



**BRIEFLY**

**Governor Gregoire's budget for 2007–09 spends \$33.4 billion from the general fund-state and related accounts, up 14.9 percent from 2005–07.**

**Ending reserves are only 2 percent of spending, too low for this point in the revenue cycle.**

**The spending commitments made in the budget are not sustainable.**

# GOVERNOR GREGOIRE PROPOSES 2007–09 BUDGET WITH \$1.2 BILLION STRUCTURAL DEFICIT

The 2007 session of the Washington Legislature begins on Monday, January 8<sup>th</sup>. As this is an “odd” year, it will be a long, 105 day session and a primary task for legislators will be to pass a budget for the 2007–09 biennium, which begins July 1.

Governor Chris Gregoire released her proposed budget on December 19<sup>th</sup>. Under this plan, general fund-state spending would reach nearly \$30 billion.

The week prior to the grand unveiling, Governor Gregoire held a number of media events across the state at which she highlighted various pieces of her spending plan: At Seattle's Garfield high school, she introduced an initiative to improve science and math education in the public schools. At a credit union in Seattle, she called for the creation of a constitutional “rainy day” fund that would build reserves to cushion the state budget against future economic downturns. Along the Puget Sound shoreline, again in Seattle, she presented her plan to restore the Sound. In Richland, the topic was her Working Lands Initiative, intended to improve the economic viability of agriculture and forestry in the state. In Vancouver the topics were higher education and workforce development; in Spokane, programs to train healthcare professionals who will locate their practices in rural communities.

All these programs reflect the Governor's priorities. Her budget marks just a starting point for legislative deliberations; legislators will add their own priorities to the budget that is ultimately enacted.

The governor's budget would increase general fund-state spending by 12.5 percent and leave a scant \$606 million in reserves (with \$262 million of this locked up in the hard to access rainy day fund). At this point in the economic cycle, this is simply too small a reserve. In addition, the spending commitments made by this budget set the state up for budget shortfalls in ensuing biennia.

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**2007-09 BALANCE SHEET**

Figure 1 presents the general fund-state (GFS) balance sheet for Governor Gregoire's proposed 2007–09 budget.

Under resources, the balance sheet shows a beginning balance of \$815 million, forecast revenues of \$29.5 billion, \$134 million transferred to



the budget stabilization account, \$6 million lost from legislation implementing the sourcing provisions of the streamlined sales and use tax agreement, \$3 million lost from minor tax code changes proposed by the department of revenue, \$11 million gained from staffing increases and better customer service at state liquor stores, and \$15 million transferred from the treasurer’s service account.

**Figure 1: 2007-09 General Fund-State Balance Sheet**  
(millions of dollars)

<b>Resources</b>	
Beginning Fund Balance	814.7
November 2006 Forecast	29,533.3
Transfer to Budget Stabilization Account	(134.0)
Streamlined Sales and Use Tax Proposal	-5.9
Department of Revenue Request Legislation	-2.9
Liquor Control Board Budget Driven Revenue	11.0
Transfer from Treasurer’s Service Account	15.0
<b>Total Resources (including beginning fund balance)</b>	<b>30,231.2</b>
<b>Expenditures</b>	
Governor’s Proposed 2007-09 Budget	29,942.6
<b>Reserves</b>	
Projected General Fund Ending Balance	288.6
Suggested Judicial Budget Savings	55.0
Budget Stabilization Account	262.0
<b>Total Reserves</b>	<b>605.6</b>

The Governor’s 2007 supplemental budget opens the budget stabilization account (BSA) with an appropriation of \$128 million. BSA will become Governor Gregoire’s constitutional rainy day fund if legislators and voters concur. Given such concurrence, 1 percent of general state revenue will automatically go into the BSA each year, beginning with FY 2009. Funds could be taken from the account only with 60 percent majorities from both houses of the legislature, unless either the Governor has declared an emergency or the forecast council has forecast annual state employment growth of less than 1 percent. In either of these events, use of BSA monies would require only simple majorities.

Governor Gregoire’s proposed budget would spend \$29,942.6 million. By law, the Governor’s budget must incorporate without revision budgets prepared by agencies in the judicial branch of state government. Governor Gregoire, however, has prepared an alternative judicial budget that would save \$55 million in the GFS and other accounts.

The Governor’s proposed GFS spending for 2007–09 is 12.5 percent greater than the \$26,570.8 million figure that we believe best measures GFS spending for 2005–07, as explained below.

The balance sheet shows \$606 million in reserves at the end of the biennium. Of this, \$288 million is unrestricted ending balance, \$55 million is judicial savings (some transferred from other accounts to the general fund) and \$262 is million locked in the BSA. Projected ending reserves are only 2 percent of GFS spending. At this stage of the revenue cycle, a 5 percent reserve would be appropriate.

**NGFS BALANCE SHEET**

Focusing only on the GFS gives an incomplete picture of the governor’s spending plan, however.

Over the past fifteen years, budget writers have increasingly routed spending on programs traditionally funded from the general fund through eight other accounts, which operate as appendages of the general fund. These accounts (the “GFS-related accounts”) include the health services account, the student achievement account, the education legacy trust account, the public safety and education account and its equal justice sub-account, the violence reduction and drug enforcement account, the water quality account, and the pension funding stabilization account. The Legislative Evaluation and Accountability Program (LEAP) Committee’s data system aggregates the GFS and the eight related accounts together as the “near general fund-state” (NGFS).

**Figure 2: Combined Balance Sheets for the Near General Fund-State**

(Millions of Dollars)

Near General Fund-State as defined by the Legislative Evaluation and Accountability Program Committee

	GFS-Related Accounts										Total
	GFS	Violence		Public	Equal	Health	Water	Education	Pension	Budget	
		Student Achievement	Reduction and Drug Enforcement								
Beginning Balance	814.7	275.6	15.2	1.4	0.1	181.6	24.3	109.4	319.7	128.0	1,870.0
Revenue	29,417.3	593.0	106.8	200.1	12.7	1,230.0	91.0	323.3	13.3	134.0	32,121.6
Expenditure	29,888.0	868.5	116.4	201.0	12.8	1,399.1	115.1	424.7	333.0	0.0	33,358.5
Ending Balance	344.0	0.04	5.6	0.6	0.1	12.5	0.3	8.1	0.0	262.0	633.1
Surplus (Deficit)	(470.7)	(275.5)	(9.6)	(0.8)	(0.0)	(169.1)	(24.1)	(101.4)	(319.7)	134.0	(1,236.9)

Note: GFS expenditure is net of \$55 million in savings to the judicial budget as recommended by Governor

Source: Balance sheet at <http://www.ofm.wa.gov/budget07/highlights/assets/pdf/balancesheet.pdf> and Table 15 at <http://www.ofm.wa.gov/budget07/summary/default.asp>

A recent report by the Washington Alliance for a Competitive Economy criticized the movement of spending from the GFS to the related accounts, saying it decreases fiscal transparency and accountability (WashACE 2006).

Under Governor Gregoire's budget proposal, spending from the eight related accounts totals \$3,470.5 million for the 2007–09 biennium. All together NGFS spending totals \$33.4 billion for the biennium, up 14.9 percent from 2005-07.

Figure 2 presents a combined balance sheet for the GFS and the eight related accounts.

For the biennium, projected revenue to these accounts is \$32.1 billion. The difference between spending and revenue—the NGFS deficit—is \$1,239 million. This deficit—3.7 percent of spending—is covered by drawing reserves down from \$1,870 million at the beginning of the biennium to \$633 million at the end. Virtually all of the ending reserves are held either in the GFS itself and or in the budget stabilization account.

These reserves amount to only 1.9 percent of NGFS spending for the biennium. Again, at this stage of the revenue cycle, we believe that a 5 percent reserve (which would be \$1,668 million) is appropriate.

#### SPENDING HIGHLIGHTS

Gregoire has stated that the three top priorities in her budget are education, economic development and health care. Much of her emphasis under economic development, however, is higher education; her priorities thus might more accurately be described as education, education and health care.

Based on analysis by Senate Ways and Means Committee staff (SWM 2006a, 2006b) \$31.5 billion of the \$33.4 billion proposed NGFS spending, represents the costs of maintaining existing programs. (Included in this maintenance cost is \$381 million for the pay increases mandated by Initia-



tive 732 for K-12, and community and technical college teachers and staff, who get COLAs of 3.4 percent for the 2007–08 school year and 2.6 percent for 2008–09.)

The remaining \$1.9 billion of the proposed budget represents new policy initiatives. The following summarizes these initiatives:

*Compensation: \$541 million GFS; \$11.7 million related accounts.* This largely represents the cost of implementing the recent collective bargaining agreement and extending comparable pay increases to non-represented state employees. Also included are \$7.5 million to raise the pay of part time faculty at community and technical colleges, \$67.4 million for K-12 salary adjustments and \$66.4 million for increased K-12 employee health care costs. The budget anticipates savings of \$106.1 million in the biennium from repealing the “gain sharing” provisions of the state pension plans (WRC 2006a).

*Vendor Rates; \$241.4 million GFS.* This includes \$ 85.8 million to boost pay and health care benefits for child care workers, \$49.5 million for pay raises under the collective bargaining agreement with home care workers and \$21.1 million for comparable raises for home care workers not covered by the agreement; \$15.8 million to boost payments to pediatricians from Medicaid; \$29.7 million to boost rates for nursing homes, boarding homes and adult family homes; \$10.8 million to increase payments to hospitals; and \$10.5 million for foster care.

*Early Learning; \$47.9 million GFS.* This includes \$27.0 million for the Early Childhood Education and Assistance Program to add 2,000 slots and boost vendor rates by 8 percent per year; \$9.3 million to begin implementation of a quality rating system for state-funded child care providers; and \$6.0 million for an early learning information system.

*K-12 Education: \$246.0 million GFS; \$57.0 million related accounts.* The governor’s science and math initiative gets \$164.8 million; \$61 million goes to increase access to special education for three- and four-year-olds; and \$41.6 million begins to phase in all-day kindergarten for students who qualify for free or reduced-price lunches.

Including teacher and staff COLAs, spending per student would rise by \$864, or 14 percent.

*Higher education: \$67.8 million GFS; \$156.6 million related accounts.* This includes \$57.5 million for financial aid, \$49.1 million for general enrollment increases, \$47.0 million for enrollment increases in high demand fields, \$19.7 million to allow community colleges to freeze tuitions, \$18.5 million for research and \$15.1 million for the governor’s initiative to train health care professionals who will practice in rural communities. The four-year institutions will get additional new money from tuition increases.

*Human Services: \$150.6 million GFS.* Among the major items are \$24.6 million for an offender reentry initiative by the department of corrections; \$23.8 million for mental health programs; \$28.2 million to developmental disabilities programs; \$16.1 million for child support enforcement; \$8.4 million for a new program to support families exiting TANF (the major federal/state welfare program); and \$8.1 million for expanded services and service improvements in long term care.

*Natural Resources: \$43.8 million GFS; \$71.3 million related accounts.* Included here are the Governor’s Working Lands Initiative providing \$6.9



million for farms and farmers and \$2.6 million for small forest landowners; \$7.8 million for Puget Sound; \$4.6 million to maintain hatcheries; and \$8.2 million for various recreation programs.

*Health Care: \$48.5 million GFS; \$42.8 million related accounts.* The major items here are \$30.9 million to add 32,000 children to the Medicaid and SCHIP programs through the Cover All Kids Initiative; and \$19.8 million for the expansion of the state’s universal childhood vaccination program.

*Judicial Agencies: \$67.6 million GFS; \$10.6 million related accounts.* The judicial agencies have requested adds totaling \$78.2 million. By law Governor Gregoire must forward these requests to the Legislature without modification as part of her budget. She has, however, put forward an alternative judicial budget that reduces the policy adds to \$23.2 million.

*Other: \$52.3 million GFS; \$10.7 million related accounts.* The biggest single item here is debt service, \$12.1 million.

**LOOKING BACK AT 2005-07**

Before turning to the outlook for the years beyond 2007–09, it is useful to review the evolution of the 2005–07 GFS budget. See Figure 3.

**Figure 3: 2005-07 General Fund-State Balance Sheet**

(millions of dollars)

Resources	
Beginning Fund Balance	869.7
November 2006 Forecast	27,365.8
Fund Transfers Enacted 2005 Session	216.8
Fund Transfers Enacted 2006 Session	(9.5)
Other Adjustments	1.7
Total Resources (Including Beginning Fund Balance)	28,444.5
Expenditures	
2005-07 Appropriations	25,952.4
2006 Supplemental Budget	
Appropriations to NGFS Accounts	
Pension Funding Stabilization Account	350.0
Student Achievement Account	275.0
Health Services Account	200.0
Other Appropriations	520.5
2007 Supplemental (Governor's Proposed)	
Appropriations to BSA and NGFS Accounts	
Budget Stabilization Account	128.0
Public Safety and Education Account	3.0
Equal Justice Subaccount	3.0
Education Legacy Account	100.0
Other Appropriations	97.9
Total Spending	27,629.8
Total Excluding BSA and NGFS Appropriations	26,570.8
Reserves	
Projected General Fund Ending Balance	814.7
Budget Stabilization Account	128.0
Total Reserves	942.7

Sources: OFM, LEAP, SWM

The budget passed by the legislature in 2005 seemed extremely aggressive at the time. Spending of \$25,952 million was a 12 percent increase from the preceding two-year budget. Expected revenues, bolstered by \$353.7 million in new taxes and other revenue enhancements, were only \$25,239 million. The balance was covered by transferring \$217 million from other accounts to the GFS and by drawing down reserves. The projected ending balance was a scant \$178 million. We panned this budget, saying it set the state on an unsustainable spending path (WRC 2005).

Much stronger than anticipated economic growth turned the deficit into a surplus, however.

From March 2005 to November 2006, statewide seasonally adjusted employment grew by 5.1 percent. In both the aerospace and software sectors, employment grew 16.7 percent, while construction employment grew 13.1 percent. State revenue particularly benefited from the strength of the construction and real estate sectors.

Washington’s revenue system is unusually sensitive to the level of activity in the construction and real estate sectors. We are one of the few states to collect sales tax on construction labor, and only four states have a higher state sales tax rate. Construction was 6.9 percent of employment in November 2006. The construction sector has not represented so large a share of the state economy since 1981.

The state also has one of the nation’s highest real estate excise taxes. The real estate excise tax is forecast to provide \$951 million in FY 2007, twice the amount it provided in FY 2003. Over the same period the comparable increase for sales tax is 30 percent, for the B&O, 37 per-





cent.

The most recent forecast (November 2006) puts revenue for the biennium at nearly \$27.4 billion, \$2.1 billion more than legislators expected at the time they wrote the initial budget for the biennium.

The 2006 legislature responded to the revenue windfall in a fairly responsible way. The 2006 supplemental budget increased programmatic spending from GFS by \$520.5 million, while appropriating \$825 million to increase the reserve levels of three GSF-related accounts (the pension funding stabilization account, the student achievement account, and the health services account).

Governor Gregoire’s proposed 2007 supplemental budget similarly adds only \$97.9 to programmatic spending for the 2005–07 biennium. Her budget appropriates \$106 million to GFS-related accounts (the public safety and education account, its equal justice sub-account, and the education legacy trust account. It also appropriates \$128 million to the budget stabilization account.

Altogether, the two supplemental budgets appropriate over \$1 billion in reserves to the GFS-related and budget stabilization accounts for carry forward to 2007–09. We don’t count these appropriations as true spending in the 2005–07 biennium, and so put GFS spending for the biennium at \$26,570.8 million.

**LOOKING BEYOND 2007–09**

Of the \$1.2 billion NGFS deficit for 2007–09 biennium, \$900 million occurs in the GFS-related accounts. Such deficits are only possible because of the large appropriations to these accounts during 2005–07. The GFS-related accounts

end the 2007–09 biennium nearly drained of reserves. As a result, they require infusions of money from the GFS in ensuing biennia to maintain funding for their programs. This “backfill” dominates the outlook for the GFS.

Figure 4 presents a three biennia GFS balance sheet prepared by OFM analysts to accompany Governor Gregoire’s budget proposal. For the biennia beyond 2007–09, for which the forecast council has yet to issue forecasts, the analysts assume that revenue will grow at 5 percent per year, which they take to be the long-run trend. Revenue is reduced by annual transfers to the proposed constitutional rainy day account.

The baseline expenditure line shows the cost of continuing all programs funded from GFS under the Governor’s 2007–09 budget. These programs expand or contract with anticipated

**Figure 4: Three-Biennia Outlook for GFS**

(Millions of Dollars)

	2007-2009	2009-2011	2011-2013
Beginning Balance (General Fund-State)	814.7	344.0	(1,206.0)
Revenues			
Baseline (5% annual growth after 2009)	29,534.0	32,620.0	35,963.0
Revenue Legislation and Budget Driven Revenue	17.3	-	-
Transfer to Budget Stabilization Account	(134.0)	(291.0)	(320.0)
Available Revenue	29,417.3	32,329.0	35,643.0
Expenditures			
Baseline Expenditures	29,943.0	32,676.0	35,643.0
Pension Cost Base shifted from Pension Funding Stabilization Account	-	333.0	333.0
Pension Costs	-	268.0	459.0
Health Services Account Backfill	-	232.0	408.0
Student Achievement Fund Backfill	-	370.0	364.0
Total Expenditures	29,943.0	33,879.0	37,207.0
General Fund Ending Balance *	344.0	(1,206.0)	(2,770.0)
Other Reserves			
Budget Stabilization Account	262.0	553.0	873.0
Total Reserves	606.0	(653.0)	(1,897.0)
GFS/BSA Deficit (Change in GFS and BSA reserves)	(336.7)	(1,259.0)	(1,244.0)

\* The General Fund Ending Balance assumes \$55 million of expenditures in Judicial agencies will not be funded.



caseload and enrollment changes. Costs generally rise with the rate of inflation (2 percent per year), while state employees and K-12 teachers and staff receive annual cost of living increases. Increases in the per capita medical costs for employees and in the medical assistance program run between 6 and 7 percent per year.

The next four lines show additional obligations on GFS: (1) pension costs that will be paid from the pension funding stabilization account in 2007–09, but must be paid from GFS once the former account is exhausted; (2) the need to pay down the state’s unfunded pension liability; (3) costs of programs funded from the health services account greater than the revenue dedicated to that account; and similarly (4) costs of programs funded from the student achievement account greater than the revenue dedicated to it.

The balance in the budget stabilization account grows over time; the balance in the GFS itself becomes increasingly negative. At the end of the 2009–11 biennium, total reserves are \$653 million to the red; at the end of the 2011–13 biennium they are \$1,897 million to the red. The deficit, measured as the change in total reserves is \$1,259 million for 2009–11 and \$1,244 million for 2011–13, figures quite close to the \$1,239 million NGFS deficit for 2007–09.

The Governor’s budget has a structural deficit of \$1.2 to \$1.3 billion.

#### DISCUSSION

Governor Gregoire’s proposed budget simply saves too little and spends too much.

In the near term the budget is expected to end the biennium with \$633 million in reserves in the GFS, the related accounts, and the budget stabilization account. This represents only 1.9 percent of 2007–09 spending from these accounts. A prudent 5 percent reserve would be \$1,668 million. Against this standard, the \$262 million put into the constitutional rainy day fund is little more than a fig leaf.

Longer term, the spending commitments contained in the budget are not sustainable. Assuming 5 percent annual revenue growth, GFS reserves are negative by \$653 million at the end of the 2009–11 biennium and \$1.9 billion at the end of 2011–13, even if the budget stabilization account is tapped. And the 5 percent growth rate used in these projections may well be too high. Reversal of the recent increase in construction’s share in the state economy could easily shave 1 percent from the revenue growth rate. Assuming 4 percent growth, GFS reserves are negative by \$1.1 billion at the end of 2009–2011 and \$3.6 billion at the end of 2011–13.

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