ARLINGTON COUNTY, VIRGINIA

County Board Agenda Item
Meeting of November 15, 2008

DATE: November 18, 2008

SUBJECT: Fiscal Year (FY) 2010 Financial Forecast and Budget Guidance

C. M. RECOMMENDATIONS:

1) Receive the County Manager's Budget Forecast for Fiscal Year 2010.

2) Provide budget guidance for Fiscal Year 2010.

ISSUE: Ensuring the long-term sustainability of the community during a national recession.

Fiscal Year 2010 Forecast

Arlington will need to make a projected $40 million adjustment to balance the FY 2010 budget at current service levels and current tax rates. The gap is based on estimates that revenues generated by current tax rates are substantially less than inflationary costs. In order to sustain service levels, it is normally assumed that revenues will increase between 4% and 5% annually. The FY 2009 adopted budget assumed a 4% increase in real estate tax revenue in calendar year 2009. We are now projecting that real estate tax revenue at current rates will decline by 2% in calendar year 2009 and be flat in calendar year 2010.

Of great significance is the unexpected increase in student enrollment in the public schools. Under the County's revenue sharing agreement with the Schools, tax revenues get automatically adjusted as student enrollment goes up or down. While there have been modest changes in the past, there is a dramatic increase of 850 students from the previous revenue sharing calculations. This increase will result in a shift of $7.1 million from the County to the Schools.

It is important to understand that current projections rely on incomplete revenue data and preliminary costs estimates. Projections will change as more data are available and further analysis is completed. Cost estimates could increase and revenue projections could decrease, exacerbating the problem. Current estimates are based on the following:

- Estimated increased costs of approximately 2.2% over the FY 2009 adopted budget to maintain current operating services. This is approximately 2.8% less than inflation in the Washington region; and
- Estimated decreased revenues of over 2% <u>less</u> than the adopted FY 2009 Budget.

County Manager: ______________

Staff: Mark Schwartz, Director, Department of Management and Finance
Richard Stephenson, Budget Director, Department of Management and Finance

The $40 million adjustment should be made based on a thoughtful balancing of tax rate increases and service reductions. The only tax rate within the County's control that generates significant money is the real estate tax rate.

Each one-cent change in the real estate tax rate generates approximately $2.8 million each for the County and the Schools (using round numbers). Thus, an increase of 14 cents on the real estate tax rate would be required to close the gap entirely. To close the gap entirely with cost reductions would have a significant impact on services. $40 million is substantially more than the entire budget of most County departments. The budgets of only four departments are larger than $40 million: Human Services, Police, Fire, and Environmental Services. The combined budgets of the County Board Office, County Manager's Office, Human Resources, Management and Finance, Technology Services, and the County Attorney's Office are only approximately $35 million. The challenge, therefore, is to find the appropriate balance between revenue increases – taxes and fees – and reductions in discretionary services.

Impacts in the Current Fiscal Year

The declines projected in FY 2010 have already impacted the current fiscal year. Current estimates are that Arlington will need to decrease expenses in the current fiscal year by approximately $14 million. These decreases in expenditures will begin to address the shortfall for FY 2010. Cost reductions are currently in development through a phased approach.

- Round 1 were targeted reductions based on program-specific revenue cuts and a modest across-the-board reduction due to a general revenue cut by the State. This effort generated $1.2 million in cost reductions, which will continue into FY 2010.

- Round 2 is near completion. It is a reduction in targeted expenditures (such as travel and training) and a freeze on non-essential personnel vacancies. This round is estimated to save approximately $6.5 million. The savings are generally expected to continue into FY 2010, although there may be a substitute for some frozen positions in order to maintain high priority services.

- Round 3 will be conducted simultaneously with the development of the FY 2010 budget development over the next several weeks. It will generate savings necessary to balance the FY 2010 budget. Many of these cuts will be implemented in FY 2009 to achieve the balance of savings required for the current fiscal year to the extent possible. The reductions will reduce services.

In addition to permanent cost and service reductions, I have recommended that the County Board create a transition fund from discretionary resources in the closeout of FY 2008. These funds would only be used to cover transitional costs necessary to achieve reductions in existing services, especially those provided by filled personnel positions. I will also soon submit to the Board a proposed list of currently funded capital and other projects for deferral until the County's fiscal situation is better understood and the larger, external economic trends are stable. These two actions – the creation of the transitional fund and the deferred project fund – will provide a very strong financial safety net for the County that goes well beyond the County's modest General Reserve of 3%. No consideration is being given to tapping the reserve at this time. One-time funds of any nature should not be used to temporarily patch ongoing costs. They should only be used to transition to long-term, sustainable solutions.

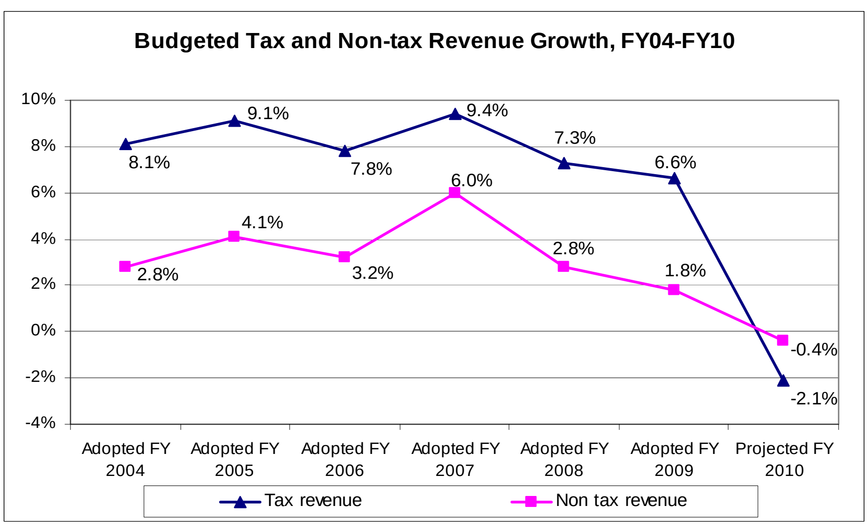
Arlington Impacted Less than Others

Local governments across the nation are confronting the same challenges that we face in Arlington. There is an ongoing national crisis in the financial markets resulting in a lack of credit to support new development and commercial real estate sales, deflation in the residential real estate market, dramatic decreases in the stock market affecting investments such as retirement funds, very low interest rates on cash investments, rapid depreciation of motor vehicle assessments, sluggish retail sales, and a pervasive mood of economic uncertainty. On the cost side of the budget, cost increases are running at approximately 5% annually in the Washington region. There are extraordinary increases in health care and energy. There are also increased demands for government to provide safety net services to support the most vulnerable in the community. Specific to Arlington, there is also the significant increase in School enrollment.

Arlington's economic environment and resulting budget issues are different than most jurisdictions in the Washington region only in that Arlington's declines in revenues are less severe. Greater revenue losses are being confronted by localities with a heavier dependence on residential real estate or income taxes. Arlington has a strong mix of different types of real estate properties, a diversity of taxes, and relatively low reliance on State aid, which is in sharp decline. Arlington's overall economy is considered one of the strongest in the nation with a balance of government and private sector employers, consistently the lowest unemployment rate in Virginia, a highly educated workforce, a safe and attractive environment, and housing that remains in high demand.

Detailed Revenue Projections

Overall, Arlington revenues are expected to decrease approximately $17 million from the FY 2009 adopted budget.



Revenue Projections as of October 31, 2008 Adopted FY 2009, Revised Estimated FY 2009, and Estimated FY 2010 ($'s in millions)					
	FY 2009 Adopted Budget	**FY 2009 Re-estimate**	**FY 2010 Projected**	**% Change FY 2009 Adopted – FY 2010 Projected**	**$ Change FY 2009 Adopted – FY 2010 Projected**
LOCAL TAXES					
Real Estate Tax	$486.2	$472.0	$466.5	-4.0%	-$19.7
Personal Property	97.2	97.8	96.8	-0.4%	-0.4
Business Tax (BPOL)	55.4	55.4	58.6	5.7%	3.2
Sales Tax	36.5	35.3	36.5	0.0%	0.0
Transient Occupancy Tax	21.4	21.8	22.6	5.5%	1.2
Meals Tax	30.3	29.7	30.5	0.7%	0.2
Other Taxes	36.4	35.3	35.5	-2.5%	-0.9
Sub-total taxes	**$763.3**	**$747.2**	**$746.9**	**-2.1%**	**-$16.4**
NON-TAX REVENUE					
License, Permits & Fees	$7.8	$7.8	$8.0	2.6%	$0.2
Fines, Interest, Misc.	29.3	25.1	26.2	-10.7%	-3.1
Charges for Services	40.7	40.7	41.9	2.8%	1.2
State	64.2	62.4	65.3	1.8%	1.1
Federal	19.9	19.9	19.9	0.0%	0.0
Sub-total non-taxes	**$162.0**	**$156.0**	**$161.3**	**-0.4%**	**-$0.6**
TOTAL (Excluding Fund Balance)	**$925.2**	**$903.2**	**$908.2**	**-1.8%**	**-$17.0 million**
*** May not add due to rounding**					

The following summarizes the factors influencing each major revenue source.

Real Estate Tax. As previously mentioned, we are developing initial FY 2010 budget estimates with the assumption that real estate assessments will decrease overall by 2 percent in CY 2009. The estimated range is between overall flat growth and a 5% decline. More precise figures will not be available until January, when the Department of Real Estate Assessment completes the annual assessment process. At this point we expect residential property to decline the most, although the changes will vary among different neighborhoods and different types of housing. Overall residential declines could be 5%. Commercial projections are much more difficult to make at this time. There have been very few sales of commercial property this year and the current national financial crisis has dramatically changed financing for commercial property. Flat commercial assessments would be very positive in this environment.

Personal Property Tax. In FY 2009, personal property assessments for the October billing were much higher than originally forecast, but are expected to decline in FY 2010. Personal property revenue assumptions assume a 2.1% reduction in motor vehicle assessments. The downturn in motor vehicle assessments is based on preliminary analysis showing that the assessed value of SUVs and small trucks fell markedly throughout the summer as gas prices skyrocketed. It also assumes that new vehicle sales will be sluggish throughout CY 2009, mirroring a trend on the national level. We project a modest 1% increase in business tangible assessments in CY 2009; however, larger economic conditions could adversely affect business investments.

Business, Professional and Occupational License Tax (BPOL). BPOL tax revenue is generated by taxes levied on entities doing business in the County and is based on a percentage of gross receipts or a fixed fee. This revenue source was very strong in FY 2008, finishing the year $4.8 million over budget. We will not know revenues for the current fiscal year until this spring. For FY 2010, preliminary projections assume BPOL will grow 1% per year off FY 2008 actual tax receipts.

Sales Tax. Sales tax revenue is the County's 4th largest revenue source. Arlington receives a local option tax of 1% on all items sold in the County. After several years of strong growth, sales tax revenue has leveled off over the past year. As a result, no growth is anticipated over FY 2009 budgeted levels.

Transient Occupancy Tax. A 5.25% local tax is levied on the amount paid for hotel and motel rooms in the County. While occupancy rates are somewhat lower than last year, a combination of continued growth in average daily room rates and increased capacity as 625 new hotel rooms come online next year should result in strong growth for this revenue.

Meals Tax. A 4% tax is charged on most prepared foods offered for sale. While meals tax revenue continues to grow, that growth has begun to slow down recently.

Other Taxes. Other taxes collected by the County include cigarette, car rental, recordation, estate, consumption, and commercial utility taxes. A 2.5% decrease in FY 2010 is forecast, primarily due to a reduction in recordation tax revenue.

Licenses & Fees. Revenues in this category are levied to offset the cost of licensing certain trades and providing related services. For FY 2010 this category is expected to increase 2.6%, reflecting annual inflationary fee increases.

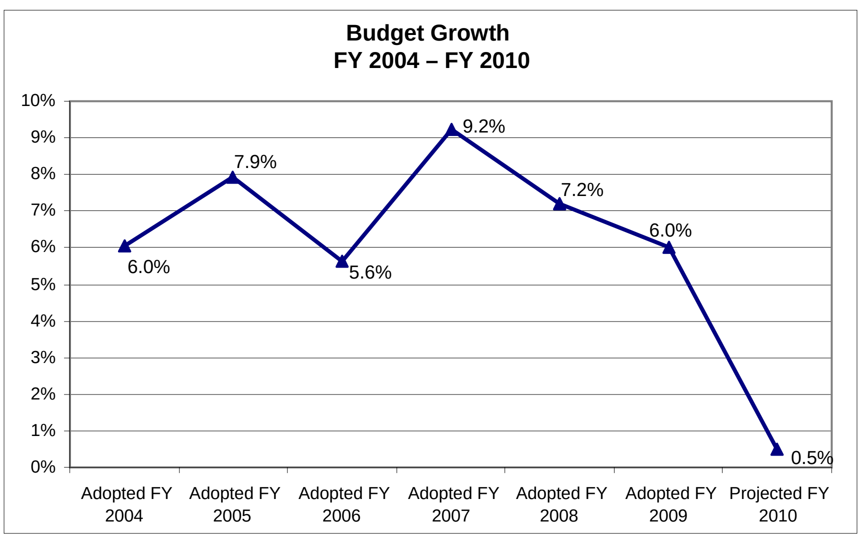
Fines, Interest, & Miscellaneous. Fine revenue from tickets and court fees, interest income on bond proceeds and general fund investments, and other miscellaneous revenue sources are included in this category. For FY 2010, this category is expected to decrease by 12.7% or roughly $3.3 million, reflecting the significant drop in interest rates over the past year.

Charges for Services. This category encompasses revenues received for a variety of County services. Service charges are structured so that the users of a particular service are the ones to pay for a majority of its costs, as opposed to using general tax dollars to fund services that benefit a small segment of the population. For FY 2010, increases in this category assume inflationary growth. The Board can anticipate recommendations to increase some fees in order to shift the costs for some discretionary services to the users rather than the general taxpayers.

Intergovernmental Revenues. This category includes state and federal revenue received by the County. Arlington receives funds from the Commonwealth of Virginia for a variety of state-mandated and supported functions and services. The County also receives a portion of some revenues collected by the state. Most federal revenue is received in the form of grants. In FY 2010, intergovernmental revenue is expected to lag behind inflation, reflecting a continued slowdown in state revenue and flat growth in federal funds. Additional cuts in FY 2010 state revenue, which are not reflected in these projections, are expected to be announced in December 2008.

Expenses

As a full service local government, Arlington provides an extremely wide range of services that differ greatly in nature. We provide basic public works services including water distribution, wastewater treatment, street maintenance, and storm sewer management. We provide a full array of public safety services, comprehensive and integrated human services, and extensive education and leisure services. Consistent with this diversity of services, there is a diversity of expense pressures ranging from the cost of fuel and asphalt to the cost of software licenses. With the significantly lower revenue forecasts, normal inflationary costs cannot be funded. This will require a restructuring of services in order to maintain appropriate service levels for those that are essential to the community and those that address policy priorities.



Expense Projections as of November 15, 2008 Adopted FY 2009, Revised Estimated FY 2009, and Estimated FY 2010 ($'s in millions)					
Expense Category	**FY 2009 Adopted Budget**	**FY 2009 Re-Estimate**	**Preliminary Estimate for FY 2010**	**% Change FY 2009 Adopted to FY 2010 Projected**	**$ Change FY 2009 Adopted to FY 2010 Projected**
Personnel	$322.4	$322.4	$331.4	2.8%	$9.0
Contractual Services	118.1	118.1	120.8	2.3%	2.7
Internal Svcs., Supplies, Equip., Other	32.6	32.6	31.9	(2.1%)	(0.7)
Public Assistance & Purchased Svcs	20.2	20.2	20.2	0.1%	-
State Cuts, September Board Action	-	(1.2)	-	-	-
Sub-total County Operations	**$493.3**	**$492.1**	**$504.3**	**2.2%**	**$11.0**
Metro	20.0	20.0	21.6	8.0%	1.6
Debt Service	52.9	52.9	57.9	9.8%	5.0
Regionals	8.1	8.1	8.1	-	-
PAYG Capital	17.8	17.8	5.5	(69.4%)	(12.3)
Schools Transfer	350.1	342.6	349.6	0.1%	0.4
TOTAL *	**$942.1**	**$933.4**	**$946.9**	**0.5%**	**$4.8**
*** May not add due to rounding**					

Schools Revenue Sharing Agreement. The County Board and School Board have operated under a Revenue Sharing Agreement since Fiscal Year 2002. The current formula for FY 2009 allocates 48.1% of net local County tax revenue to the Schools. Based on a school enrollment increase of 850 students, the proposed agreement shares 49.1% of local tax revenues with the Schools for FY 2010. This change equates to a tax revenue shift from the County to the Schools of approximately $7.1 million. This will require an equivalent reduction in County services. The table on the following page shows the historical County/School tax revenue sharing percentages, school enrollment, and the adopted School transfer.

Historical Revenue Sharing Percentages, Schools Enrollment, and Transfers				
Fiscal Year	**County's Share**	**School's Share**	**Schools Enrollment***	**Adopted Schools Transfer ($ millions)**
2002	52.2%	47.8%	18,882	$232.5
2003	51.4%	48.6%	19,097	$233.2
2004	51.4%	48.6%	19,140	$252.0
2005	51.4%	48.6%	19,120	$275.0
2006	51.9%	48.1%	18,744	$290.0
2007	52.3%	47.7%	18,411	$311.4
2008	52.2%	47.8%	18,451	$331.3
2009	51.9%	48.1%	18,684	$350.1
2010	50.9%	49.1%	19,534	$349.6 (proj.)
Revenue at the FY 2009 Revenue Share Level - 48.1%				$342.5

*Enrollment is as of September 30 of the previous fiscal year. For example, the FY 2010 revenue sharing percentage was based on the September 30, 2008 enrollment. Prior to FY 2005, the revenue sharing percentage was not tied to enrollment.

Personnel. The County has 3,397.4 full-time equivalent positions approved in the FY 2009 General Fund budget, the cost of which is 34% of the County's operating budget.

- Salary: Performance step increases range from 2.3% to 4.1% depending on how long an employee has been with the County. The estimated cost in FY2010 is from $5.1 million to $7.8 million (including FICA and retirement). Approximately 800 employees will not be eligible for performance increases in FY 2010 due to being at the top end of the pay scale, many of whom received no pay adjustment in FY 2009. Market pay line adjustments are made to ensure competitiveness with surrounding employers and to offset the impacts of inflation on employees, especially those at the end of the pay scale. Arlington has lagged in market adjustments as we focused on retirement and healthcare changes. No adjustment was made in the current year. Each 1% increase costs approximately $3.1 million annually.

- Health Care: With changes in health care adopted by the County Board in April 2008, the employees are at risk for increasing health premiums. The County continues to experience increasing costs in health care which could reach 20% in FY 2010. An employee task force is currently reviewing the health care plan to find ways to lower costs. The FY 2010 budget will also continue to fund the County's obligation for retiree health care (Other Post Employment Benefits (OPEB)). With the changes adopted by the County Board in April 2008, FY 2009 contributions are $15.4 million in ongoing resources to fully fund the required actuarially required contribution for these benefits. The County will be working with its actuary to revise estimates of costs for FY 2010.

Retirement. Significant changes were made to employee retirement beginning in January 2009 and are funded with a portion of the two cent real estate tax increase implemented in CY 2008.

- Effective January 1, 2009, employer contributions for Defined Benefit Retirement System increase to 13.5% (up from 10.6%) of pay for general employees, and 35.9% (up from 20.9%) for uniformed employees. This supports an increase in the retirement multiplier to 1.7% (up from 1.5%) retroactively for general employees. Uniformed employees get multiplier increases to 2.7% in conjunction with an increased employee contribution to 7.5% (up from 5%). Overtime and premium pay will no longer be used in retirement calculations.

- Effective January 1, 2009, the County increases the Defined Contribution contributions for general employees to 4.2% of base pay (previously 2%); the contribution for uniformed employees is eliminated (previously 1%).

Metro. The County's contribution is based on Arlington's proportional share of the Metro budget, and revenue support from user fees, state aid and gasoline taxes. The County's share will be determined based on the budget adopted by the Metro Board in June 2009; a preliminary projection will be provided in January. The estimated costs for FY 2010 is $21.6 million, compared to $20.0 million for FY 2009 (8.0% increase).

Debt service. For FY 2010, County debt service is projected to increase by $5.0 million to $57.9 million (9.5% increase), based on bonds already sold and those anticipated to be sold during FY 2009. The planned schedule of bond sales in the spring of 2009 is under reexamination.

Maintenance Capital (Pay-As-You-Go). Beginning in FY 2006, an on-going source of funding was provided in the base budget. The FY 2009 base budget now has $5.4 million of on-going PAYG funding, which is projected into FY 2010 at approximately the same level. An additional $17.8 million would be required to meet the CIP target adopted in the spring of CY 2008. Traditionally, one-time revenue sources, such as prior year fund balance, have been a primary source of capital funding. The transitional fund proposed for creation from FY 2008 fund balances could be reallocated to pay-go capital in the future if it is not otherwise needed.

Subject to Appropriation Leases. The County enters into short-term and long-term leases for a number of different County purposes. These leases are subject to annual appropriations. Unlike a typical lessee, the County Board is not able to legally bind future Boards. However, the County has always paid its debt obligations and is committed to meeting these commitments each year. Failure to do so would undermine our bond ratings and make it impossible to negotiate leases in private sector buildings.

Summary

The budget is where the County Board translates the vision, values and polices of the community into action. Every year the development and adoption of the County's operating budget is challenging because our desires for the community exceed resources available. The FY 2010 budget will be especially difficult in light of the substantial economic pressures facing the County and the country at large. We will be required to focus more on priority needs than discretionary desires that enhance Arlington as a place to live and work. The creation and adoption of the County budget is always about striking a balance: obviously a financial balance, but also a service balance.

Attachment A. Reference Material

Guidelines adopted by the County Board for the FY 2009 budget

- Present a balanced and sustainable base budget within existing tax rates.
- Fully fund all debt, lease, and other contractual commitments including those that are “subject to appropriation” in the base budget.
- Add no new positions or programs supported by local tax revenues.
- Continue to increase our commitment to maintain infrastructure (maintenance capital).
- Provide the most sustainable compensation plan possible while retaining competitiveness in the region.
- Adjust fee and grant funded programs up or down, relative to available revenues.
- Comply with the Revenue Sharing Agreement with the Schools.
- Prudently increase our budget reserves to continue to maintain our AAA bond rating.

County Manager working principles

- Preserve the community’s trust in government by being honest, open, and participatory;
- Respect our workforce by being honest, open, participatory, and sensitive to the impact of the economy on our workers;
- Stay true to the County vision by being strategic, taking care of the basics, avoiding excess or inefficiency, and preserving our legacy;
- Promote social equity by helping those in Arlington who are in most distress; and
- Ensure sustainability with long-term financial stability and environmental quality.