NAPA COUNTY
5-YEAR GENERAL FUND FORECAST
PREPARED IN FISCAL YEAR 2022-23 FOR FISCAL YEAR 2023-24 THROUGH 2027-28

Introduction:

Napa County has a long history of financial stability and fiscal prudence, which results in services that are provided consistently. The **5-year General Fund Forecast** (5-year Forecast) is one of the tools to support fiscal prudence. The **5-Year Forecast** is updated annually and is used with the County's five-year **Strategic Financial Plan**, and the annual **Budget Policies** to guide the annual Recommended Budget.

Each year, as part of the annual budget process, staff provides the Board with a forecast of what the General Fund's financial condition could look like over the next five years. This is important, because revenue and expenditure decisions that are made in the budget year can have a significant impact on future year General Fund resources and obligations. The results of the 5-Year Forecast are used, along with the County's multi-year Strategic Financial Plans to guide how we prepare the Recommended Budget.

The 5-Year Forecast provides the Board with a representation of the General Fund outlook. The projections assume that the county will provide the existing level of service. The projections also include some of the Board's priorities such as Fire protection. The projection assumes there will not be legislative changes that will affect revenues or programs and our adopted policy structure will remain constant during these five years. The figures provided in the **5-Year Forecast** are based on high-level assumptions. Projected amounts are intended to show general trends and are not preliminary budget figures.

Forecasting Methodology:

Forecasting revenue and expenditures is full of uncertainty. The economy continues to show mixed signals with some sectors being strong and other sectors clearly weak. For the purposes of this report, future years' projections are based on the Adopted Budget for FY 2022-23 General Fund revenue and expenditures. In addition, the report makes several assumptions about what will happen over the next five years including inflation rates, state budgets, and economic conditions. This forecasting methodology does not include any capital improvement projects, Federal Emergency Management Agency (FEMA) reimbursements or insurance proceeds.

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Economic Conditions:

Supply chain disruptions continue to hamper certain industries and strong consumer demand is also driving inflation. Inflationary pressures, which were previously isolated to certain industries such as lumber, now extend well into the economy. This includes the service sector which is more reliant on labor. Inflation is now no longer seen as short-term phenomena. Geopolitical issues, particularly the war in Ukraine continue to impact the high price of fuel and food, both of which have broader knock-on effects.

In response to a 40-year high inflation rate, the federal reserve has increased interest rates multiple times over the previous months. Additional rate hikes totaling 0.75% are expected later this year. This has led to slumping financial markets, though not a significant economic slowdown. The higher interest rates are increasing borrowing costs. The industries which will be negatively impacted the most from these high borrowing costs are the industries that rely on consumer credit, these are housing and automobiles.

The unemployment rate remains low and is a signal that the job market is strong but may also partially reflect a historically low labor force participation rate. However, there may be worrying signs among certain industries. Amazon, Twitter, Microsoft, Google, and Meta (the parent company of Facebook) have all announced they are laying off thousands of their employees. The high wages and high share value of these companies had previously been a main driver of wealth in California and in the Bay Area region. This is especially true for the state's General Fund, which relies heavily on proceeds from financial assets and high-income earners.

As of 2022, the State of California's budget has experienced four consecutive months of revenues coming in lower than expectations. The January 2023 state budget proposal projects a $22.5 billion budget deficit. The governor's office, however, does not expect significant reductions in programs. Additionally, Napa County's General Fund does not rely heavily on state revenues. While a reduction in state revenues may be concerning, it will have little impact on the county's general fund. This is because the county does not backfill reductions in state programs.

Locally, travel and tourism have returned to pre-pandemic levels. Meanwhile sales tax receipts have continued to improve and are expected to grow modestly. The Napa workforce, however, remains stagnant as employers have a harder time finding workers. The labor force is expected to grow modestly. The local Napa population, like the state, continues to decline in population. Furthermore, Napa's population continues to age resulting in schools closing. This trend is expected to continue. Housing prices in Napa are expected to decline modestly (around 4.6%) though this is not likely to mean property tax revenue will decline, property tax revenues may simply grow slower than in previous years.

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Baseline assumptions:

The baseline forecast assumes the existing level of service. Certain previously identified board priorities such as Fire prevention, Groundwater and Cyber Security are included in the projection. This forecast assumes that the Board will continue to maintain the fiscal approach set forth in its Budget Policies.

The baseline forecast also assumes that most outside resources will increase at the current pace to continue to fund program services, and there is no incremental encroachment on the General Fund. The baseline includes a conservative revenue growth estimate and increases the additional annual operating costs for the replacement jail beginning in FY 2023-24. We estimate the cost of the replacement jail at $855,000 initially. Once the jail has been fully staffed for an entire year the cost is estimated at $3.42 million, which we expect to grow by roughly 4% each year. Fire protection is included as an expense in this forecast.

Napa County's Budgeting Practices:

The basic categories of General Fund expenses in Napa County's budget are Salaries and Benefits, Services and Supplies, and Other Expenses. Napa County budgets positions assuming that all positions will be filled for the entire year with the full weight of their benefit costs. Then a vacancy factor is calculated to account for turnover and hiring lags. The difference between budgeted amounts for salaries and benefits and actual expenditures varies from year to year.

Napa County budgets and encumbers the maximum cost of executed contracts. When the total amount allowed to be spent in a contract is not used, it creates savings. When comparing the budget to actual activity, the percentage difference has averaged 11% annually in unspent appropriations since 2012-13 and varied significantly. We are using a more conservative 7% assumption of services and supplies savings.

<u>Revenue projections</u>:

Taking what economists are projecting for the economy, the current state of the local housing market, and State and Federal budgets into consideration, we assume that revenue will grow modestly during Fiscal Year 2023-24.

- Secured Property Tax revenues are expected to grow 4% each year of the forecast.
- Unsecured Property Tax revenues are expected to grow at 2% for all 5 years. These projections are supported by data provided by the County Assessor.
- Property Taxes-Vehicle License Fee Swap (VLF) revenue projections are based on the 2022-23 adopted budget with a growth rate of 3%. We anticipate that the County's only remaining non-basic aid school district will turn basic aid in Fiscal Year 2023-24. Pending any legislative change, this will eliminate the only remaining statutorily defined funding source and will significantly impact the County, as well as our cities and town.

If the state follows its past practice, the anticipated result is a sudden two-year lag in receiving these revenues, which is reflected in the forecast as a loss of $25M in Fiscal Year 2024-25 and $25M in 2025-26.

- Supplemental Property Tax revenue projections are based on the 2022-23 adopted budget with a 4% assumption for years 1 through year 5.
- Sales Tax revenue is based on projections provided by the County's independent tax consultant. Sales tax is expected to grow but not at the pace it had in previous years.
- Transient Occupancy Tax revenues are estimated to grow compared to previous years. The current projection is based on data from Visit Napa Valley. This revenue is then projected to increase by 2% each year. This projection is, however, conservative because Transient Occupancy Tax is one of the more volatile revenue sources for the County.
- Other discretionary revenues are based on 2022-23 adopted budget with a flat or 2-3% growth assumed per year.

Expenditure projections:

The projections assume existing levels of service (including staffing and program costs) and assume that expenses will grow.

- Salary and Benefits assumes growth of 3.25% per year due the Memorandum of Understanding agreed upon in 2022. Subsequent years project increases in Salary and Benefits of 3% per year.
- Services and Supplies assumes growth of 5% per year in Fiscal Year 2023-24. The next two years project that the increases will decline to 4% then 3% the following two years after that, as inflation cools. Some of our contracted services have built in CPI inflators.
- Other Expenses
    - Operating cost increases for replacement jail – these are expected beginning in early FY 2023-24 at $855,000. Once the replacement jail is fully operating, the fiscal year cost is estimated at an additional cost of $3.4 million with growth of 4% per year assumed.
    - The forecasts include costs to start addressing high priorities, including implementing the American with Disabilities Act (ADA) Transition Plan for accessible services, cyber security, groundwater, and the County's participation in regional climate action planning. These four costs amount to $3.2 annually starting in Fiscal Year 2023-24 and growing steadily in subsequent years.
- Fire prevention – the current forecast includes the cost to implement the Community Wildfire Protection Plan (CWPP). This forecast assumes that no additional revenue will be received to meet this board priority. Without additional revenue for fire prevention, the Board may need to provide significant additional General Fund support for fire protection which will begin to erode core county services. The projection estimates an annual cost of $8.5—9.6 million, over the next 5 years.

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After accounting for all these assumptions, the forecast shows that the General Fund is structurally sound. This means that over the next 5 years the General Fund does not project long term expenses that will outpace the likely growth in revenues.

The General Fund has recovered from the COVID-19 pandemic, but there are new concerns for future years. One of the most significant issues the General Fund potentially faces is the two-year loss in VLF Swap revenues beginning in Fiscal Year 2024-25. Second, additional increases in inflation, particularly for employee Salary and Wages, might increase expenses faster than revenues in the coming fiscal years. Inflation, however, appears to be cooling. Lastly, the additional costs of operating the replacement jail and the costs to fire protection are significant expenses in the coming years. Without new dedicated revenue, the costs of fire protection may begin to erode core county functions.

The below chart shows the forecast's potential surplus or deficit in each fiscal year. This forecast assumes the County will not receive VLF revenues for two fiscal years, will pay the cost of the Community Wildfire Protection Plan entirely from the General Fund, and adds the cost of operating the replacement jail among other cost mentioned above. This projection estimates modest revenue growth with no recession.

	23-24	24-25	25-26	26-27	27-28
Potential Surplus or Deficit	$8,491,000	($17,239,000)	($17,468,000)	$8,984,000	$9,151,000

The forecast shows that if the VLF issue does not have a legislative fix, the County's General Fund would take a significant hit beginning in 2024-25 and lasting through 2025-26.

Two Hypotheticals: One of modest revenue growth and one of Mild Recession

<u>Base Projection:</u>
The below base projection follows the assumptions described above. This projection assumes conservative but realistic revenue growth with no recession over the next 5 years. This projection also assumes that there will be no legislative fix to the VLF. The projection furthermore assumes that there will be no dedicated new revenue for Fire protection and that the replacement jail will initially cost an additional $855,000 then will be $3.42 million once it is fully operational for a full year and that this additional cost will grow at 4% each year after that. Other costs include implementing climate action, groundwater, ADA, and cyber security.

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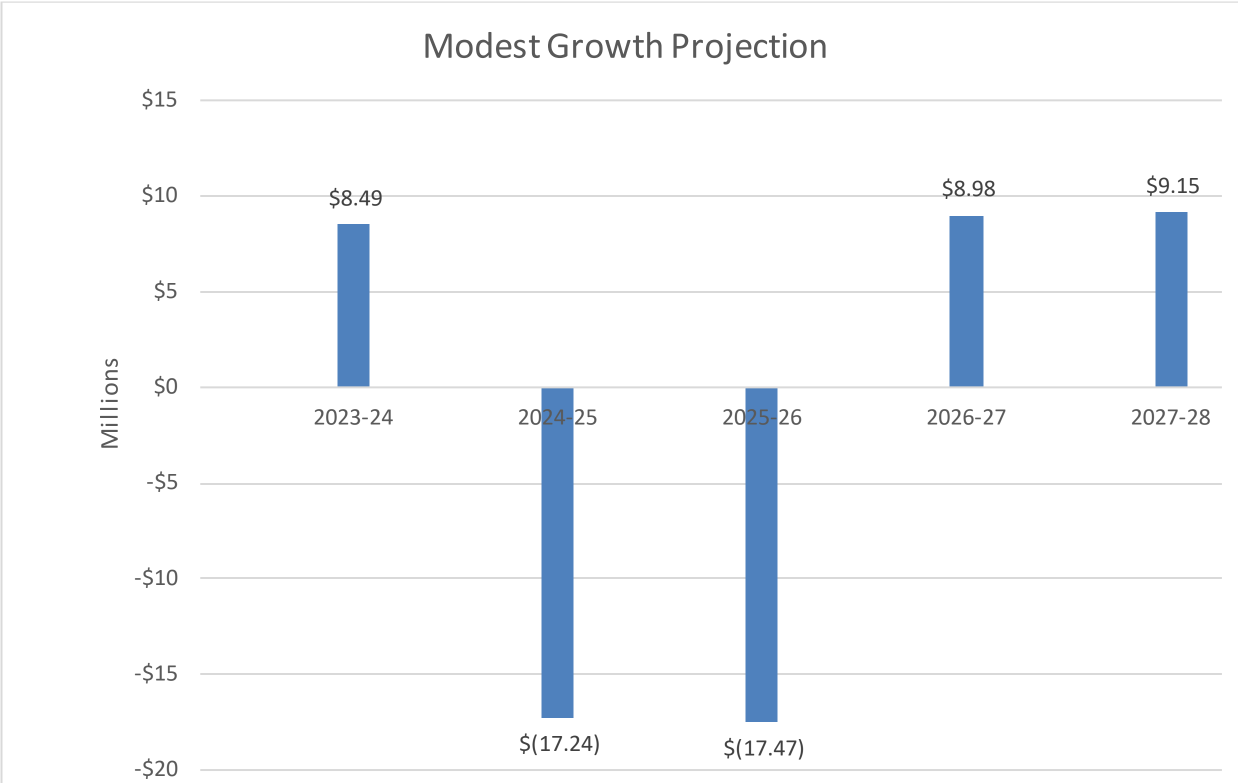

The deficit shown in FY204-25 and FY2025-26 is due to no legislative fix from the VLF.

Mild Recession Scenario:

The mild recession scenario makes similar assumptions throughout the base forecast with some major exceptions. This projection assumes the three major General Fund revenue sources, Property Tax, Sales Tax and Transient Occupancy Tax will decline or grow more slowly. Property tax is not projected to decline even with a mild recession because history has shown that, due in part to the state's housing shortage, property tax receipts are particularly resilient to economic slowdowns. Sales Tax is projected to decline by 2% in FY2024-25 and FY2025-26 then beginning to recover after that. Transient Occupancy Tax is projected to decline by 3% in FY2024-25 and decline by 2% in FY2025-26. Transient Occupancy Tax is a more volatile revenue source and therefore more subject to potential market changes.

This projection continues to assume that the VLF issue will not have a legislative fix and that the County does not identify a new dedicated revenue source for Fire protection. Other costs such as Salary and Benefits, Services and Supplies and groundwater, cyber security are all the same as the baseline projection.

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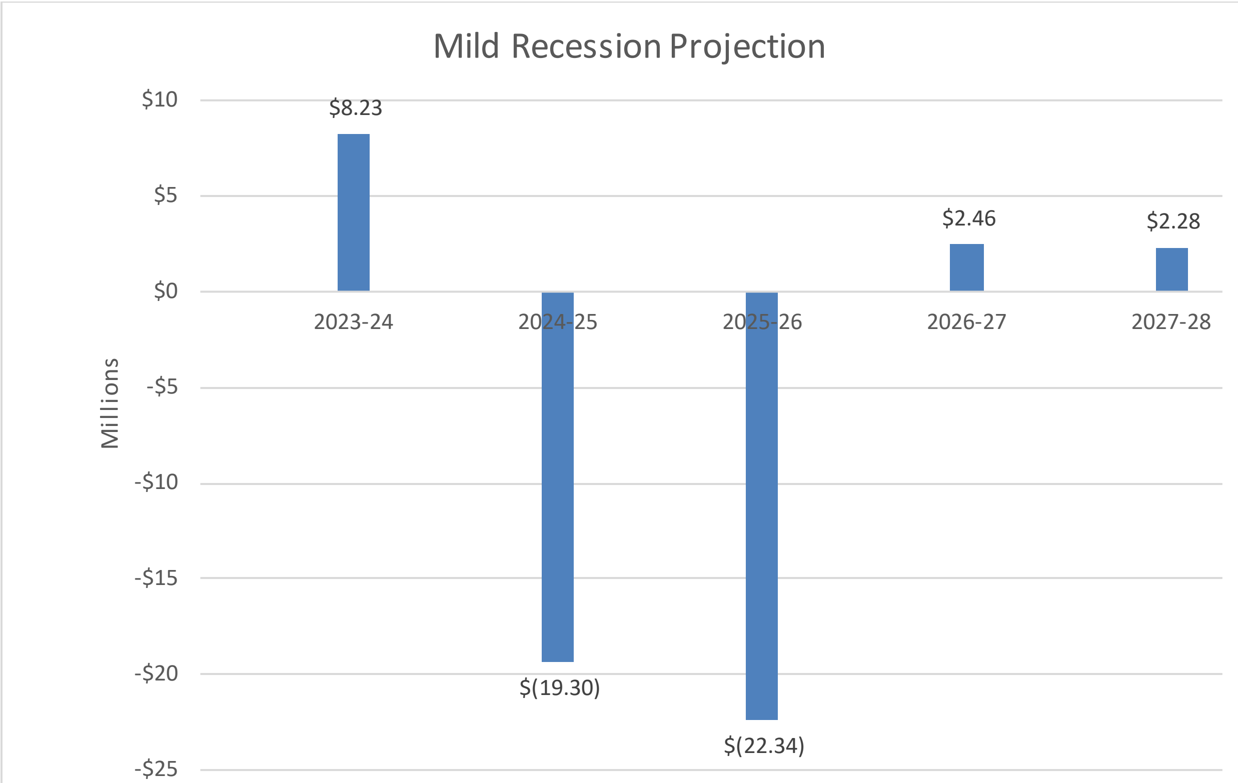

This projection shows the potential impact of a mild recession with the impacts being felt in FY2024-25 and FY2025-26. The reason that this hypothetical recession's impacts are shown in FY2024-25 instead of FY2023-24 is that there is often a lag of several months, or nearly a year, for the effects of a recession to be reflected on county revenues. After that, the projection assumes a stead and slow recovery. Even with a mild recession the only two years the county General Fund would have expenses exceeding revenues are in FY2024-25 and FY2025-26. In both years the deficit is entirely due to the loss of VLF revenue. The two remaining years, FY2026-27 and FY2027-28 show a recovering and positive General Fund.

More mainstream economists are beginning to project a recession potentially in the coming year. Macroeconomic fundamentals are currently strong and there are not major bubbles in the United States economy. However, if there were an economic slowdown it would likely be a mild recession. Even when factoring in a mild recession where county revenues decline or grow slower, the General Fund is still resilient. The General Fund remains structurally sound and can accommodate a mild recession.

Identified unmet needs:

Throughout the year, the Board identifies unmet needs. These are included in the 5-Year Forecast so that the list can be reviewed and updated annually. Some of these priorities may have potential revenue sources beyond the General Fund, which would be used to meet these ongoing funding needs.

- One-time funding needs
  - Homeless services
  - Affordable housing, including family farmworker housing
  - Americans with Disabilities Act Transition Plan implementation
    - Facilities improvements
    - Website accessibility
  - Cyber security
  - Capital Improvement Projects
    - Major maintenance of Napa County facilities
    - Culvert and bridge maintenance
    - Road maintenance and repairs
    - New County Administration Building
  - General Plan update
  - Preparing and Implementing Climate Action and Resiliency strategies
  - Fire Prevention and Water

Conclusion:

The General Fund is currently structurally sound. A cause for concern is the significant, but potentially short-term impact of losing the Vehicle License Fee. Besides this, the need to provide General Fund support to fund the Community Wildfire Protection Plan would make the General Fund less resilient and could over time begin to erode core county services. If the County did lose VLF revenues, and experience a mild recession, the county would need to use Assignment for Fiscal Uncertainty or make reductions to core county services or identify other short-term solutions.

County revenues have recovered from the pandemic. Inflationary pressures on employee Salary and Wages may grow faster than revenues in the coming years. It is, however, unlikely that County revenues would decline without similar declines in major County expenses. It remains imperative that staff continue constant vigilance in implementing the Board's budget policies and that all requests for use of discretionary revenue, especially for on-going uses, be analyzed and carefully considered. It is also imperative that one-time resources continue to be used to address priorities that protect future service delivery, such as paying down the pension liability and investing in major maintenance projects to prevent costly system failures and increasing costs in the future.