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SEVEN IN A ROW: STATE REVENUE FORECAST REDUCED AGAIN

BRIEFLY

The September forecast reduced combined general fund revenues for the 2007–09 and 2009–11 biennia by \$757 million. For the broader near general fund, the reduction was \$752 million.

The Economic and Revenue Forecast Council (EFRC) met in Olympia yesterday to formally update its forecasts of the state's economy and general fund revenue. The revisions added \$3.5 million to the "forecast" of general fund revenues for the completed 2007–09 biennium and subtracted \$760.2 million from the general fund forecast for current 2009–11 biennium. For the broader "near general fund-state" (NGFS), which combines the general fund and other accounts, 2007–09 revenues are up \$3.5 million and 2009–11 revenues are down by \$755.8 million. (See the box on page 4 for a discussion of the distinction between the general fund and the near general fund.)

This marks the seventh consecutive reduction in the forecast for 2009–11 revenue since the initial forecast was made in February 2008.

This forecast will provide the basis for the supplemental budget that Governor Chris Gregoire is to prepare for the 2010 legislative session. Altogether the June, September and November revenue forecast revisions have reduced available revenue by almost \$1.7 billion. Including unbudgeted expenses (which we discuss below) Office of Financial Management Director Victor Moore puts the gap to be closed by the supplemental budget at around \$2.6 billion.

THE ECONOMIC FORECAST

The initial reading on third quarter GDP shows 3.5 percent (annualized) growth over the second quarter. The recession in output is over. The questions are now how soon the recovery in employment will begin and whether there will be a "double dip."

The economy returned to growth in the third quarter and the focus of the recovery has now shifted to labor markets. Employment growth lags the recovery in activity as employers hold off on rehiring workers until they are certain that demand has returned. On the downside, there are severe headwinds buffeting the economy. A second round of credit contraction is possible due to the vulnerability of local and regional banks around the country from their disproportionate exposure to commercial real estate. Credit to small businesses and retailers heading into the holiday season remains tight. Consumer confidence is up off the floor, but trading water and still in recessionary territory. We continue to expect a U-shaped recovery, which means we'll be crawling along the bottom for a while before a robust return to growth becomes evident. . . .

The greatest risk to the recovery is that consumer spending will not grow sufficiently to generate self-sustaining growth as the fiscal stimulus tapers off in about a year. Consumer confidence remains weak and is unlikely to improve until the job situation improves.

The unemployment rate jumped to 10.2 percent in October, its highest level since May of 1983. Consumers continue to reduce revolving credit, paying down debt and saving more. (EFRC 2009a)

EFRC staff expect Washington to outperform the nation:

The Washington economy is likely to have turned the corner in the third quarter of this year although employment in the state has continued to decline through [October]. The rate of job loss, however, has slowed sharply since the freefall stage of the recession. . . . We expect employment in Washington to bottom out in the fourth quarter of this year with a peak-to-trough decline of 165,000 jobs. The Washington recovery, like the national recovery, will be slow and U-shaped. However, we expect to once again outperform the U.S. economy thanks to our export orientation and the relative stability of our key basic industries, aerospace and software. (EFRC 2009a)

Over the last 7 months, the Washington unemployment rate has held relatively steady as the national rate continued to climb. This week, the state Employment Security Department issued its initial estimate of the state's

October unemployment rate, which, at 9.3 percent, was nearly a full point below the national rate. "There has not been a statistically significant change in the unemployment rate since it jumped 0.8 percentage points from 7.3 percent to 9.1 percent in March 2009." (EFRC 2009a) EFRC staff forecast that the state unemployment rate will hit 9.8 percent in the second quarter of 2010 and then gradually decline from that point, reaching 8.4 percent by the fourth quarter of 2011.

While the EFRC economic forecasts have been close to the mark, the revenue forecasts have not been so accurate. For the two months since the September EFRC meeting, collections were \$97.4 million (4.7 percent) below forecast. In the EFRC's words "continued weakness in consumer spending is creating a 'revenue-less recovery.'"

BALANCE SHEET

The table on this page presents a near general fund-state balance sheet for the 2007–09 and 2009–11 biennia. We have based this balance sheet on the balance sheet published in the 2009 session edition of Legislative Budget Notes, updated to reflect the June, September and November revenue forecasts.

The NGFS began the 2007–09 biennium with a \$2.1 billion balance. Revenues (net of the transfer to the budget stabilization account, the constitutionally established rainy day fund) were \$30.1 billion. NGFS resources were boosted by more than \$700 million transferred from other state accounts, including \$400 million from the budget stabilization account (BSA).

Coming into the 2009 session, NGFS appropriations for the 2007–09 biennium were a bit less than \$33.7 billion. The "early action" and regular supplemental

Estimated Revenues and Expenditures Near General Fund Excluding Known Supplemental Adjustments that Will Add to Shortfall (Dollars in Millions)		
	2007-09	2009-11
RESOURCES		
Beginning Fund Balance	2,105.2	391.2
Revenue		
September Forecast	30,250.3	29,979.8
November Revision	3.5	(755.8)
Transfer to Budget Stabilization Account	(115.1)	(259.3)
Total Revenue	30,138.7	28,964.7
Other Resource Changes		
2007 & 2008 Fund Transfers	117.1	-
ESHB 1694 Fund Transfers	91.3	-
Use Budget Stabilization Account	400.0	45.1
Use Capital Budget Resources	77.0	700.1
Other Fund Transfers	24.5	146.7
Other Changes	18.9	1.0
Total Other Resource Changes	728.8	892.9
Total Revenues and Resources	32,972.7	30,248.8
EXPENDITURES		
Spending		
2007-09 Budget As Enacted Prior to 2009 Session	33,655.2	
2008 Actual Spending Adjustment	(15.6)	
ESHB 1694 (Early Action, 2009)	(634.7)	
2009 Supplemental	(423.4)	
Enacted 2009-11 Budget		31,388.6
Total Appropriations	32,581.5	31,388.6
RESERVES		
Ending Balance & Reserves		
Unrestricted Ending Fund Balance	391.2	(1,139.8)
Budget Stabilization Account Balance (Includes Interest)	21.4	235.7
Total Reserves	412.6	(904.1)
Addendum:		
Expenditures of Federal Stimulus Funds	910.7	2,528.3
NGFS Appropriations + Expenditures of Stimulus Funds	33,492.2	33,916.9

Sources: LEAP, EFRC, OFM; WRC calculations

November 2009 Caseload Forecast

Differences from Caseloads Assumed in Adopted 2009–11 Budget

	FY 2010		FY 2011	
	#	%	#	%
Education:				
K-12 Basic Education	1,236	0.1%	3,925	0.4%
Special Education	-22	0.0%	239	0.2%
Bilingual	-2,556	-2.9%	-4,005	-4.4%
Juvenile Rehabilitation Services:				
	28	4.1%	85	13.4%
Corrections:				
Adult Inmate	2	0.0%	-295	-1.7%
Contact Required	1,005	5.3%	-871	-4.3%
Economic Services Administration:				
TANF	1,525	2.4%	1,255	2.0%
General Assistance	1,502	4.0%	2,926	7.1%
Children's Administration:				
Foster Care	-94	-1.3%	-326	-4.9%
Adoption Support	81	0.6%	97	0.7%
Health & Recovery Services Administration:				
Families	28,283	9.5%	42,150	13.8%
Children	26,351	5.7%	54,421	11.3%
Aged, Blind, and People with Disabilities	6,216	2.6%	15,238	6.3%
Other programs	-188	-0.9%	-244	-1.1%
Long Term Care:				
Nursing Homes	206	2.0%	344	3.5%
Home/Community Services	-145	-0.3%	-278	-0.6%
Division of Developmental Disabilities:				
Medicaid Personal Care—Children	120	5.9%	189	9.0%
Medicaid Personal Care—Adults	89	2.1%	225	5.1%
Infant Toddler Early Intervention Program	-123	-2.5%	-104	-2.0%

budget bills shaved about \$1.1 billion from NGFS appropriations for the biennium. Much of this reduction in appropriations from the general fund was backfilled with federal stimulus funds, as indicated in the addendum at the bottom of the table, so that the overall decrease in spending was around \$160 million.

Appropriations from the NGFS exceeded revenue by \$2.4 billion, and the NGFS ended the biennium with a balance of less than \$400 million.

Forecast revenues for the 2009–11 biennium (net of the required transfer to the BSA) are now \$29.2 billion. These revenues are supplemented by nearly \$900 million in transfers to the NGFS from other state funds, including \$45 million from the BSA.

Appropriations from the NGFS 2009–11 total a bit less than \$31.4 billion for 2009–11. In addition to these appropriations, the state anticipates spending \$2.5 billion in federal stimulus funds during the biennium.

The projected balance in the NGFS at the end of the biennium is *negative* \$1,139.8 million, while the projected ending balance for the BSA is *positive* \$235.7 million. Projected net reserves are *negative* \$904.1 million.

ADDITIONAL COSTS

A presentation prepared by the Office of Financial Management identifies factors that will further increase the budget gap by an additional \$900 million (OFM 2009).

Dot Foods: On September 10 the Washington Supreme Court ruled for Dot Foods in a case challenging the Department of Revenue's denial of a B&O tax exemption to the company, which sells products in the state exclusively through a *direct seller's representative*. The case is currently under reconsideration. If the decision stands, the revenue loss is estimated to be \$154 million: \$59 million in refunds to Dot and similarly situated companies, and \$95 million in future tax payments.

Caseload increases. On November 13, the state Caseload Forecast Council updated its forecasts for K-12 enrollments and for various human services caseloads. The table on this page summarizes the differences between the new forecasts and the caseloads assumed in the adopted 2009–11 budget. The key changes include:

- *K-12.* Enrollments are now expected to exceed the numbers assumed in the adopted 2009–11 budget by 1,236 (0.1 percent) during this school year and by 3,925 (0.4 percent) next year.
- *Welfare.* The new forecasts for the federal/state TANF program exceed the budgeted numbers by 1,525 (2.4 percent) for FY 2010 and 1,255 (2.0 percent) for FY 2010. For the state-only General Assistance programs, the new forecasts are 1,502 (4.0 percent)

greater than budgeted for this fiscal year and 2,926 (7.1 percent) greater than budgeted for next year.

- *Medical assistance.* For programs that serve families, the new forecasts exceed budget assumptions by 28,283 (9.5 percent) for FY 2010 and 42,150 (13.8 percent) for 2011. For those programs that specifically serve children, the new forecasts exceed budget assumptions by 26,351 (5.7 percent) this year and 54,421 (11.3 percent) next year.

The pure impact the new forecasts (i.e. the impact calculated without adjusting for changes in the utilization of services) is to increase spending for the biennium by \$277 million from the budgeted level.

Other caseload costs. Other factors will add \$348 million. These include increased use of medical services, failure of the 2009 legislature to pass several cost-saving bills that were assumed by the budget, and failure of the Department of Social and Health Services to implement cost reductions ordered by the legislature.

Lawsuits. In certain cases, lawsuits have delayed planned program reductions. These delays are projected to add \$71 million to costs.

Emergencies. Expenses of fighting forest fires and other emergency responses are expected to add \$12 million to costs.

The Near General Fund

Sound fiscal policy minimizes the amount of tax earmarking.

The Research Council has long lamented the proliferation of special accounts through which the legislature has funded general government programs (WRC 1995). In recent years, eight specific accounts (the "general fund related accounts") have functioned as adjuncts to the general fund: the health services account, the student achievement account, the education legacy trust account, the public safety and education account and its equal justice sub-account, the violence reduction and drug enforcement account, the water quality account, and the pension funding stabilization account. Monies have been freely transferred back and forth between these accounts and the general fund as needs arise. In 2006, the Washington Alliance for a Competitive Economy, of which we are a member, called for these accounts to be consolidated into the general fund (WashACE 2006).

For several years, legislative fiscal staffs have been reporting state spending in terms of a synthetic "account," the near general fund—state (NGFS), which aggregates the general fund and the eight related accounts. This has improved transparency and accountability, and we have generally chosen to use the NGFS in our discussions of the state budget (WRC 2007).

During the 2009 session, the legislature passed and the governor signed Senate Bill SB 5073, which consolidates six of the eight related accounts (all but the education legacy trust account and the pension funding stabilization account) into the general fund. We applaud this, but believe that the education legacy trust account should likewise be consolidated into the general fund. (As no taxes are dedicated to it, the pension funding stabilization account is effectively dead.)

ADDING IT UP

Adding these costs to the \$1.7 billion cumulative reduction in the June, September and November revenue forecasts gives the \$2.6 billion gap that OFM Director Moore cites. The calculation does assume a NGFS ending balance of just under \$500 million and a \$236 million balance in the budget stabilization account. The gap will be smaller to the extent that budget writers are willing to accept a lower level of reserves.

The Governor's supplemental budget proposal will be released in mid December. The Legislature convenes on January 11 and is scheduled to adjourn on March 11. The EFRC will update the revenue forecast on February 18. Legislators are likely to postpone major decision making on the budget until they see this update.

Looking into the more distant future, the state faces another significant budget gap in the 2011–13 biennium. The existing 2009–11 budget relies on \$3.4 billion in one-time money: \$900 million in transfers to the NGFS from other state funds and \$2.5 billion in federal stimulus funds. Even if the budget writers close the 2009–11 gap, projecting forward using normal growth rates in revenue and program costs suggests a 2011–13 budget gap in the \$2.0 billion to \$2.7 billion range.

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