County of Santa Cruz Board of Supervisors
Agenda Item Submittal
From: County Administrative Office
(831) 454-2100

Meeting Date: February 27, 2018

Recommended Action(s):

Accept and file update regarding the General Fund Mid Year Budget Report including the 2017-18 Estimates and Preliminary 2018-19 Budget Requests and an update on the five year General Fund forecast.

Executive Summary

The purpose of this annual report is to provide an update on the fiscal position of the County Budget. The General Fund is the focus of this report because it is most at financial risk from state and federal budget impacts and economic trends, and provides the majority of funds for quality of life services such as public safety and matching funds for health and human services. The report also includes an update to the General Fund five year forecast based on current information and revised estimates for the current year and the upcoming budget year. The County Administrative Officer will provide the 2018-19 Proposed Budget by May 8th , for consideration by the Board. The Board and the public will also have an opportunity to provide input during budget hearings scheduled June 18-26, 2018.

Background

On December 5, 2017, the County Administrative Office (CAO) presented a 2018-19 preliminary budget projection and study session. The session provided an overview of the 2017-18 General Fund budget compared to estimates, preliminary information on the 2018-19 General Fund budget projections; and emerging issues from some departments with significant changes and challenges that could impact their budget and operations.

Preliminary estimates indicated General Fund revenue growth would exceed expenditure growth and budget to actual savings would be available to help finance the FY 2018-19 budget in the amount of $5 million. In addition, the 2018-19 General Fund projected budget expected costs to exceed revenues with an estimate of modest revenue growth of 4% from General Purpose Revenues like property tax, sales tax and cannabis business tax offset by rising costs with above average increases for health insurance and retirement.

The five year forecast anticipated that the General Fund will meet its obligations over the next five years and preserve the 10% reserves only if departments are able to absorb the majority of cost increases. This will be challenging for most departments, especially public safety given the magnitude of increases projected for health and retirement costs. If a recession occurs by 2019-20, General Purpose Revenue growth would decline further or be flat and budget to actual savings are unlikely. It would also be difficult to maintain the 10% reserves goal and larger budget deficits would likely be made up by further cuts and/or transfers from reserves.

Based on the current financial outlook, the CAO requested that departments submit a 2018-19 budget request absorbing all cost increases by increasing revenues and fees wherever possible and reducing other costs in order to achieve no change to the General Fund contribution.

Analysis

State Budget Outlook

Focused on Fiscal Balance. Governor Jerry Brown released his Proposed Budget on January 10, 2018. With a healthy budget surplus, the Governor focused on what has been a consistent mantra during his governorship: maintaining fiscal balance. To that end, the Governor proposes to utilize the state's budget surplus by bringing the Rainy Day Fund to 100 percent of its constitutional target, fully funding the Local Control Funding Formula (LCFF) for K-12 schools two years early, and investing in state infrastructure.

Federal Impacts Uncertain. While recent federal actions will definitely impact the state's budget, many of them occurred too late in the year to be incorporated in budget estimates. The May Revision will include preliminary analyses of any changes to the state's economy and revenues on federal tax changes, the potential failure to reauthorize the Children's Health Insurance Program (CHIP), and other federal cost shifting, particularly in the area of health care or other entitlements that Congress considers.

2018-19 Economic Outlook

Slowing Economic Growth. As the economy nears full employment, economic growth has begun to slow in both the nation and California. While California's unemployment rate fell to 4.7% in May and June of 2017, matching the all-time low unemployment rate in November 2000, the unemployment rate recently increased to 5% and is expected to remain near that rate throughout the forecast period. Job growth is slowing and is expected to slow through 2021. Inflation began to pick up in 2016 due to increasing housing costs, medical costs, and energy prices and is expected to remain higher in California than the nation.

Unemployment Rate Down, Job Growth Up. From a local perspective, unemployment rates continue to fall gradually at this moderate rate of economic growth as jobs are added. Santa Cruz County's unemployment rate was 5.1% in November 2017, down from prior years but still above the state and national average. Locally, various economic indicators are expected to improve, with job growth expected to be 1.4% in 2017 with an average growth rate of 0.4% from 2017 to 2022. Average salaries are expected to rise by 2.2%. Employment growth is expected to be broad-based, with the largest gains in education and healthcare, leisure and hospitality, wholesale and retail trade, and professional and business services. These sectors will account for more than 100% of net job creation in the County with losses in construction and manufacturing offsetting the gains. The population is expected to increase by 0.5% per year and real income per capita is forecasted to increase 1.7% per year through 2022.

2017-18 General Fund Budget

Revenues Better, Expenditures Higher, Savings Expected. County departments have submitted their estimates for 2017-18 revenues and expenditures based on actuals to date and estimates through year-end. Overall costs are higher than anticipated and additional revenue growth is available resulting in an estimated fund balance of $5.4 million to carry forward to FY 2018-19. Increased costs are primarily in public safety and land use due to increased salary and benefit costs that departments are unable to absorb through turnover and vacancies. Unused contingencies are available to cover these increased costs. Additional financing is available primarily from unanticipated increases in property taxes and transient occupancy tax.

General Fund	2017-18 Budget	2017-18 Estimates	Estimated Change
Financing			
Fund Balance Available	$12.6	$12.6	$0.0
General Purpose Revenues	$134.6	$137.1	$2.5
Total Financing	**$147.2**	**$149.7**	**$2.5**
Net Expenditures			
General Government	$21.1	$20.8	($0.3)
Health & Human Services	$25.1	$24.6	($0.5)
Land Use & Community Services	$7.7	$8.7	$1.0
Public Safety & Justice	$75.2	$77.8	$2.6
Subtotal Net Expenditures	**$129.1**	**$131.9**	**$2.8**
Debt Service	$5.1	$5.1	$0.0
Capital Improvements	$0.0	$1.0	$1.0
Contingency	$6.7	$0.0	($6.7)
Net Expenditures before Reserves	**$140.9**	**$138.0**	**($2.9)**
Increase Reserves to achieve 10%	$6.3		$0.0
Net Expenditures with Reserves	**$147.2**	**$144.3**	**($2.9)**
Preliminary Budget Savings	**$0.0**	**$5.4**	**$5.4**

2018-19 General Fund Budget

Modest Revenue Growth, Covers Majority of Growing Costs. General Fund departments have submitted their requests for the 2018-19 Budget. Preliminarily, total financing available is $145.8 million and requested financing uses are $148.1 million, which results in net costs higher than financing by approximately $2.3 million. The CAO is working with departments to modify their requests in order to present a balanced budget to the Board in May.

General Fund	2017-18 Budget	2017-18 Estimates	Estimated Change
Financing			
Fund Balance Available	$12.6	$12.6	$0.0
General Purpose Revenues	$134.6	$137.1	$2.5
Total Financing	**$147.2**	**$149.7**	**$2.5**
Net Expenditures			
General Government	$21.1	$20.8	($0.3)
Health & Human Services	$25.1	$24.6	($0.5)
Land Use & Community Services	$7.7	$8.7	$1.0
Public Safety & Justice	$75.2	$77.8	$2.6
Subtotal Net Expenditures	**$129.1**	**$131.9**	**$2.8**
Debt Service	$5.1	$5.1	$0.0
Capital Improvements	$0.0	$1.0	$1.0
Contingency	$6.7	$0.0	($6.7)
Net Expenditures before Reserves	**$140.9**	**$138.0**	**($2.9)**
Increase Reserves to achieve 10%	$6.3		$0.0
Net Expenditures with Reserves	**$147.2**	**$144.3**	**($2.9)**
Preliminary Budget Savings	**$0.0**	**$5.4**	**$5.4**

Revenue Growth Offsets Reduced Fund Balance. Financing is decreasing overall by $1.4 million based on better revenue estimates of $5.8 million offset by a reduction in prior year fund balance available of $7.2 million, which includes one-time funding of $3.4 million for encumbrances (prior year obligations). It is projected that General Purpose Revenues will continue with modest growth of 5%, primarily from increased property tax, transient occupancy tax and minor increases in sales tax, deed transfer and cannabis business tax based on current experience and economic trends.

Expenditure Increases Support Current Operations. Expenditures are primarily increasing based on net expenditures of $11.4 million from departments offset by a one-time reduction in Contingencies of $4.6 million and Reserves of $5.9 million, leaving a budget shortfall of $2.3 million. The major cost driver for current operations is rising costs for health insurance and retirement.

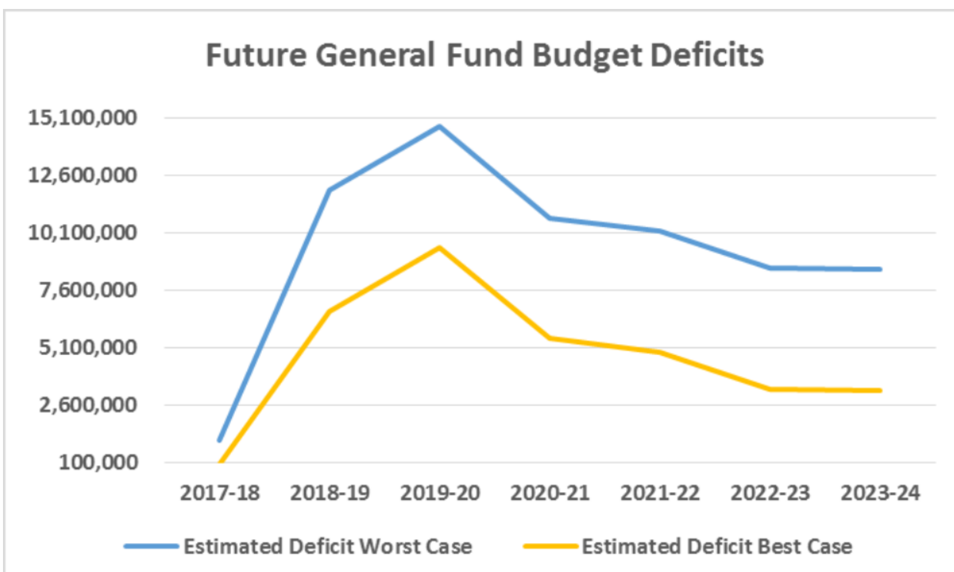
While budget requests are under review, most departments have raised fees wherever possible, used one-time revenues to cover one-time costs, unfunded vacancies due to financial constraints, and only funded new programs and staffing with new ongoing offsetting revenues. At this time, no additional General Funds are available for capital improvements or major infrastructure repairs, replacing aging equipment like voting equipment systems, and new local initiatives without offsetting funding, unless additional budget to actual savings occurs in the current year.

Looking Ahead and Preparing for the Future

Budget Shortfalls Anticipated. Looking ahead, the General Fund is expected to meet its obligations for FY 2018-19 through serious belt tightening. However, by 2019-20 through 2021-22, the General Fund is unlikely to meet its obligations without new or increased General Purpose Revenues or major cost reductions that could potentially impact programs and services. The likely ongoing annual budget shortfall will be $7-10 million but it could be as high as $12-$15 million if prior year savings are not achieved or general revenues stagnate or decline. By FY 2022-23, revenue growth could potentially cover expenditure growth based on current operations and expected increases since the retirement rates may level out to more modest average increases of 2-3%.

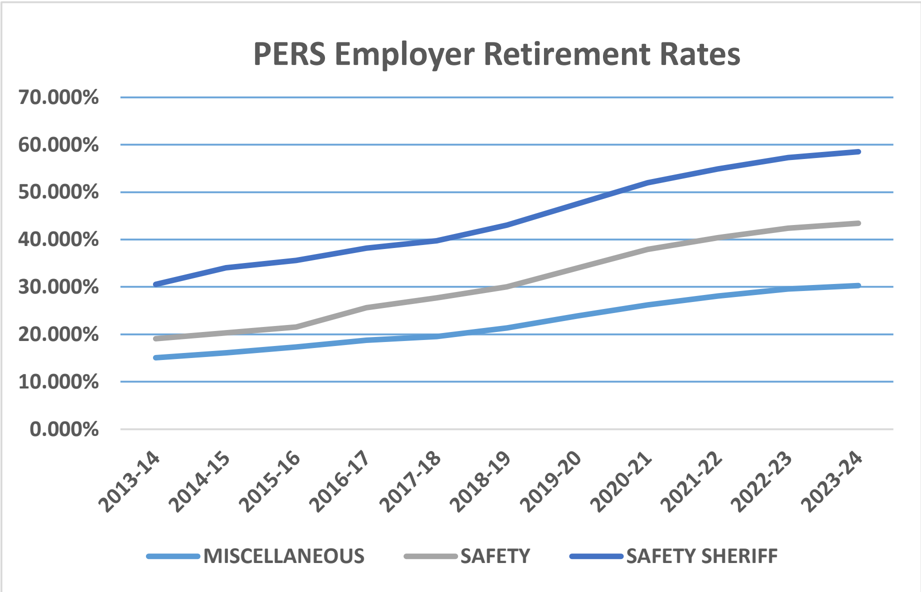
Our five year forecast also assumes the following:

- General Purpose Revenues decline from 5% to 3% average annual growth;
- Increased costs for Salaries and Benefits, with best case 50% cost recovery through current revenues and fees and worst case only 40% cost recovery;
- Annual budget to actuals savings of 0.5-1.0% best case and worst case no savings;
- Assumes all other grant, federal and state funding remains constant;
- Increased costs for In-Home Supportive Services growing annually by $1-$2 million.

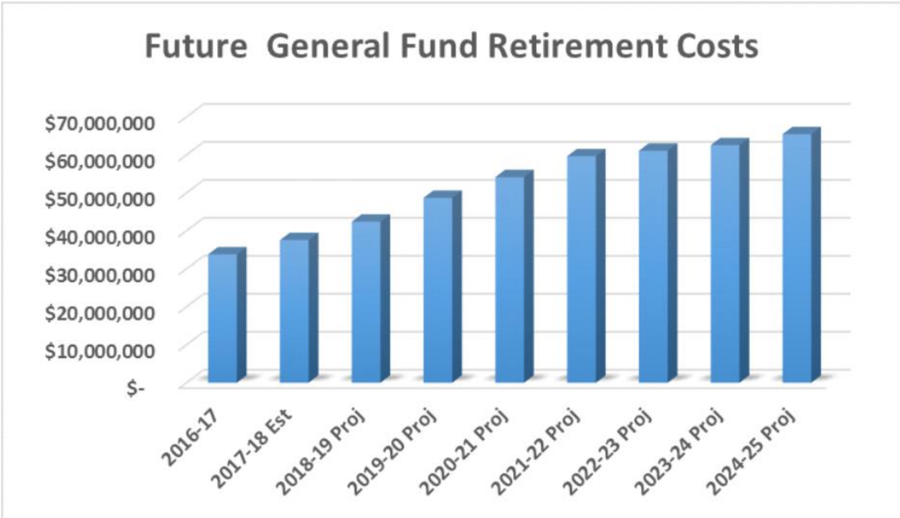


If a recession occurs by 2019-20, General Purpose Revenue growth will decline further or be flat. Budget to actual savings of 0.5 to 1.0% are unlikely. Contributions will not be available to preserve the 10% reserves, and a larger deficit will likely be made up by further cuts and/or transfers from reserves.

Rising Retirement Rates Drive Costs. The primary cost driver in the next five years is the increased cost of retirement due to rising rates which is facing all agencies invested in CALPERS. Retirement rates are anticipated to double by 2024-25. Rates have primarily been impacted by (1) the loss of investment earnings during the Great Recession, (2) decreases in projected future investment earnings from 7.75% to 7.0%, (3) changing demographics.



The County's retirement cost is estimated to grow from $43 million in 2017-18 to $76 million by 2024-25. The General Fund cost is expected to grow from $37 million to $65 million which is a cost increase of $28 million. Assuming that approximately 50% of this cost increase is recovered through intergovernmental revenues and fees, the cumulative unbudgeted ongoing net cost increase over the next seven years is approximately $14 million. Below is the chart showing the rising retirement costs.



The forecast does not anticipate additional changes to the retirement rates under discussion by the CALPERS Board which include reducing the discount rate from 7% to 6% to more accurately reflect average investment earnings. On February 13, 2018, the CALPERS Board approved a change to the amortization period from 30 to 20 years, which is not reflected in the above retirement costs and the forecast. This change in amortization period will have a substantially increase on the annual cost by 2020-21. An updated forecast will be provided in the 2018-19 Proposed Budget as more information becomes available.

Revenue Options

Due to rising costs exceeding available financing, the County will continue to investigate possible revenue options to maintain and preserve core services and programs. One possible option is to increase general sales tax for the County by 0.5% from 8.5% to 9.0%. The Unincorporated County sales tax rate is less than all the nearby cities by at least 0.5%. The unincorporated area operates much like a city and provides similar municipal services like police, fire, roads and parks that could be supported by a general tax. If supported by voters, an additional 0.5% sales tax would generate approximately $5.6 million in General Purpose Revenues and could go a long way to help preserve core services and programs.

Other revenue options include the possibility of increasing the Transient Occupancy Tax, Emergency Response Fee or Park and Recreation CSA#11 Tax. Each of these options could generate funding that would help preserve core programs and create better cost recovery for the General Fund. A Transient Occupancy Tax of 1% and full cost recovery for the Emergency Response Fee could each generate $800,000. If the Parks and Recreation CSA#11 Tax covered 50% of the net costs for Parks and Recreation, then $2.1 million could be generated.

Financial Impact
None.

Submitted by:
Carlos J. Palacios, County Administrative Officer

Recommended by:

Carlos J. Palacios, County Administrative Officer