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REVENUE FORECAST LOWERED

BRIEFLY

The February revenue update dropped the forecast for 2007–09 by $423 million, to $29.5 billion.

On Friday, February 15, Washington's Economic and Revenue Forecast Council (ERFC) updated its forecasts for the state economy and general fund revenue. With the new forecasts now in hand, the legislature's fiscal committees will intensify their work on the 2008 supplemental budget. The House Appropriations Committee is expected to release its supplemental by the end of this week.

The update reduced the forecast of 2007–09 general fund–state (GFS) revenues by $423 million, to $29,463 million. This is the second consecutive downward revision: the November update dropped the 2007–09 forecast by $111 million. At the February 15 meeting, the ERFC also forecast that GFS revenues for the forthcoming 2009–11 biennium would be $31,981 million. This is the first official forecast for 2009–11 revenues and represents an 8.3 percent increase over the forecast for 2007–09 (ERFC 2008b).

A SLOWING ECONOMY

Underlying the reduced revenue forecast is the ERFC's reduction in its economic forecast for the state. The state economic forecast is built upon a national economic forecast prepared by the consultancy Global Insight. The most recent Global Insight national forecast is much weaker than the one that the ERFC used for the November forecast. Global Insight now sees the U.S. economy in recession during the first two quarters of 2008. It is a mild recession, however. The national unemployment rate is expected to peak at a relatively low 5.65 percent in the second quarter of 2009. (It was not so long ago that most economists viewed an unemployment rate of 6 percent to be full employment.)

Housing prices are dropping across the nation, reducing household wealth and dampening consumer spending. How much lower housing prices will go is uncertain. The market for subprime mortgages has contracted dramatically. In the market for jumbo prime mortgages, interest rate spreads have widened, while at the same time credit standards have tightened.

The credit crunch has moved beyond housing. How much worse it will get is anybody's guess. Over the past 15 years, financial engineering has created a bewildering range of products for transferring risks. As a result, the nation's financial structure has become dangerously opaque.

In the last month, state level data have shown definite signs that the Washington economy is slowing.

Initial unemployment insurance claims and weeks of unemployment compensation paid are up compared to 2006 and 2007 (ESD). The most recent revenue collection report, which was issued on February 10 and generally reflects economic activity from the month of December, was quite weak. Revenue Act taxes were up only 3.4 percent over the same period a year ago. This is the smallest increase since May 2004 (ERFC 2008a).

WASHINGTON RESEARCH COUNCIL
108 S Washington St., Suite 406
Seattle WA 98104-3408
206-467-7088
fax: 206-467-6957
www.researchcouncil.org

As we have noted before, the employment numbers released monthly by the state employment security department are based on a survey rather than a complete count of jobs. These estimates are subsequently revised based on unemployment insurance tax returns (a process known as benchmarking). The estimates are generally quite accurate—except at turning points in the business cycle. The initial estimates tend to be too high at the peak of the cycle and too low at the trough (WashACE 2007).

Preliminary benchmarking has reduced the estimate of employment in the state for the third quarter of 2007 by 15,000 (from 2,950,300 to 2,935,300). Of this reduction, 4,700 occurred in the critical construction sector (from 212,000 to 207,300). The outlook for construction has weakened. While the ERFC had previously believed that the peak in employment for this cycle would occur in the 4th quarter of 2007, it now appears that the 2nd quarter saw the peak. In November the ERFC forecast that permits for 48,366 housing units would be issued in 2007 followed by 43,169 in 2008. They now put the number for 2007 at 44,944 and forecast only 38,657 for 2008. Commercial construction is expected to remain strong. But if the credit crunch intensifies, this sector could turn down also. State revenues are quite sensitive to the level of construction activity (WRC 2007b).

ERFC economists continue to believe that the current phase of expansion in aerospace employment is near the end. The new economic forecast has aerospace employment reaching 84,200 in the 3rd quarter of 2008 and then holding at that level through the end of 2011. The Boeing Company's January 31 count of jobs in Washington (74,026) was actually down by 134 from December 31. This is the first monthly decline in Boeing Washington employment since May of 2004.

At this point it is not clear what the implications would be for the Washington economy of a Microsoft takeover of Yahoo. Certainly the merger would absorb much of Microsoft's cash hoard, money which might otherwise be spent in this state. It is possible that, after the combination, Microsoft will direct an increased share of employment growth to Yahoo's base in Northern California.

2007–09 Enacted Budget Balance Sheet
With 2009–13 Approximate Outlook
General Fund-State
Dollars in Millions

	2007–09	2009–11	2011–13
RESOURCES			
Beginning Fund Balance	780.5	524.2	(1,633.6)
November 2007 Forecast	29,886.4	-	-
February 2008 Update	(423.4)	31,917.8	-
Projection at Average Rate of Growth	-	-	35,189.4
Current Revenue Totals	29,462.9	31,917.8	35,189.4
Transfer to Budget Stabilization Account (BSA)	(136.1)	(285.7)	(314.9)
Net Transfers to/from Other Funds	39.8	-	-
Total Resources (including Beginning Fund Balance)	30,147.1	32,156.4	33,240.8
EXPENDITURES			
2007–09 Enacted Budget	29,622.9	-	-
Baseline Expenditures	-	32,221.4	34,957.5
Pension Costs	-	651.8	699.2
Health Services Account Backfill	-	446.1	603.7
Education Legacy Account & Student Achievement Fund Backfills	-	470.7	670.8
Total Expenditures	29,622.9	33,790.0	36,931.2
RESERVES			
Projected General Fund Ending Balance	524.2	(1,633.6)	(3,690.4)
Emergency Reserve Fund Transfer To BSA	293.3	-	-
New Deposits	136.1	285.7	314.9
Projected BSA Ending Balance	429.4	715.1	1,030.0
Total Reserves	953.7	(918.6)	(2,660.4)

2007–09 GFS Balance Sheet

The table to the left includes a GFS balance sheet for 2007–09 incorporating the budget enacted last April and the updated revenue forecast. The GFS began the biennium with a $781 million balance. Transfers to and from other funds add $40 million (net) to available resources. The enacted budget spends $30,147 million, exceeding current revenues by $160 million. The new rainy day fund—the budget stabilization account

(BSA), which was created by I-937—receives a $293 million rollover from the old rainy day fund–the emergency reserve fund–and $136 million transfer from the GFS. The biennium is expected to end with $954 million in reserves, $430 million in the BSA and $524 million in the GFS itself.

(Governor Gregoire in December proposed a supplemental budget that would increase GFS spending for the biennium by $144 million and decrease GFS revenue by $35 million. With the new forecast, we believe that proposal is dead.)

THE OUTLOOK BEYOND 2007–09

The table also presents an "outlook" for the following two biennia. Revenue for 2009–11 comes from the new ERFC forecast. Revenue for 2011–13 is projected using the standard rule for these exercises (5 percent growth per year, which with compounding is equivalent to 10.25 percent per biennium). Spending numbers for 2009–11 and 2011–13 are from an analysis prepared by the Senate Ways and Means Committee staff of the six-year outlook under Governor Gregoire's proposed supplemental budget. (We do *not* include the governor's supplemental budget in our outlook, however.) Baseline expenditures represent the cost of carrying forward the programs funded in the enacted 2007–09 budget, with allowances for increasing costs, caseloads, and enrollments. 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 three lines, *Pension Costs, Health Services Account Backfill,* and *Education Legacy Account & Student Achievement Fund Backfills* largely reflect such commitments, which ultimately must be fulfilled from the GFS. They add up to nearly $1.6 billion in 2009–11 and $1.9 billion in 2011–13.

Largely because of these carry-forward demands from outside of the GFS, projected expenditures exceed current revenues by $1.9 billion in 2009–11 and $1.7 billion in 2011–13, indicating a structural deficit. As a result, the GFS shows negative balances of $1.6 billion at the end of FY 2011 and $3.7 billion at the end of FY 2013. The shortfalls might be offset somewhat by funds from the budget stabilization account. However, under the current economic forecast employment growth will remain above the 1 percent threshold that triggers access to those funds.

DISCUSSION

There is an extraordinarily high degree of uncertainty today about where the national economy is headed. While a lot is going well in this state at the present time, it would be a mistake to ignore the risks.

The recent $423 million reduction in the revenue forecast cut GFS reserves by almost one-third. At the recent ERFC meeting, Forecast Council Director ChangMook Sohn put the reduction in perspective: "$423 million is just . . . 1.4 percent [of the $30 billion forecast], which is just a minor adjustment." Several more "minor adjustments" of this size would eliminate the GFS's projected positive ending balance.

Projected reserves are 3.2 percent of biennial spending. The legislature would need to cut spending by $500 million to reach the 5 percent reserve we believe to be ideal. Cutting spending now would also reduce the size of the structural deficit that the legislature will face next year, when it sits down to write a budget for the 2009–11 biennium.

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