Thrive WASHINGTON
Strategies to move our state forward

Nine Steps to Budget Sustainability in Washington State

A joint research series from the Washington Roundtable and Washington Research Council

THE THRIVE WASHINGTON PROJECT

The Great Recession dramatically changed fiscal conditions in Washington state, possibly forever. The impact of falling revenues and structural budget deficits has elicited a near universal call for a transformative shift in state government. This research series—developed by the Washington Roundtable and Washington Research Council—will provide actionable state policy recommendations that, if enacted, will preserve essential services, lay a foundation for sustainable economic growth and create an environment in which Washingtonians can thrive.

When Governor Chris Gregoire launched her state budget transformation initiative this summer, she emphasized the need to think differently about state government, challenge the status quo and put the Washington state budget on a trajectory that ensures sound financial footing over the long-term.

"Today must mark the start of something different," she said during a June 24 news conference. "We must consider a new approach to government."

> "We must consider a new approach to government."
> —Governor Chris Gregoire

As documented in the first paper in the Thrive Washington series, Charting a New Course, Washington has struggled, like most states, with falling revenues and recurring deficits over the course of the Great Recession. Across the nation, governors and legislators have addressed their budget crises with short-term fixes, including heavy reliance on federal stimulus, fund transfers, temporary tax increases and spending cuts.

The National Conference of State Legislatures reports that states have cut funding for even the highest priority services. States have trimmed money for education, social services, Medicaid and other health programs. They have sliced aid to local governments, revised sentencing policy to stem prison costs, and changed employee benefit plans.

Washington state employed some of these strategies during the last two years. Our state also took the step of raising $800 million in new taxes in 2010 (a portion of which was repealed by voters). However, these measures provide only a temporary fix.

In September, the state revenue forecast sliced $1.4 billion from projected tax collections through June 2013. The immediate result: across-the-board spending reductions of $520 million to balance the budget for the current fiscal year and a projected $4.8 billion deficit for the 2011-13 biennium. The projected costs of maintaining current services, including employee compensation and scheduled growth in entitlement spending, far exceeds forecasted revenues, even as the state seems poised for recovery.

NINE STEPS TO BUDGET SUSTAINABILITY IN WASHINGTON STATE

1. Manage the size and compensation of the state workforce to improve efficiency.
2. Improve budget transparency.
3. Reinstate a firm expenditure limit.
4. Implement sound pension reforms.
5. Expand use of the State Efficiency and Restructuring Account.
6. Examine inventory of real property assets for possible sale.
7. Leverage the rainy day fund to protect against future downturns.
8. Better manage debt service.
9. Integrate priority-based budgeting with performance reviews.

The state's chief economist forecasts robust revenue growth of 14.4 percent for the 2011-13 biennium (revenue growth of 10 percent is considered historically average). When combined with revenue from recent tax increases, the state anticipates growth of 16.6 percent during the 2011-13 biennium, or $4.8 billion of additional revenue.

SEPTEMBER 2010 REVENUE FORECAST
(Near General Fund State)

	2009-11	2011-13	% Growth
BASE	28,092	32,143	14.4%
TAXES	706	1,442	–
TOTAL	28,798	33,585	16.6%

**Data adjusted to account for I-1107*

Even with such a high level of projected revenue growth, the state will not be able to fund all existing services or those promised in the future. There also remains a real possibility that collections will underperform the forecast.

Even with 16.6 percent revenue growth, the state will not be able to fund all existing or promised services.

The persistence of the Great Recession exhausted the state's capacity to bridge the revenue gap with short-term strategies. In 2009, faced with a three-year budget deficit approaching $12 billion, the legislature enacted 2009 supplemental and 2009-11 biennial budgets that relied heavily on one-time funds. Federal stimulus funds, fund transfers and reserves, and pension funding deferrals totaled $6.4 billion, more than half of the budget solution.

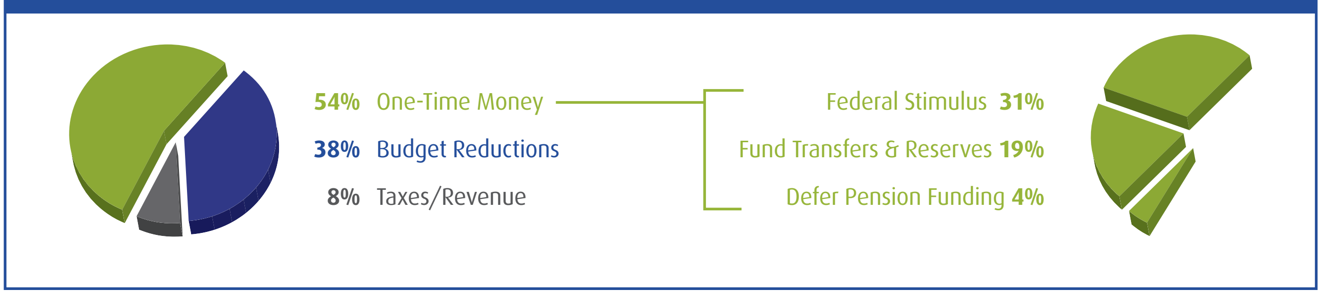
These options will not be available to the next legislature. Federal officials have advised states not to expect another round of bailouts, state reserves and fund balances have been depleted and further deferral of pensions carries significant downside risk.

Carry forward costs (sometimes called "bow wave," i.e., spending commitments pushed out from previous biennia) magnify the budget problem considerably. A May 2010 Washington State Senate Ways and Means Committee analysis found that legislative decisions during the 2009 and 2010 sessions pushed forward or created new costs exceeding $3 billion for the 2011-13 biennium and $5 billion for the 2013-15 biennium.

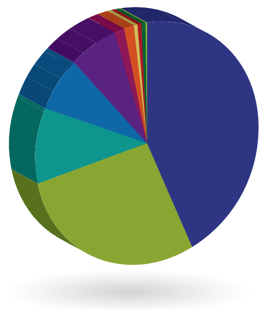
CONFRONTING THE $4.8 BILLION GAP

Limited options exist for swift elimination of the $4.8 billion deficit projected for 2011-13. For the 2009-11 biennium, budgeted Near General Fund State (NGFS) spending amounted to approximately $31 billion. Nearly 80 percent of that is for K-12 education, DSHS and other human services—spending commitments over which the legislature has limited control, absent

2009-11 OPERATING BUDGET SOLUTION
(NGFS in billions, includes 2010 supplemental)



2009-11 OPERATING BUDGET, INCLUDING SUPPLEMENTAL
(NGFS in billions)



$13.44	Public Schools
$8.76	DSHS
$3.09	Higher Education
$2.21	Other Human Services
$2.04	Special Appropriations
$0.46	Governmental Operations
$0.37	Natural Resources
$0.23	Judicial
$0.13	Other Education
$0.15	Legislative
$0.08	Transportation

Source: Fiscal.wa.gov

$4.8 billion shortfall for 2011-13: more than 12% of projected spending

specific policy changes with respect to entitlement programs (e.g., Medicaid) and basic education.

The state constitution protects funding for K-12 basic education, which represents more than 80 percent of the state's public school spending. Further, maintenance-of-effort provisions tied to acceptance of federal stimulus grants during the current biennium also limit lawmakers' ability to reduce spending in certain areas or shift resources to higher priority services.

These restrictions make it all the more challenging to affect budget transformation.

Consequential reductions in programs valued by many Washingtonians will be unavoidable.

The governor's 6.3 percent across-the-board cuts for the current fiscal year took effect October 1. State agency responses to the governor's order provide a preview of what may be on the table during the 2011 legislative session.

- DSHS announced plans to achieve $168 million in savings by eliminating 370 jobs, scheduling more unpaid furloughs, closing a ward at Western State Hospital and making other service reductions.
- The Department of Corrections proposes to cut $50 million by closing Larch Corrections Center, confining inmates to their cells one day a month and eliminating 277 jobs.
- Outpatient prescription drug coverage for Medicaid recipients may also be eliminated, along with subsidized health insurance for 27,000 children in low-income homes.

The $4.8 billion shortfall for the 2011-13 biennium represents more than 12 percent of projected spending. A significant portion of that gap can be closed by increasing efficiency and eliminating low priority services. However, consequential reductions in programs valued by many Washingtonians will be unavoidable. State workers must also contribute to the savings.

Near-term tactics to address the $4.8 billion shortfall for 2011-13 undoubtedly will be painful, which is precisely why those actions, and budget transformation as a whole, must also lead to long-term solutions.

The reset must look beyond the current crisis and address our state's enduring structural deficit.

The following nine steps will set a trajectory for budget sustainability while enabling the state to preserve services that propel economic growth (namely, education and infrastructure) and establishing a foundation for recovery and prosperity.

Nationwide, public and private sector employees pay more than **two times** what Washington State employees pay for healthcare coverage.

84 percent of public employees have defined benefit plans compared to 21 percent of private sector workers.

NINE STEPS TO LONG-TERM BUDGET SUSTAINABILITY

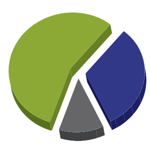
1. Manage the size and compensation of the state workforce to improve efficiency.

A leaner, more efficient state government will require a smaller workforce. The number of state employees must shrink, through retirement, attrition and layoffs.

Contracting out lower priority services, or services where there is established private sector expertise and efficiency, has significant potential to save money and improve service delivery. Washington voters support contracting out. In fact, a strong majority of voters surveyed in the fall of 2010 believe the private sector would do a better job of providing the same service as the public sector.

A future paper in this series will examine the benefits of and potential cost savings from using the private sector to perform activities currently delivered by state workers. Compensation differentials between the public and private sectors also will be reviewed further.

IF BOTH PUBLIC AND PRIVATE SECTORS COULD PROVIDE THE SAME SERVICE, WHO DO YOU THINK WOULD DO A BETTER JOB?



Source: Thrive Washington, Sept. 2010

Last March, The Seattle Times investigated state compensation, examining wage data provided by the state Employment Security Department. The analysis is complicated by state government's occupational mix and the challenge of finding appropriate private sector comparables. On a strict wage basis, the Times reported, "Overall, lower-wage state workers tended to earn more than their non-state counterparts, while higher paid professionals made more in the non-state sector."

An acknowledged weakness in the wage comparison, as the Times noted, is that it did not include health care plans and pensions, which represent about 30 percent of total state employee compensation. The defined benefit pension plans provided to many state workers and the relatively low employee-paid share of health insurance coverage are better than the private and public sector norm.

Washington state employees pay an average of 12 percent of their health insurance premium, family and individual. This is well below what most public and private employees pay nationwide. The 2010 survey of employer health benefits conducted by the Kaiser Family Foundation and Health Research and Education Trust found that "on average (covered workers) contribute 19 percent of the total premium for single coverage (up from 17 percent in 2009) and 30 percent for family coverage (up from 27 percent in 2009)."

The cost difference is substantial. For all plans, Kaiser reports that the average employee pays $3,997 for family coverage. By comparison, Washington state workers enrolled in the Uniform Medical Plan (the most popular of the state plans) pay just $1,476. The cost difference is only slightly higher when comparing Washington state employee costs solely to those of private sector employees. An October 2010 study from the Bureau of Labor Statistics found that in 2009, the annualized average flat-rate premium for family coverage was $4,196, nearly three times the amount paid by state workers in Washington.

Nationally, 84 percent of all public sector employees enjoy defined benefit pension plans, often retiring with a lifetime pension based on the last two or three years of their salary compensation. In contrast, defined benefit plans are available to just 21 percent of private sector workers.

Policymakers must better **utilize** the tools available to manage the state workforce and compensation.

High compensation costs for state employees drive up the cost of public services, creating a higher tax burden and greater budget pressure. As this is being written, collective bargaining in Olympia is stymied over the issue of health care benefits. The state should move to establish parity with the private sector.

Legislative influence over employee compensation was reduced by the Personnel System Reform Act of 2002, which expanded the collective bargaining rights of state workers. The act specifically allows public employee unions to bargain wages and benefits. This provision was enacted in exchange for allowing the state to pursue competitive sourcing or contracting out of state services. As this series will explore, state agencies have not yet made significant attempts to pursue competitive sourcing. Similarly, state lawmakers have not used their ability to revisit collective bargaining agreements in the face of fiscal crises.

Current law directs the governor and unions to "immediately enter into collective bargaining for a mutually agreed upon modification of the agreement" when the legislature declares a "significant revenue shortfall." The state has not invoked the "significant revenue shortfall" option during the current fiscal crisis, even as Washington has struggled with multi-billion-dollar shortfalls.

Policymakers must better utilize the tools already available to manage the state workforce and compensation in order to preserve essential services and position the state for economic recovery.

A population-plus inflation spending limit would put the state on a path to sustainable budgeting.

2. Improve budget transparency.

Washington has been a leader in government transparency, a process expanded by the governor's recent efforts to engage citizens in transforming the state budget. Successful public engagement requires timely access to reliable, accurate information regarding taxes and spending.

In the short-term, the state must engage in a clear, public assessment of the entire budget. This effort should clarify revenues and expenditures associated with the general fund and other major accounts. It should include a thorough review of committments launched by citizen initiatives with no funding source as well as unfunded programs created by previous legislatures. It should identify the fastest growing areas of the budget and determine where the biggest efficiency gains need to be made. Future papers in this series will look at fast growing budget areas—Medicaid and other state health care spending for example—and make recommendations to contain spending growth while improving outcomes.

Additionally, there is room to improve communication with the public. Budget issues are complex and the rush to secure enough legislative votes to pass a budget often leaves the public behind. To ensure open, transparent fiscal policy, the state should:

- Require 48-hour notification before a public hearing on any bill with fiscal impact.
- Establish a 72-hour rule, requiring all fiscal legislation be made available to the public for three days before a vote on final passage.
- Provide electronic notification of fiscal hearings and tax legislation 24 hours in advance to all Washingtonians requesting such notice.

3. Reinstate a firm expenditure limit.

Unprecedented revenue growth in the middle part of this decade spurred dramatic spending growth. NGFS spending increased by one third from 2004 to 2008. Such a remarkable rise in spending during the "boom" years left the state exposed to gut-wrenching budget shortfalls when the Great Recession took hold. This is precisely why the state needs to cap spending growth: to mitigate against the boom-and-bust cycle.

As seen in the last decade, priority-based budgeting only works when there is an appreciation of limits. A short-term, cyclical revenue surge is common in the years directly

A spending limit similar to the population-plus-inflation factor approved by voters as Intitiative 601 in 1993 would put the state on a path to sustainable budgeting and effective long-range planning.

Required pension payments are projected to nearly **double** in 2011-13 and double again over the following six years.

following a recession. Having a reasonable expenditure limit, and thereby requiring budget prioritization, would ensure such a surge does not fuel unsustainable spending.

A spending limit similar to the population-plus-inflation factor approved by voters as Initiative 601 in 1993 would put the state on a path to sustainable budgeting and effective long-range planning. In its early years, the limit effectively restrained state spending. Over the years, the initiative has been amended many times. In 2005, lawmakers replaced the population-inflation growth factor with one based on personal income, a much more generous factor.

4. Implement pension reform.

Required pension payments are projected to nearly double in the 2011-13 budget and double again over the following six years. Washington state's actuary estimates that state government contributions, as a share of employee salaries, will exceed historical maximums for the next 15 years. The majority of the cost increase is due to the unfunded liability in the state's Public Employees Retirement System Plan 1 (PERS 1) and Teachers' Retirement System Plan 1 (TRS 1).

The two plans closed to new enrollees in 1977, but had already developed a liability due to historical underfunding. From 1991 to 2000, the legislature made actuarially required contributions to pay down the liability in nine of 10 years. From 2001 to present, the legislature made less than the required contribution every year. Since 2001, the unfunded liability has grown from under $1.5 billion to nearly $7 billion.

The actuary's 2009 report on the financial condition of the state's pension plans characterized TRS & PERS 1 as "at-risk" due to delayed and suspended contributions, increased benefits passed by the legislature in recent years, and investment losses.

The actuary's August 2010 risk assessment concluded there is a 41 percent chance the plans will go bankrupt if past funding and benefit improvement practices continue. That would require retiree benefits to be appropriated from the operating budget, costing billions.

Three major structural reforms are necessary to get pension funding back on track.

- **Amend the State Constitution to require legislative supermajority approval to make less than the actuarially-required payment.** As a recent Pew Center study on pensions found, the "make or break factor for keeping a retirement system well funded is to pay the actuarially required contribution consistently."
- **Follow the model required of private sector plans to ensure benefit improvements are sustainable.** Federal law prohibits private sector pension plans from increasing benefits if the plan's funded ratio would be less than 80 percent with the benefit improvement, unless the employer immediately contributes the full actuarial value of benefit improvement to the pension fund. Both TRS & PERS 1 are currently below 80 percent funding.
- **Create a defined contribution plan for all new employees.** The state could use the approach that universities in Washington use for faculty and professional staff. Enrollees put an escalating percentage of their salary into the plan as they age and benefit from an employer match, a full range of investment options, complete portability and access to life-cycle options after retirement. Defined contribution plans also increase budget stability and predictability. With defined benefit plans, employer contributions fluctuate with investment returns, increasing taxpayer risk.

5. Expand use of the State Efficiency and Restructuring Account.

Upfront costs and the lack of significant immediate savings have been historical obstacles to institutional closures. This has been true even when long-term savings are projected to be

Facility closures are **inevitable.** Removing financial roadblocks to realizing the benefits is **responsible** fiscal policy.

significant. When political considerations are factored in, closures become nearly impossible.

In 2010, however, the legislature created the "State Efficiency and Restructuring Account" (SERA), which capitalizes long-term savings and enables budget writers to capture those savings up front. SERA was most notably used by the Department of Corrections, allowing the agency to immediately realize $49 million in facility closure and downsizing savings. The SERA allowed the department to close two correctional facilities and downsize two others. Additional facility closures are inevitable. Removing financial roadblocks to realizing the benefits is responsible fiscal policy.

6. Examine inventory of real property assets for possible sale.

State government routinely conducts an inventory of owned and leased property and has a practice of disposing of assets no longer needed. Given the gravity of the state's current budget problems, a more aggressive review of real property assets is needed to determine whether they serve essential state purposes.

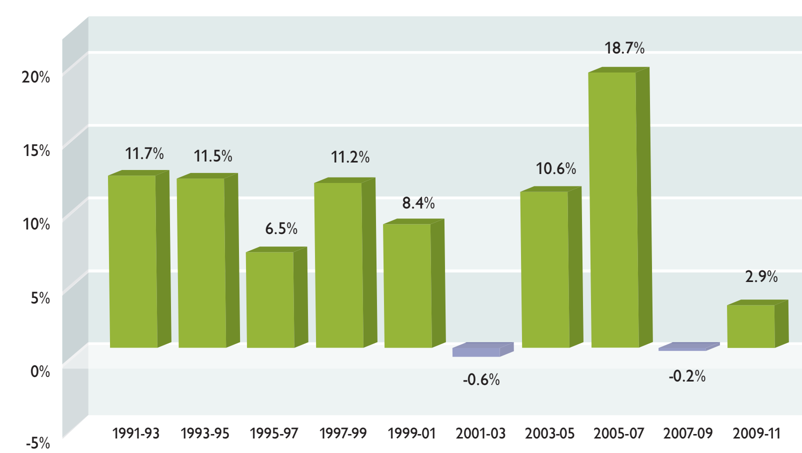
We do not favor the sale-leaseback strategy that has been pursued in other states. The California Legislative Analyst Office (LAO) recently evaluated a proposal to sell and lease back 11 state-owned office properties. The LAO conclusion seems broadly applicable. While the "major benefit of the sale-leaseback transaction is the one-time revenue from the sale…the ongoing lease payments…would be far greater than the amount" currently spent in owning and operating the facilities. Incurring greater long-term costs to obtain a short-term benefit simply magnifies the structural deficit.

Nonetheless, as a major property owner, the state may be able to realize significant revenues from the sale of real property. If so, we recommend using the proceeds of any sale to pay down long-term obligations to reduce future costs.

7. Leverage the rainy day fund to protect against future downturns.

In 2007, Governor Gregoire and State Senators Lisa Brown and Joe Zarelli led a bipartisan effort to adopt a constitutional

HISTORICAL GENERAL FUND STATE REVENUE GROWTH



Source: Washington State Economic and Revenue Quarterly Forecast, September 2010. 2009-11 inclusive of 2009 statutory changes to definition of general fund. Under general fund definition prior to law change, revenue growth would be -4.4%

rainy day fund, SJR 8206, which voters overwhelmingly approved. Pursuant to the law, every year, 1 percent of general fund state revenues are deposited in the Budget Stabilization Account (BSA). Those revenues can be tapped only by a supermajority vote of both houses of the legislature, unless job growth falls below 1 percent a year, when just a simple majority vote is required.

A constitutional requirement that a share of exceptional revenue growth be placed in the Budget Stabilization Account would provide an additional reserve safeguard.

The Great Recession demonstrated the need for even more robust measures to build reserves that can be used in emergencies or dire fiscal circumstances.

State revenue growth in 2005-07 was more than double the average growth over the prior five biennia, fueling a $4.6 billion expansion in spending.

Fiscal analysts commonly recommend state government maintain reserves equal to 5 percent of annual general fund expenditures (or NGFS in Washington's case). Reserve levels in 2007-09 were well short of this target. The cushion carried forward to the current biennium proved to be inadequate during the recession. Successive quarters of declining revenue forecasts swiftly depleted reserves.

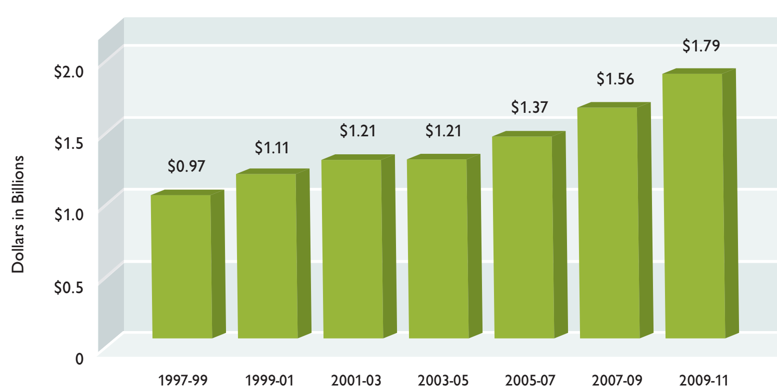
A constitutional requirement that a share of exceptional revenue growth be placed in the Budget Stabilization Account would provide an additional reserve safeguard. Two benefits would accrue from this policy: spending would be controlled at a sustainable level and the reserve funds would grow more rapidly.

For example, a bipartisan group of lawmakers has considered establishing a simple formula that would trigger an additional BSA deposit when biennial revenue growth exceeds historical trends by one-third. If that standard had been applied to the revenue surge in 2005, more than $2 billion would have been deposited into the state's rainy day fund and the subsequent state deficit would have been reduced by more than $4 billion.

8. Better manage debt service.

Washington's taxpayer-supported debt is untenably high. The credit-rating service Moody's ranked the state eighth in the nation

DEBT SERVICE EXPENDITURES
(Operating Budget—Near General Fund State)



Source: Fiscal.wa.gov, Historical Reports, Bond Retirement and Interest

Debt service costs are projected to reach 8.75 percent of general state revenues in 2010, a threshold never before reached in state history.

The legislature should restore the **7 percent statutory debt limit.**

on a per capita basis for 2009. The $2,226 state government-issued debt per capita is more than twice the median figure of $936.

The budget implications are clear. When the state authorizes bonds in the capital budget, those costs are repaid in the operating budget. The level of bonds authorized more than doubled from 1997-99 to 2009-11 and operating budget debt service payments grew from $970 million to $1.8 billion. In the current budget, while state appropriations for services were reduced, debt service expenditures—a contractual obligation of the state to bondholders—increased $229 million. Debt service costs are projected to reach 8.75 percent of general state revenues in 2010, a threshold never before reached in state history.

To put the $1.8 billion in debt service payments in context, the state appropriation for the Department of Corrections, including its 13 prison facilities, was $1.55 billion for 2009-11. The state appropriation for all 39 community colleges, in which more than 150,000 students are enrolled, was $1.35 billion.

The state constitution establishes a debt limit. Debt may not be issued if it would cause debt service to exceed 9 percent of the previous three-year average of general state revenues. For 30 years, the state also had a statutory debt limit (the 7 percent limit), which was a further constraint on debt issuance. During the last decade, however, the statutory debt limit definition was expanded to the point that it allowed greater debt issuance than the 9 percent constitutional limit. Because it was no longer serving a purpose, the legislature eliminated the statutory limit in 2009.

The legislature should restore the 7 percent statutory debt limit, ensuring the debt and revenue definitions mirror those found in the constitutional limit. Had the limit not been increased, the maximum biennial debt service now would be nearly $500 million below current levels, freeing up funds to be used elsewhere. Adopting the lower limit now—recognizing current obligations will require the reduction to be phased in—would restore necessary fiscal discipline.

9. Integrate priority-based budgeting with performance reviews.

The Priorities of Government budget process (POG) has been an effective tool for protecting the state's most important programs and services. The POG works best when budget writers know in advance how much money they will have to spend. In addition to a firm expenditure limit, priority-based budgeting should be reinforced by performance budgeting.

The first paper in this series, Charting a New Course, outlined the valuable tools already in place to evaluate services, through the state auditor's performance audit division and the governor's Government Management Accountability and Performance project. There must be a direct correlation between performance and budget decisions, with full transparency. Each review should include specific reference to the following questions, which the governor asked in this year's budget development process:

1. Is the activity an essential service?
2. Does state government have to perform the activity, or can it be provided by others?
3. Can the activity be eliminated or delayed in recessionary times?
4. Are there more cost-effective, efficient ways to do the activity?
5. Can the activity be the subject of a performance contract?
6. Can the activity be the subject of a performance incentive?

To ensure proper allocation of resources, priority should be given to reviews of major state expenditure areas. Legislators should conduct annual reviews of agency performance, with an explicit link to the appropriations process.

Legislators must also engage in a transparent dialogue with agency directors to communicate expectations and encourage innovation. The questions Governor Gregoire posed to state agencies, listed earlier, yielded a number of responses indicating satisfaction with the status quo. More than 62 percent of initial agency responses stated that a more efficient or cost-effective way to perform the activity did not exist. Only 41 percent felt the activity could be subject to a performance contract. Just one in five concluded an activity could be eliminated or delayed during a recession.

Transforming government cannot be a one-time event.

Given the deep and enduring nature of the current fiscal crisis, Washington cannot be content with the status quo. The reset will require state agencies to innovate and find more efficient methods of service delivery.

CONCLUSION

Transforming state government and resetting the state budget involves an ongoing program of review and adaptation. It cannot be a one-time event or an episodic response to a temporary or cyclical change in market dynamics. The current fiscal crisis is an opportunity to build on strengths and overcome weaknesses. Non-essential activities should be curtailed or eliminated. New, more productive ways to achieve essential outcomes must be identified.

The cultural shift required for a successful transformation requires blending a positive long-term vision of the state with a nimble, adaptive short-term response to rapidly changing conditions. Insightful recommendations coming from state workers to reduce spending are encouraging. The bipartisan commitment of legislative leadership and the governor to transform government should also be applauded.

Clearly identifying the enduring values and priorities for state government will allow policymakers to make certain that imminent budget reductions preserve those services and activities taxpayers consider essential. Further, given the magnitude of the looming shortfall, the public must be an active participant in the process. That is why transparency must be greatly enhanced. An informed, engaged public can play a critical role in assessing and shaping priorities and supporting lawmakers as they make difficult decisions.

The actions proposed here and in subsequent papers in the Thrive Washington series will help transform government and preserve essential services that propel economic growth. They will also set a trajectory for a stable and sustainable budget over the long-term.

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