WashACE Washington Alliance for a Competitive Economy

COMPETITIVENESS BRIEF

CB 08-04 September 19, 2008

September Forecast Widens Budget Gap

The Bottom Line

The September forecast cut estimates of state revenues by $529 million, sending projections of the looming state budget shortfall to $3.2 billion. Although worsening economic conditions have deepened lawmakers' budget problems, unsustainable state spending dug the budget hole.

Yesterday, the Economic and Revenue Forecast Council reduced the official estimate of state revenues by $529 million. That means lawmakers now face a projected shortfall of roughly $3.2 billion for the two-year budget they begin writing in January.

The $529 million cutback comes in two parts. About $273 million reflects actual and projected revenue reductions in the current two-year budget cycle, which ends June 30, 2009. The balance, $256 million represents a reduction in projected revenues for the 2009-2011 biennium.

This is the fourth consecutive downward revision in estimated revenue collections to support the 2007-2009 budget. Since September 2007 estimated revenues have fallen from $30.0 billion to $29.1 billion. The forecast council now estimates that lawmakers will have $31.5 in revenues for the 2009-2011 biennium, growth of $2.4 billion, or 8.1 percent.

Despite the drumbeat of bleak revenue forecasts, Washington continues to do better than most states. The forecast council believes the state will avoid a recession. Their forecast projects employment growth of 0.6 percent this year, 1.2 percent next year, and 2.0 percent in 2010.

Nonetheless, unsustainable spending commitments made in the last two budget cycles have put the state in a deficit position for the upcoming biennium. In 2007, lawmakers adopted a two-year budget that spent $1.3 billion more than anticipated revenues. Earlier this year, they increased spending by $300 million, even as the economy began to slow. Although the national near-recession and collapse in the housing have made things worse, the budget deficit stems directly from the spending decisions made in Olympia.

2007–09 Balance Sheet

The table on page 2 includes a GFS balance sheet for the current biennium. The general fund began the biennium with a balance of $781 million. With the September update, as noted, revenues for the biennium are forecast to total $29,129 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 $132 million. Numerous transfers between the GFS and other state accounts have added $147 million (net) to the GFS. With the 2008 supplemental budget, appropriations for the biennium stand at $29,838 million, giving a $709 million gap between expenditures and current revenues. It is projected that the biennium will end with balances of $87 million in the GFS and $442 million in the budget stabilization account, for total reserves of $529 million.

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	87	(3,211)
June 2008 Forecast	29,402	31,755	-
September 2008 Update	(273)	(256)	-
Projection at 5% Annual Rate of Growth	-	-	35,061
Current Revenue Totals	29,129	31,498	34,808
Transfer to Budget Stabilization Account (BSA)	(132)	(283)	(319)
Net Transfers to/from Other Funds	147	-	-
Total Resources Available	29,925	31,302	31,279
Expenditures			
2007–09 Enacted Budget	29,838	-	-
Baseline Expenditures	-	32,895	35,681
Additional Pension Costs	-	132	180
Family Medical Leave	-	72	89
NGFS Backfill	-	1,413	1,620
Total Expenditures	29,838	34,513	37,570
Reserves			
Projected General Fund Ending Balance	87	(3,211)	(6,291)
Emergency Reserve Fund Transfer To BSA	303	-	-
New Deposits *plus* Interest Earned	139	329	395
Projected BSA Endinng Balance	442	773	1,167
Total Reserves	529	(2,438)	(5,124)
Budget Gap			
Current Revenue *less* Total Expenditure	(709)	(3,015)	(2,762)
Percent of Current Revenue	2.4%	9.6%	7.9%

Source: WashACE from Senate Ways and Means Committee & Office of the Forecast Council

In August Governor Gregoire imposed a freeze on hiring, the purchase of equipment, out-of-state travel and personal service contracts that her staff projects could save $90 million this biennium. She recently instructed the Office of Financial Management to find an additional $200 million of savings. If successful, these actions could add up to $300 million to the GFS ending balance.

The Outlook Is Bleak

The table also presents an "outlook" we have assembled for the GFS in the next two biennia. The outlook largely replicates the six-year outlook published in June by Senate Ways and Means Committee staff; the major difference is that we have updated it to reflect the revised forecasts. Senate Ways and Means Committee staff intend to issue their own update to the six-year outlook, which should differ only slightly from the update that we present here.

Baseline expenditures represent the cost of carrying forward the programs funded in the current budget, with allowances for increasing costs, caseloads, and enrollments. Additional pension costs add $132 million in the upcoming biennium 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 $72 million in the upcoming biennium and $89 million in 2011–13.

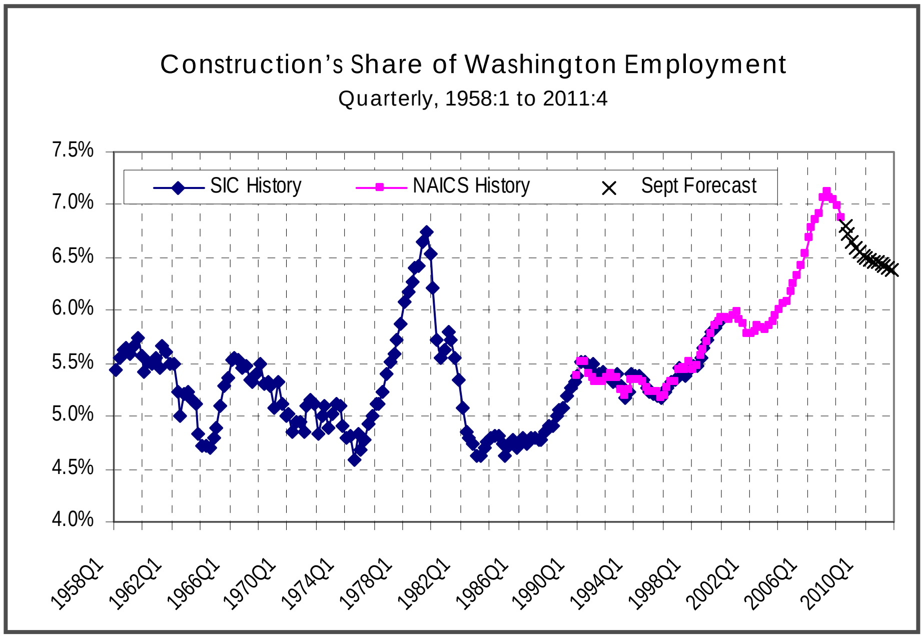
We have written extensively about the problems the state faces with respect to unsustainable spending commitments that have been made in accounts outside of the general fund (WashACE 2006, 2007a; WRC 2007a, 2007c, 2008). The line NGFS Backfill reflects the cost of these commitments, which ultimately must be fulfilled from the GFS. They add up to more than $1.4 billion in the upcoming biennium and $1.6 billion in 2011–13.

The Problem Is a Structural Deficit

In large part because of these carry-forward demands from outside of the GFS, projected expenditures exceed current revenues by $3.0 billion in the upcoming biennium and $2.7 billion in 2011–13, indicating a structural deficit. As a result, the GFS shows shortfalls of $3.2 billion at the end of FY 2011 and $6.3 billion at the end of FY 2013. The negative ending balances in the GFS 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.

Construction Is Troubling

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). 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 under 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 2010, the projected construction job share is 6.45 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 16 of the 202 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 two quarters of 2008. The ERFC projects that the construction job share will remain above 6.45 percent through the end of 2010.



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 has slowed and the number of new home permits issued is down sharply. Nonresidential construction is peaking. Nonresidential activity 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.

Things May Get Worse

This is a time of extraordinary economic uncertainty.

The lawmakers who convene in Olympia in 2009 to write a budget for the upcoming biennium will confront a budget gap of roughly $3 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 four revisions to the 2007–09 forecast have been down. November may make it five in a row. The recently adopted revenue forecast is based on a forecast of the national economy that was prepared in late August, before the financial crisis intensified.

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