2002 Budget Act: Supplemental but Not Sustainable

At midnight on March 12th, cheering senators and representatives adjourned the 2002 legislative session. Legislators were pleased they had managed to finish on time and to paper over the state budget deficit with relatively modest spending cuts and without a general tax hike.

Preliminary projections show a gap of $1.5 billion between spending and resources for the 2003-05 biennium. As a result, when legislators reassemble in Olympia next January they will face pretty much the same old crisis. Only by then the reserve funds will be tapped out, a quarter of the tobacco settlement funds will be gone, and the easy spending cuts will already have been made. Don’t expect to hear much cheering.

### The Problem

It took legislators the full regular session and two special sessions to reach agreement last year on a budget for the 2001-03 biennium. As the General Fund-State balance sheet (Chart 1) shows, the budget they enacted last June was fiscally aggressive, appropriating $666 million more than forecast revenues. This gap was covered by transferring monies to the General Fund from other state accounts and by drawing down General Fund reserves.

Subsequently, it became clear that the economic recession would reduce significantly state revenues and drive spending higher than had been budgeted.

### Revenue Losses

When legislators completed work in 2001, they expected that the General Fund would receive $22,117 million in state revenue over the 2001-03 biennium.
Downward revisions at the September, November, and February meetings of the Revenue Forecast Council erased $1,155 million of state revenue. In addition, lower than forecast revenues for the 1999-2001 biennium reduced the beginning balances in the General Fund and the Emergency Reserve Fund by $1 million and $23 million respectively, while lower interest rates and lower balances reduced expected interest earnings in the Emergency Reserve by $46 million. All together, the losses in resources totaled $1,225 million.

**Maintenance Increases**

The legislature also faced pressure to increase spending beyond the $22,783 million originally appropriated.

Early in the session, Marty Brown, Director of the Office of Financial Management, put the overall need for additional spending at $450 million. Later, the budget proposed by the Chair of the Senate Ways and Means Committee set the needed additional spending at $387 million. But, in the end, “need” is subjective. The cleanest way to quantify the pressure for additional spending is to total the legally unavoidable adjustments to the appropriated spending that budgeteers call maintenance changes.

Budget documents identify $265 million (net) in maintenance changes. These changes are concentrated in three areas: the Department of Corrections, the Department of Social and Health Services and Public Schools. See Chart 2.

- The maintenance change for the Department of Corrections is $41 million. The primary driver here is an increase in the inmate population forecast.
- The maintenance change for the Department of Social and Health Services is $96 million. Much of this is in the Medicaid program. Three factors have combined to push up Medicaid expenses: The caseload forecast has increased, per-case health care costs are higher than anticipated, and the federal government is picking up a smaller share of Medicaid costs than anticipated.
- The maintenance change for K-12 education is $126 million. This reflects an increase in enrollment forecasts and the cost of living increase paid to teachers under Initiative 732.
Together the loss in revenue and the maintenance changes created a $1,490 million hole in the originally enacted budget. Legislators closed the gap with a combination of four tactics: revenue increases, spending reductions, transfers, and reserves.

Chart 3 depicts how the supplemental budget filled the hole. Eighty-eight million dollars in new revenues provide 6 percent of the solution. Five hundred and two million dollars in transfers, most derived from the tobacco settlement, provide 34 percent. Three hundred million dollars in reserves contribute 20 percent of the solution. Finally, $601 million is cut from general fund spending. Of this, $120 million is not a true spending cut but rather a shift of funding responsibility to other state accounts or to federal monies.

New Revenues

The most recent forecast, prepared in February foresees $20,962 million in revenue for the biennium. Actions taken by the legislature are projected to add $88.0 million.

Increased audit activity and delinquent account collection effort by the Department of Revenue is expected to add $46.6 million. The supplemental budget appropriates $6.3 million to the Department of Revenue to support these efforts.

The state will join “the Big Game” multistate lottery. This lottery is expected to increase the state’s net lottery revenue by $24 million, after accounting for prize payouts, administrative expenses (all outside of the General Fund), and the reduction in net revenues to other state games.

Legislation (SB 6835) extended the use tax to apply to: (1) transportation charges on goods shipped from out of state to Washington buyers; (2) out-of-state printing of direct mail advertising for an in-state retailer mailed from out of state to Washington residents; (3) out-of-state repair services on Washington residents’ property. These changes are expected to raise $27.2 million.

Nursing home license fees will be diverted from the General Fund, decreasing General Fund-State (GF-S) revenues by $3.4 million. Investment income of non-financial business is exempted from the business and occupation tax (HB 2641), reducing GF-S revenue by $3.6 million. Expired business and occupation and public utility tax deductions that encourage employers to provide financial incentives to employees for commute trip reduction are reestablished, decreasing GF-S revenue by $1.2 million. Five other bills reduce GF-S revenue by a total of $1.8 million.
The original budget transferred $228 million to the General Fund from other state accounts. (See Chart 4.) Of this, $70 million came from the MultiModal transportation account and offsets a $70 million transfer from the Emergency Reserve Fund to the MultiModal account. One hundred fifty million of the original transfer came from the Health Services Account. The state expected to receive these funds from the federal government as a result of the Nursing Home Proportionate Share program (ProShare), a scheme under which payments to public hospitals operating nursing homes generate additional federal Medicaid revenues. Finally, $8 million came from the Treasurer’s Service Account.

The supplemental budget included a number of additional transfers.

The largest new transfer results from the state’s tobacco windfall. Because of the 1998 settlement negotiated between major tobacco companies and state governments, Washington should receive a substantial stream of revenue. The state attorney general estimates Washington will get about $4.5 billion over the next 25 years. The state will sell bonds backed by a portion of the tobacco settlement money (investment bankers term this “securitization” of the revenue stream), generating $450 million to be transferred to the General Fund.

Seventeen million dollars in transfers are related to the supplemental capital budget. The capital projects these monies were to fund will now be funded with general obligation bond proceeds.

A total of $34.1 million is transferred to the General Fund from 14 other accounts.

**Reserves**

Under the supplemental budget, the combined ending balances of the General Fund and the Emergency Reserve Fund are $300 million less than had been projected for the original budget. The supplemental budget transfers $325 million from the Emergency Reserve Fund to the General Fund.

**Spending cuts**

Policy changes cut spending by $601 million in the supplemental budget. (See Chart 5.) When policy and maintenance changes are combined, the overall reduction in spending in the supplemental budget is $335 million. However about one fifth of the policy change, $120 million, represents not cuts in services but shifts in funding responsibility away from the General Fund-State to other state accounts or to federal grants.
Some of the more significant cuts are detailed below.

**Public Schools**

Maintenance changes added $126.3 million to public schools spending, while policy changes subtracted $175.1 million. The result was a net reduction of $48.5 million in GF-S support for public education from the $9.9 billion originally appropriated. The reduction in GF-S support is offset in part by $24.1 million in new federal grants.

Among maintenance changes, the increased enrollment forecast added $126.3 million and levy equalization added $12.7 million. Providing teachers with a 3.6 percent cost-of-living increase (pegged to the Seattle CPI under I-732), rather than the originally budgeted 3.1 percent, costs $14.5.

The largest policy change is a $53.9 million reduction state funding for public school employee pensions. This is the result of an actuarial study of the retirement system. Employee contributions are also reduced. The monthly per-employee state contribution for health benefits is decreased from $493.59 to $457.07, saving $29.5 million. The budget eliminates funding for one learning improvement day, saving $12.1 million. Learning improvement days are paid workdays on which teachers and other certificated staff members do not meet with students.

In the special education, learning assistance, and Washington Assessment of Student Learning programs, federal monies replace GF-S funds for a $24.1 million saving.

Funding for the Better Schools class size reduction program is reduced, saving $24.6 million. The better schools program was established by the legislature before the people enacted Initiative 728, which also reduces class sizes.

**Higher Education**

GF-S support for higher education is reduced by $68.9 million from the $2.8 billion originally appropriated.

General Fund support for operating costs is reduced by 5 percent at the four-year schools and 3 percent at the community and technical colleges, saving $53.9 million.

The community and technical colleges get an additional $1.4 million to boost the cost-of-living increase for faculty covered by I-732 to 3.6 percent rather than the 3.1 percent originally budgeted. COLAs for other college and university employees are eliminated, saving $21.5 million. The governor vetoed $6 million in legislative appropriations for targeted faculty recruitment and retention pay increases at the four-year schools.
Contribution rates for pensions are reduced, saving $2.2 million. State contributions for health benefits are decreased, saving $4.3 million.

Funding for the State Need Grant program is increased by $2.2 million to offset expected tuition increases. Funding for the Washington Promise Scholarships is decreased by $2.5 million.

The budget provides $9.5 million to settle a lawsuit over pension contributions for part-time faculty at the community and technical colleges.

Four million dollars is provided to expand the worker-retraining program at the community and technical colleges.

The University of Washington and Washington State University are allowed to increase tuition for resident undergraduate students by 16 percent. The other 4-year institutions are allowed 14 percent increases for resident undergraduates. The community and technical colleges are allowed to raise resident tuition rates by 12 percent.

If fully exploited, these tuition increases would raise about $18 million to offset in part the decrease in GF-S support.

**Human Services**

Maintenance changes added $95.9 million to the Department of Social and Health Services. Offsetting these was a net reduction $154.7 million in policy changes, for an overall reduction of $58.8 million from the $6.2 billion original appropriation. Of the cuts, $41 million actually represent shifts of funding responsibility away from the GF-S to other state accounts or to federal grants.

For other human services, a net maintenance increase of $41.4 million was offset by a net policy decrease of $39.6 million. Of these cuts, $29 million are simply shifts of funding responsibility.

The supplemental budget increases GF-S appropriations for the Medical Assistance programs serving low-income people by $91 million. About one third of this represents increases in enrollments, and two-thirds represents increased costs per enrollee. An additional $3.7 million is provided to increase the rates paid to physicians and to ambulance operators.

Legal immigrants who have been in this country for less than 5 years and undocumented children will be directed away from the Medical Assistance program and to the Basic Health Plan. The Basic Health Plan is funded from the Health Services Account rather than the General Fund; the shift will reduce GF-S spending by $23 million. The Basic Health Plan provides a less comprehensive package of services than the Medical Assistance program, and requires recipients to share the costs of care.

Caseload growth in the state-funded General Assistance-Unemployable welfare program adds $13 million to GF-S spending. However, the state expects to save $5.4 million by tighter application of eligibility rules. The state will save $28 million by limiting the payment of supplemental benefits to people receiving benefits federal Supplemental Security Income program.

A drop in caseloads saves $25 million in long-term care. An increase in nursing home license fees will save $2.7 million GF-S. And the state will save $1.7 million GF-S by giving only a 1.5 percent increase to contractor service providers’ rates than the 2.3 percent increase originally budgeted.
Funding for developmental disabilities programs is increased by $9.9 million GF-S.

Caseload growth has increased spending on mental health programs by $8.5 million GF-S. The state will save $22.2 million GF-S by spending down reserves held by the Regional Support Networks.

Caseload decreases in juvenile rehabilitation will save $5 million in GF-S. Low risk juvenile offenders will be released early, and parole services will be restructured, saving $2.5 million GF-S. The Mission Creek Youth Camp will be closed saving $1.5 million GF-S.

Maintenance changes in the Department of Corrections add $41.1 million GF-S. While much of this represents the increased forecast for prison populations, workload in the community supervision program is up also, and healthcare costs are up significantly.

**Natural Resources**

GF-S spending on natural resource programs is reduced $39.8 million from an original appropriation of $355 million.

Of the cuts, however, $18.9 million represent shifts of funding responsibility from the General Fund to other state accounts: Among the larger shifts, the Disaster Response account picks up $3.5 million in fire suppression costs. The Salmon Recovery account picks up $2.8 Million in salmon related expenditures. And the Water Quality Account picks up $9.6 million in water quality related expenditures.

Administrative reductions and efficiencies are expected to save $4.8 million.

The Department of Fish and Wildlife’s salmon recovery grants program is eliminated, saving $3.3 million. It is expected that potential recipients will apply instead to the Salmon Recovery Funding Board.

Park closings and reduced maintenance save $2 million GF-S. The McAllister Creek hatchery will be closed, saving $273 thousand.

**State Employee Compensation**

State employees will receive no cost-of-living increase for the second year of the biennium, saving $28.9 million.

Reductions in pension contribution rates save $6.1 million GF-S, while reductions in state contributions for employee health benefits saves $5.1 million GF-S.

A separate appropriation of $6 million serves to reduce the impact of the cuts in health benefits for state and higher education employees. At one point this $6 million had been targeted for recruitment and retention of state employees.

**Special Appropriations**

Assistance provided to cities and counties to offset revenues lost as a result of the elimination of the motor vehicle excise tax is reduced significantly, saving $57.4 GF-S.
Risks to the Budget

The $308 million combined balances of the General Fund and the Emergency Reserve Fund leave little margin for further bad news.

Recent reports suggest that the national economy is emerging from recession more quickly than had been assumed by state revenue forecasters when they prepared the most recent revenue forecast in February. Perhaps as a result of this, revenue collections have $17 million more than forecast over the last two months. However, there are no signs that local aerospace employment will turn around soon, which is a key to ending the state’s recession.

The troubles in the Middle East increase the risks of higher oil prices and a double-dip recession.

The budget counts on the state receiving significant “disproportionate share” money from the federal government to support state medical programs. The federal government is disputing state claims, putting at risk up to $400 million.

A major goal of the governor and legislative budget writers was to provide $25 million in additional funds for the Liability Account, from which the state pays tort claims that are not covered by insurance. The budget passed by the legislature included such an appropriation. The governor vetoed this provision, however, to bring reserves to the $300 million level. There is thus a risk of tort claims exhausting the Liability Account.

Sustainability

In early April, before the governor announced his vetoes, analysts at the state Office of Financial Management prepared a budget projection for the 2003-05 biennium based on the supplemental budget that passed the legislature.

This outlook extends spending forward based on forecasts of growth in public school enrollments, prison populations, and human service caseloads. The calculation assumes that medical costs increase at 12 percent per year, that state employees are given cost-of-living increases in 2003 and 2004 equal to the rate of Seattle CPI inflation, and that higher education enrollments are allowed to increase at the state’s rate of population growth.

The Research Council has adjusted this projection to reflect the governor’s vetoes.

The adjusted projection shows expenditures exceed revenues by about $1,230 million in the 2003-05 biennium resulting in a negative ending balance for the General Fund of $920 million.

The Research Council believes that the state should begin a biennium with a budget that projects a positive ending balance of at least 2.5 percent of appropriations, which translates to about $600 million for the 2003-05 biennium. Thus the gap that the legislature will face when it assembles next January to write a budget for 2003-05 looks to be on the order of $1.5 billion.