ARLINGTON COUNTY, VIRGINIA

County Board Agenda Item
Meeting of October 24, 2009

DATE: October 22, 2009

SUBJECT: Fiscal Year (FY) 2011 Financial Forecast and Budget Guidance

C. M. RECOMMENDATIONS:

1) Receive the County Manager's Budget Forecast for Fiscal Year 2011.

2) Provide budget guidance for Fiscal Year 2011.

ISSUE: Ensuring the long-term sustainability of the community during a difficult economic period.

Fiscal Year 2011 Forecast

Preliminary estimates of tax and other revenues for Fiscal Year 2011 show a revenue decline of between $40 and $50 million at current tax rates. This impact will affect the County and Schools proportionally. Similarly, both the County and the Schools are projecting expense increases of $20 to $25 million each. In total, a budget gap $80 to $100 million is projected for FY 2011 were the County and Schools to sustain current services.

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; estimates could also improve. These projections are based on staff's best analysis with limited information.

Closing a gap of this magnitude will require a thoughtful balancing of tax and fee increases and noticeable service reductions.

Impacts in the Current Fiscal Year

The declines projected in FY 2011 impact the current fiscal year, with a currently projected revenue shortfall in FY 2010 estimated to be between $20 and $25 million, proportionally impacting the County and Schools. In addition to the projected decline in real estate tax revenue,

County Manager:

38. B.

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

the County was also informed by the State that it would reduce funding in this fiscal year of approximately $1.7 million.

While it is critical to readjust current year spending to within revenue forecasts, we do not have to take the dramatic steps taken last fall when the economy dropped unexpectedly and precipitously. Due to the unsettled economy in CY 2009, the County Board created a $10 million Budget Stabilization Fund in the adopted FY 2010 budget.

The Budget Stabilization fund provides the County Board with an opportunity to deliberate on the appropriate balance of revenue increase and expense reduction options to balance the budget in FY 2011. Some decisions made for the FY 2011 budget may impact FY 2010 and additional FY 2010 budget savings should be realized. In any event, it is clear that the County's work force will need to shrink beyond the approximately 100 positions that were reduced from FY 2009 to FY 2010. Therefore, a selected hiring freeze has been imposed to both reduce costs and to create opportunities to transfer employees whose current positions may not be funded in FY 2011. Essential positions however will be selectively filled.

Finally, we are also evaluating how to manage the State reductions, which have a serious impact on the Sheriff's Office in particular. Again, the Budget Stabilization Funds provides the ability to carefully evaluate the impacts of different strategies. An update on the FY 2010 budget will be provided to the Board before the end of the calendar year.

Detailed Revenue Projections

Overall, Arlington revenues are expected to decrease approximately $44 million from the FY 2010 adopted budget (as noted in the introduction a range of $40 to $50 million is possible). Local tax revenue at current tax rates would decline by 5.5% or $42.3 million while non-tax revenue is projected to decline 1.0% or $1.8 million. The County share of the tax and non-tax revenue decline is approximately $23.3 million. The Schools share, based on the current revenue sharing agreement, is $19.5 million. The projections do not reflect revenues that the Schools may lose from sources other than the County, including state and federal funds. The table on the following page outlines revenue estimates for FY 2010 Revised and FY 2011 Projected.

Revenue Projections as of October 24, 2009
Adopted FY 2010, Revised FY 2010, and Projected FY 2011
($'s in millions)

	FY 2010 Adopted Budget	FY 2010 Revised	$ Change FY 2010 Adopted – FY 2010 Revised	FY 2011 Projected	% Change FY 2010 Adopted – FY 2011 Projected	$ Change FY 2010 Adopted – FY 2011 Projected
LOCAL TAXES						
Real Estate Tax	$494.1	$471.7	(22.4)	$448.7	(9.2%)	($45.4)
Personal Property	92.5	92.5	-	95.0	2.7%	2.5
Business Tax (BPOL)	58.3	58.3	-	58.9	1.1%	0.6
Sales Tax	36.5	36.5	-	37.1	1.8%	0.6
Transient Occupancy Tax	22.2	22.0	(0.2)	22.2	0.0%	0.0
Meals Tax	30.5	29.7	(0.8)	29.4	(3.6%)	1.1
Other Taxes	35.4	35.7	0.3	35.8	1.1%	0.4
Sub-total taxes	**$769.4**	**$746.4**	**($23.0)**	**$727.1**	**(5.5%)**	**($42.3)**
			↑			↑
Impact of Lower Tax Revenue - County Share			**(13.0)**			**(21.5)***
Impact of Lower Tax Revenue - School Share			**(10.7)**			**(20.8)***
NON-TAX REVENUE						
License, Permits & Fees	$8.4	$8.4	-	$8.1	(3.0%)	(0.3)
Fines, Interest, Misc.	24.0	24.0	-	23.8	(0.9%)	(0.2)
Charges for Services	42.3	42.3	-	42.4	0.3%	0.1
State	64.3	62.6	(1.7)	62.6	(2.7%)	(1.7)
Federal	18.2	18.2	-	18.6	1.9%	0.4
Sub-total non-taxes	**$157.2**	**$155.6**	**(1.7)**	**$155.4**	**(1.0%)**	**($1.8)**
Total County Impact			**(12.3)**			**(23.3)**
TOTAL (Excluding Fund Balance) County & Schools	**$926.6**	**$901.9**	**(24.7)**	**$882.5**	**(4.8%)**	**($44.1 million)**

*** Revenue impact based on FY 2010 revenue sharing percentage of 50.9% County / 49.1% Schools. In FY 2011 enrollment projections change the revenue sharing percentage to 50.0% for County and Schools. The School share is increased by $6.1 million. The increased enrollment will need to be funded from increased taxes or reductions in County services.**

The following summarizes the factors influencing each major revenue source.

Real Estate Tax. As previously mentioned, we are developing initial FY 2011 budget estimates with the assumption that real estate assessments will decrease overall by roughly nine percent in CY 2009. The estimated range is a decline between 5 and 11%. Commercial property assessments are expected to fall 14%, reflecting the tightest credit environment for commercial developers in a generation or more. The commercial market is extremely unsettled at this time. Residential assessments are expected to fall 5%. More precise figures will not be available until January, when the Department of Real Estate Assessment completes the annual assessment process. The estimates at this time are made based on very limited data.

Personal Property Tax. FY 2011 personal property tax revenue, which includes both business tangible and motor vehicle personal property tax, is expected to increase by 2.7% above the FY 2010 adopted budget. This upward adjustment for FY 2011 reflects the inevitable rebound of vehicle prices after a sharp downturn during the last few months of 2009, as well as continued business investments within the County. As more data on vehicle prices and purchases is received and analyzed, this projection will be revised.

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. In FY 2009, this revenue source exceeded FY 2008 levels, despite the sharp economic decline at the end of CY 2008. Given continued low vacancy rates and continued business investment within the County, a modest 1% increase over adopted FY 2010 levels is forecast; however, actual numbers will not be available until the third quarter of the fiscal year.

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 after netting out the effect of reallocations of sales tax receipts due to Arlington that were originally allocated to another jurisdiction (this was a regional problem not unique to Arlington). For FY 2011, a modest growth rate of 1.8% is forecast, but will be impacted on larger economic factors.

Transient Occupancy Tax. A 5.25% local tax is levied on the amount paid for hotel and motel rooms in the County. Over the past 12 months, excluding January, during which transient occupancy revenue spiked as a result of the Inauguration, both the occupancy rate and the average daily room rate have declined from the previous year. However, it is projected that this downward trend will be offset by the full impact of the 625 new hotel rooms expected to come online in the County during FY 2010. Accordingly, no change in FY 2011 revenue is projected.

Meals Tax. A 4% tax is charged on most prepared foods offered for sale. For FY 2011, meals tax revenue is projected to decline 3.6% over adopted FY 2010 levels, reflecting a more realistic revenue forecast. However, meals tax revenues overall continued to increase, albeit modestly throughout FY 2009.

Other Taxes. Other taxes collected by the County include cigarette, car rental, recordation, estate, consumption, and commercial utility taxes. A 1.1% increase in FY 2011 is forecast, primarily due to a positive adjustment to commercial utility tax revenue, reflecting higher than budgeted revenue in recent years.

Licenses & Fees. Revenues in this category are levied to offset the cost of licensing certain trades and providing related services. For FY 2011 this category is expected to decrease 3.0%, reflecting lower anticipated site plan fee revenue.

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 2011, this category is expected to decrease by 0.9%.

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 2011, increases in this category assume inflationary growth.

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 2011, intergovernmental revenue is expected to be negative, reflecting a continued slowdown in state revenue and flat growth in federal funds. It is likely that this category will be revised downward based on General Assembly actions during the upcoming legislative session.

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. As noted at the beginning of this report, expense pressures are expected to equal $15 to $20 million above adopted FY 2010 level (excluding School transfer). These pressures primarily stem from unavoidable costs for retirement, METRO, debt service, and normal inflationary cost increases. The total increased costs from the table on the following page; excluding one-time and formula calculations is $14.9 million, plus $6.1 million due to increased school enrollment per the Revenue Sharing Agreement. No services, other than the Schools, are adjusted for increased service demand or need.

Expense Projections as of October 24, 2009
Adopted FY 2010, Revised Estimated FY 2010, and Estimated FY 2011
($'s in millions)

Expense Category	**FY 2010 Adopted Budget**	**Preliminary Estimate for FY 2011**		**% Change FY 2010 Adopted to FY 2011 Estimated**	**$ Change FY 2010 Adopted to FY 2011 Estimated**
Personnel	$323.1	$326.2		1.8%	$3.1
Non-Personnel	162.8	166.5		2.3%	3.7
Fire Recruit Class	-	1.5		-	1.5
Regionals/Transfers	8.0	8.0		-	-
Sub-total	**$493.9**	**$502.2**		**1.7%**	**$8.3**
Metro	20.5	22.5		9.7%	2.0
Debt Service	53.7	58.3		8.6%	4.6
Sub-Total	**$74.2**	**$80.8**		**(8.9%)**	**$6.6**
County Services	**$568.1**	**$583.0**		**2.6%**	**$14.9**
School Enrollment					**$6.1**
Total Increased Cost (Does not include School Operating budget expense increases)					**$21.0**
The following County accounts are not projected based on expense needs and are an understatement of requirements.					
Contingents: includes Revenue Stabilization Fund in FY 2010	16.8	6.7		(61.7%)	(10.0)
PAYG Capital: only includes dedicated on-going funds; not total need	9.5	5.9		(38.2%)	(3.6)
Schools Transfer : based on Revenue Sharing Formula, not need	352.4	332.9		(5.5%)	(19.5)

Schools Revenue Sharing Agreement. The amount projected in the above table for the Schools is based on the Revenue Sharing Agreement, not on School expense projections. As noted earlier, the Schools face expense pressures similar to the County, but which are not part of this analysis. School expense requirements will be presented by the Superintendent to the School Board.

The County Board and School Board have operated under a Revenue Sharing Agreement since Fiscal Year 2002. The current formula for FY 2010 allocates 49.1% of net local County tax revenue to the Schools. However, based on a school enrollment increase of 699 students between CY 2008 and CY 2009, the local tax revenue sharing percentage for the Schools would increase to 50.0% of shared local tax revenues for FY 2011. The estimated cost for the higher enrollment for the Schools is approximately $6.1 million, which will have to be generated by tax increases or reductions in County services. If the revenue sharing formula was not adjusted for enrollment in FY 2011 the Schools would experience a $19.5 million decline in local tax revenue support from FY 2010. With an increase for enrollment, however, County funding for the Schools is still projected to decline approximately 3.8%, which is $13.4 million less than the FY 2010 Adopted Budget.

Note, the Schools are also impacted by projected revenue declines in FY 2010. Based on current estimates, the Schools will need to reduce spending in the current year by $10.7 million

The following table shows the historical County/School tax revenue sharing percentages, school enrollment, and the adopted School transfer. It is important to note that the percentage that the Schools receive is based a complex formula in the Revenue Sharing Agreement and is not applied to all County revenues. While the FY 2011 School funds are 50% of shared tax revenue, <u>the projected School percentage of all County revenues is 38%.</u>

Historical Revenue Sharing Percentages, Schools Enrollment, and Transfers

Fiscal Year	County's Share	School's Share	Schools Enrollment*	Adopted Schools Transfer ($ millions)	Year Over Year Change ($ millions)
2002	52.2%	47.8%	18,882	$232.5	
2003	51.4%	48.6%	19,097	$233.2	$0.7
2004	51.4%	48.6%	19,140	$252.0	$18.8
2005	51.4%	48.6%	19,120	$275.0	$23.0
2006	51.9%	48.1%	18,744	$290.0	$15.0
2007	52.3%	47.7%	18,411	$311.4	$21.4
2008	52.2%	47.8%	18,451	$331.3	$19.9
2009	51.9%	48.1%	18,684	$350.1	$18.8
2010	50.9%	49.1%	19,534	$352.4	$2.3
2011	50.0%	50.0%	20,233	$339.0	($13.4)

*Enrollment is as of September 30 of the previous fiscal year. For example, the FY 2011 revenue sharing percentage was based on the September 30, 2009 enrollment. Prior to FY 2005, the revenue sharing percentage was not tied to enrollment.

County Expenses

Personnel. The County has 3,306.44 full-time equivalent funded positions approved in the FY 2010 General Fund budget, the cost of which is 55% of the County's service's operating budget. Compensation will be among the most challenging issues in FY 2011, as the Board weighs compensation increases in salary and health care against workforce reductions.

- 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 FY 2011 is approximately $3.2 million (including FICA and retirement), which is in the projections. However, approximately 750 employees will not be eligible for performance increases in FY 2011 due to being at the top end of the pay scale, many of whom have not received to pay adjustment since 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. In recent years 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 in market pay adjustments cost approximately $2.9 million annually. The current estimates only include step increases; however, these may not be affordable. To the extent that any compensation increase is possible, a better approach may be an across the Board market adjustment so that all employees receive a base pay increase. In FY 2010 there were no base pay increases of any kind. It was the first year that the County was unable to provide at least step increases.

- Health Care: With changes in health care adopted by the County Board in April 2008, the employees are responsible for health premiums, with the County's contribution capped, unless increased by the County Board. The County continues to experience increasing costs in health care which could rise another 10% in FY 2011. In the current budget projections there are no assumptions made that the County will absorb any of the additional costs of health care. A 10% increase in health care costs equate to approximately $4 million across the entire County workforce.

The following items are included in the projections based on the best available information at this time.

- 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. The County's retirement fund, like most investments pools over the last 18 months has declined in value. The current assumption in the budget forecast estimates is that the County will need to contribute an addition two percent of employee salaries and FICA or an additional $4.4 million in FY 2011. Additional actuarial information will be available to the County later this calendar year.

Non-Personnel.

- 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. These costs are incorporated into overall non-personnel expenses.

- Utilities: Natural gas, electricity, vehicle fuel, and water are adjusted based on historical usage and projected cost changes and forecast energy usage efficiencies.

- <u>Fire Recruit Class</u>. Due to attrition projections in the spring of CY 2009 it was determined that the Fire Department could delay a recruit class until FY 2011. The budgeted costs were removed from the Fire Department in FY 2010 with the recognition that funds would need to be added back in FY 2011. The estimated cost for personnel and non-personnel in the recruit class is $1.5 million.

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 2010; a preliminary projection will be provided in January. The estimated costs for FY 2011 is $22.5 million, compared to $20.5 million for FY 2010 (9.7% increase).

Debt service. For FY 2011, County debt service is projected to increase by $4.6 million to $58.3 million (8.6% increase), based on bonds already sold and those anticipated to be sold during FY 2010 (e.g. Metro, transportation, neighborhood conservation, Long Branch, Thomas Jefferson). We continue to monitor the credit market for opportunities to refinance existing bonds at lower rates.

Maintenance Capital (Pay-As-You-Go). Beginning in FY 2006, an on-going source of funding was provided in the base budget. The FY 2010 base budget now has $5.9 million of on-going PAYG funding, which is projected into FY 2011 at approximately the same level. Traditionally, one-time revenue sources, such as prior year fund balance, have been a primary source of capital funding. The Budget Stabilization fund in FY 2010 could be reallocated to pay-go capital in the future if it is not otherwise needed. The annual on-going and one-time funds needed to meet PAYG requirements is in the range of $20 to $25 million

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 2011 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. As the County positions itself for the an economic recovery, it will be necessary to adopt a strategic balance between the fundamental services that local government deliver with the programs that are so important to Arlington residents and the community at large. The creation and adoption of the County budget is always about striking a balance: obviously a financial balance, but also a service balance.