POLICY
brief

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Gregoire Presents Budget Plan – Legislature Must Protect Reserves

BRIEFLY

The governor has said she intends to protect reserves in the coming session. That's the prudent and commendable approach. The legislature should match her restraint.

Governor Chris Gregoire presented her proposed supplemental budget December 20. Since the legislature adopted the two-year budget plan for 2005-2007 last spring, solid economic growth has substantially boosted revenue collections and expectations. With the November forecast, the state's projected 2007 ending fund balance has soared to about $1.4 billion from slightly more than $200 million at the end of the legislative session.

Supplemental budgets amend the adopted biennial budget, primarily in response to changed conditions, such as increases or decreases in school enrollments, health and social service entitlement programs, prison populations, and the like. These are routine adjustments and account for much of the new spending proposed by the governor.

The supplemental budget can also be an opportunity to initiate new programs, taking advantage of an influx in new revenue from a stronger economy. Within a supplemental budget, there's the opportunity to begin such programs on the cheap, since only half the biennial cost shows up in the remaining year of the two-year budget period. The bow-wave effect of such program launches can be considerable, and the short legislative session offers less time to consider the long-term implications of the new spending. Typically, analysts believe that the supplemental budget is not an appropriate vehicle for major program initiation; it is better to have new programs compete within the priority-setting context that accompanies the development of the full biennial budget.

The governor proposes about $504 million in new spending, of which she says $281 million is required as a result of caseload and economic changes. An additional $223 million would be used primarily for education, environmental clean-up, economic development, and pension funding.

Legislative analysts slice the numbers slightly differently. The Senate Ways and Means Committee overview describes the governor's supplemental budget as consisting of $151 million in maintenance level spending and $398 million in new policy level items (including $45 million in revenue reductions and transfers). Besides the revenue ad-

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Chart 1: Breaking Down the Supplemental

$ in Millions

Reserve Accounts	
Emergency Reserves	112.6
Pension Stabilization (net)	127.4
Unrestricted Reserves	200.7
Economic Stability Account	464.0
Total in Reserve	904.7
Policy Changes	
Human Services	106.1
Health Services Account Transfer	85.0
K-12 and Higher Education	77.3
Pensions	49.0
Revenue Reductions/Transfers	45.0
All Other	18.0
Energy Efficiency Grants	17.5
Subtotal Policy	397.9
Maintenance Spending	150.5
Grand Total	1,453.1

Source: Senate Ways and Means Committee

justment, most of the difference stems from the treatment of $85 million in backfill funding for the Health Services Account, which is a policy decision, and $30 million for the courts. The Ways and Means staff says there is some subjectivity involved in the breakdown; they chose to be consistent with the system used in previous years. (The governor's budget speaks of "required spending," not "maintenance level" spending, the more specific term referring to mandatory or entitlement spending growth.) For this report, we will allocate the funding following the more conventional Ways and Means breakdown, which is similar to the analysis by the House Office of Program Research. (See Chart 1.)

Arguing for fiscal restraint – an argument strongly buttressed by the state budget office's own projections showing a return to deficits within three years – the governor leaves $201 million in unrestricted reserves, with more allocated among three separate savings accounts. On the balance sheet (Chart 2), these transfers show up as a $112.6 million transfer to the Emergency Fund, a reduction in resources, and a $591.4 million appropriation to reserves. Of that $591.4 million, $464 million is appropriated to a new Economic Stability Account, to help cover costs in the next biennium, and $127.4 million to a new Pension Funding Stabilization Account, to fund a portion of pension obligations through 2009. Total reserve funds, then, amount to $904.7 million.

Given the growth of the reserve, the pressure in the legislature to increase spending beyond the level set by the governor will be great. But it should be remembered that a half-billion dollars is still a lot of money, and most of it will be spent in just one year of the biennium, amounting to a 3.3 percent boost in planned spending for the 2007 fiscal year. Overall, if the governor's budget holds, the state will have increased biennial spending by about 12 percent from the previous two-year budget cycle, after accounting for the supplemental budget passed in 2004.

"REQUIRED SPENDING"

There will be little argument over the governor's proposed "required spending" to address caseload and enrollment changes, fuel price increases, the costs of fighting last summer's forest fires, higher inflation, and other unanticipated expenses. These expenditures primarily reflect the routine and appropriate budget adjustments anticipated in the second year of the biennium.

Under Initiative 732, for example, public school teachers and community college faculty receive cost-of-living allowances tied to the Seattle Consumer Price Index. The original budget forecast the CPI to be 1.7 percent; the latest forecast has the CPI rising by 2.7 percent. The additional cost for the 2006-2007 school year: $31.3 million.

Similarly, the prison population is expected to increase by 360 inmates in the coming year, reaching 18,200. And an additional 2,500 offenders are expected to require community supervision. The cost required to handle the higher caseload is $22.2 million.

And the transfer of $85 million in General Fund State money to the perennially strapped Health Services Account, while not strictly required, has become nearly routine.

Chart 2: 2005-2007 State General Fund Balance Sheet
With Governor's Supplemental - Dollars in Millions

Resources	
Beginning Fund Balance	852.6
November 2005 Revenue Forecast	26,335.7
Fund Transfers and Other Adjustments	216.8
Governor's Supplemental	
Energy Initiative - Utility Tax Credit	(7.5)
Tax Penalty & Payment Date Revisions	(18.3)
All Other Proposed Revenue Legislation	(2.5)
Subtotal	26,524.2
Adjustments to Transfers	(16.8)
Transfer to Emergency Reserve	(112.6)
TOTAL RESOURCE (with beginning balance)	27,247.4
Expenditures	
Current 2005-2007 Appropriation	25,952.4
Governor's Supplemental	
Maintenance and Other	503.0
Appropriations to Reserves	591.4
Subtotal Supplemental	1,094.4
TOTAL EXPENDITURES	27,046.8
Balance	
Unrestricted General Fund-State Balance	200.7

Source: Proposed 2006 Budget and Policy Highlights, Office of the Governor

NEW SPENDING

In addition to the required spending, the governor's supplemental includes a number of new and expanded "targeted investments." Included among the targets: putting money toward the state's looming pension obligation, helping students who fail the WASL exam, creating a cabinet-level department of early learning, promoting development and use of biofuels, cleaning up Puget Sound, and bolstering the WorkFirst program. She also provides business tax incentives and jump-starts funding of the life sciences project authorized in the last legislative session.

Pensions. Last session, the legislature chose not to make a payment of $176 million, recommended by the state actuary, to reduce a nearly $4 billion unfunded pension liability. The governor creates a Pension Funding Stabilization Account, appropriating $176 million to it and taking $49 million out to meet current obligations. It's part of a three-year plan to catch up with obligations. An analysis by Senate Republicans says the lag in contributions increases costs by $552 million over the next 25 years (combined state and local obligations) as the missed payment is re-amortized.

Education. To graduate from high school, the class of 2008 must pass the Washington Assessment of Student Learning. The governor says she supports the high standards, and believes the state should provide more assistance for students who fail the test. Her supplemental budget sets aside $38.5 million for a new program to help students who fail one or more of the 10th grade WASL tests. She also provides funding for math remediation and assistance with higher energy costs affecting the schools.

The governor proposes creation of a cabinet-level Department of Early Learning. She uses one-time funds of $1.5 million to establish the program, which would consolidate existing child care and early-learning programs, develop ratings systems to evaluate providers, and generally work to improve day care and pre-school programs.

Funding is also provided to create BA programs in four community and technical colleges and to assist community and technical colleges with the costs of operating new facilities. The University of Washington will receive $2.5 million for a planned life science research facility on Lake Union.

Biofuels. The governor would provide $17.5 million for low-interest loans to firms investing in equipment and facilities to produce biodiesel and other alternative fuels.

Puget Sound clean-up. The supplemental also provides about $42 million for Puget Sound clean-up. Most of the money would come from dedicated accounts outside the general fund, which is only scheduled to commit $500,000.

WorkFirst. The supplemental budget provides $46 million to subsidize low-income childcare and childcare for parents enrolled in WorkFirst, the state's welfare-to-work program.

Chart 3: Six Year General Fund-State Outlook
$ in Millions

	2006	2007	2008	2009	2010	2011
Beginning GFS Balance	853	386	201	396	(179)	(981)
Revenues						
Baseline	12,946	13,389	14,059	14,762	15,500	16,275
Transfers	130	87				
Subtotal	13,076	13,476	14,059	14,762	15,500	16,275
Revenue Proposals		(28)	(28)	(24)	(22)	(18)
Transfers	(5)	(12)				
Pension Stabilization Set-aside			115	12		
Economic Stability Set-aside			464			
Emergency Reserve Transfer	(113)					
Total Revenue	12,958	13,436	14,610	14,750	15,478	16,257
BIENNIAL TOTAL		*26,396*		*29,359*		*31,735*
Expenditures						
Baseline	12,769	13,184	13,431	13,676	13,932	14,212
Pension Costs			147	259	357	389
Pension Costs - Gainsharing			90	96	101	107
I-732 COLAs			68	169	247	347
State worker/higher ed COLA			45	96	150	211
Employee health insurance			92	194	306	431
Medical assistance			148	309	486	680
Health Services Acc't Backfill			39	119	274	351
Continue Ed Legacy Programs			106	111	117	123
Subtotal	*12,769*	*13,184*	*14,166*	*15,029*	*15,970*	*16,851*
Governor's Supplemental						
Maintenance of Effort	45	235	134	159	167	175
Options (including $49 MM to pension)	20	203	116	137	144	151
To Pension Stabilization Acc't	127					
To Economic Stability Acc't	464					
Total Expenditures	13,425	13,622	14,416	15,325	16,281	17,177
BIENNIAL TOTAL		*27,047*		*29,740*		*33,457*
General Fund-State ENDING BALANCE	386	200	395	(179)	(982)	(1,901)
Balance using Emergency Reserve and Pension and Economic Stability Accounts	499	905	208	(366)	(1,169)	(2,087)

Source: Office of Financial Management

Economic Development. The proposed budget includes $1 million for start-up costs associated with the $1 billion Life Sciences Discover Fund established last session. It also provides $3 million in tax incentives for aerospace suppliers and $18 million in tax savings to small business by changing reporting requirements and reducing penalties – essentially returning to the way things were done prior to the 2003 legislative session.

DISCUSSION

Although the state budget appears now to rest comfortably upon an ample cash cushion, the structural deficit analysts have warned of in recent years continues to plague budget writers. As is customary, the Office of Financial Management has prepared a six-year general fund-state budget outlook, which shows the state returning to the red in 2009. (See Chart 3.)

Perhaps the best way to think of the present good fortune is to acknowledge that the state is enjoying a cyclical surplus in the midst of a continuing structural deficit. The uptick in revenues temporarily masks the underlying imbalance between persistent revenue and expenditure trends, an imbalance exacerbated by the twelve percent boost in spending in the biennial budget adopted last session.

The outlook, which includes Gov. Gregoire's supplemental budget, highlights the importance of continued spending restraint. As noted, revenue projections for the current biennium are based on the November 2005 forecast. For later years, analysts plug in a forecast of five percent annual growth after 2007.

Several expenditure items warrant particular attention.

Health care costs dominate. Employee health insurance costs, projected to increase annually by ten percent per capita, add nearly $300 million to the 2007-2009 biennial budget and nearly $750 million to the 2009-2011 budget. Medical assistance, primarily Medicaid, continues to grow. OFM assumes annual per capita cost increases of 6 percent and caseload growth of 3.5 percent. For the 2007-2009 biennium, that boosts spending by about $450 million dollars; for 2009-2011, the budget impact exceeds $1 billion. The Health Services Account will continue to require a general fund bail-out, $150 million in 2007-2009 and more than $600 million in the following biennium.

Pension costs also rise steadily. Gain-sharing, enacted during the late 1990s when investment returns were skyrocketing, is projected to cost about $200 million a biennium. As noted in a recent report by the Select Committee on Pension Policy (SCPP), gain sharing has created a substantial liability to the general fund. The legislature can repeal or amend it.

And the Education Legacy Fund, established last session and funded by tobacco and estate tax dollars, will need additional supplementary funding of more than $100 million a year to satisfy its intended obligations.

Note, also, that the shortfall in 2009 occurs after the two new reserve accounts are drained. All this occurs in a scenario projecting five percent annual revenue growth.

Holding nearly a billion dollars in reserves under these conditions makes sense, although it’s hard to see that the Economic Stability Account adds more than rhetorical heft to the debate. The ESA is reserved for the very functions – health care and education – that already dictate most state spending. Still, the account does underscore the problem to be confronted in the next biennium. Of more concern, the money put into the economic stability account is not enough to cover the anticipated shortfall.

Nonetheless, the governor has shown restraint in the face of great temptation. More funding – perhaps several hundred million dollars more – for pensions would be desirable, as would be steps to undo gain-sharing. Those obligations will not recede without affirmative steps being taken today. Delay is costly.

Some of the new spending – the creation of a new state department for early education and the launching of a biodiesel program, for example – more properly would be considered in 2007, when the state writes its biennial budget. Both this supplemental budget and the six-year outlook underscore the dangers of dedicated funds like the Education Legacy Fund and Health Services Account.

Finally, further tax relief, particularly repeal of the estate tax unnecessarily enacted last session, could easily have been justified given the recent revenue growth. Certainly, it should be considered before expanding or launching new expenditure obligations.

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