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Financial State-of-the-State

It's the Day of Reckoning

by Bob Williams

March 11, 2010

Governor Gregoire and Democrat leaders have crafted a financially irresponsible budget. They are postponing necessary spending reductions, perhaps hoping for a miracle of sorts. But in political eschatology, it's the day of reckoning.

A recent report by the National Governors Association (NGA) estimates states will face budget deficits totaling $134 billion over the next three years. NGA Chairman and Vermont Governor Jim Douglas believes the worst is probably yet to come.

Executive Summary

- The new supplemental budget continues the trend of lawmakers spending more money than they have: Senate @ $2.95 billion more and the House @ $2.7 billion more.
- This state spending is being propped up with underfunded pensions; altered actuary recommendations; use of one-time federal stimulus, and money raided from other accounts, most of which will need to be refilled.
- State employees earn more on average than private sector employees, and they have unsustainable retiree and benefit packages. But new spending for benefits has been proposed by both Chambers and the governor.
- Moody's gave our state a negative bond rating outlook and noted that our per-capita debt for bonds is twice the national average—now at $2,306.38 per Washingtonian.
- Our State Actuary, Insurance Commissioner, Treasurer, and Auditor have all sounded alarms, as have the CAFR Report, Moody's, the National Governors Association, and the Pew Center. Their warnings have not been addressed.

It is true that Washington state has faced declining revenues in the past two years, but that pales in comparison to the steep revenue increases we have enjoyed since 1993.

Most legislators are unaware of the economic severity they face and the consequences of their budget votes. But their leaders know. Rather than fundamentally reshaping government to reflect declining state revenues for some time to come, legislators are relying on accounting gimmicks, one-time funds, and federal stimulus money to balance the budget. In the process, they are artificially propping up a higher level of spending that can't be supported by the economy in the near-to-medium future.

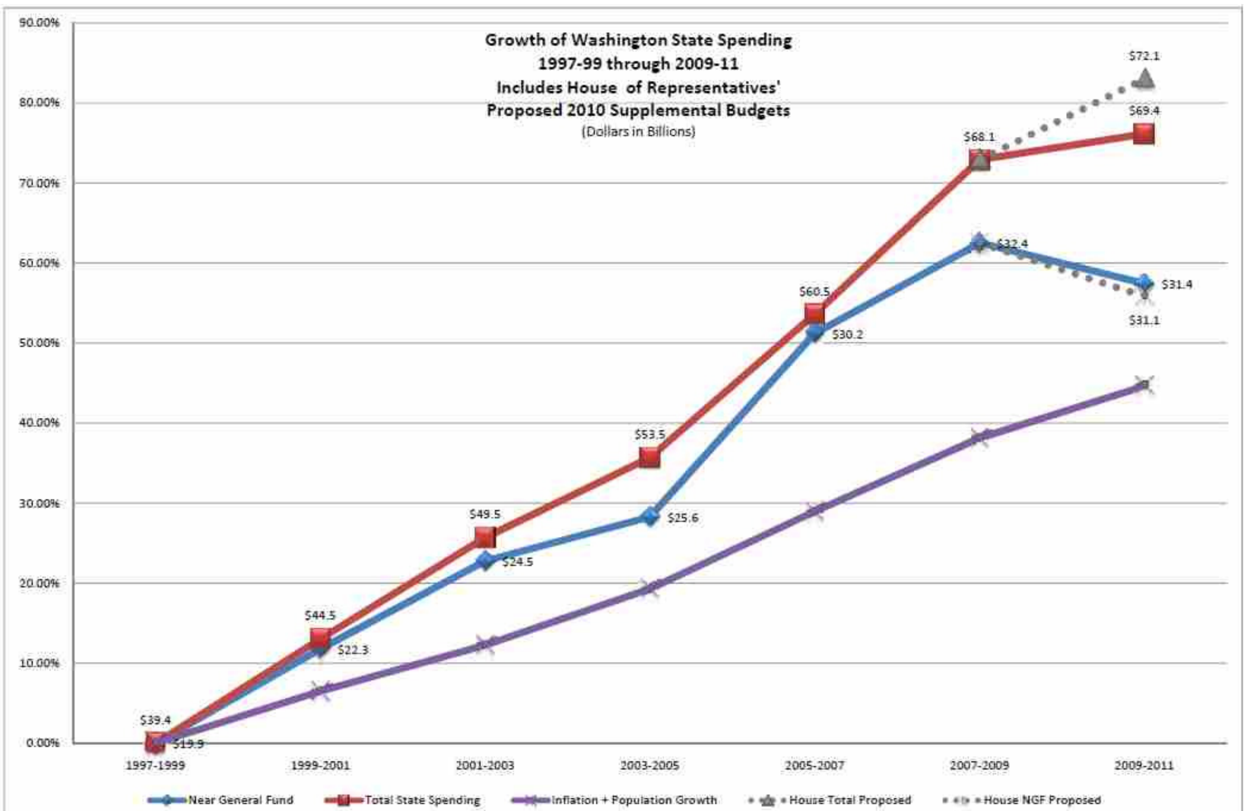
This problem has been building for some time. It exploded exponentially last year. Governor Gregoire and legislative leaders convinced the public that the state was facing a $9 billion shortfall out of a $30 billion two-year general fund budget. Talk of "budget cuts" ran thick. But when they finished the 09-11 budget, legislators had increased total spending by $1.3 billion.

Most legislators, however, are still describing the $1 billion budget cut they made in one portion of the overall budget (near-general fund) as if that is the only account that matters.

This year the governor said our state had another $2.8 billion budget shortfall. Again the tough budget cut talk began. Tears were shed. Dramatic speeches were made. Yet the final proposals look like this: the Senate proposed budgets that **would raise** total spending by $2.95 billion and the House proposed budgets **would raise** spending by $2.7 billion.

Put this increased spending in context: 1) an $11.8 billion budget shortfall over three fiscal years, 2) budgets that legislative leaders and our governor say have been cut to the bone, and 3) reductions in proposed spending that were counted as a "cut." In reality, based on the proposed House and Senate budgets, total state spending will be increased by billions.

Clearly these rates of increase are totally unsustainable.



(Click here for a printable PDF version of this chart.)

The true financial status of the state is hidden from taxpayers because of the way in which liabilities are disclosed (or not). Following is my analysis of the **true financial state-of-the-state**. I write as a former U.S. Government auditor, certified public accountant, and five-term state representative who served on the budget committee each of my 10 years in office.

1. Level of spending: Unsustainable

State spending is being propped up with one-time accounting gimmicks: funds transferred from other accounts, most of which will need to be refilled; pensions that are underfunded, but whose obligations must be met; actuary recommendations that are changed for short-term gain, and use of one-time federal stimulus money for ongoing programs.

2. Federal stimulus funding: Short-term

Lawmakers balanced the state budget last year by utilizing more than $3 billion in federal stimulus money. This year they hope to access another $580 to $640 million. Legislators and the governor have not cut future obligations to reflect this $3.6 billion in funding that will not be available once the federal stimulus funds expire.

3. Cash flow: Dire

In December 2009, the State Treasurer issued an urgent warning that the state will run out of money in September of *this year* unless action is taken. His words seem to have been ignored by the governor and legislators. Looking at the current actions from the legislature, I foresee two outcomes: the state will have to borrow short-term funds in order to pay bills that will come due this fall, and to the extent possible some bill payments will be delayed until "later."
www.tre.wa.gov/documents/TreasurerLetterToGovAandLegLeaders.pdf

4. State employee salaries and benefits: Unsustainable

State employees earn an average of $4,302 more than private sector employees. In addition, state employee benefit packages are worth 30 percent of their salaries on average. But the rich benefits public employees receive are in peril. To meet the obligations under the current contracts, taxpayers will have to come up with even more money.

a. State Employee Salaries

State employees earn an average of $4,302 more than private sector employees. From 2005-09 state employees received a 25.4 percent increase in salaries. Because generous retiree and benefit packages are based on salary levels, raising salaries heavily impacts long-term liabilities for taxpayers.
www.senaterepublicans.wa.gov/budgettidbits/2010/011310BudgetTidbit.pdf

The National Governor's Association recognizes this problem. "For many years, state and local governments have been increasing the benefit portion of employee compensation at a greater rate than the wage portion. Much of the reasoning behind this was the belief that state government salaries could not compete with the private sector. As a result, benefits for state employees gradually became more generous than those in the private sector while state salaries lagged. Today, the average compensation for state and local employees exceeds that of private workers**.** And, by using benefits as a compensation equalizer, states have placed long-term liabilities on their balance sheets."
www.nga.org/Files/pdf/1002STATEGOVTAFTERGREATRECESSION.PDF

b. State Employee Benefits:

From 2005-09 state employees received a 50.5 percent increase in benefits.
www.senaterepublicans.wa.gov/budgettidbits/2010/011310BudgetTidbit.pdf

- The state employee benefit fund is facing a $220 million deficit. In a December 2009 letter to the Governor, State Insurance Commissioner Mike Kriedler stated that the health care benefit account had "stunning declines in assets [$247 million in one year], capital and surplus, net income, and cash provided by operations." He went on to say that if the Health Care Authority "were a domestic insurer, these outlier ratios would likely result in a finding of financially-hazardous condition, justifying my entry of corrective orders or my placing the insurer under administrative supervision."
- Rather than requiring state employees to pay more than 12 percent of their healthcare premiums, the governor and legislature are considering providing more taxpayer dollars to continue these generous medical, dental, and vision benefits. The House is proposing to

add $95 per month to the state's contribution of $768 per employee per month. The governor proposes an increase of $62 per employee per month and the Senate an increase of $27 per employee per month.

- A 2008 study by the Washington Roundtable determined that state employee health care costs were 5.8 percent higher than private sector employee costs of large employers, and that the average monthly contribution of state employees nationwide for family health care coverage was nearly four times that of Washington state employees. waroundtable.com/2006/archives/Policy%20Publications%20Archive/HC%20Report%20Design%20Feb%2008.pdf

c. **Retiree Health Care:** Credit Suisse reported that Washington has an unfunded retiree health care liability of $10 billion. The Pew Center reported the unfunded liability was $7.9 billion. Both of these estimates are considerably higher than the state's Consolidated Annual Financial Report (CAFR) report of only $4 billion as of June 30, 2009. It appears the state is significantly underestimating the liability.

d. **Pensions:** Matthew Smith, Washington State Actuary, warned that the unfunded pension problems have grown due to "delayed and suspended contributions, increased benefits, and investment losses." He recommended "a shift in focus to identifying, measuring, and managing retirement system risks. Without such a plan to manage these risks, the retirement systems as we know them may not be sustainable." He recommends **tripling contributions from all employers and the state general fund for the next twelve fiscal years.** Even then, he projects "a 30-40 percent drop in funded status" due to investment declines. He estimates it will take ten to twenty years to recover those losses.

Projected Employer Contributions		
(Dollars in Millions)	GF-S	Total Employer
2009-11	$661.0	$1,739.6
2011-13	1,357.4	3,429.1
2013-15	1,887.9	4,765.7
2015-17	2,321.2	5,866.1
2017-19	2,730.8	6,922.6
2019-21	$3,008.3	$7,582.6

Note: Excludes LEOFF 2.

But Smith said, "Previously healthy plans remain healthy, but are now at risk of becoming unhealthy. Previously unhealthy plans are now at risk of running out of assets before all benefits get paid. This may call into question whether employers can afford such increases. The health of each plan weakens further if employers don't make the expected contributions. For example, healthy plans like the Plans 2/3 will likely become unhealthy. 'At-risk' plans like PERS 1 and TRS 1 will likely run out of money with large contractual benefit payments remaining."

The Actuary observed "a propensity to increase benefits when returns exceed the assumed rate and delay or simply not make required increases in contributions when returns fall below the assumed rate."

The Pew Center criticized Washington state for contributing just 37 percent of what the pension system needed over the preceding five years. Only one other state made less effort to keep its pensions whole.

In 1989, legislators agreed to make up the unfunded liability by 2024. But, last year, the Legislature decreased contributions to the pension systems in response to decreased revenue caused by the economic recession. The 2009 Legislature also changed the funding method for paying off the unfunded past liability of PERS and TRS Plans 1. **These actions have increased the unfunded pension liabilities.**
osa.leg.wa.gov/Actuarial_Services/Publications/PDF_Docs/Pension_Studies/PFC_Ltr_Rpts_Combined9-16-09.pdf

5. Workers Compensation funds: In trouble
Auditor Sonntag's financial and actuarial audit of workers compensation revealed serious financial problems in the solvency of the accident fund. The response of Labor and Industry Director Judy Schurke was stunning. She said, "…one of the unique benefits of the Washington State Fund is that it can continue to make good on its benefit obligations when projected liabilities exceed its projected assets when private insurers would not be able to do so." That's because taxpayers are legally obligated to pick up the tab, something she neglected to mention.
www.sao.wa.gov/auditreports/auditreportfiles/ar1000474.pdf

6. State bonds and debt per capita: Excessive
Washington state has gone from $8.5 billion in outstanding bonds as of June 30, 2003, to $15.4 billion as of January 27, 2010. (Data Book page 47)
www.tre.wa.gov/documents/debt_bondsBondsOutstanding.pdf

Moody's bond rating firm expressed concern on December 31, 2009, when they talked about our state debt per capita at $2,098 being twice the national average. It is now $2,306.38 per person in Washington state just for bonds. www.tre.wa.gov/documents/debt_bondsSelectedDebtRatios.pdf

On top of this, the state has authorized, but not yet issued, $12.7 billion in bonds as of June 30, 2009. The amount of bonds authorized but not issued as of June 30, 2005, was $6.3 billion—a 102 percent increase in 4 years. www.tre.wa.gov/documents/annualReports/ar09-18_debt2.pdf

7. Washington's bond rating: Stable to negative
Moody's downgraded Washington's bond rating outlook to "negative" on December 31, 2009. They warned that the state's significant use of one-time funds to balance the current budget reduced necessary flexibility to address unexpected revenue shortfalls.

Moody's further warned about factors that could lower the rating:
- "Deeper and longer recession or muted recovery that restrains consumer confidence, leading to prolonged revenue weakness and employment erosion.
- "Protracted structural budget imbalance.
- "Increased reliance on one-time budget solutions.
- "Cash flow narrowing, leading to strained liquidity.

- "Failure to adopt a plan to cover expenditures once federal fiscal stimulus monies are no longer available."

When Governor Gregoire released her supplemental budgets both in November of 2009 and again this January, she did not address the structural budget imbalance, the State Treasurer's concerns about cash flow, or the lack of a plan to cover expenses when federal stimulus funds are gone. www.tre.wa.gov/documents/Moodys_Dec09.pdf

8. Plan to fix the bond rating problem: Creates deeper problems

The plan coming from the legislature and the governor does not rely on sustainable cuts in spending. It relies on use of one-time funds, accounting gimmicks, and increased taxes and fees—some from sources that will also dry up.

9. Comprehensive Annual Financial Report (CAFR): Troubling trends

A. The Budget Stabilization Account has a balance (June 30, 2009) of only $21.4 million (CAFR, p 34). This is all that is left of the rainy day fund that should be 5 percent of general fund state revenues, or $1.4 billion.
B. The workers compensation fund had a net loss (deficit) for the year (FY 2009) of $680 million (CAFR, pp 38-39).
C. Workers Comp had a net asset deficit of $10.6 billion as of June 30, 2009 (CAFR, p 46).
D. The unemployment compensation fund had a net loss (deficit) for FY 2009 of $789 million (CAFR, pp 38-39).
E. In FY 2009 the state had revenues of $30.7 billion and expenditures of $35.3 billion for an over expenditure of $4.6 billion (CAFR, p 44).
F. The state's risk management fund (self-insurance) has a deficit of $617 million as of June 30, 2009 (CAFR, p 108).

10. Education Obligations: In question

A. **Guaranteed Education Tuition (GET) Program:** What is the state's potential liability for this program?
B. **Basic Education Lawsuit:** What is the state's potential liability of Judge Erlick's February 4, 2010, decision that the state is underfunding basic education?

Conclusion

In the face of this data, the governor and leaders of the majority party are in one of three positions, or perhaps a combination of several.

1. They do not understand the urgency of the situation.
2. They do not understand that taxpayers are on the legal hook for contractual obligations they have made.
3. They understand, but consider it their duty to keep the program spending levels high and are therefore willing to continue increasing taxes and fees to cover the costs.

Voters will have to decide which answer works for them.

Bob Williams is the Co-Founder and Senior Fellow of the Evergreen Freedom Foundation. He is known as a national expert in the areas of fiscal and tax policies, election reform, and disaster preparedness. He received his Bachelor of Science in Business Administration from Pennsylvania State University. Williams worked as a GAO auditor of the Pentagon and Post Office before moving to Washington state where he served five terms in the Washington State Legislature and was the 1988 Republican nominee for governor.