2008 Session
Budget Outlook

Senate Finance Committee
November 15-16, 2007

2008 Session Budget and Economic Outlook

- **Recap of the 2006-08 budget.**
- **Budget outlook for the remainder of the 2006-08 biennium.**
  - Closing the gap on the budget shortfall in the current biennium.
    - Strategies currently in place.
    - Options to address the remaining shortfall.
- **Budget outlook for the 2008-10 biennium.**
  - Funding pressures.
  - Available resources and spending requirements.
  - Options for closing the projected shortfall.

Recap of the 2006-08 budget – maintaining "structural balance"

Revenue growth in the 2006-08 biennium covered funding for mandated spending, and allowed investments in other areas.

- Adopted tax policy changes.
- Made investments in areas with long-standing commitments -- addressed the "bills in the drawer".
- Rebuilt the "Rainy Day Fund" balance.
- Matched revenues and appropriations year-to-year, without relying on year-end balances.
- Avoided partially funding initiatives that had major out-year costs.
- Directed some of the potentially one-time revenue/ to one-time uses, rather than building on-going obligations.
  - Funded a major capital outlay program with $1.2 billion in general fund cash.
  - Set aside $200 million for Water Quality Improvement initiatives.
  - And, earmarked $500 million for a one-time appropriation for transportation.

Revenues fall short in 2007

- The amended 2006-08 budget adopted in April of this year anticipated about $600 million more in revenues, compared to the budget adopted in 2006.

  - FY 2007 ended with a shortfall of $234.4 million, 1.5 percent below the forecast.

- The **Code** requires the Governor to develop a re-estimate of general fund revenues if individual income, sales, and corporate income tax collections are **1 percent** or more below the official forecast.

- Based on input from advisory groups of economists, business leaders, and housing industry representatives, in August the Governor issued a new revenue forecast for FY 2008.

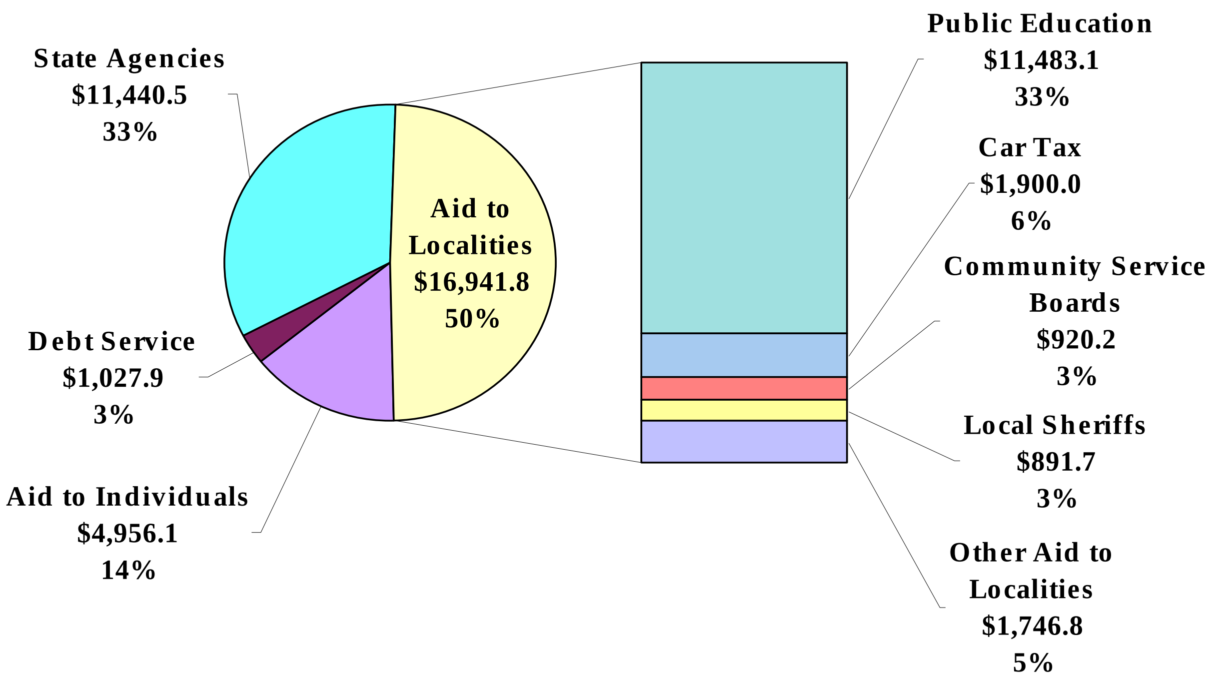
As of August, 2007
($ in millions)

FY 2007 Official Forecast	$15,800.2
Actual	15,565.8
Revenue Shortfall	**($234.4)**
FY 2008 Official Forecast	$16,432.4
August Revised Forecast	16,025.7
Downward Revision	**($406.7)**
2006-08 Biennial Budget Shortfall	**($641.1)**

Components of the general fund budget

- The operating budget for 2006-08 totals $70.0 billion, all funds.
  - Nongeneral fund revenues comprise over half of this amount, $36.6 billion, from sources such as federal funds, tuition, fees, and hospital revenues.
- About one-half of the general fund operating budget supports local programs – the largest share goes to public education, at 33 percent of the total GF operating budget.

Approved 2006-2008 GF Operating Budget
$34,366.3 million



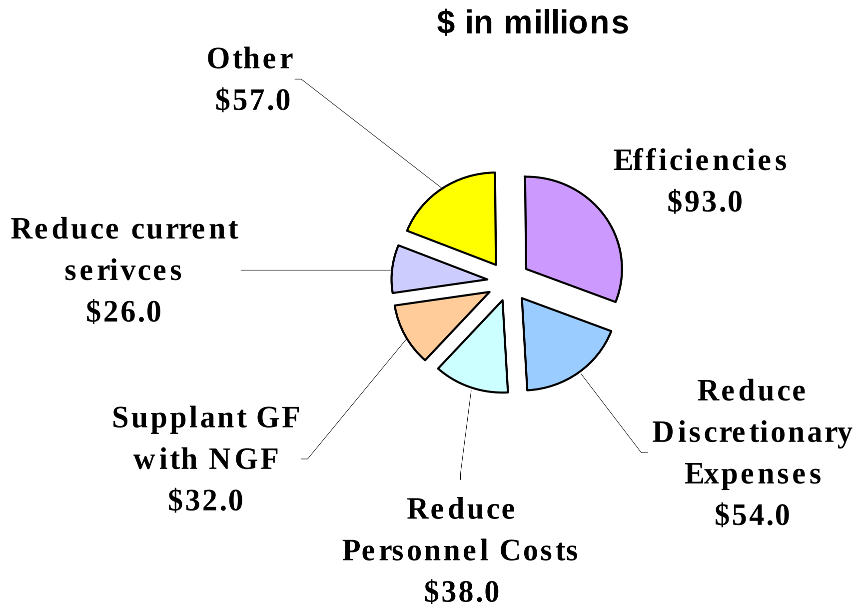
Agency budget reductions proposed

- To help close the $641.1 million budget gap, in October Governor Kaine presented $300.3 million in agency budget reductions for FY 2008.

- Two-thirds of the general fund base, or $11.5 billion, was exempted from budget reductions (SOQ, aid to individuals, debt service).

- Cuts of about 5 percent on average were applied to a base of $5.8 billion. Higher education agencies saw reductions of 5 to 6.25 percent, absorbing roughly $83 million of the reductions.

- Budget reduction strategies include:



Detail on the reductions is included in Appendix III.

Other reduction strategies

- In addition to budget reductions proposed by the Governor, roughly $100 million in FY 2007 general fund agency balances were identified.
- The SFC revenue forecast adds about $100 million above the Governor's August reforecast for FY 2008. Lottery proceeds have been adjusted upward by $45 million.
- Since August, budget savings in Medicaid and K-12 have been identified, but are offset by additional costs for CSA, Comp Board, and other areas in FY 2008 bringing the shortfall to about $150 million.

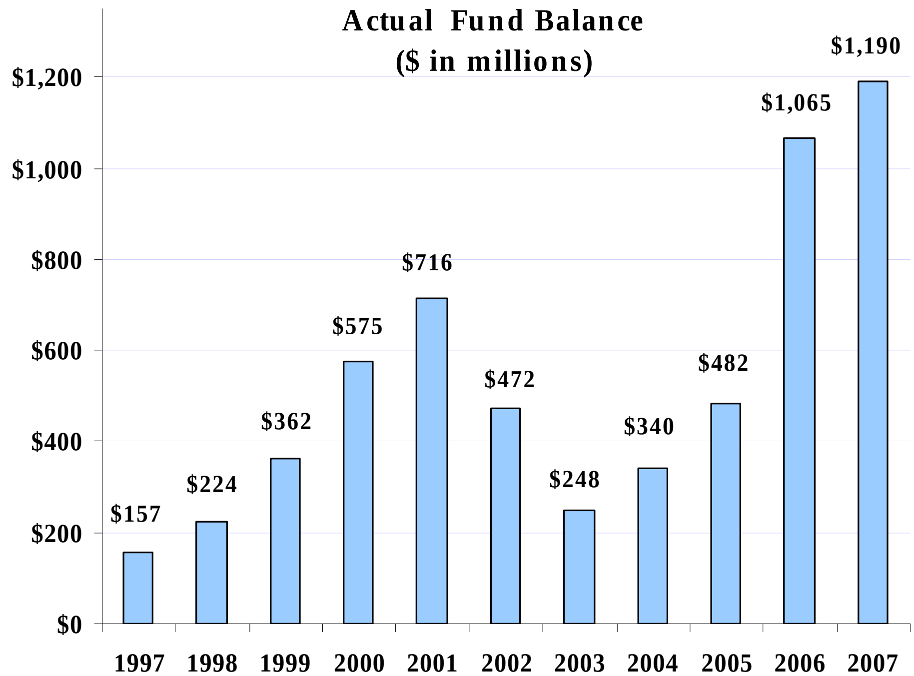
2006-08 Biennial Budget Shortfall	**($641.1)**
SFC Revenue Adjustment/Lottery	**145.0**
Revised Shortfall Amount	($496.1)
Agency Budget Reductions	$300.3
General Fund Balances	100.0
FY 2008 Budget Savings	
Medicaid	$49.7
K-12 ADM (estimated)	25.0
Other	31.5
FY 2008 Additional Costs	
Comprehensive Services Act	($54.3)
Comp Board, Criminal Fund	(39.4)
Other	(63.7)
Revised 2006-08 Shortfall	**($147.0)**

Strategies to address the remaining shortfall

Potential strategies to address the remaining $150 million shortfall include:

- Direct state agencies to make further FY 2008 reductions.
  - Timing of the adopted budget makes this a limited option.
- Revert discretionary balances that agencies were allowed to carry forward.
- Eliminate or defer one-time spending items.
  - Over $1.2 billion in general fund capital outlay projects were appropriated in the 2006-08 biennium.
  - Also, one-time funding for water quality and transportation could be deferred.
- Or, the Governor may <u>propose</u> a withdrawal from the Rainy Day Fund in his "caboose" budget bill to address the 2006-08 budget shortfall.

Rainy Day Fund



- A withdrawal can only be made for a shortfall in the current enacted budget.

- Based on the SFC revenue forecast for FY 2008, the maximum withdrawal would be about $250 million, or about one-half of the roughly $500 million shortfall, subject to the final caboose bill.

  - **Net** benefit to the general fund would be about $191 million (due to lost interest earnings scheduled to be transferred to the general fund).

- **The General Assembly has the final say on whether a withdrawal is the best strategy, and must weigh this strategy against other options.**

Developing the 2008-10 budget: What does it cost to fund current services?

- The biennial base budget is the approximate cost of maintaining current services and caseloads.

- The operating budget for FY 2008 (from Chapter 847, 2007 Appropriation Act) is the starting point.

  - Any one-time spending items are deducted from the base (e.g., non-state agencies, Rainy Day Fund payment, water quality funding).

  - The incremental cost of any items funded for only part of FY 2008 (e.g., employee salaries, rent) is added to the base.

2008-2010 Base Budget Calculation
($ in millions)

Ch. 847 FY 2008 GF Operating	**$17,333.1**
Minus: One-time costs & savings	($415.0)
Plus: Annualized partially funded costs	$83.4
Total, Adjustments to Base	**($331.6)**
Adjusted Annual GF Base	**$17,001.5**
SFC Biennial (Two-Year) Base	**$34,003.0**

How do forecast revenues compare to the cost of continuing the current base budget?

- Based on the SFC staff forecast, about $2.1 billion in new general fund revenue should be available in the 2008-10 biennium.

		($ in millions)	
	FY 2009	FY 2010	2008-10
Revenue Growth Rates	3.3%	6.6%	
SFC Forecast	$16,666.9	$17,766.5	$34,433.4
Lottery & Transfers	825.8	842.1	1,667.9
Total GF Revenues	**$17,492.6**	**$18,608.7**	**$36,101.3**
GF Base Budget	**$17,001.5**	**$17,001.5**	**$34,003.0**
Resources Above Base	*$491.1*	*$1,607.2*	*$2,098.3*

- First claim against the available new revenue will be to cover mandated and other high priority cost increases for the next biennium.
  - **Existing statutory commitments.**
  - **Increasing caseloads or related issues.**
  - **Revised costs of providing services, based on updated data (re-benchmarking or rebasing).**

Mandates and selected traditional, high priority funding items total about $2.5 billion

Funding Item	FY 2009	FY 2010	2008-10
K-12 SOQ Re-benchmarking	**$555.0**	**$645.0**	**$1,200.0**
Medicaid Utilization and Inflation	**38.6**	**185.2**	**223.8**
Comprehensive Services Act	**65.4**	**93.2**	**158.6**
DSS Offset Federal Revenue Losses	17.0	17.0	34.0
Foster Care/Adoption Subsidies	3.4	7.1	10.5
S-CHIP Utilization and Inflation	4.1	6.2	10.3
VRS Rate (excludes teachers)	32.3	33.8	66.1
Health Ins, Other Employee Benefits	26.8	27.9	54.7
Debt Service Requirement	54.9	81.6	136.5
Public Safety - New facilities on line	0.0	14.1	14.1
Public Safety - Operating Costs	27.4	34.9	62.3
HB 599 Funding	7.6	21.6	29.2
Comp Board: Jail per diem, staffing	47.3	63.7	111.0
Criminal Fund	16.1	16.1	32.2
HE New Facilities On-line	8.2	16.7	24.9
HE Interest Earnings/Rebates	17.0	17.0	34.0
VITA Payment Adjustments	10.0	10.0	20.0
Econ. Dev Incentive Payments	16.7	14.7	31.4
Equipment for Capital Projects	47.4	47.4	94.7
Maintenance Reserve	50.0	50.0	100.0
Total	**$1,045.2**	**$1,403.2**	**$2,448.3**

SOQ Re-benchmarking: The formula-driven "technical" update of costs

- Re-benchmarking is the formula-driven cost increase to meet the public education Standards of Quality (SOQ) minimum staffing requirements and related support services.

  - Updated for each biennial budget.

  - Based on current cost calculation methods only.

  - Does not include any changes in policy.

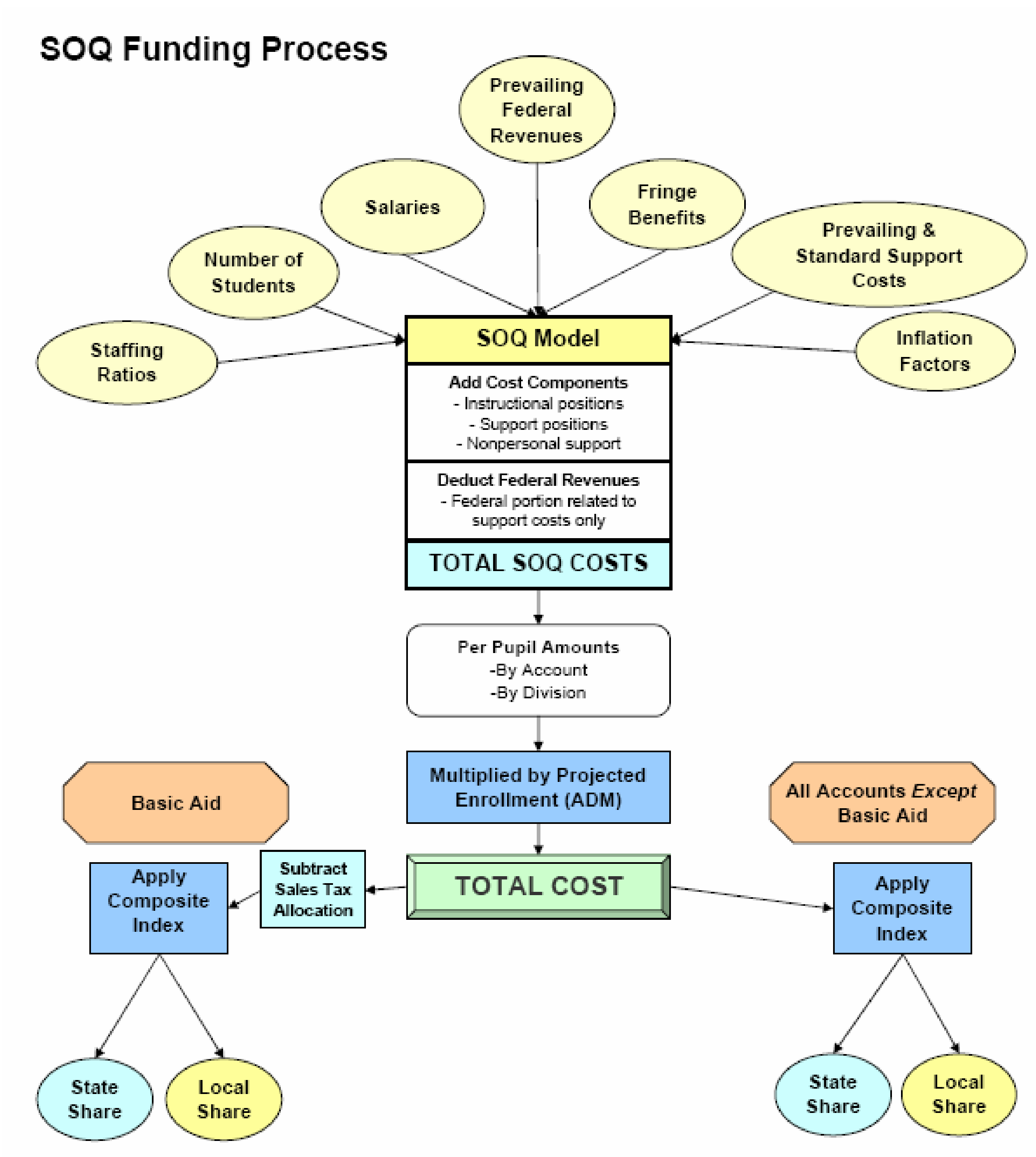
- **Article VIII of the Constitution of Virginia.**

  - **Section 2.** "Standards of quality for the… school divisions shall be determined and prescribed from time to time by the Board of Education, subject to revision only by the General Assembly.

    The General Assembly shall determine… the cost… and shall provide for the apportionment… between the Commonwealth and the local units of government…

    Each…local government shall provide its portion… by local taxes or… other funds."

SOQ Re-benchmarking: Costs are reconstructed, top to bottom



Source of graphic: Virginia Department of Education (VDOE)

SOQ Re-benchmarking: Timeline

- **September 15, 2006** – Deadline for school divisions to submit FY 2006 Annual School Report (ASR) revenue and expenditure data to DOE.
  - FY 2006 forms the "base year" for 2008-10 re-benchmarking.
- **Late 2006 through Spring/Summer 2007** – DOE reviews, loads, and runs available data for 2008-2010 biennium (FY 2009 & FY 2010) re-benchmarking.
  - Base year prevailing non-personal expenditures are adjusted for inflation.
  - Base year Prevailing Salary averages are adjusted for FY 2007 & FY 2008 compensation supplements.
- **July 25, 2007** – DOE presented a preliminary biennial cost increase for Direct Aid of **$1.1 billion**.
- **October 12, 2007** – VRS Board approves actuary's rates.
- **October 15, 2007** – September 30 enrollment data due.
- **Mid-November 2007** – Composite index to be released.
- **December 17, 2007 –** All factors since July 25 will be incorporated prior to the Governor's Proposed Budget.

SOQ Re-benchmarking: Putting the increase in context

- The 2006-08 re-benchmarking cost increase was similar in magnitude at $1.3 billion.
- Re-benchmarking is a two-year figure: $520 million in FY 2009, $581 million in FY 2010.
  - The FY 2008 "base budget" amount is $5.95 billion. For biennial budgeting, the "base budget" is 2 times this FY 2008 amount - $11.9 billion.

Biennial Basis

	($ in millions)	Increase	
FY08 Base Budget	$ 5,951		
FY09	$ 6,471	$ 520	
FY10	$ 6,531	$ 581	
		$ 1,102	**9.3%**

- Shown on an annual, rather than biennial, basis:

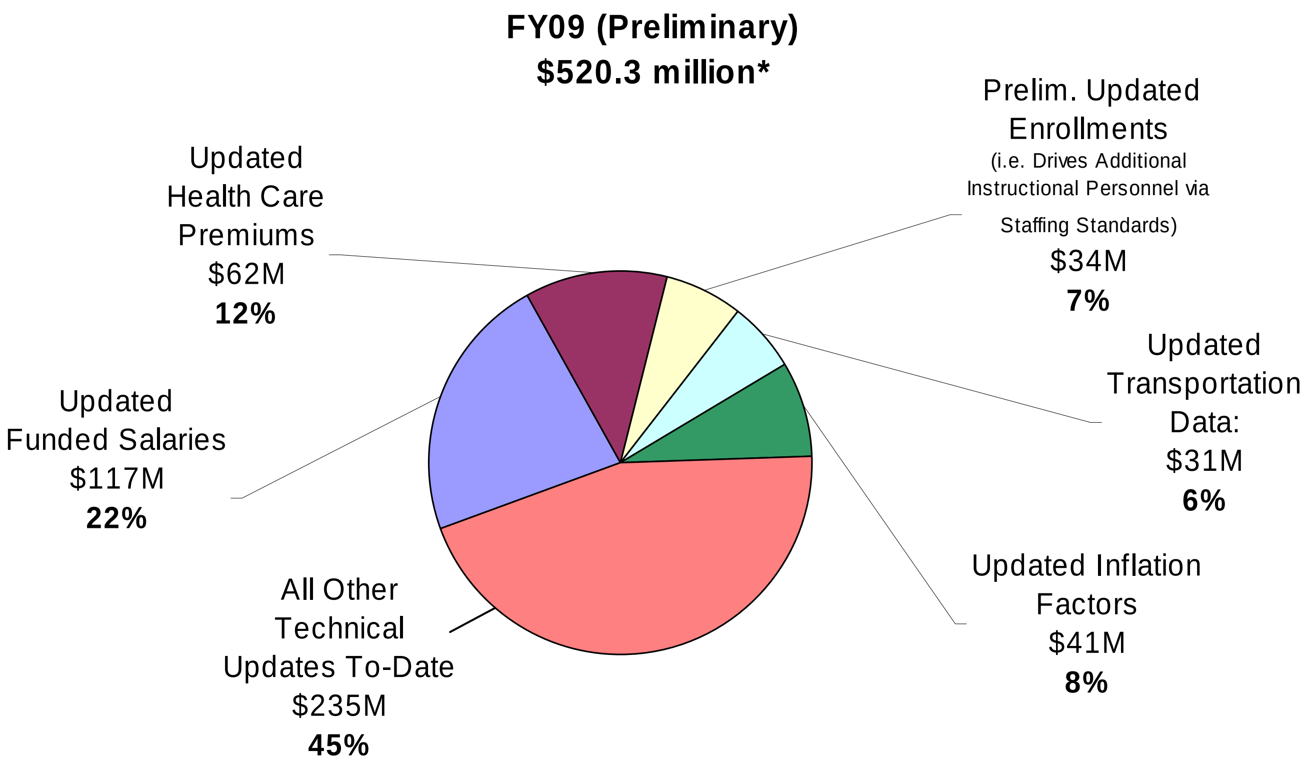
Annual Basis

	($ in millions)	Increase	
FY08 Base Budget	$ 5,951		
FY09	$ 6,471	$ 520	**8.7%**
FY10	$ 6,531	$ 61	**0.9%**

SOQ Re-benchmarking: What cost factors are driving the preliminary figure?

- The preliminary figure reflects 22 separate steps in updating the data in the SOQ computer model. Those steps can be grouped into six key categories: **funded salaries, health care premiums, inflation factors, projected enrollment, pupil transportation, and all other.**

  - The largest single factor – salaries – accounts for 22% of the cost increase.



SOQ Re-benchmarking: First, what does "prevailing" mean?

- For cost components for which there is no quantifiable standard that can be applied, *such as for salaries*, prevailing costs are used.

- Conceptually, "prevailing" simply means:

  - **What most school divisions spend.**

- In the context of SOQ re-benchmarking, "prevailing" has a very specific operational definition. Instead of being simply the mathematical average, it is the:

  - **Linear Weighted Average (LWA), with costs clustered around the middle <u>weighted 5 times</u> higher than of the costs at the low or high extremes.**

  - **<u>Example:</u>**

    The simple mathematical *average* of the following 9 values:
    28, 30, 32, 33, 34, 35, 36, 40, and 58 = **36.2**

    The *Linear Weighted Average* of those same 9 values is the mathematical average of:
    28, 30, 30, 32, 32, 32, 33, 33, 33, 33, 34, 34, 34, 34, 34, 35, 35, 35, 35, 36, 36, 36, 40, 40, and 58 = **34.9**

SOQ Re-benchmarking: Funded Salaries

- **Prevailing Salary** – The Linear Weighted Average of the 132 school division salary averages in the base year (FY 2006 = $43,158).

- **Funded Salary** – The Prevailing Salary is adjusted for compensation supplements provided in the prior Appropriation Act.

Secondary Teachers[1]	2006-08	2008-10	Percent Increase
Prevailing Salary	$40,403 (FY2004)	$43,158 (FY2006)	6.8%
Compensation Supplements	↓	↓	
FY05 = 0.0			
FY06 = 3.0	+3.0%		
FY07 = 4.0			
FY08 = 3.0		+7.12%	
Funded Salary	$41,615	$46,230	11.1%

[1]Separate funded salary amounts are calculated for: elementary teacher, elementary assistant principal, elementary principal, secondary teacher, secondary assistant principal, secondary principal, and instructional aide.

- *The actual average salary for all classroom teachers, which is weighted for the number of teachers, for FY 2004 was $43,936 and increased 7.5 percent over two years to $47,248 in FY 2006.*

SOQ Re-benchmarking: Other data elements driving the preliminary estimate

- **Health care premiums:** Increased 22 percent from $4,274 for FY 2004 to $5,211 for FY 2006.

- **Inflation factors:** The (un-weighted) average of the funded non-personal support inflation factors was 5.39 percent.

- **Enrollment:** The initial statewide enrollment projections anticipate:

  - 1,210,373 Average Daily Membership in FY 2009, an increase of 10,672 students, or 0.89 percent, over FY 2008; and 1,221,682 in FY 2010, an increase of 11,309 students, or 0.93 percent, over FY 2009.

  These net statewide figures reflect both increases and decreases at the local school division level.

- **Textbooks:** The funded per pupil amount increased 17 percent from $101.81 to $119.39.

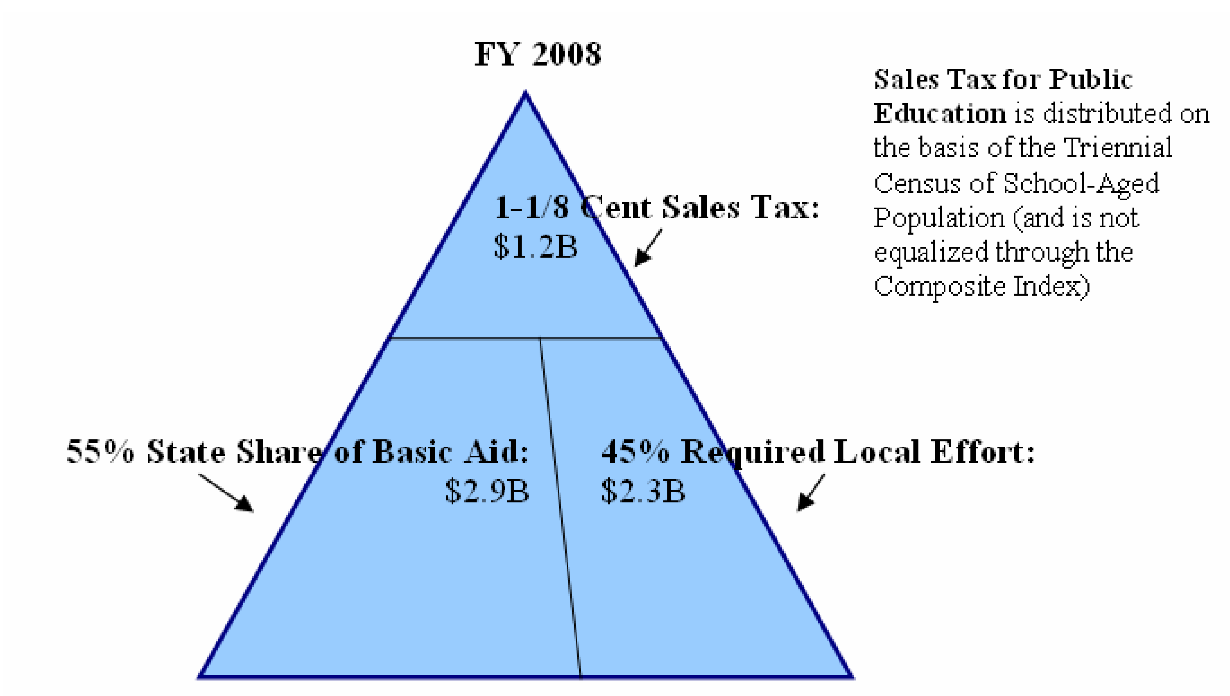
- **Expenditure data:** Total school division operating expenditures (from all revenue sources) increased 16 percent from FY 2004 to FY 2006. Significant additional state dollars were provided for education in the 2004 Session (FY 2005 and FY 2006), so 2008-10 is the first time the base year for re-benchmarking reflects those actions from the 2004 Session.

SOQ Re-benchmarking: Other factors that will affect the final cost of about $1.2B (est.)

- **Sales Tax for Public Education.** Assuming growth rates of 3.2% in FY 2008, 5.3% in FY 2009 and 6.0% in FY 2010, net SOQ funding would increase by **<u>$48 million</u>**.

- **Composite Index of Local Ability-to-Pay.** The net state cost is expected to be about **<u>$10 million</u>**. Locality-by-locality there will be winners and losers.

    - True value of real property, adjusted gross income, retail taxable sales, population, and ADM data is updated from 2003 to 2005.



Actual percentages for individual school divisions range from a maximum 80% local share to less than 20% local share depending on the locality's composite index.

SOQ Re-benchmarking: Other factors that will affect the final cost of about $1.2B (est.)

- **VRS rates.** The VRS Board approved an employer contribution rate of 11.84 percent, up from the 10.30 percent funded in the FY 2008 budget.

  The approved rates for the Retiree Health Care Credit and Group Life rates are down slightly from FY 2008.

  The net cost of these rates would be about **<u>$79 million</u>**.

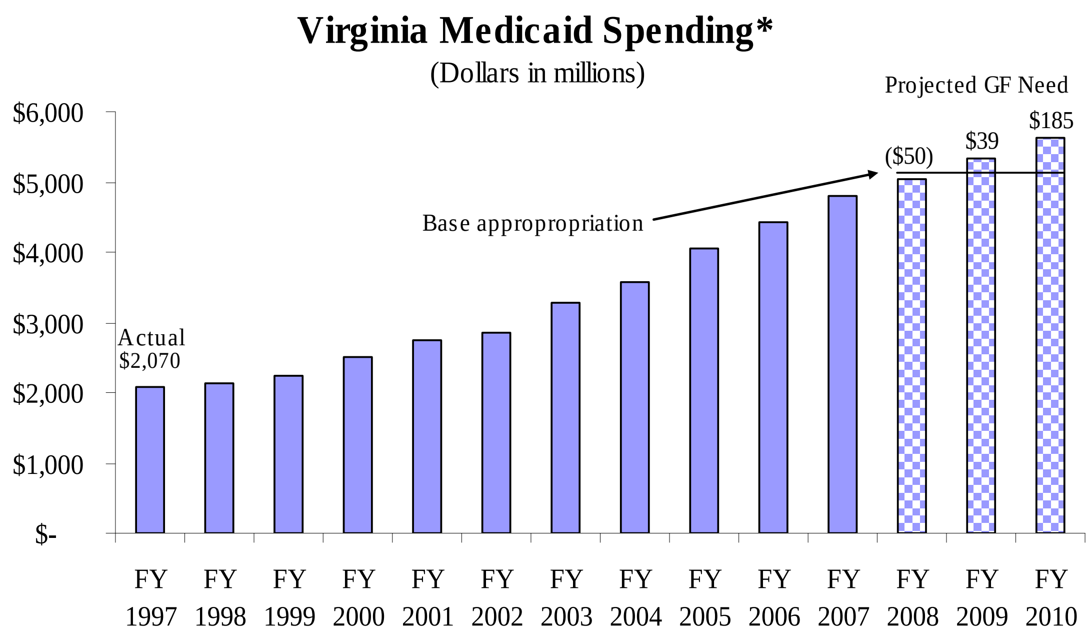
- **Lottery.** Profits are projected to be up $44 million for FY 2009 and FY 2010 over the FY 2008 budgeted levels.

  - The usual split is about 60 percent supporting SOQ costs and the rest distributed to school divisions on a per pupil basis. This would result in a net increase in Direct Aid of about **<u>$35 million</u>**.

- **"Final" enrollment projection.** Actual September 30, 2007 enrollment grew just <u>0.15 percent</u> over September 30, 2006 enrollment.

  - As a result, **<u>the preliminary cost estimate due to projected enrollment growth will be reduced</u>**.

Projected Medicaid Spending



* Does not include state mental health and mental retardation facilities.

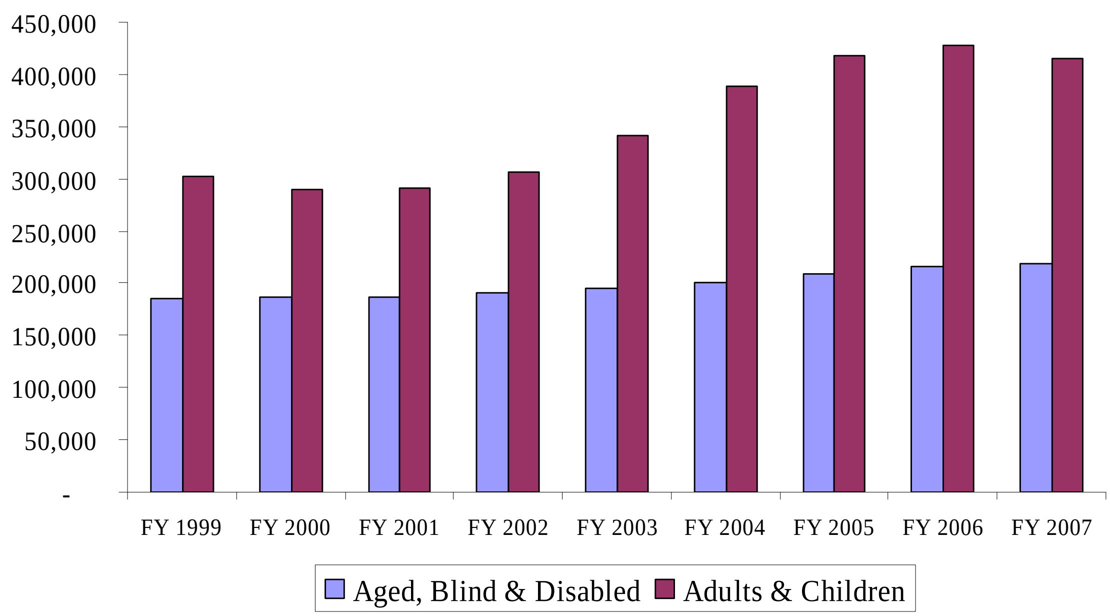
- Medicaid spending continues to slow compared to previous years.
  - General fund spending was $66 million less than anticipated last year, and expected to be $50 million less than originally forecast in FY 2008.
  - Lower than expected enrollment among low-income children and families and a reduction in payments for managed care accounts for most of the projected cost savings.
- The preliminary Medicaid forecast anticipates average annual growth of 5 to 7 percent, resulting in additional general fund needs of $224 million in FY 2008-10.

Recent Trends in Medicaid Enrollment

- Enrollees who are aged, blind, and disabled – the most expensive population in Medicaid on a per capita basis – continue to grow at a steady rate of 3 to 4 percent annually.

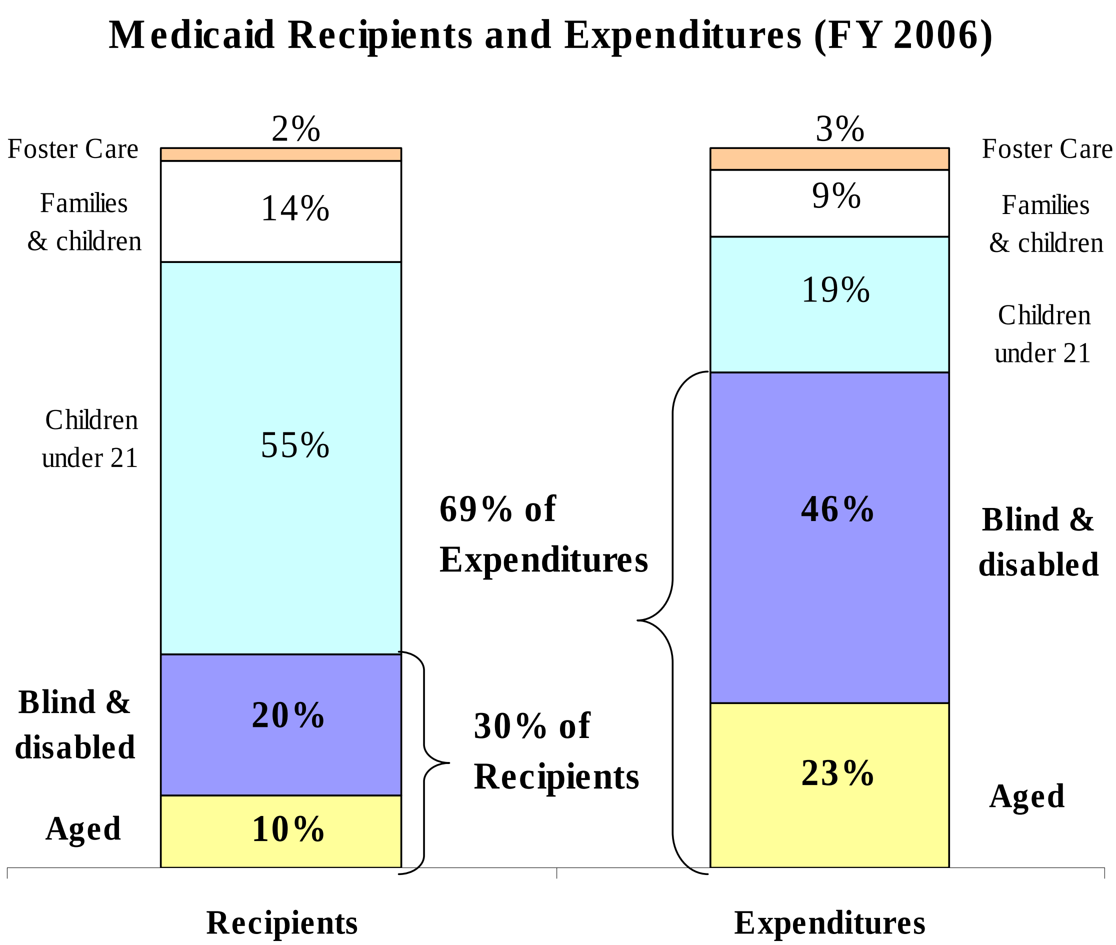
  – The number of low-income children and adults enrolled in Medicaid has remained virtually unchanged in the past two fiscal years.

Medicaid Enrollment (July 1999 - July 2007)



Medicaid Recipients and Expenditures

- Individuals who are aged, blind, and disabled account for 69 percent of expenditures but only a fraction of all Medicaid recipients.



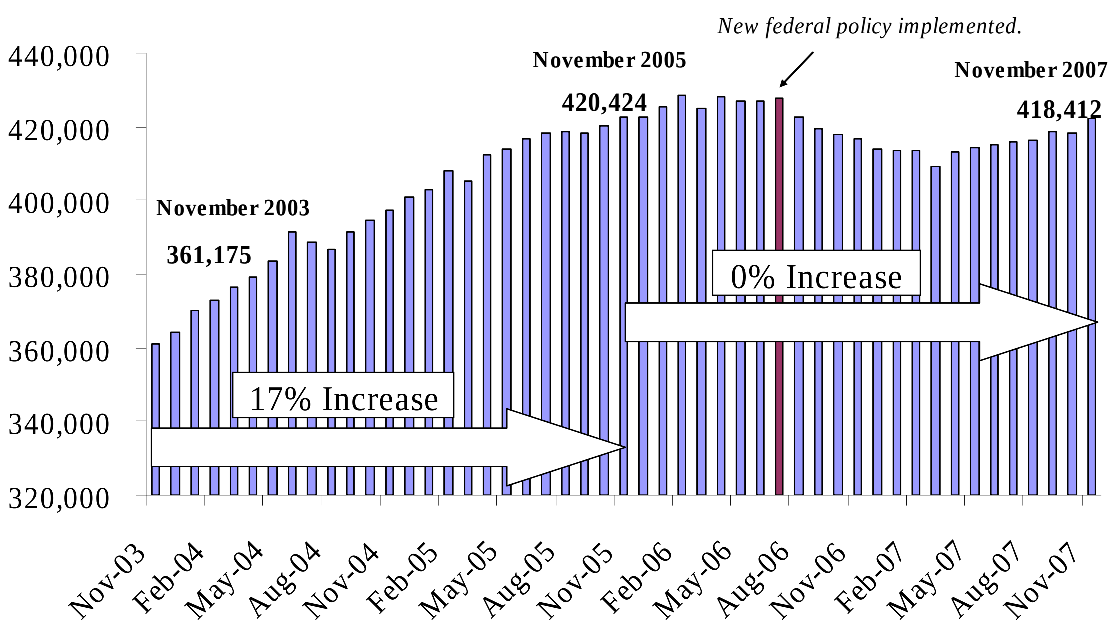
Low-income Children and Adults on Medicaid

- After a sharp rise in enrollment, the number of low-income children and adults receiving Medicaid has remained unchanged in the past two years.

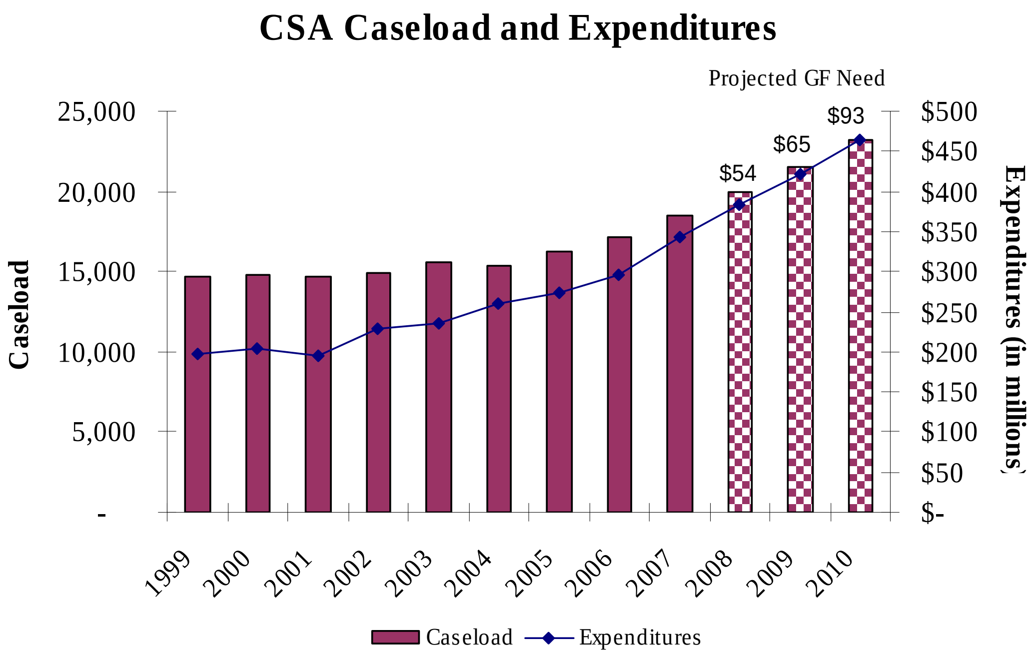
  – On July 1, 2006, the federal government began requiring Medicaid recipients to document their identity and citizenship;

  – The policy appears to have temporarily slowed the growth in enrollment of low-income children and adults.

Monthly Medicaid Enrollment (Adults & Children)



Comprehensive Services Act for At-Risk Youth and Families (CSA)



- From FY 1999 through FY 2004, CSA caseloads remained flat, hovering around 15,000 children.
  - During the same time period, expenditures grew at an average annual rate of 7 percent.
- The number of children receiving services through CSA began to increase significantly in FY 2005. In FY 2007, 1,300 children were added to the program and eight percent annual caseload growth is anticipated in the next biennium.
- A shortfall of $54 million GF in FY 2008 and $158 million GF in FY 2008-10 is expected for CSA as expenditures grow at 10 percent annually.

What's Driving CSA Expenditure Growth?

- Federal policy changes, more intense utilization of services, higher payment rates, and additional children are contributing to higher CSA expenditures.

- Local CSA officials report an overall increase in caseloads including more cases of abuse and neglect, higher referrals for special education in communities with a strong military presence, increases in court-ordered referrals, sibling groups and cases involving substance abuse.

- Responding to guidance from the Attorney General's Office and a report from JLARC, CSA officials implemented a new policy this year that requires the provision of mental health services for children who are "at-risk" of placement.

  - This policy appears to be a contributing factor in the overall increase in children being served in CSA.

Other funding pressures for 2008-2010

- **Employee and Retiree Benefits:** Costs increases for employee and retiree benefits will be about **$126 million**.

  - Adjusting VRS to the 2008-10 actuarial rates requires $66 million.

  - Employee health insurance costs are expected to grow about 8 percent, requiring funding of $61 million.

- **Debt Service:** Additional debt service payments on state-supported bonds will require $**137 million** next biennium.

- **Comp Board:** Adjustments for jail per diems and new sheriff staffing requires **$111 million** next biennium.

- **Public Safety:** The costs of new prisons coming on-line, as well as operating expenses for existing correctional facilities and State Police require another **$75 million**.

Other traditional, high priority items

- **Capital Outlay:** New state facilities coming on-line in the next biennium will require about **$95 million** in furnishings and equipment.

  - Based on a documented backlog of over $1.0 billion, minimum funding for Maintenance Reserve would be about **$100 million**.

- **Higher Education:** About **$197 million** in additional funding represents the cost to close the gap for "base adequacy" for Virginia's public colleges and universities.

- **Student Financial Aid**: To phase-in adequate financial aid funding for students attending Virginia's public institutions requires about **$102 million.**

- **Salary Increases for State & State-Supported Local Employees, Faculty, and Teachers:** The cost of providing a **1 percent** salary increase in each year of the biennium for all of the major employee groups is **$175 million**.

Summary: 2008-10 Budget Picture

- Based on revenue projections for the next biennium, SFC staff estimates about $2.1 billion in additional resources will be available.

- The first call against the new resources will be about $2.5 billion in mandated and/or high priority funding items.

		($ in millions)	
	FY 2009	**FY 2010**	**2008-10**
SFC Staff Forecast	**$17,492.6**	**$18,608.7**	**$36,101.3**
Base Budget	**$17,001.3**	**$17,001.3**	**$34,002.7**
Resources Above Base	**$491.3**	**$1,607.4**	**$2,098.6**
Spending Adjustments	**$1,045.2**	**$1,403.2**	**$2,448.3**
Difference	**($553.9)**	**$204.2**	**($349.7)**

- FY 2009 spending -- the base budget plus mandated/high priority items -- is out of balance with projected revenues for the year.
  - Part of the problem -- no projected balance forward from FY 2008.

- Revenues and spending are more in line in the second year of the biennium due to a higher projected revenue growth rate of 6.6 percent.

How to balance the 2008-10 budget?

- In order to balance available revenues and spending in the 2008-2010 biennium, actions will be required to:

  - Reduce base budgets.

    -- Extend the cost-cutting reductions in place for FY 2008 into each year of the next biennium.

    -- Based on the Governor's proposal, this approach could generate some **$250 to $300** million per year.

  - Reduce or phase-in new required spending;

  - Generate additional resources by creating a general fund balance in FY 2008 that rolls forward into FY 2009.

- One-time spending adopted in the 2006-08 biennium for capital outlay, transportation, or water quality could be deferred.

Challenges of the 2008 Session

- First, decisions will need to be made about how to address the budget shortfall in the current 2006-08 biennium.

  - "Caboose bill" proposed by the Governor will include his savings identified in October, along with other strategies to close a remaining $150 million gap.

- The next priority will be to eliminate the "structural imbalance" that exists between revenues and spending requirements in the first year of the 2008-10 biennium.

- In addition, other potential budget issues for the 2008 session include:

  - Access to mental health and campus safety.

  - Modifications to the 2007 transportation program.

  - Governor's initiatives on access to health care and early childhood education.

- Given the uncertain economic outlook, and the structural imbalance in the first year, caution is the watchword about new initiatives or expansion of existing commitments.