Today, January 14, the Washington legislature convenes in Olympia for the 2008 regular session; it is scheduled to be a short session (this is an even-numbered year) adjourning by March 13. The state is now in the seventh month of the 2007–09 biennium, operating under a two-year budget enacted during the 2007 legislative session. During the 2008 session, the legislature will enact what is known as a supplemental budget, making minor adjustments to this spending plan. On December 18, Governor Chris Gregoire released a supplemental budget proposal, which will provide the starting point for legislative deliberations.

Until recently, most discussions of the operating budget focused on spending from the general fund–state (GFS), which is the account that receives most of the state’s general tax revenues. To provide a more transparent accounting of state spending, legislative fiscal committees have begun to report spending for a composite “account”—dubbed (rather inelegantly) the near general fund–state (NGFS)—that includes the GFS and seven “related” accounts: the health services account, the student achievement account, the education legacy trust account, the public safety and education account, the violence reduction and drug enforcement account, the water quality account, and the pension funding stabilization account. When the accounts have excess revenues, the surpluses are transferred to the GFS; when the accounts run short of funds, money is transferred to them from the GFS.

We would prefer to see the related accounts (and other accounts, also) consolidated into a larger GFS (WashACE 2006). Short of this, the decision of legislative committees to report spending on a NGFS basis is a positive development. Unfortunately Governor Gregoire’s budget office, which is the source of the most detailed information on the state budget, continues to report in terms of the GFS.

With the 2007–09 budget, it is particularly important to look beyond the GFS. The related accounts entered the 2007–09 biennium with roughly a billion dollars in reserves. The enacted budget draws these reserves down almost completely, increasing appropriations from the related accounts by 55 percent, from $2.4 billion in 2005–07 to $3.7 billion for 2007–09 (LEAP 2007). This level of spending from the related accounts will not be sustainable in 2009–11 without large transfers from the GFS.

The Governor’s proposed supplemental budget would increase NGFS spending for 2007-09 by $234 million to $33.6 billion. By historical standards, these are small supplemental increases. But, coming on the heels of the large increases enacted in 2007, the proposed spending will not be sustainable in 2009–11.
GFS Balance Sheet

We have reproduced on this page the 2007–09 GFS balance sheet incorporating Governor Gregoire’s supplemental budget proposal prepared by the Office of Financial Management (OFM). (The Governor’s budget materials do not include an NGFS balance sheet.)

At the time that the legislature enacted the 2007–09 budget last April, it was expected that the 2007–09 biennium would begin with $788 million in the GFS and $31 million in the emergency reserve fund, and that revenue for the biennium would total $29,491 million. The June and September forecasts added $264 million to 2005–07 revenues (boosting 2007–09 GFS and emergency reserve fund beginning balances) and $545 million to 2007–09 revenues. The September forecast capped a remarkable 16-quarter string of upward forecast revisions.

The November forecast revised 2005–07 down by $2 million and 2007–09 down by $111 million. As a result, the biennium began with a $786 million dollar balance in the GFS and $293.3 million in the emergency reserve fund—for total reserves of $1,090 million—and revenue for the biennium is now forecast to total $29,906 million, as the balance sheet shows.

The balance sheet shows a number of transfers and other adjustments. The recent extension by Congress of the Internet access tax moratorium is expected to reduce GFS revenue by $20 million. Various transfers between the GFS and other state accounts approved by the 2007 legislature add $40 million (net) to the GFS. In November, voters ratified an amendment to the state constitution (SJR 8206, WRC 2007d) establishing a rainy day fund called the budget stabilization account, which will receive an automatic transfer from the GFS each year. The amount of the first transfer, due at the end of the 2007–09 biennium, is projected to be $136 million. (The balance of the emergency reserve fund—the old rainy day fund—has rolled over to the budget stabilization account.) Agency request legislation and budgetary changes will reduce revenue by $1.1 million. Governor Gregoire’s budget proposal would transfer $11 million to GFS from the Treasurers Service Account and $45 million from GFS to the Health Services Account. With these transfers and other adjustments, resources available in the GFS for the biennium total $30,541 million.

The existing 2007–09 GFS budget appropriates $29,623 million. Governor Gregoire’s supplemental proposal would raise that to $29,767 million. It is projected that the biennium would end with a $774 million balance in the GFS and $429 million in the budget stabilization account.
Senate Ways and Means Committee (SWM) staff have provided an NGFS-based breakdown of the Governor’s proposed supplemental spending, which is summarized in the table on this page. Generally, changes in appropriations are classified to be either maintenance level—changes that are necessary to fund entitlements and other legally unavoidable costs—or policy level—new programs, and additions or reductions to existing programs. By the reckoning of SWM staff, the Governor’s budget adds $148.4 million at the maintenance level. This includes $47.3 million for K–12, $68.4 million for the Department of Social and Health Services, and $29.1 million for debt service.

Policy level additions and subtractions on balance increase spending by $68.4 million.

The largest policy decrease is a $106.1 million reduction in the appropriation to the Public Employee Benefits Board (PEBB) to fund state employee healthcare benefits. During the 2007 session, budget writers appropriated sufficient funds to PEBB to cover 8.5 percent per year medical cost inflation; actual increases have averaged about 3.3 percent. With the reduced appropriation, the projected balance at PEBB at the end of the 2007–09 biennium will be $19.2 million rather than $125.3 million. (One could arguably classify this reduction as maintenance rather than policy level.)

Policy level changes other than the health care reduction add $191.9 million. SWM places these changes into eight groupings:

Health Care/Long Term Care/Developmental Disabilities/Mental Health, $24.5 million. This grouping includes $6.3 million savings due to lower than anticipated premium increases for the Healthy Options managed care program. Major adds include $7.4 million for nursing home rate increases that will allow pay and benefit increases for low-wage workers or staffing increases; $5 million for family planning services for sexually transmitted disease services for people who had previously been covered under the Medicaid Take Charge family planning waiver; $4.4 million to cover increases in state costs due to Pierce County’s decision to cease operating a pre-paid community mental health plan; $2.4 million to reimburse Pierce and Spokane Counties for costs incurred due to the Involuntary Treatment Act; $2.1 million to increase rates for adult family homes; $2.1 million to increase state psychiatric hospital staffing; and $2.0 million for administrative expenses of the Health Insurance Partnership, a recently enacted program intended to lower the cost of health insurance for small businesses.

Other Human Services, $19.1 million. This grouping includes $6.2 million for administration of the newly enacted family leave insurance program; $4.8 million to extend the integrated crisis response and intensive case management pilot programs, which are intended to reduce the high use of hospital and jail services by individuals with drug and alcohol addictions; $3.5 million to develop a payment system for home health care and other providers who collectively bargain with the state; and $2.7 million to offset IRS regulations that will reduce the ability of the state to use inter-
accepted tax refunds to cover state Medicaid and welfare costs.

**Corrections/Criminal Justice, $32.2 million.** The largest items here are $9.8 million to fund 130 chemical dependency treatment beds; $5.0 million for in-person verification of sex offenders’ locations; $3.8 million for correctional staff compensation increases; $2.4 million to recruit staff needed to open additional capacity at the Washington State Penitentiary and the Coyote Ridge Corrections Center; $2.4 million for overtime; and $2.1 million for the Juvenile Rehabilitation Administration to replace Federal funds for the Functional Family parole program.

**Lawsuits, $31.6 million.** The largest expenditure here results from the Shared Living lawsuit, which challenged DSHS’s rule that provided lower payments under Medicaid to in-home personal care providers who lived with their clients. In 2006, the Washington Supreme Court ruled that live-ins must receive the same treatment as other providers.

**Natural Resources, $10.9 million.** NGFS spending is reduced by $4.0 million as livestock programs are moved to the capital budget. Adds include $8.7 million to make water from Lake Roosevelt available for municipal, industrial and agricultural users, and to maintain stream flow for fish; and $3.7 million for fire suppression.

**Higher Education, $7.5 million.** The largest items here are $3.0 million for a workplace-based program to qualify licensed practical nurses to become registered nurses and $2.9 million for campus safety.

**K–12 Education, $5.9 million reduction.** The largest item here is an $8.2 million net saving from including more multiple choice questions in the WASL test and shortening the test in certain grades.

### Sustainability

Last April, as legislators finalized the 2007–09 budget, we complained that their spending plans left too little in reserve against a downturn in the economy and made commitments that are unsustainable in the long run. The upward revisions to the revenue forecast in June and September have given the state a bit bigger cushion against a downturn. But since April, economic uncertainty has increased Projected GFS reserves are short of the 5 percent we believe to be desirable at this point in the cycle, and a good share of these reserves are locked up in the budget stabilization account.

The additional revenue provides little help with respect to the long-run sustainability problem. The balance sheet to the left summarizes OFM’s “planning outlook” that looks forward to the 2009–11 biennium. The Forecast Council will not issue an offi-
cial forecast for the 2009–11 biennium until February. OFM projects baseline 2009–11 revenue to be $32.8 billion, assuming a 5 percent annual rate of growth from the official forecast for FY 2009. (Five percent annual revenue growth is OFM’s standard assumption for projections beyond the official revenue forecast horizon; OFM analysts reckon 5 percent to be the long-run average rate of growth of GFS revenue.) Proposed legislation would reduce 2009–11 revenue by $34 million, while the constitutionally required transfer to the budget stabilization account would be $293 million, leaving $32.4 billion available.

Baseline expenditures for the biennium—OFM’s estimate of the cost of carrying forward existing GFS programs—are $32.1 billion. This baseline assumes 2.5 percent pay raises each year for K-12 teachers and others covered by Initiative 732; increases of 1.9 percent and 1.8 percent for other state employees; 5 percent per year increases in per capita health care costs; and general inflation at 1.9 percent for FY 2010 and 1.8 percent for FY 2011. (The 5 percent health care cost growth rate is down from the 7 percent growth rate OFM was projecting last winter.)

Baseline expenditures are $280 million less than available revenue, which would indicate a GFS surplus for the biennium. OFM, however, identifies another $1.8 billion of “necessary” GFS spending: Responsibility for funding employee pensions reverts to the GFS with the exhaustion of the pension funding stabilization account ($448 million); pension costs grow ($163 million); revenues to the health services account, the student achievement account and the education legacy trust are not sufficient to cover commitments ($820 million); and Governor Gregoire’s 2008 supplemental budget throws a bow wave into 2009–11 ($344 million).

Including these additional expenses, GFS expenditures would exceed available revenues by $1.4 billion in 2009–11. The projected GFS ending balance is negative $621 million. While the negative GFS ending balance is offset by a $723 million balance in the budget stabilization account, these funds would not be accessible unless economic growth turned out to be significantly slower than implied by the assumed 5 percent growth in GFS revenue.

**Risks**

Within the last month, many economists have reduced their 2008 forecasts for the national economy and upped the odds they place on the economy sliding into recession. Although the December and January collections reports were on track with the November forecast, we expect that the increased pessimism with respect to the national economy will cause a downward revision to the state revenue forecast in February.

It is conventional wisdom that
even if the national economy does slip into recession, Washington’s economy will continue to grow, albeit more slowly, based on the strength of Boeing, Microsoft, biotechnology and agriculture. While this scenario is plausible, we believe a slowdown in construction is the major risk both for the current and the following biennia (WashACE 2007b). As we have noted elsewhere, state tax revenue is highly sensitive to the level of construction activity (WRC 2007b). In the third quarter of 2007, 7.2 percent of state jobs were in the construction sector. As the chart on page 5 shows, at no other point within the past 50 years was construction this high as a share of employment. In fact, between the first quarter of 1958 and the third quarter of 2005, the only times that the share of employment exceeded 6 percent were in 1978, 1979 and early 1980, when Washington’s population growth reached nearly 4 percent per year, and the “Whoops” nuclear power plants were under construction.

The Forecast Council’s economic forecast shows construction’s share of employment declining in 2008 and 2009, as shown by the chart. This relative decline in construction is a major reason that GFS revenue growth is projected to be relatively weak in FY 2008 and FY 2009 (2.3 percent and 3.8 percent). But even with this decline, construction’s share is forecast to be a historically high 6.9 percent at the end of 2009. Thus we see a good chance that construction will continue to decline as a share of economic activity well into 2011. If it does, below average revenue growth should continue well into the 2009–11 biennium and the 5 percent growth assumed in the OFM outlook will prove to have been overly optimistic.

References


———. 2007c. Senate and House Head Towards a Compromise Budget. PB 07-09. April 17.