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BRIEFLY

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State Budget Intact, For Now

Introduction

As California staggers into a new fiscal year reeling under the weight of a crushing deficit, gridlocked political system, and soggy economy, Washingtonians can take heart: The state budget adopted by the legislature and signed by the governor in June remains delicately balanced. Even with a \$158 million downward revision in the forecast for 2003-2005 revenues, the state is expected to have about \$120 million in the bank at the end of the biennium.

That's about 0.5 percent of biennial appropriations, which is to say, not much of a cushion.

Still, the general approbation attending the resolution of this year's budget challenge is justified. Following the governor's lead, lawmakers put together a reasonable budget without resorting to extraordinary fiscal gimmicks or general tax increases. Initially faced with a budget shortfall - the gap between available revenues and projected spending - of about \$2.5 billion, legislators handled the problem with a combination of spending cuts and freezes.

The budget buys the state time. Any substantial weakening in revenues will result in another round of tough choices in 2004; a stronger-than-anticipated recovery will substantially ease budget concerns and, perhaps, signal a return to fiscal stability.

Which is why policy makers watch the revenue forecast so closely.

June Forecast - Clouds Linger

On June 19th the Forecast Council updated the forecast of general fund revenue for the 2001-03 and 2003-05 biennia. The forecast for the 2001-03 biennium was down by \$1.0 million, to \$21,163 million. The forecast for the 2003-05 biennium dropped by \$157.4 million, to \$22,295.1 million, before accounting for non-economic changes.

In presenting the forecast, Dr. Chang Mook Sohn, the Executive Director of the Office of the Forecast Council, sounded much more pessimistic than would be expected for a drop of that magnitude. This pessimism reflected the great deal of uncertainty facing the state's economy at the present time and the possibility that in September the forecast will need to be revised downward significantly.

Dr. Sohn cites four factors that contributed to his pessimism.

First is a reduction in the forecast for the national economy. The forecast of the state economy is based upon the national forecast pre-

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Figure 1
General Fund-- State Balance Sheet
(Dollars in Millions)

| | 2001-03 | 2003-05 | Difference | Percent |
|---|------------------|-----------------|----------------|---------------|
| General Fund Current Revenues | | | | |
| March Revenue Forecast | 21,163.0 | 22,451.5 | 1,288.5 | 6.1% |
| June Forecast Update | (1.0) | (156.4) | | |
| Budget Driven Revenue | | 51.9 | | |
| Nursing Home Quality Fee | | 78.0 | | |
| I-728 Property Tax Diversion | | 237.0 | | |
| Aerospace Incentives | | (25.3) | | |
| Other Revenue Legislation | | 104.1 | | |
| Other Adjustments | 55.7 | | | |
| Total Revenues | 21,217.7 | 22,740.8 | 1,523.1 | 7.2% |
| General Fund Appropriations | | | | |
| Prior 2001-03 Appropriations | 22,451.5 | | | |
| 2003 Supplemental | 130.9 | | | |
| 2003-05 Appropriations | | 23,061.7 | | |
| Total Appropriations | 22,582.4 | 23,061.7 | 479.3 | 2.1% |
| Revenue Minus Appropriations (Deficit) | (1,364.7) | (320.9) | 1,043.8 | -76.5% |
| General Fund Balance | | | | |
| Beginning Balance | 599.1 | 298.3 | (300.8) | -50.2% |
| Emergency Reserve Transfer | 325.0 | 59.4 | (265.6) | -81.7% |
| Other Fund Transfers | 289.0 | 81.2 | (207.8) | -71.9% |
| Tobacco Securitization | 450.0 | | | |
| Balance Reduction to Cover Deficit | (1,364.7) | (320.9) | 1,043.8 | |
| Projected Ending Fund Balance | 298.3 | 118.2 | (180.1) | |
| Emergency Reserve Fund Balance | | | | |
| Beginning Fund Balance | 462.1 | 57.6 | | |
| Transfer to General Fund | (325.0) | (59.4) | | |
| Other Transfers and appropriations | (95.0) | | | |
| Interest | 15.5 | 1.7 | | |
| Projected Ending Fund Balance | 57.6 | 0.0 | (57.6) | |
| Total Reserves | | | | |
| Combined Ending Balances | 356.0 | 118.2 | (237.8) | |

(Detail may not sum to totals due to rounding.)

Source: Research Council compilation from Office of Financial Management and House and Senate Fiscal Committees balance sheets.

pared by Global Insight. Global Insight's forecast has weakened considerably since March.

Second, payroll data for the first quarter indicates that employment and incomes in the state were lower than the state's economists had anticipated.

Third, revenue collections in the first five months of 2003 are virtually unchanged from year ago levels, indicating that the economy remains stagnant.

Finally, Boeing layoffs are occurring at a faster pace than had been anticipated.

Dr. Sohn notes that while some people believe that recent stability in the state's unemployment rate is a sign that the recession has ended, they are premature. Employment peaked in late 2000; it will not regain that level until the second quarter of 2005.

This is a much slower recovery than is typical for the state.

Deflation is also a concern. Falling prices for many consumer prices is one explanation why the growth in revenue from the sales tax has been so low.

Optimistic and pessimistic scenarios bracket the baseline forecast shown in the balance sheet (Figure 1). Dr. Sohn places only a 45 percent probability on the baseline scenario. This is lower than the probability usually associated with the baseline, reflecting the unusually high degree of uncertainty in the present economic environment. The optimistic scenario provides \$916 million more revenue than the baseline. Dr. Sohn assigns a 25 percent probability to this outcome. The pessimistic scenario provides \$1,157 million less, with a 30 percent probability.

Historically Global Insight has been excessively pessimistic at the bottom of the business cycle and that this might well be the case with this cycle. For that reason, the decrease in the Global Insight forecast was not fully incorporated in the June revenue forecast. If Global In-



sight remains as pessimistic in September, there will be a further reduction in the state revenue forecast.

2003-2005 Adopted Budget

Although not adopted until the first week of June, the final legislative budget did not vary dramatically from the package introduced last December by Governor Gary Locke and modified by the Republican-led Senate. The decision to produce a budget without a general tax increase, the position taken by Locke and Republicans, drove all subsequent decisions. Budget differences focused on priorities. The House-passed budget, which relied on a handful of tobacco, liquor and candy taxes plus Keno revenues, served mostly as a vehicle to launch negotiations. There was simply little support for tax increases in the middle of the recession.

The two-biennia general fund spreadsheet (see Figure 1) shows the projected condition of the state general fund through the coming biennium.

Current Revenues

The biggest revenue gain in the budget stems from the suspension of the I-728 transfer of property tax revenues to the Student Achievement Fund, the dedicated account established by the initiative to pay for class reduction and other school program enhancements. Lawmakers did not repeal the SAF and did maintain existing funding. Legislation modifying the initiative results in a \$237 million increase in available general fund revenues.

The legislature also acted to accelerate tax collections and increase enforcement efforts. Small revenue gains are anticipated from new and relocated liquor stores and an increase in liquor prices. Most nursing home in the state will also be subject to a new \$6.50 per patient day fee, which will be used to increase state payments for nursing home services.

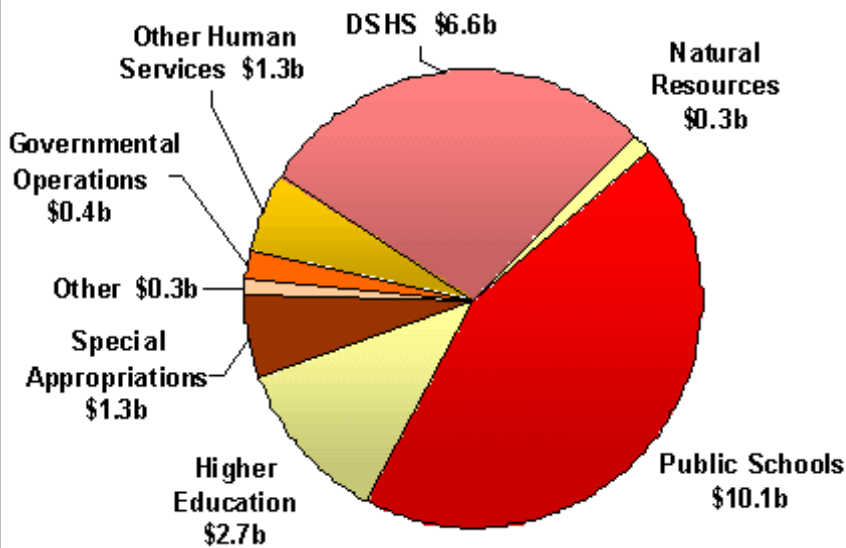
Offsetting the revenue increases are a handful of tax exemptions and incentives, including a bundle of measures to assist the state's semiconductor industry and an incentive package to promote biodiesel and alcohol fuel.

Transfers into the general fund total more than \$140 million. The budget drains the emergency reserve fund, about \$59 million, in addition to more than \$80 million in transfers from other accounts.

Appropriations

While total revenues (including transfers) increase by seven percent, appropriations for the biennium grow by just two percent. Much of the solution to the state budget problem came from a handful of major actions involving employee compensation, health care benefits, and the suspension of costly initiatives. Coupled with the aggressive use of fund balances and emergency reserve money, the cost containment and budget cuts allowed the legislature to pass a tenuously balanced biennial budget, one that will require careful monitoring and possible adjustment over the coming year.

FIGURE 2: 2003-05 Appropriations

*Employee Compensation and Workforce.*

Overall, the state workforce is expected to shrink by about 1,100 full-time equivalent positions. No across-the-board increases are provided for state employees and public school personnel. Initiative 732, adopted in November 2000, required an annual cost-of-living adjustment for public school employees and some community and technical college staff.

The initiative was suspended, saving about \$475 million for the state general fund. To address rising health

insurance costs, expected to climb 15 percent a year through the biennium, state employees will experience higher co-pays for office visits and pick up an increased share of benefit costs.

Salary increases are granted for beginning teachers. The state-funded salary for first- and second-year teachers will increase 3 percent for the 2003-2004 school year. Third-year teachers will receive a 2.5 percent increase; fourth-year, 1.5 percent; fifth-year, 1 percent; and sixth- and seventh-year teachers, 0.5 percent. Similar increases will be granted in the second year of the biennium, with about one-third of all teachers receiving some increase under this schedule.

Public Schools. Public schools continue to represent the largest share of state general fund spending, which does not include the Student Achievement Fund. (See Figure 2) Lawmakers reduced funding for a number of programs (e.g., flexible education, better schools, levy equalization, school bus replacement) outside the basic education requirement.

Combined spending from the Student Achievement Fund and General Fund State increases more than \$220 million from the 2001-2003 biennium to the 2003-2005 budget, an increase of 2.2 percent. Enrollment increases boosted maintenance level costs by about \$670 million; program reductions, including adjustments to Initiative 729 and Initiative 732, totaled about \$450 million.

Higher Education. General fund support for higher education is expected to decline by about \$89 million. About \$21 million in increased funding was provided for high demand programs (e.g., nursing, applied science and engineering, viticulture, speech pathology, and worker training). And a number of rather small increases were granted for a variety of targeted activities.

The legislature granted college governing boards the authority to set tuition for most students (except resident undergraduates) for the

next six years. Lawmakers limited tuition hikes for resident undergraduates to 7 percent a year. Tuition increases are expected to offset part of a \$131 million reduction in university and college operating budgets.

Health and Social Services. As in most states, medical assistance is one of the fastest-growing areas of state spending, and second only to public school spending in magnitude. Combined GFS and Health Services Account spending will increase from \$2.8 billion to \$3.1 billion from the 2001-2003 biennium to 2003-2005. That increase leaves spending below the \$3.4 billion projected under "current services" projection; that is, without policy changes, medical assistance spending in the 2003-2005 biennium would have been \$3.1 billion.

Policy changes, then, were required to bring the state budget in balance within available revenues. Lawmakers imposed enrollment lids on services provided by hospitals to medically indigent patients, increased premiums for children's medical coverage, adopted a consolidated drug purchasing policy, reduced adult dental overages, tightened eligibility verification, and caps enrollment in the Basic Health Plan through December 2003. The BHP will be restructured effective January 2004.

Wages for homecare workers were increased by 75 cents an hour, well below the level sought in the contract negotiated in the wake of Initiative 775. (See PB 03-04 March 17, 2003, "No Rush to Fund Collective Bargaining Agreement for Home Care Workers" <http://www.researchcouncil.org/Briefs/2003/PB03-04/collectivebargaining.htm>.)

Discussion

Further weakening of the state economy could easily throw the 2003-2005 budget into the red, forcing additional budget reductions. Credit must go to those legislators who committed themselves to a budget solution that relied neither on an abundance of one-time fiscal gimmicks nor on tax increases. The package they crafted, which changed little from the budget introduced by Senate Ways and Means chairman Dino Rossi, met the challenge of the times. (For more comprehensive review of the legislative budget, visit the Senate Ways and Means Committee Website, <http://www.leg.wa.gov/senate/scs/wm/default.asp>.)

The Priorities of Government (POG) process used by Governor Locke and endorsed by the legislature has justifiably been hailed for allowing Washington to reach a timely and prudent budget agreement. That said, the major challenges lie ahead, if not next January, then certainly by January 2005, when lawmakers must draft the next biennial budget.

Reserves are depleted. Pressure to increase compensation after several years without cost-of-living adjustments and increased employee-paid benefit costs will be intense. Advocates for increased public school spending, unhappy with suspension of Initiative 728, will be pushing to see funding restored to the Student Achievement Fund. And the list goes on.

The work begun with the POG - setting priorities, identifying desired outcomes and holding agencies responsible for meeting the objec-



tives, questioning the appropriateness of whole categories of public spending - must continue.

The broad strokes painted this session, important as they were, represent little more than a very good beginning. Suspending initiatives, capping compensation, and limiting enrollment in social service programs are, in many respects, simply traditional and temporary forms of cost containment. The fundamental restructuring implied by the POG has yet to be accomplished.

