Costs		(7,894,800)
Total Remaining Balance	**$**	**-**

The Cannabis Fund Balance was accumulating since 2018, as revenues in the early years continually exceeded estimates, and then the Board allocated a significant portion of the balance in the FY 2021-22 adopted budget. The available balance at the beginning of FY 2021-22, after factoring in FY 2021-22 appropriations and set-aside for a prudent reserve, is $3.25 million. However, staff anticipates that most of this balance may be necessary to offset a potential $2.97 million shortfall in the budgeted revenue for the current year. The shortfall is the result of lower than expected tax collections that began to decline in June. It is recommended that the fund balance not be allocated for other purposes until final collections are determined.

Cannabis Fund Balance (9815 Account) Adjusted		
Available Balance (net of FY 2021-22 Appropriations incl. prudent reserve)	$	3,253,400
Less:		
Revenue estimate shortfall for FY 2021-22 (Noted Qtr 1)		(2,972,000)
Total Remaining Balance	**$**	**281,400**

Other General Fund committed reserves are shown in Attachment A on page 4.

<u>Other Major Operating Funds</u>

Several of the County's other major operating funds that receive some level of General Fund contribution, including the Mental Health Funds, the Health Care Fund, the Social Services Fund, and the Roads Operations Fund, are anticipating gaps spurred largely by lingering COVID-related revenue losses, ongoing gaps between revenues and expenditures, and legislative impacts. These special revenue funds are projecting deficits in anticipation of state and federal revenue levels that will not keep pace with increases in salaries and benefits and reinforce the importance of limiting ongoing expansions in the coming years to ensure that these funds remain self-sufficient.

Major Special Revenue Funds Cumulative Gaps

Dollars in millions

Fund	2022-23	2023-24	2024-25	2025-26	2026-27
Roads-Operations (Public Works)	($0.7)	($2.7)	($3.0)	($3.0)	($3.0)
Health Care (Public Health)	($3.4)	($6.2)	($6.9)	($7.5)	($7.8)
Mental Health Services (Behavioral Wellness)	($1.7)	($2.3)	($3.0)	($3.6)	($4.3)
Mental Health Services Act (Behavioral Wellness)	$0	$0	$0	$0	$0
Environmental Health Services (Public Health)	($0.2)	$0	($0.1)	($0.3)	($0.2)
Social Services	($3.2)	($5.0)	($5.0)	($5.0)	($5.3)
SB IHSS Public Authority (Social Services)	($0.7)	($1.0)	($1.1)	($1.2)	($1.3)
Planning and Development	($0.1)	($0.1)	($0.3)	($0.2)	$0

Some of the most significant fiscal issues noted for major operating fund departments include:

Public Works – Roads Division: Public Works has been using a portion of limited fund balance to maintain Roads Division operations at current level of service, which has been a fiscal issue concern for the past few years. The department anticipates full depletion of the available fund balance in FY 2023-24 that would result in service level impacts if not mitigated. More detail and analysis will be provided at budget workshops with options for long-term fiscal planning related to this fund.

Public Health – 340B Pharmacy Discount Elimination: The State is changing the pharmacy benefit for Medi-Cal beneficiaries from managed-care plans and transitioning to a fee-for-service program. This change was initially planned for January 2021, but was postponed until January 2022. The Governor's budget also included backfill funds to cover loss of 340B revenue for covered entities, however the mechanism for the backfill has not been determined as of this writing. The maximum loss could be $4.4 million. The Department has been monitoring this issue for many years and has already taken steps, such as transitioning away from an in-house Clinical Laboratory, to reduce costs. The Health Center programs are also developing plans to streamline organizational structures and look at service delivery to reduce future costs as well as increase patients and visits to increase revenue. They are also working with the County's governmental advocate and local elected officials on additional backfill legislation to help mitigate the loss.

Behavioral Wellness – State Hospital Beds: Costs are rising at a faster rate than revenues, driven by the increasing utilization and costs of the Department of State Hospitals beds as well as other long term IMD (Institution for Mental Disease) beds. The Department anticipates available fund balance could be depleted in the current fiscal year, and if sources of revenue, such as 1991 Realignment, don't increase enough to cover the costs, the Department could face a $1 million to $2 million issue in coming years. Some funding may be available in General County Programs Mental Health fund balance to help temporarily bridge this gap, but there are other planned uses for those funds as well. Staff continues to monitor this issue, and advocate at the State level for additional resources, given the slow growth of 1991 Realignment revenue compared to the rising cost of IMD beds.

FY 2022-23 PROPOSED BUDGET DEVELOPMENT POLICIES

Budget development policies serve as guiding principles for development of the upcoming year's recommended budget. The FY 2022-23 policies proposed herein are similar to those adopted last year, with several additions to further guide and focus budget development. New proposed policies are explained below with the complete policy document presented in Attachment B (new additions are presented in bold italicized text).

Policy Updates. Five new components have been added to the policies for Board consideration.

<u>Policy 1.e)</u> **For a clearer accounting structure, Project Clean Water, currently a special revenue fund in Public Works but supported almost entirely by General Fund Contribution, will transfer to Public Works' General Fund budget unit.**

When Project Clean Water was first created it received a significant amount of funding from State and federal sources, and was thus established as a Special Revenue Fund for accounting purposes. Over time, those revenues dwindled, with federal grants ceasing in FY 2012-13, and State sources becoming more irregular and smaller in size. General Fund Contribution has remained steady at around $600,000 annually for the past decade, and in the FY 2021-22 adopted budget, makes up 96% of Project Clean Water's total sources, excluding one-time fund balance draws. Given that this funding breakdown is unlikely to change in the foreseeable future, and to more accurately reflect a program that's funded almost entirely with General Fund dollars as part of the General Fund, staff is recommending establishing Project Clean Water as a program within Public Works' General Fund budget unit instead of as a separate Fund. This will not impact operations, or Project Clean Water's ability to receive State and federal dollars if they become available.

<u>Policy 3.a) i)</u> **Due to continued unpredictability in cannabis revenues, no new allocations beyond those adopted in the FY 2021-22 budget will be made towards ongoing expenditures, with the exception of expenditures to support the cannabis program or to cover costs of negotiated labor increases, if necessary. Remaining cannabis revenues will be used towards one-time expenditures,**

or held in fund balance. Additionally, a prudent reserve equal to 25% of projected cannabis revenues will be maintained in General County Programs (9815 Account).

When the FY 2021-22 budget was adopted in the spring, three quarters of FY 2020-21 cannabis revenue had come in, and each quarter was significantly higher than the same quarter in prior years. Given that cannabis had grown faster than assumptions in every year since inception of the program, and that Q4 was (within the limited history of the program) typically the highest quarter of the year, staff made optimistic projections on what growth in the revenue would look like in FY 2021-22. The budget was built with an assumption of $19.1 million in total tax revenue, and that funding was allocated towards a wide variety of uses, many of them ongoing.

Unfortunately, tax revenues for Q4 ended up coming in at $3.8 million, significantly less than the assumed $6.1 million. This volatility between quarters, as well as indications that a supply glut could be driving down prices, and thus tax revenue, has caused staff to reassess both anticipated FY 2021-22 tax revenue as well as growth in the coming years. The adopted budget assumed $19.1 million, but current projections after last year's fourth quarter, as well as the first quarter of the current year, have lowered estimates to $16.1 million for the year. Allocation practice prior to FY 2021-22 was to limit ongoing allocations, as much as possible, to just the cannabis program, and all other revenue would be allocated towards one-time projects and needs. Staff recommends reverting to this practice in the coming fiscal year, as reflected in the policy above, until enough stability and history exists in the program to lessen the volatility and increase the accuracy of projections.

The total amount of cannabis revenue allocated towards ongoing uses in the FY 2021-22 budget is $13.5 million, which includes $5.2 million for cannabis program costs as well as $8.3 million for non-cannabis programs and uses. This policy will allow for continued funding of all these uses, but recommends no further ongoing allocations to non-cannabis programs. This policy will be re-evaluated each year as new data becomes available.

<u>Policy 5.d)</u> A minimum reserve of $5 million will be maintained in the Litigation fund balance in General County Programs for uninsured litigation costs and settlements.

The County currently maintains a Litigation fund balance in General County Programs to pay for outside expert counsel costs as well as set-asides when there are known to be potential settlements. Recently, there have been several uninsured litigation cases impacting the budget that were not planned and are now limiting available one-time sources for budgeting. It would be prudent to maintain a minimum reserve of $5 million in the event of unanticipated significant legal settlements, or multiple settlements at the same time, to minimize impacts on budget development.

<u>Policy 5.e)</u> A working capital or advance construction reserve fund balance shall be established in General County Programs to provide cash flow, when necessary, for capital projects that will not receive State, federal or other reimbursement in a timely manner while the project is underway. The funds are for temporary cash flow needs and shall be reimbursed to the General Fund within a specified period of time. The balance of reserve will be transferred to General Fund unallocated fund balance (9940 Account) when no longer needed.

On March 16, 2021, the approved a temporary cash flow loan for the Floradale Bridge project for a total of $6.8 million. Then on August 17, 2021, the Board also approved the Foothill Bridge project requiring a temporary loan of $9 million through FY 2024-25. The outstanding loan balance needed for FY 2022-23 is estimated at $9.8 million. This amount has been earmarked in the General Fund unallocated fund balance (9940 Account) to cover this temporary transfer. The Public Works Department has worked with the Auditor-Controller to develop a proposed process of tracking and repayment to the General Fund once reimbursements are received and the County Executive Office would require a status update of those repayments in the Quarterly Budget Reports to the Board until the General Fund has been fully repaid.

Policy 7.c) Funding will be recommended annually for the following Countywide projects:

- A minimum of $500,000 for Americans with Disabilities Act improvements (already an existing policy)
- **A minimum of $1.3 million for energy reduction upgrades, security improvements, and roof replacements in County facilities.**

Policy 7.c., which previously contained only the funding plan for ADA improvements adopted in FY 2020-21, will be expanded to include funding in three additional areas for Countywide facilities projects. This change is formalizing into the budget development policies actions recommended by the CEO and adopted by the Board in the FY 2021-22 budget. Ongoing funding has already been allocated as part of the FY 2021-22 budget in the amounts listed above, for these specific purposes, and adoption of these policies will create no additional burden on the General Fund in FY 2022-23 or future years.

Policy 7.g) The CEO and Department will determine, for capital projects funded through debt issuance in a General Fund Department where the project is expected to generate increased revenue, if any portion of the new revenue could be used towards debt service payments.

On November 16, 2021, the Board discussed a proposed Certificates of Participation financing that includes a park project that is anticipated to result in some revenue generation related to the project. The Board asked staff to develop a policy that would ensure that new revenue for debt financing related to General Fund projects would be evaluated and considered for potential offset of debt service payments.

Policies Looking Forward. In looking beyond FY 2022-23, staff is anticipating the need for policies related to countywide strategic initiatives, and the alignment of department goals, objectives and performance measures that support the initiatives, as a result of changes in the Government Finance Officers Association (GFOA) budget award criteria that is effective for FY 2023-24. The CEO will be coordinating discussions with department leadership and the Board related to information on this in the coming months.

PRELIMINARY DIRECTION ON BOARD PRIORITIES FOR FY 2022-23

The five-year forecasts of major budgetary components projected a slight deficit in the General Fund in the coming year and challenges for many of the special revenue funds. As with every year, we will not fully know revenue and expenditure impacts until we work on specifics with departments and refine estimates. As we embark upon budget formation for FY 2022-23, the Board at this time may wish to provide priorities for us to keep in mind as we work with departments on developing the budget.

Since the General Fund forecast currently exhibits overspending and a deficit in FY 2022-23, Board priorities that are one-time in nature, and not ongoing, should be considered over ongoing requests. The amount of one-time funding that may be available will be limited and depends on final litigation costs that are determined, actual cannabis collections for the current year, and what departments don’t spend that carries forward at fiscal year-end.

Given the past Board and staff discussions, the following are one-time uses of funding that could be considered in the coming months as part of budget development:

- High priority Long Range Planning projects: $1.65 million for a team of long-range planners ($550,000 per year), for a period of three years
- Open space and recreation projects
- Countywide Library System support
- Temporary enhancement of Co-Response Program (continuation of the existing program is included in forecast)
- CIP list of priority projects
- County ERP capital purchase and implementation set aside
- Workforce Housing set aside
- Greater criminal justice diversion projects
- Augmentation of set aside for litigation or future liabilities
- Deferred maintenance

The next stage in budget development will be budget workshops in April, where we will bring forward information about how certain issues have been or will be addressed through the recommended budget, and will provide a framework for Board consideration of options to prepare for and address anticipated fiscal demands in the coming years.

Impacts:

The five-year fiscal outlook on the County's General Fund and other major operating funds are presented in this report and Attachment A, along with discussion of significant fiscal issues that may further impact demands on funding in future years.

Attachments:

A – Five-year forecast of major budgetary components
B – FY 2022-23 Budget Development Policies & General Fund Allocation Policy

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