2009 Session Budget Outlook

- **Revenues for the 2008-10 biennium will likely fall short by about $3.2 billion.**

  - Combined with spending pressures from high-priority, mandated programs of about $350 million, the budget shortfall could be closer to **$3.5 billion**.

  - Actions to address about $1.0 billion of the problem in FY 2009 have been proposed and are being implemented.

  - The remaining $2.5 billion problem will need to be addressed in the 2009 Session.

- **Closing the budget gap will take a combination of strategies.**

  - Cuts to agency budgets will include both across-the-board reductions and targeted reductions.

  - Reductions in state aid programs are likely.

  - Revenue sources may need to be considered.

  - One-time strategies should be limited.

- **Looking ahead to the 2010-12 biennium.**

  - Actions taken this session impact the next biennial budget.

  - Meaningful, permanent changes to the budget may take more time and thought than possible in a short session.

What makes this budget problem so painful?

In contrast to recent recessions, the impact of this one may be more widespread.

- State revenues are down, as are those for local governments.
  - Falling home and car values will have a significant impact on local tax revenues.
- Transportation revenues are also down significantly due to falling demand for gasoline and fewer new and used car sales.
- Colleges will find it harder to turn to tuition to help offset reductions in general funds.
  - Parents and students are feeling the downturn as well, with less access to home equity lines and fewer loan dollars available.
  - Returns on endowments will be down, combined with less private giving.
- Last period of revenue and budget constraints ended less than five years ago.
- No real end in sight --- may take a long time for the "U-shaped" recovery to turn back up.

Revenue actions through the 2008 Session

Budget cutting began a year ago…

- **August, 2007:** FY 2007 revenues fell short of the forecast by 1.5 percent, requiring the Governor to revise the forecast for FY 2008. Through administrative action, the Governor trimmed some $300 million in spending from the FY 2008 budget.

- **2008 Session:** Slower revenue growth was anticipated, based on the lowered FY 2008 forecast, and $300 million in reductions were continued in each year of the 2008-10 biennial budget.

  - ***February, 2008:*** Year-to-date revenue collections through January prompted a downward revision to the forecast.

    - As budgets were about to be reported, money committees trimmed another $323 million from the FY 2008 budget, and roughly $500 million **from each year** of the introduced 2008-10 budget.

  - In total, $1.9 billion of reductions were approved in the 2008-10 budget.

  - Strategies to cover the shortfall included:

    - Reducing proposed discretionary spending,

    - Reverting $100 million in state aid to localities, and

    - Moving GF capital outlay and transportation projects to debt to create balances in FY 2008 that rolled forward into FY 2009.

Key revenues underperform in FY 2008

- **October, 2008:** FY 2008 ended with a small surplus of $6.5 million – but that surplus masked overall weakness in the major revenue sources. Individual income (withholding and non-withholding) and sales tax revenues fell short.

  - 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.

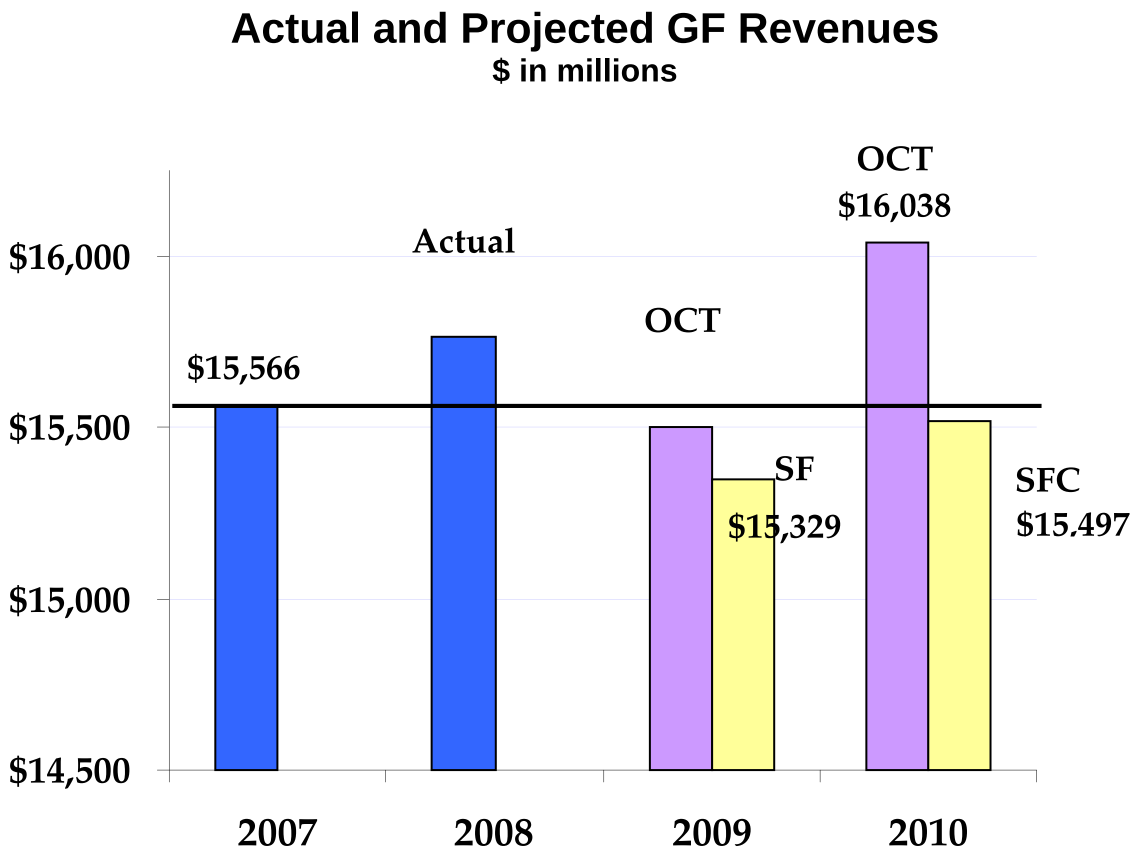
- Although the 1 percent threshold was not reached, the Governor initiated the revenue reforecasting process for fiscal years 2009 and 2010.

- In October the Governor issued a new revenue forecast for FY 2009 and FY 2010. SFC staff analysis suggests that further downward revisions will be needed.

October 2008 Rev. Forecast with SFC Adjustment

GF Revenues	FY 2009	*($ in millions)* FY 2010	2008-10
Budget as Adopted	**$16,474.7**	**$17,577.6**	**$34,052.3**
Oct. Revised	($973.6)	($1,540.1)	($2,513.7)
SFC Adjustment	*($172.1)*	*($539.8)*	*($711.9)*
Total Reductions	($1,145.7)	($2,079.9)	($3,225.6)
Revised Forecast	**$15,329.0**	**$15,497.7**	**$30,826.7**

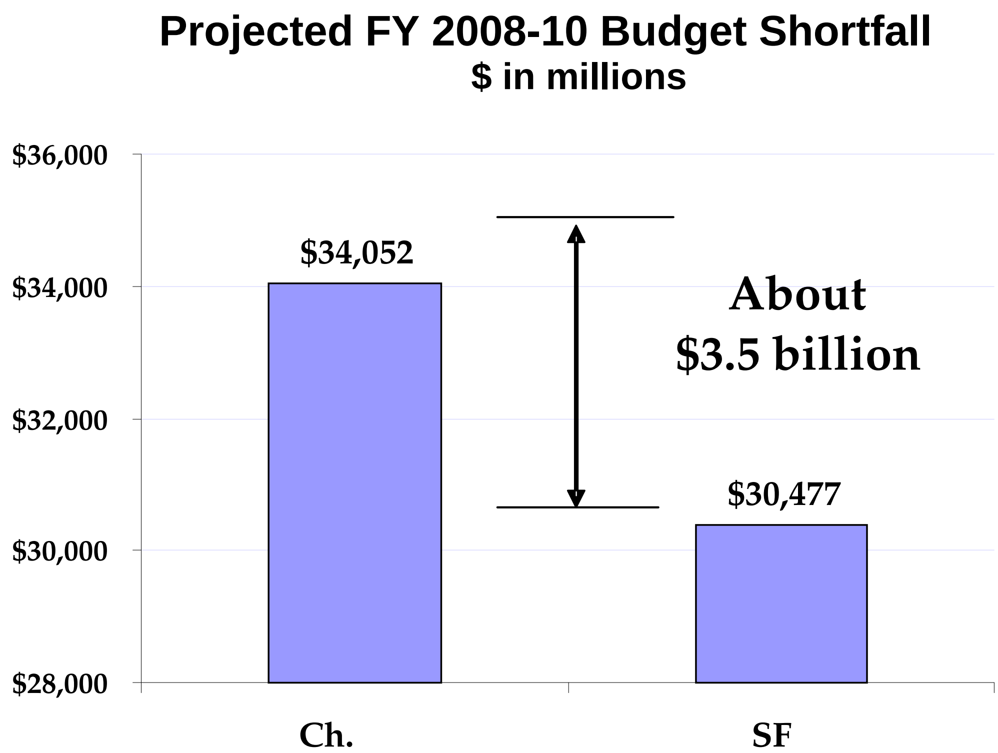
2008-10 Budget Picture, Revised



- In addition to the revenue shortfall, additional funding of about $350.0 million may be required for mandated or high priority programs.

	FY 2008-10
Medicaid, FAMIS, S-CHIP	$336.3
DSS Adoption Subsidies	3.7
Public Safety (new facilities, fuel costs)	36.1
Criminal/Invol. Mental Com. Fund	20.0
Employee Health Insurance	39.2
Savings	
Net K-12 Lower ADM, Sales Tax	$(80.7)
HB 599 Revenue Adjustment	(13.1)

2008-10 Budget Shortfall



Options for closing the budget gap

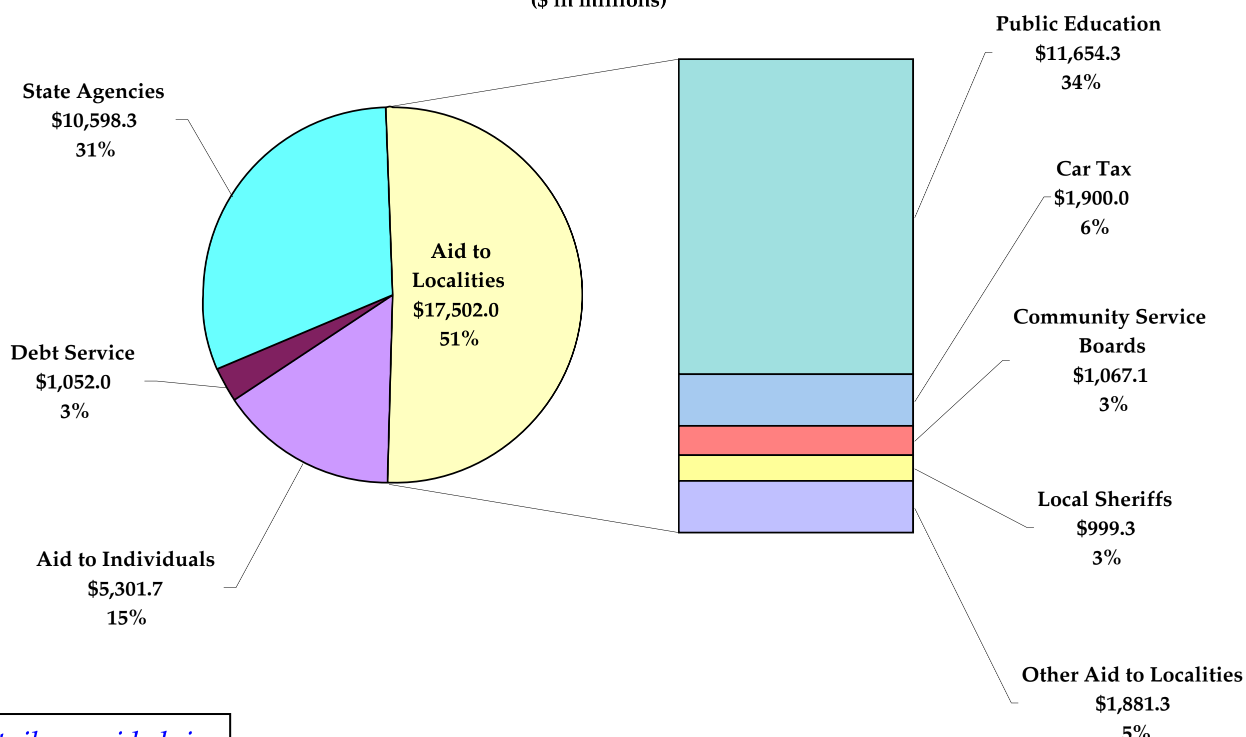
- Reduce agency budgets.
- Reduce state aid programs to localities or individuals (two-thirds of the general fund budget).
- Generate one-time revenues or savings.
- Increase on-going revenues.
- Shift costs to nongeneral fund sources.

What drives the state budget

The general fund operating budget for 2008-10 totals about $34.5 billion.

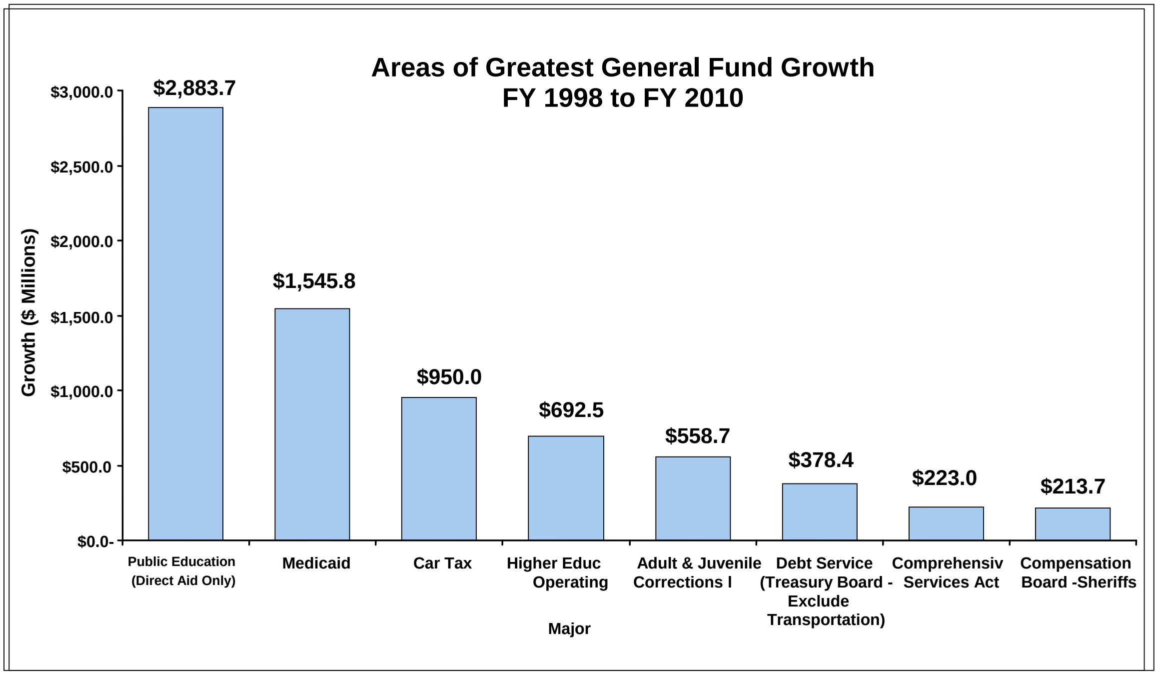
- What comprises the GF budget?
- What are the major budget drivers?
- What are the budget and policy choices made in recent years?

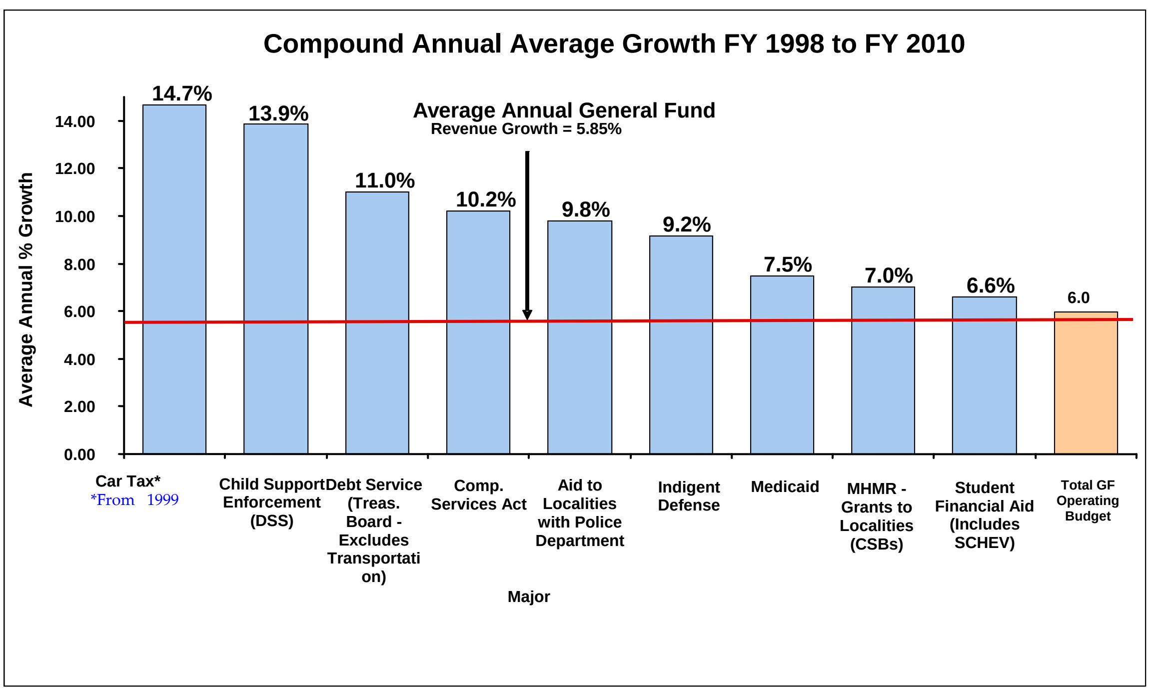
2008-2010 GF Operating Budget = Chapter
($ in millions)



Detail provided in Appendix

Growth in the GF Budget, 1998-2010





- Tax policy actions detailed in Appendix.

Closing the budget gap – FY 2009

- To address the downward revision in revenues, the Governor proposed the following actions in October:

	($ in millions) FY 2009
Revenue Shortfall	**$973.6**
One-time Actions	
Rainy Day Fund (balance of $1.0 billion)	$400.0
Move GF capital to debt	250.0
Literary Fund Balance, other agency balances	92.0
August Redux and unappropriated balance	24.4
Tuition Moderation Fund balance	6.2
Subtotal, One-time Actions	$ 772.6
Selected Reductions	
Delay first year salary increase to July 1, 2009	$44.7
Across-the-Board Reductions - Non-exempt	
Agency Budget Reductions	$279.0
GF Revenue-Related Adjustments	
K-12 Sales Tax Reduction	20.7
HB 599 Reduction	7.7
Total	**$1,124.7**
Planned balance forward for FY 2010	**$151.1**

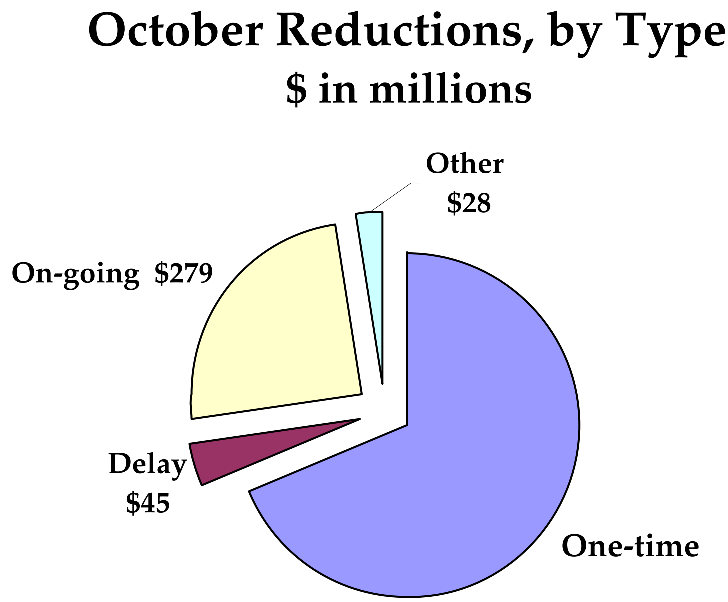
- SFC forecast lowers FY 2009 revenues by another $172.0 million. Plus, Medicaid spending is projected to be short by $136.0 million. These amounts could be covered by:

  - Increase withdrawal from the Rainy Day Fund (up to one-half of shortfall, or about $500 million), and

  - Eliminate planned balance forward.

Closing the budget gap – FY 2009

- One-time savings represent about 70 percent of the reductions in FY 2009.



- On-going savings include $279.0 million in agency budget reductions. Employee layoffs total 567.

- Cuts of about 7.5 percent on average were applied to a base of $3.7 billion.

  - Higher education agencies saw reductions of 5 to 7 percent, absorbing roughly $83.0 million of the reductions.

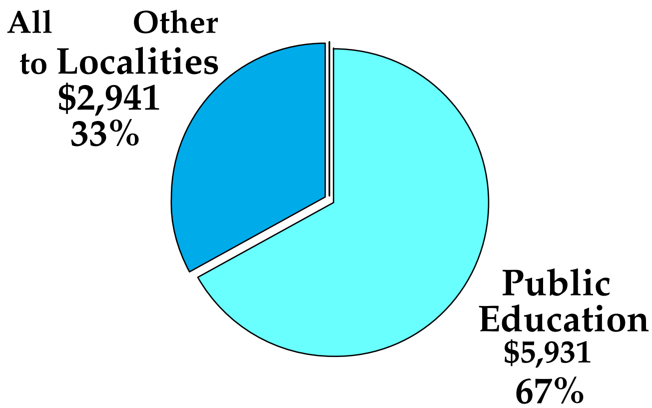
- The Appropriation Act limits the Governor's authority to withhold operating authorization for no more than 15 percent cumulatively of the annual general fund appropriation contained in the act for operating expenses of any one state or non-state agency or institution.

Across-the-board reductions – what's in, what's out?

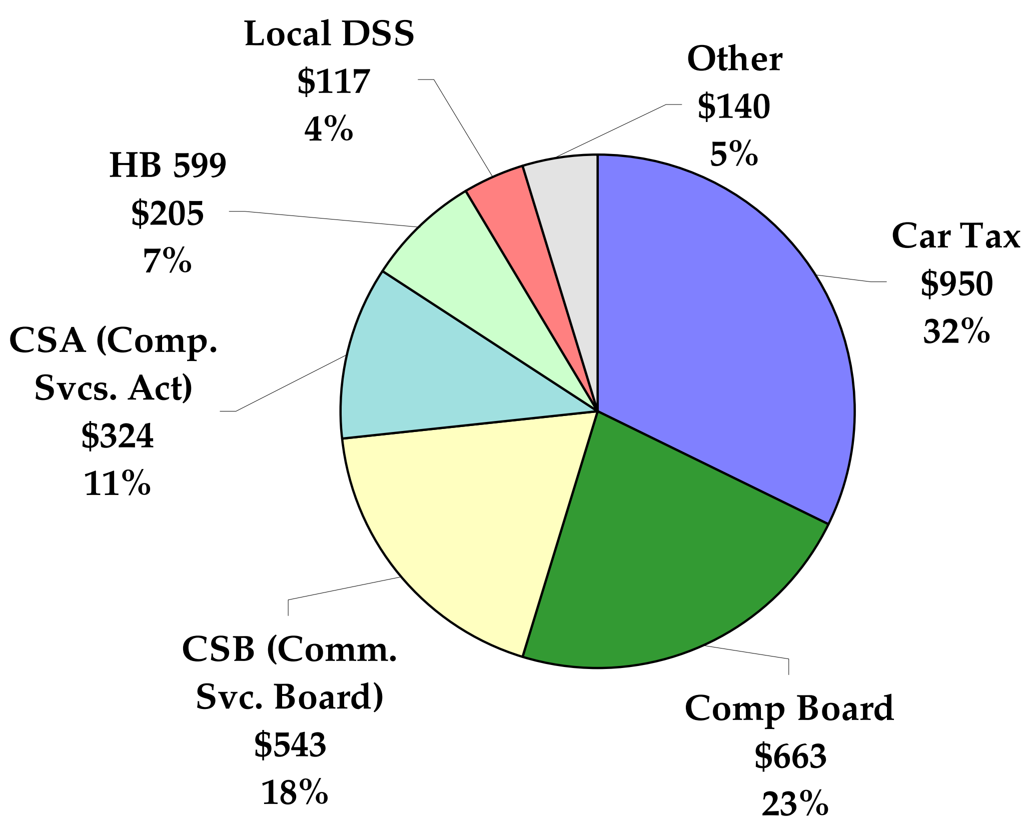
- More than **75 percent** of the FY 2009 general fund budget was **exempted** from the October reductions.
  - Typically, programs that provide aid to localities (such as public education) and aid to individuals (such as Medicaid) are exempted from across-the-board reductions.
  - Exempted programs may be considered for targeted program reductions.

General Funds, in millions	FY 2009	FY 2010
2008-10 Budget	**$16,965.4**	**$17,488.6**
Exemptions Include:		
Direct Aid to Public Ed	$5,707.4	$5,815.4
Medicaid (inc. waivers)	2,616.6	1,052.4
Corrections	1,103.5	1,105.2
Car Tax	950.0	950.0
Other HHR	913.8	777.3
Debt Service	493.6	558.3
State Police	223.8	220.5
Student Financial Aid	204.4	204.4
Judicial/Legislative	473.0	473.0
Other Exemptions	80.2	41.7
Total, Exemptions	$12,766.3	$11,198.2
SFC Reduction Base	**$4,199.0**	**$6,290.4**
5 Percent	**$210.0**	**$315.0**
10 Percent	**420.0**	**630.0**
15 Percent	**630.0**	**945.0**

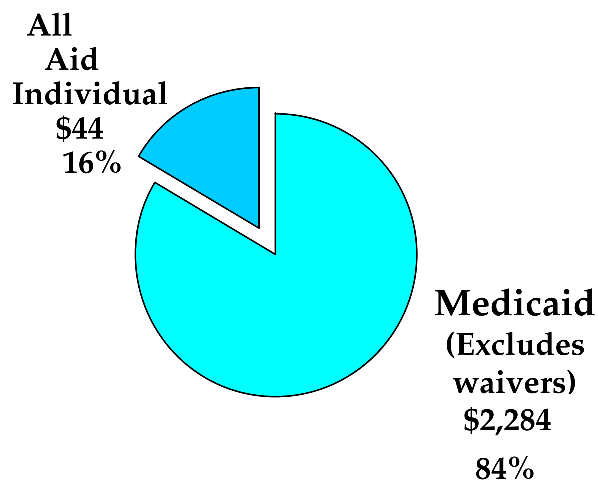
Aid to Localities, FY 2010 -- $8.9 billion

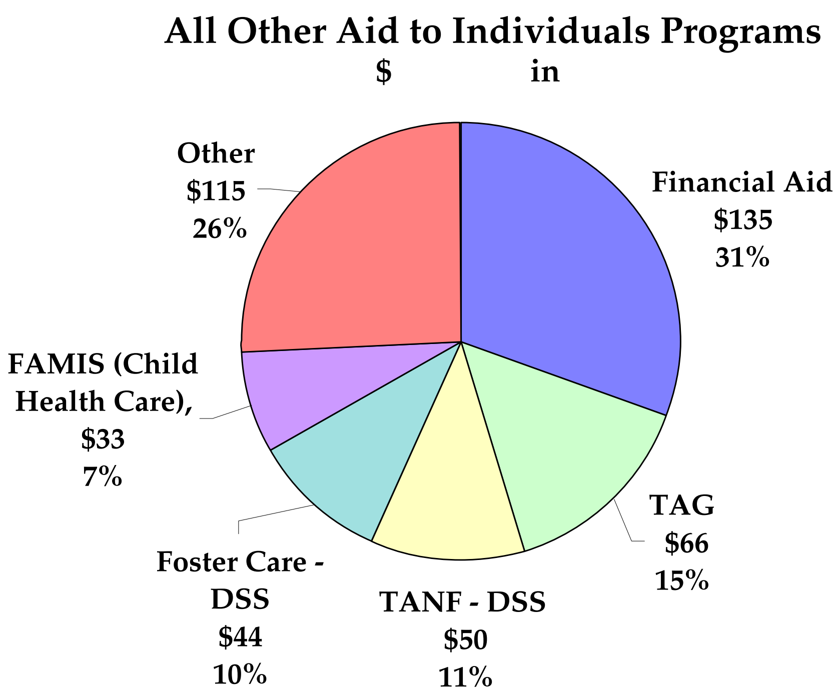


All Other Aid to Localities Programs
$ in millions



Aid to Individuals, FY 2010 -- $2.7 billion





Closing the budget gap – FY 2010

- Enough spending needs to be trimmed from the FY 2010 budget to maintain "structural balance" between spending and resources for the 2010-2012 biennium.

- One-time savings or revenue actions don't help in the long run, but may provide time to plan for deeper, more permanent reductions.

Scenario to Close FY 2010 Budget Gap
($ in millions)

Revenue Shortfall (SFC Staff Forecast)	**$2,080.0**
Add: Net Funding Requirements	**250.0**
Projected Budget Shortfall	**$2,330.0**
One-time Strategies	
Projected FY 09 Balance Forward	?
Rainy Day Fund	?
Selected Reductions	
Defer Yr 1 and Yr 2 Salary Increase	126.0
Defer Teacher Salary Increase (Public Educ.)	77.0
Expenditure Reductions	
Continue Oct. Reductions from FY 09	$300.0
Add'l 10% Reduction to Non-exempt Programs	630.0
Targeted Reductions to Other GF Programs	800.0
Other	
Misc. NGF balances, transfers	150.0
Other targeted savings, efficiencies	250.0
TOTAL	**$2,333.0**

Strategies for dealing with FY 2010

- The revenue shortfall for FY 2010 is twice that of FY 2009, but there is more time to make meaningful reductions. Three fundamental questions guide budget cutting decisions:

  1) **What services do you provide?**

     - Reduce the breadth of services provided.
     - Redefine standards, guidelines that drive funding.
     - Eliminate programs or services that are not mandated or core services.
     - Re-organize or consolidate agencies.

  2) **Who receives the services?**

     - Change criteria for who qualifies to receive the services.

  3) **Who pays?**

     - Shift costs to other payers: localities, increase fees for services, raise tuition.
     - Reduce reimbursements to providers.
     - Or, leave federal matching funds on the table.

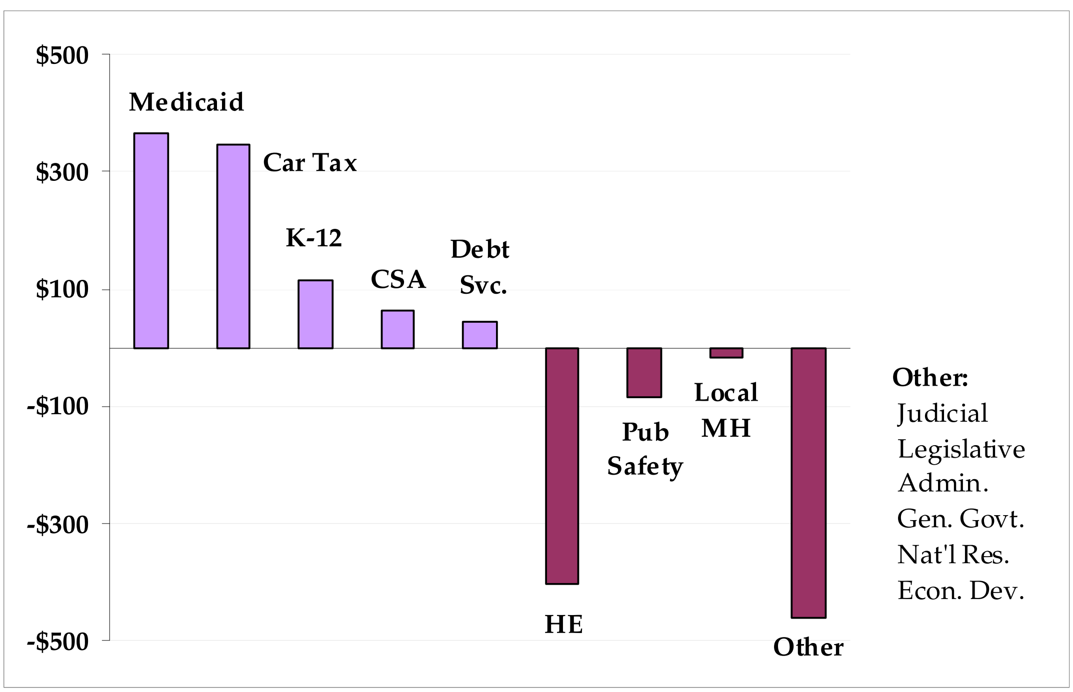
- If budget cuts are viewed as being "too deep", consider the revenue side of the equation or limited use of one-time strategies.

How does this recession compare?

- **2001 Recession:** Over three fiscal years, the General Assembly addressed **$6.0 billion** in budget shortfalls (revenue and spending pressures).
  - **2002 Session:** $1.4 billion for remainder of FY 2002.
  - **2002 Session:** $2.4 billion for 2002-04 biennial budget.
  - **2003 Session:** Additional $2.1 billion for <u>revised</u> 2002-04 budget.

- Most of the budget reductions came from about 25 percent of the budget.

Change in General Fund Support by Major Area
FY 2004 Operating Budget Compared to FY 2001
($ in millions)



Potential Targeted Reductions

Public Education

- The Joint Subcommittee on Elementary and Secondary Education Funding considered the following ideas at its meeting on October 7th.

- Allow flexibility by reducing certain minimum required staffing levels, scaling back, or eliminating programs.

  - Example: Increase the maximum school-wide pupil-teacher ratio (grades 5 through 12) from 21:1 to 22:1, for state SOQ Basic Aid savings of about $50 million per year.

- Improve cost methodology to better represent the actual cost of individual components.

  - Example: Funding the state's share of the prevailing health insurance premium to reflect the numbers of teachers that actually participate (about 75 percent statewide). May result in savings of about $60 to $90 million per year.

- Reduce the state's share of SOQ support, currently 55 percent on average.

  - A 50-50 split would result in state savings of about $300 million in FY 2010.

- See the notebook tab "Other Information" for a complete copy of the report.

Potential Targeted Reductions

Medicaid

- In the 2008 Session, Medicaid inflation was reduced for two provider groups -- nursing homes and hospitals. One option is to eliminate remaining inflationary increases for other Medicaid providers.

  - The 2008 Medicaid Forecast includes projected medical inflation for certain provider groups, notably nursing homes and hospitals, as well as higher managed care payment rates based on recent actuarial analyses.

  - Excluding inflation and eliminating projected increases in managed care payment rates could result in $59.8 million in general fund savings during FY 2010.

- Expansions of Medicaid coverage to "optional" populations could be reconsidered.

  - Earlier this decade, Medicaid was expanded to the aged, blind, and disabled with income up to 80 percent of poverty, up from 74 percent of poverty.

  - At the time, the cost was estimated to be about $5.0 million per year. Currently, the expansion costs about $60.0 million per year.

  - Rolling back coverage to 74 percent of poverty would result in general fund savings estimated at $60.0 million per year.

Other Options for Reducing Spending

- To meaningfully downsize state spending to align with projected revenues requires both short-term and longer-term strategies.

- Create a legislative branch "sunset commission".

  - Sunset is the regular assessment of the continuing need for a state agency to exist. Sunset asks a basic question: "Do the agency's functions continue to be needed?"

  - The sunset process works by setting a date on which an agency will be abolished unless legislation is passed to continue its functions, allowing the legislature to look closely at each agency and make fundamental changes to an agency's mission or operations if needed.

- Conduct administrative efficiency reviews for state agencies, similar to those conducted with Virginia's public school divisions.

  - Allows for a closer look at administrative expenditures, purchasing, staffing, travel, and information technology costs.

  - Contract for outside consultant; foster buy-in by requiring agencies to cover a portion of the cost if savings are not implemented.

- Make better use of the "Virginia Performs" data – use performance data to evaluate programs and services.

Challenges of the 2009 Session

- Uncertainty surrounds the national economic outlook and the FY 2010 revenue forecast for Virginia.

- The total projected budget shortfall for the biennium could approach $3.5 billion.

  - Actions have been taken or proposed to close the $1.0 billion budget shortfall in FY 2009.

  - Closing the remaining gap in FY 2010 – without using one-time items or "gimmicks" -- will be the real challenge.

  - Keep an eye on "structural balance".

- Balancing the budget through across-the-board reductions to central state agencies and higher education likely will not be sufficient to close the gap.

  - Tough choices will have to be made about reductions to state aid programs.

  - Unless services or employment are significantly reduced, savings will not be substantial.