WashACE
Washington Alliance for a Competitive Economy

COMPETITIVENESS BRIEF

CB 08-03 June 23, 2008

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June Reduction to Revenue Forecast Widens 2009–11 Budget Gap

The Bottom Line

The June update reduced the forecasts of GFS revenue by $49.6 million for 2007–09 and $117.2 million for 2009–11. These reductions are not that large by historical standards. However, with a large budget gap looming for the 2009–11 biennium, any reduction in revenue is unwelcome.

On June 19, the Economic and Revenue Forecast Council (ERFC) met in Olympia to approve updates to the revenue forecasts for the current 2007–09 and upcoming 2009–11 biennia. The Forecast Council now projects that General Fund–State revenue for the 2007–09 biennium will total $29,402.4 million ($29.4 billion), which is $60.5 million less than EFRC had forecast when it met in February. Of this $60.5 million, $11.0 million is due to legislation enacted during the last session and is thus not news, while $49.6 million is due to a weaker outlook for the national economy. (These numbers fail to add up because they are rounded.)

For the 2009–11 biennium the General Fund–State (GFS) forecast is now $31,754.5 million, a reduction of $163.4 million from February. Of this, $46.1 million is due to legislation, and $117.2 million is due to the weaker economic forecast.

Watching U.S. economy react to the bursting of the house price bubble is like watching a super slow motion video of an automobile crash. While the problems in the sub-prime mortgage market were first widely noted in early 2007, it was not until late in the year that it became clear that the turmoil would push the economy into recession. The ERFC's February 2008 forecast was the first GFS forecast to show a major effect of the housing bust and associated credit crunch on state revenues. In February the EFRC reduced the forecast for 2007–09 GFS revenues by $423 million and issued a forecast of 2009–11 revenues (its first for that biennium) that was $854 million less than the informal projection that legislative analysts had been using.

Since February, oil prices have moved much higher than had been projected, worsening the outlook for the national economy, and this largely accounts for the downward revision in June.

The economic reduction to the forecasts, $166.8 million over a biennium and a half, is not that large by historical standards. (It is less than 0.4 percent of revenue.) However, with a large budget gap looming for the 2009–11 biennium, any reduction in revenue is unwelcome.

2007–09 Balance Sheet

The table on page 2 includes a GFS balance sheet for the 2007–09 biennium. The general fund began the biennium with a balance of $781 million. With the June update, current revenues for the biennium are forecast to total $29,402 million. It is projected that the amount of the constitutionally required transfer to the budget stabilization account at the end of FY 2009 will be $133 million. Numerous transfers between the GFS and

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other state accounts have added $147 (net) to the GFS. With the recently enacted supplemental budget, appropriations for the biennium stand at $29,838 million, giving a $436 million gap between expenditures and current revenues. It is projected that the biennium will end with balances of $359 million in the GFS and $442 million in the budget stabilization account, for total reserves of $801 million. Another downward revision of the magnitude seen in February would totally exhaust the GFS reserve.

The Outlook for 2009–11 and 2011–13

The table also presents an "outlook" we have assembled for the GFS in the 2009–11 and 2011–13 biennia. The outlook largely replicates the six-year outlook published in April by Senate Ways and Means Committee staff; the major difference is that we have updated revenue for 2007–09, 2009-11 and 2011–13 to reflect the revised revenue forecasts.

2007-09 Balance Sheet and Approximate 2009-2013 Outlook
General Fund-State
Dollars in Millions

	2007–09	2009–11	2011–13
Resources			
Beginning Fund Balance	781	359	(2,612)
February 2008 Forecast	29,463	31,918	-
June 2008 Update	(50)	(117)	-
Projection at 5% Annual Rate of Growth	-	-	35,061
2008 Revenue Changes/Adjustments	(11)	(46)	-
Current Revenue Totals	29,402	31,755	35,061
Transfer to Budget Stabilization Account (BSA)	(133)	(291)	(321)
Net Transfers to/from Other Funds	147	(12)	(12)
Total Resources Available	30,197	31,811	32,117
Expenditures			
2007–09 Enacted Budget	29,623	-	-
Baseline Expenditures	-	32,175	34,907
2008 Supplemental Budget	215	608	659
Additional Pension Costs	-	132	180
Family Medical Leave	-	75	92
NGFS Backfill	-	1,432	1,759
Total Expenditures	29,838	34,423	37,597
Reserves			
Projected General Fund Ending Balance	359	(2,612)	(5,480)
Emergency Reserve Fund Transfer To BSA	302	-	-
New Deposits plus Interest Earned	140	337	399
Projected BSA Endinng Balance	442	780	1,178
Total Reserves	801	(1,831)	(4,302)
Budget Gap			
Current Revenue less Total Expenditure	(436)	(2,668)	(2,536)
Percent of Current Revenue	1.5%	8.4%	7.2%

Source: Senate Ways and Means Committee, Office of the Forecast Council, WRC

Baseline expenditures represent the cost of carrying forward the programs funded in the originally enacted 2007–09 budget, with allowances for increasing costs, caseloads, and enrollments. The carry-forward from the 2008 supplemental budget adds $608 million to spending for 2009–11 and $659 million for 2011–13. (In each case this more than twice the amount that the supplemental added to 2007–09, manifestations of the "bow wave" effect). Additional pension costs add $132 million in 2009–11 and $180 million in 2011–13 to baseline expenditures. The legislature in 2007 enacted the family medical leave program, which is scheduled to start up in 2009, but has yet to specify how this employment benefit will be funded. The outlook assumes that funding will come from the general fund, at a cost of $75 million in 2009–11 and $92 million in 2011–13.

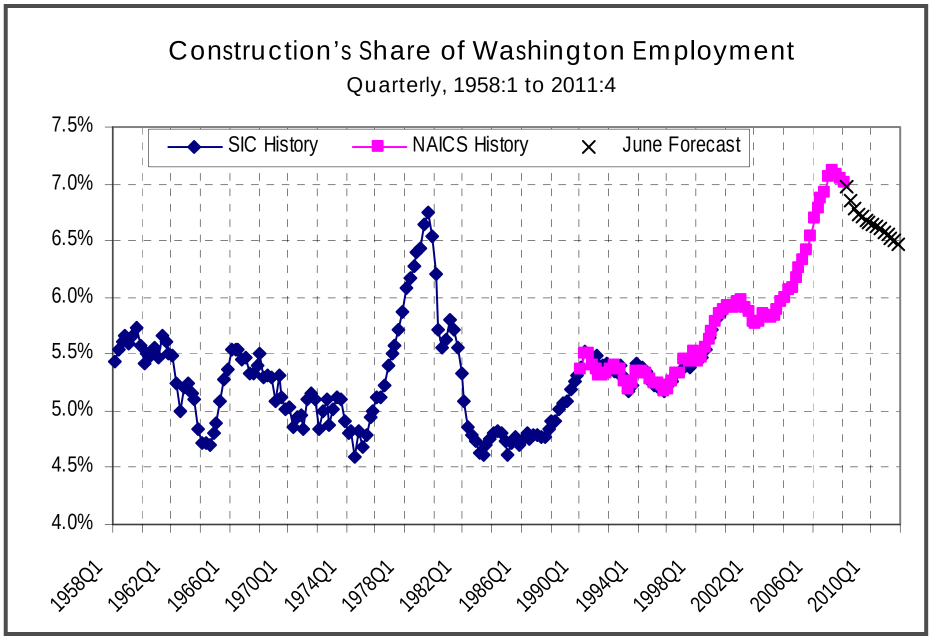
We have written extensively about the problems the state faces with respect to unsustainable spending commitments that have been made in accounts outside of the general fund (WashACE 2006, 2007a; WRC 2007a, 2007c, 2008). The line NGFS Backfill reflects the cost of these commitments, which ultimately must be fulfilled from the GFS. They add up to more than $1.4 billion in 2009–11 and nearly $1.8 billion in 2011–13.

In large part because of these carry-forward demands from outside of the GFS, projected expenditures exceed current revenues by $2.7 billion in 2009–11 and $2.5 billion in 2011–13, indicating a structural deficit. As a result, the GFS shows negative balances of $2.6 billion at the end of FY 2011 and $5.5 billion at the end of FY 2013. The shortfalls might be offset somewhat by funds from the budget stabilization account. Under the current economic forecast, in FY 2009 employment growth will dip below the 1 percent threshold that triggers access to those funds. If the March 2009 forecast continues to show such a dip, about $600 million would be available in FY 2009 for appropriation from the BSA by simple majority vote of both houses of the legislature.

On June 26th, the Caseload Forecast Council will revise its forecasts of health and human service program caseloads, K-12 education enrollments and prison populations . It's likely that the new caseload forecasts will increase the projected costs of carrying existing programs forward into 2009–11 and 2011–13, further widening the budget gaps for those two biennia. After the release of the new caseload forecasts, Senate Ways and Means Committee staff intend to update their Six-Year Outlook to incorporate both the revenue and the caseload updates.

Construction

We have previously written on the large contribution made by construction to employment growth in Washington State in recent years and on the sensitivity of GFS revenues to the level of construction activity (WashACE 2007b; WRC 2007b). We believe that the biggest risk to the revenue forecast is that construction activity will prove to be weaker than the ERFC has projected.



The chart on this page shows actual and projected construction employment as a share of nonagricultural wage and salary employment, beginning with the first quarter of 1958 and extending through the fourth quarter of 2011. It is estimated that construction jobs were just over 7 percent of total employment in the first quarter of 2008. The ERFC's forecast has construction's job share declining sharply in the next several quarters, then continuing to decline at a slower rate through the end of the forecast horizon. For the fourth quarter of 2011, the projected construction job share is 6.48 percent, which is still very high by historical standards. The chart shows 201 quarters of history and 15 quarters of projections. The construction job share was greater than 6.45 percent in only 15 of the 201 historical quarters—the second, third and fourth quarters of 1979, the fourth quarter of 2005, all four quarters of both 2006 and 2007, and the first quarter of 2008. The ERFC projects that the construction job share will remain above 6.45 percent for the next 15 quarters.

The ERFC's models did not accurately forecast the recent boom in construction. Our fear is that—symmetrically—the models are failing to foresee a sharp decline that is in the works.

With the troubles in the mortgage markets, residential construction activity is slowing and the number of new home permits issued is down sharply. Nonresidential construction remains strong, for the time being. But this largely reflects projects that have been in the pipeline for a long time. In its first quarter analysis of the Seattle metropolitan office market, the real estate brokerage Grubb & Ellis notes:

> Construction starts have slowed to a trickle—a casualty of the credit crunch. The financing pool has become a puddle as lenders impose higher standards. Work continues, however, on a substantial 2.8 million square feet of office projects in Seattle and over 3 million square feet on the Eastside. This "pig in the python" is scheduled to hit the market beginning this summer . . .(Mullen 2008).

As these projects reach completion, it is not clear where the workers employed on them find new work.

Discussion

The lawmakers who convene in Olympia in 2009 to write a budget for the 2009–11 biennium will confront a budget gap of nearly $2.7 billion—by current projections. This gap reflects a structural deficit that was largely put into place over the last three years as a booming economy allowed budget writers to fund programs that were not sustainable in the long run.

Some may have assumed that 2007–09 would play out like 2005–07, when quarter after quarter the ERFC raised its forecasts of GFS revenue. It has not. The last three revisions to the 2007–09 forecast have been down.

The June update reduced projected GFS revenues for the combined 2007–09 and 2009–11 biennia by $166.8 million. As we said earlier, this is not a big reduction by historical standards. It only seems large if you were banking on a large upward revision.

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