City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 24, 2004

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: PHILIP SUNDERLAND, CITY MANAGER PS

SUBJECT: BUDGET MEMO #9: IMPACT OF THE STATE BUDGET CRISIS ON THE CITY BUDGET

Councilman Macdonald has asked for information related to the potential impact of the State budget crisis on the City's FY 2005 budget. The following responds to this request and represents the impact of the State budget impasse on the City's FY 2005 budget:

1. If the Senate version of the budget passes (the Senate and House budget and tax comparisons are attached), then the City could see up to $2 million more in additional revenue, mostly in the education area. While the education funding increases proposed by the Senate are still in play, the Senate is backing off of a gas tax increase to support increases in funding to support highway, street and transit purposes. It now appears unlikely that these gas tax increases will occur. However, the City's FY 2005 Proposed Budget and Capital Improvement Program (CIP) did not assume that a gas tax increase would occur, so there is no immediate impact on the City budget in FY 2005 as proposed because of a shift in the Senate's gas tax position. However, without a gas tax increase the capital projects that the City CIP plans as State funded may be at risk for reduction in the State's transportation six-year capital plan.

2. On the down side with the House budget, it appears that the City could see up to a $1 million loss, mostly in the area of law enforcement (HB599) funding. This would represent a revenue loss that is <u>not</u> assumed in the FY 2005 proposed City budget.

3. Another potential fiscal impact on the City of the State budget deliberations will be what Virginia Retirement System (VRS) teacher's retirement funding rate is agreed to jointly by the House and the Senate. The School Board built an assumed rate increase into their operating budget that is higher than either the House, Senate or Governor's proposed VRS teacher's rate increase for FY 2005. As a result some $1 million of the $3.5 million that the Schools had requested and budgeted for increased retirement costs may not be needed for FY 2005. It should be noted that this is close to the $960,000 Schools's funding reduction proposed in the City budget, and if it occurs, the City Manager is

recommending that this VRS teacher's retirement budget savings be used to offset this $960,000 reduction. It appears likely that when the House and Senate agree on a budget, the teacher's retirement funding rate will be less than what is assumed in the FY 2005 School Board proposed budget, although the exact amount is still unknown.

4. The major impact on the City besides the factors discussed in the above three paragraphs, is the uncertainty of what State aid the City could count on and how that will affect other City Council decisions on the budget and tax rates for FY 2005. The more uncertainty, the less able Council will be to make definitive decisions about FY 2005.

Attached as background is the Virginia Municipal League's (VML) analysis of the effects of a budget impasse. These effects, while real, will vary in impact upon local governments depending on how much a local government relies on State aid as part of its overall budget. As a result, the impact on Alexandria will be less than many other jurisdictions. However, if there is no State budget by July 1, and if the State stops dispensing State aid to localities as of July 1, the impact on all jurisdictions, including Alexandria, will begin to be significant.

Attachment

VML
VIRGINIA MUNICIPAL LEAGUE

Comparison of budget items of interest to localities

The following is a breakout of how the three budgets being considered by conferees would affect programs of interest to local governments.

The budget introduced by the governor is referred to as *"Introduced,"* the budget proposed by the House of Delegates is referred to as *"House,"* and the budget proposed by the Senate is referred to as *"Senate"*.

The Senate budget includes tax restructuring and a major investment by the state in core state responsibilities, including public education, public safety, mental health and mental retardation, transportation and natural resources.

HB 599 – Aid to Localities with Police Departments

Introduced: Complies with the Code of Virginia and increases funding to eligible localities by $35.56 million for the biennium; funding increase is contingent upon passage of tax reform.

House: Freezes funding at the FY03 level, which continues non-compliance with the Code of Virginia.

Senate: Eliminates contingency language from introduced budget, and by complying with the Code of Virginia, increases funding to eligible localities by $35.56 million for the biennium.

ABC Profits and Wine Tax

Introduced: Increases ABC profits shared with localities by $3.05 million in 2005 and by $4.25 million in 2006 (increase is over the FY04 level); increases wine tax distribution by $450,000 above the FY04 level each year

House: Freezes distribution of ABC profits and wine liter taxes at the FY04 level for each year of the biennium.

Senate: Increases funds at the same level as in the introduced budget.

Jail per diems

Introduced: Adds $6.0 million in 2005 and $9.1 million in 2006 to support a portion, but not all, of the state's share of costs for housing inmates in local and regional jails.

House: Cuts funding for the state share of jail per diems by an additional $16.2 million for the biennium by reducing by 25 percent the state share of per diem costs, and adjusting upward the payment for out-of-compliance prisoners. This comes on top of the approximately $13.2 million in cuts carried forward each year as the result of budget actions taken in 2003.

Senate: Restores the reductions taken in 2003 by providing $13.2 million each year to pay the state share of costs for housing prisoners in local and regional jails.

Education budget overview

A key concern for localities is the level of state funding for K-12. The Senate budget makes a major commitment to public education by adding funding for an additional 8 teachers per 1000 students. This means the state would start contributing to 8,589 additional positions. Most localities already fund these positions, but with local dollars.

Further, the Senate makes major progress on funding the recommendations made by JLARC in its study of education funding. The introduced budget is the only of the three to include a salary increase for teachers. The House budget caps the teacher retirement contribution rate paid by the state, but leaves open-ended the rate to be paid by localities. This action could pass on to localities hundreds of millions of dollars in teacher retirement costs.

The following provides a snapshot of the three budget proposals:

Introduced: increase in total education spending of 7.16 percent from the current budget to FY05, and increase of 2.87 percent from FY05 to FY06. Biennial increase of 10.23 percent.

- Deducts federal revenues and locally-generated revenues from the cost of the SOQ (decrease of $208.3 million in FY 2005 and $209.8 million in FY 2006).
- Transfers non-personnel technology costs from the SOQ (decrease of $54.6 million in general funds for FY 2005 and a reduction of $55.2 million for FY 2006)
- Funds a pooled teacher/state employee VRS contribution rate of 6.56 percent of payroll contingent on tax reform; 7.82 percent otherwise.
- Increases funding for ESL students (contingent on tax reform, $9.1 million in FY 2005 and $10.6 million in FY 2006).
- Expands access to at-risk four-year-old program (contingent on tax reform, $2.2 million a year)
- Funds cost of competing for support personnel for PD 8 (contingent on tax reform, $3.5 million in FY 2005 $3.7 million in FY 2006)
- Increases funding for SOQ remediation ($20.5 million in FY 2005 and $20.6 million in FY 2006)
- No loss provision to maintain current funding levels for those school divisions that would have otherwise lost funding from base year 2004. ($1.5 million in FY 2005, $2.2 million in FY 2006.)
- Changes basis of funding K-3 class size reduction program (reduction of $6.0 million a year)
- For FY06, funds 3 percent teacher salary increase, effective Dec. 2005 ($50.9 million in FY 2006).

House: increase in total education spending of 7.76 percent from the current budget year to FY05, and increase of 1.71 percent from FY05 to FY06. Biennial increase of 9.61 percent.

- Retains proposal in introduced budget to deduct federal revenues from the cost of the SOQ; does not deduct locally-generated revenues (decrease of $153.2 million in FY 2005 and $154.2 million in FY 2006)

- Retains proposal in introduced budget to transfer non-personnel technology costs from the SOQ ($54.6 million in general funds for FY 2005 and a reduction of $55.2 million for FY 2006).
- Funds teacher retirement rate of 6.03 percent for FY05; in FY06 the rate would be 6.63 percent, but the state would base its funding only on 6.03. In future years, the state would only pay its share of the 6.03 percent rate, even if the rate increases to double-digits (as has been predicted by the VRS actuary). There is a short-term gain for localities, especially in FY05, because the rate is lower than even the blended rate. Long-term, this is a dangerous and very costly proposal for localities.
- Maintains 2004 funding levels for remediation.
- Funds no loss provision ($1.7 million in FY 2005 and $1.5 million in FY 2006)
- Eliminates Student Achievement Grant program (decrease of $21.3 million a year)
- Retains change in introduced budget for funding K-3 class size reduction program (savings of $9.9 million for biennium, difference in savings from introduced budget relates to difference in VRS costs)
- Eliminates additional revenues for cost of competing included in introduced budget
- Eliminates additional revenues for ESL included in introduced budget
- Expands access to at-risk four-year-old program as in introduced budget but changes method of reimbursement (Decrease of $4.9 million in FY 2005 and $5.0 million in FY 2006)
- Eliminates funding for FY06 salary increase; funds FY05 salary increase for state and state-supported local employees, but no funding for teacher salaries.

Senate: increase of 19.9 percent from current year to FY05, and increase of 1.14 from FY05 to FY06. Biennial increase of 21.27 percent.

The Senate version:

- Eliminates deduction of federal revenues and locally-generated revenues
- Funds teacher retirement rate at 6.56 percent.
- Funds cost of competing as proposed in introduced budget, with different funding source (VIA) ($$3.5 million in FY 2005 $3.7 million in FY 2006)
- Funds ESL program as proposed in introduced budget, with different funding source (VIA) $9.1 million in FY 2005 and $10.6 million in FY 2006).
- Retains change in introduced budget for funding K-3 class size reduction program (reduction of $6.0 million a year)
- Adds 8 additional instructional positions per 1000 by funding some Board of Education SOQ proposals and JLARC recommendations (details below)
- Increases funding to implement three major proposals by the Board of Education to revise the SOQ to more accurately reflect prevailing practice:

  --daily planning periods in middle and high schools ($123.0 million in FY 2005 and $128.0 million in FY 2006)

  --elementary resource teachers ($74.6 million in FY 2005 and $76.7 million in FY 2006)

--instructional and support technology positions ($15.6 million in FY 2005 abnd $16.2 million in FY 2006)

- Funds some JLARC Tier 1 and Tier 2 recommendations;

---completes funding of administrative/support positions ($22.8 million in FY 2005 and $23.4 million in FY 2006)

---corrects a one-time cost savings action that rolls a month of fringe benefit costs from one fiscal year to the next ($22.1 million in FY 2005)

---funds at-risk four-year-old program at 100 percent participation, allowing localities that currently are not eligible to receive these state funds to start doing so. This would allow these localities to use federal Title 1 funds for other educational programs. (Increase of $49.3 million in FY 2005 and $49.6 million in FY 2006)

- Eliminates funding for FY06 salary increase.

Compensation (other than teachers, which are covered above)

Introduced: Adds funding, contingent on adoption of tax reform, for a 3.0 percent salary increase for one-half year beginning in FY 2006. For state supported local employees (constitutional officers, social service workers, local election board employees, health employees, juvenile justice, etc.) the increase would be effective Dec. 1, 2005 and would cost the state $12.4 million.

House: Adds $52.4 million to provide a 3 percent salary increase, effective Dec. 2005, for state employees, deputy sheriffs, state-supported local employees, and higher education faculty. Eliminates funding in introduced budget for FY 2006 salary increase, for a savings of $105 million.

Senate: Adds funding for a 3 percent salary increase, effective Dec. 2004 for state employees and state-supported local employees; public safety officers receive 6.42 increase. Eliminates funding for FY 2006 salary increase, for a savings of $105 million.

Treasurers & commissioners of the revenue

Introduced: Adds $1.1 million each year to fund the shortfall in the 2.25 percent salary increase for all locally-elected constitutional officers that was approved in 2003.

House: Reduces funding by $2.12 million each year, or 13 percent, for Treasurers' offices; reduces funding by $1.27 million each year, or eight percent, for Commissioners' offices. Does not reduce funding for directors of finance.

Senate: Same as the introduced budget.

Circuit court clerks

Introduced: Funds the shortfall in the 2.25 percent salary increase for all constitutional officers.

House: Reduces the percentage of clerks' fees retained by localities and transfers it to the state, for a loss of at least $1.6 million each year to local governments.

Senate: Adds 323 positions statewide to meet the staffing standards. Adds $5.3 million in non-general funds each year to allow the use of Clerks' Technology Trust Funds for processing land records and frees up general fund dollars to fully support the Compensation Board's staffing standards for circuit court operations.

Mental health services

Introduced: Adds 160 new mental retardation waiver slots, contingent upon passage of tax reform, at a cost of $2.7 million in 2005 and $4.0 million in 2006

House: Removes the contingency from the introduced budget to fund these slots.

Senate: Adds $22 million each year to create 880 new mental retardation wavier slots to reduce the emergency/urgent waiting list (currently more than 950 consumers on this list); allocates $6.7 million to discharge 160 individuals in state facilities awaiting release into the community; funds a three percent rate increase for mental retardation service providers ($8.2 million) to keep pace with inflation.

Virginia Natural and Historic Resources Fund

Introduced: Establishes a new fund dedicated to water quality and land conservation with $15.1 million in non-general funds each year. Capitalizes the fund through a $10 recordation fee originally approved by the 2002 General Assembly, which currently goes to the general fund.

House: Eliminates language that would have deposited recordation tax revenues into the Virginia Natural and Historic Resources Fund, and ensures that the fees would continue to be deposited to the general fund.

Senate: Establishes the new Fund, but capitalizes it with $30 million per year from a proposed sales tax increase on non-food items. Provides funding for soil and water conservation districts, the Water Quality Improvement Fund, open space, and historic and cultural sites.

State water supply planning

Introduced: Provides additional general funds of $500,000 each year for state water supply planning. The new funding allows the state to assist local governments in developing plans and provides planning grants to local governments.

House: Eliminates the planning funds entirely, $500,00 each year.

Senate: Reduces the funds by $150,000 each year.

Environmental permit programs

Introduced: Provides $2.6 million each year and adds $6.5 million each year through increased fees paid by public and private holders of landfill, wastewater, water and other DEQ environmental permits.

House: No amendments.

Senate: Appropriates $400,000 each year and adds $6.0 million each year through increased permit fees to fund these environmental permit programs.

Water Quality Improvement Fund

Introduced: Provides $7.7 million in first year. Deposits to the WQIF come from 10 percent of the year-end revenue surplus and unappropriated balance for FY03.

House: Supports the $7.7 million WQIF deposit for the first year from the unappropriated balance.

Senate: Appropriates $5.7 million in the first year and $7.4 million in the second year. The source of these funds is the proposed Virginia Natural and Historic Resources

Fund. This is in addition to the $7.7 million for the first year from the unappropriated balance.

Chesapeake Bay Local Assistance Department

Introduced: No changes.

House: No amendments.

Senate: Merges the functions and budget resources of CBLAD into the Department of Conservation and Recreation.

Transportation

Introduced: Transfers $309 million in state general funds to transportation initiatives, including debt and pay-as-you-go supported projects; defers $37.9 million in highway maintenance from 2004 to 2005 as a result of Hurricane Isabel-related expenses.

House: Increases by $58.0 million over the biennium the state non-general fund support to the Transportation Trust Fund, including: $46 million to VDOT for highway construction; $8.4 million to the Department of Rail and Public Transportation for public transportation; $2.4 million to the Virginia Port Authority; and $1.4 million to the Department of Aviation. Transfers $154 million from the state General Fund to support transportation initiatives.

Senate: Increases by $1.6 billion over the biennium the state non-general fund support to the Transportation Trust Fund, including: $948.7 million to VDOT for highway construction; $177.2 million to the Department of Rail and Public Transportation for public transportation; $50.6 million to the Virginia Port Authority; and $28.9 million to the Department of Aviation. Transfers $80 million from the state general fund to support transportation initiatives.

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Comparison of tax plans

Governor's plan

Gov. Mark R. Warner's proposal would generate more than $1.1 billion in new revenue for the next biennium ($478 million in 2005 and $541 million in 2006), and would:

- Increase the sales tax on non-food items from 4.5 to 5.5 percent;
- Reduce the sales tax on food from 4 cents to 3 cents in 2004, and to 2.5 cents by July 1, 2005;
- Increase the tax on a pack of cigarettes from 2.5 cents to 25 cents, to generate approximately $145 million annually for health care purposes;
- Adjust the state income tax structure by increasing personal and dependent exemptions and standard deductions;
- Increase the top rate on those who earn more than $100,000, alter filing thresholds, phase out the age deduction for those between 62 and 64 and tie the age deduction to income for filers 65 years of age and older;
- Repeal the estate tax on certain taxpayers, including family farms and some closely-held businesses;
- Repeal the accelerated sales tax collection for businesses;
- Eliminate specific corporate income tax loopholes; and
- Adopt the national streamlined sales tax project agreement to permit the state to collect the sales and use tax on Internet retail purchases.
- Phase-out the car tax in 2008 (77.5 percent for 2005, 85 percent for 2006, 92.5 percent for 2007 and 100 percent for 2008). The reimbursement rate currently is 70 percent. (The House and the Senate agreed to leave reimbursements frozen at 70 percent.)

House plan

The House plan would repeal long-standing sales and use tax exemptions held by several blue chip companies. It would affect power companies, oil and gas companies, airlines, telephone companies, interstate truckers, shipbuilders and specific contractors. The exemptions apply to business-to-business purchases and not to retail sales.

The House estimates that its plan would generate **$345 million** in state general fund revenue during the biennium. Local governments would gain an estimated $115 million in additional revenue over the biennium through the 1 percent local option sales and use tax. The Transportation Trust Fund would gain approximately $57 million over the biennium because of the one-half cent of the sales tax dedicated to that fund.

The Department of Taxation estimates, however, are lower than the House estimates. The department estimates that the House plan would generate approximately $208 million in new state revenue in the 2007-2008 biennium. Local governments would gain an estimated $69 million in additional revenue over the biennium through the 1 percent local option sales and use tax. The Transportation Trust Fund would gain approximately $35 million over the biennium because of the one-half cent of the sales tax dedicated to that fund.

Senate plan

The Senate revises Virginia's tax code and would generate more than $3.6 billion over the biennium. (*Dollar amounts are expressed in biennial aggregate totals and reflect offsets in tax relief.*)

Income tax changes

The Senate estimates that income tax changes, including personal, age, and corporate, would generate more than $700 million for the biennium.

Individual income tax changes

- Add a new rate of 6.25 percent for income between $100,000 and $150,000; add a new rate of 6.5 percent for income over $150,000;
- Increase the standard personal and dependent exemption from $800 to $1,000;
- Increase the standard deduction for singles from $3,000 to $3,500 and for joint filers from $5,000 to $7,000;
- Modify low income tax credit options and minimum filing thresholds;
- Eliminate the tax on estates valued up to $10 million and working farms;
- Adjust age preferences, by 1) retaining current preferences for those over 65 years of age; 2) retaining preference for persons 62-64 years of age until they reach 65 only if combined modified adjusted gross income is less than $200,000; and 3) eliminating the $6,000 benefit for persons turning 62 after Jan. 1, 2004;
- Eliminate age benefit reductions for those 65 and older who make more than $52,000 plus social security (individuals); $88,000 plus social security (couples). Reduces benefit for individuals making between $40,000 and $52,000 and for couples making between $64,000 and $88,000. It would make effective as of 2011 the age benefit at normal federal retirement age, not age 65.

Corporate income tax changes

- Eliminate three common corporate tax loopholes; and
- Eliminate the accelerated sales tax requirement whereby businesses make prepayments in June 2005.

Sales tax changes

The Senate plan would generate more than $900 million in the biennium. It would:

- Reduce the state sales tax on food by 2 percent. (no change in the 1 percent local option).
- Increase the state sales and use tax on non-food items by 1 percent to 5.5 percent (inclusive of the 1 percent local option); and
- Eliminate the sales tax exemption for common carriers of motor vehicles.

Recordation taxes
Recordation fee changes would generate more than $320 million and increase the deed recording tax from 15 cents to 30 cents per $100.

Transportation taxes and fees
The Senate plan would generate an additional $1.6 billion for transportation purposes by:

- Increasing gasoline and diesel taxes to 20.5 cents per gallon for an increase of 3 cents on gasoline and 4.5 cents on diesel;
- Increasing the vehicle titling tax from 3 percent to 4.5 percent;
- Applying the 5.5 percent sale and use tax to the pre-tax price of gasoline; and
- Increasing the vehicle registration fee by $10.

Tobacco taxes
Tobacco tax changes would generate more than $340 million for Medicaid by increasing the state tax on a carton of cigarettes to 20.5 cents on July 1, 2004, and to 35 cents on July 1, 2005.