1 BALDWIN STREET,
DRAWER 33
MONTPELIER, VT 05633-5701

PHONE: (802) 828-2295
FAX: (802) 828-2483

STATE OF VERMONT
JOINT FISCAL OFFICE

MEMORANDUM

FY2005 Fiscal Context and Out-year Implications

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The Joint Fiscal Office has reviewed FY2005 revenue proposals and summarized potential budget concerns that have a significant fiscal impact for Vermont in FY2005 and future year funding. Any such review has to be done at a point of time and must be qualified in that available information continues to change. As the budget adjustment and FY 2005 budget acted on, some of the numbers and out year picture may change. In addition, we have been working with administration staff to clear up and bring consensus to some of the revenue estimates. These too may continue to change. The review is based on existing official forecasts which are conservative as compared to the Joint Fiscal Office economist original estimate and may be impacted by continued economic growth.

The issues facing Vermont are similar to those faced in other states. On a comparative basis, Vermont is in better fiscal condition than many other states. A February 19, 2004 NCSL survey of state fiscal conditions found that 18 states are showing FY 2004 budget gaps with 31 states projecting deficits for FY2005. The FY 2005 budget shortfalls total $35.6 billion. Of these FY 2005 deficits, in 16 states the deficit exceeds 5% of budgets. In 5 of these states they must resolve deficits over 10%. The 5 states with 10% or greater gaps are: Alabama, Alaska, California, Michigan, and New Jersey. Four other states have projected deficits from 7.5% to 10% include Indiana, Louisiana, Nebraska and New York. Vermont is one to 19 states that report no gap.

Within New England, only New Hampshire and Vermont report no FY2005 projected deficits and Connecticut reported a .6% deficit. Maine, Massachusetts and Rhode Island report FY 2005 deficits of 5.2%, 6.5% and 5.8% respectively. (Source: NCSL State Budget Update: February 2004).

FY2005 Fiscal Context and Out-year Implications

This review focuses on the following areas:

Revenue Issues

Based on the review of these areas some overall issues emerge:

- The Administration's corporate and individual tax proposal is estimated to be revenue neutral. The Administration tax proposals regarding healthcare are anticipated to negatively impact general fund revenues in FY2005 and FY2006 official forecast. General fund revenue growth from FY2005 to FY2006 is projected to be 3.8%. With the state budget pressures and other pressures discussed below, even a 3.8% revenue growth rate creates challenges for the next few years. Revenue reduction will make the budget process more challenging.

- Based on the President's budget proposal, Vermont faces the risk of lower federal funds in FY2005 and FY2006. While Congressional action might alleviate some of this risk, the ability of Congress to act will be constrained by the federal deficit.

- The Vermont Health Access Trust Fund has a projected deficit of $40 million in FY2006. FY 2005 health care trust fund spending relies on $26 million in depletion of fund balances and other one time funds. Given this deficit there will be minimal capacity to address state implications of federal Medicare changes and possible revisions to the premium program.

- A number of budget pressures in the general fund are being addressed by the use of one-time funds. Rather than disappearing, these pressures have the potential to increase in the coming fiscal year.

- Transportation and capital needs continue to exceed available resources. In both cases, the bills are supported by some one-time revenues or by postponement of spending obligations.

- Deficits remain in several other state funds. While we project full reserves in our stabilization fund, remaining deficits in fee-for-space and VISION, and other areas of funding need create out-year risks.

Tax Proposals – GF Revenue Impacts

1) Individual and Corporate – Administration Tax Proposal
GF impact FY2005 & 2006

The Administration's personal income and corporate tax proposals have been projected to be revenue-neutral in FY2005 and beyond. However there are some timing issues that must be kept in mind. Some effects of rate reductions will occur immediately, while increases attributable to the change in capital gains tax will primarily occur at year's end. The change in the way multi-state corporations are taxed (Unitary tax) will also produce increased revenue primarily in future years. Growth in capital gains revenues should offset the timing effects and preserve neutrality or possibly produce revenue growth.

2) Health Care – Administration Tax Proposals - Small Market Access Reinvestment Trust and Small Business Health Care Tax Incentive

FY2005 GF Impact Analysis ($2. 8 million preliminary est.)
The administration budget has indicated that $2.8 million was set aside to offset revenue losses from the health care proposals. There are no firm estimates for a number of health related tax impacts and impacts can vary widely. Our current estimates are as follows:

- Dedicating $1 million premium tax which currently goes to the general fund to the reinsurance trust. In addition the proposal raises another $12 million in premium taxes dedicated to the reinsurance trust. FY2005 impact is -$1 million.
- The impact of federal changes to taxable income caused by the Health Savings Accounts which reduce federal and Vermont taxable income beginning in calendar year 2004. FY2005 revenue impact -$300,000.
- The small business health tax credit, in conjunction with changes in federal law, will decrease revenue in three ways. The first is the direct effect of the tax credit. The second is the increased deduction from revenues by employers who newly offer health insurance. The third is the deduction from revenue taken by employees who make contributions to their HSAs. The cumulative impact is roughly estimated to be about -$1.5 million.

FY2006 GF Impact ($6 million preliminary est.)

- Lost revenue from dedicating the current premium tax which goes to the general fund being dedicated to the reinsurance trust ($1.15 million est.)
- Health Savings Accounts - As Vermont develops incentives for increased use of HSAs state and federal tax revenues will be further reduced. ($400,000 estimate)
- Small business health tax credit. (FY2006 $3.5 estimate) Note that there is expanded eligibility for this credit in 2007.
- Tax deductions resulting from additional small businesses offering health insurance ($900,000 estimate).

Federal Fund Risks

The Federal 2005 Budget will impact three-quarters of our state 2005 fiscal year and one quarter of SFY2006. The President's FFY2005 proposal contains a number of risks for Vermont. With large federal deficits and non-discretionary spending growth, including the new Medicare bill, the FFY2006 budget is likely to continue the decline in federal revenue received by the states.

The FFIS projected impacts of the President's FFY2005 budget on Vermont. These include:

- **Federal discretionary funding. Vermont resources are estimated to be reduced from FY2004 enacted levels**.
  - Education changes include $2.3 million increase for LEAs and Special Education and a $4.4 million decrease for vocational education.
  - Homeland security formula grants to decline $8.2 million - money is proposed to be re-targeted to high threat urban areas
  - Vermont's Federal election monies are reduced from $7.5 million to $200,000
  - EPA Clean Water Grants reduced by $2.4 million
  - Byrne and Juvenile Justice grants consolidated into a Justice Assistance Grant with a 36% reduction. The Vermont impact could be $800,000 reduction
  - Employment and Training grants are consolidated into "Consolidated Worker Grants" with a 3% overall reduction.
  - Distribution formulas for the consolidated funding are not yet clear.
- **Federal nondiscretionary funding. Vermont resources are estimated to drop $18 million or 2.7% from FY2004 enacted levels.**
  - Medicaid match rate for information technology investments will be reduced from current levels of 90% federal to 75% federal. The impact on Vermont is projected at $1.9 million.
  - SSBG and TANF will be level funded for FY2005

Key Health Care Fiscal Issues

Health Access Trust Fund (HATF) – The Health Care Access Trust Fund has relied on one time funds and flat revenue sources for a number of years. Due to this long standing situation, the fund is projected to have operating deficits of $40 million in FY06, and $60 million in FY07. In FY 2005 health access fund spending is based on $26 million in fund balances and other one time funds. Causes for this shortfall include:

- Spending growth of 8% - 10% per year
- About one-third of revenues are from sources that are flat or declining (cigarette and tobacco taxes, tobacco settlement)
- The Governor's budget calls for a 2.8% increase in the GF transfer to the HATF.
- The FY04 temporary increase in the federal Medicaid match rate has ended, leaving Vermont with an even lower rate than it had prior to the temporary increase.
- The President's proposed budget reduces the match rate for Medicaid spending on information technology. This may cost the state as much as $2 million.
- If downward adjustments are necessary in the premium system, this may reduce program revenue.

Medicare Prescription Drug, Modernization, and Improvement Act – This act affects Vermont in several different ways, including a prescription drug benefit for all Medicare beneficiaries and creation of "Health Savings Accounts" which, in conjunction with a high-deductible health insurance policy, will allow Vermonters to shelter income from federal and state taxation.

The prescription drug coverage represents a major change in Medicare, and will have several different effects in Vermont, most notably on the Medicaid program. Currently, the state provides drug coverage to two distinct groups: dual-eligibles (those who qualify for both Medicare and FULL Medicaid coverage) and other Medicare beneficiaries up to 225% of poverty through its Medicaid waiver programs, VHAP Pharmacy and VScript, and its state-only program, VScript Expanded.

By FY06, the state would have spent nearly $30 million to provide prescription drug coverage for dual-eligibles. Under the provisions of the act, the state will be required to remit 90% of this amount to the federal government (the "claw-back" provision), but will be able to keep 10% of the savings, or about $3 million.

While the financial consequences of the act on spending for dual-eligibles is clear, there is substantial uncertainty about the effects on the waiver programs. Questions include:

- How will the waiver programs operate in conjunction with the Medicare benefit? The most likely scenario is as a wrap-around program, using only state funds. This will require several million dollars in new spending. Less likely scenarios include continuing federal participation (a substantial savings to the state) or, as a worst case, a prohibition on any wrap-around, saving the state even more funds, but reducing the benefits by about half.

- Will the claw-back provision apply to waiver spending? There has been no clear answer to this question, but if the provision does apply, the state will be required to remit even more to the federal government, more than wiping out any savings in the dual-eligible program.
- Since the VScript Expanded program is currently funded using only state dollars, there will be savings to the state, regardless of how the waiver programs are affected.
- Even if the state chooses to provide wrap-around coverage for the Medicare benefit, the amount of drug spending for which the state has primary responsibility will decline sharply. This will probably reduce the state's ability to negotiate supplemental rebates.

Health Savings Accounts Based on estimates by the Congressional Budget Office, Health Savings Accounts will have a minimal effect on state tax revenues. CBO estimates that nationally, HSAs will reduce federal income tax revenues by about $0.5 billion per year in the first few years of operation. This translates into a loss of about $1 million in federal income tax revenue in Vermont, or about $300,000 in state revenue.

The act also includes funds to provide incentives for employers to continue their own pharmacy coverage for retirees. The state is eligible to receive these funds.

Administration Health Care Tax Proposals – There are two aspects of the Governor's health proposal are likely to have fiscal consequences.

Reinsurance – The Governor is proposing a reinsurance plan for the individual and small group insurance markets. The administration estimates that this program will produce about a 10% reduction in premiums. Funding comes from two sources. The first is the existing 2% premium tax on for-profit health insurers. Currently, revenue from this tax, about $1 million per year, is deposited in the General Fund, but under the Governor's proposal, revenue would be put in a reinsurance trust. The 2% premium tax will be extended to Blue Cross and MVP Health plan. This will raise about $12 million. If this funding is determined by the Commissioner of BISHCA to be inadequate, the Commissioner may assess all health insurers, on a *per capita* basis to raise additional funds.

Employer Health tax credits - The Governor also proposes to offer tax credits to employers with fewer than 25 employees. During FY05 and FY06, these credits would be available only to those small employers who haven't offered health insurance in the last 24 months. Starting in FY07, credits would be available for all employers with fewer than 25 employees. Credits would be based on 25% of the employer's cost, to a maximum of $40 per employee per month. The value of the credit would decline after two years. The underlying health insurance must meet IRS requirements as an HSA. The fiscal impact of this proposal is $1.5 million in FY05 when the effect of the credits is combined with the impact of the employer deductions and employee use of HSAs.

Fiscal Impact - The preliminary estimate of the administration proposals is general fund revenue loss of $2.8 million and $6 million in FY2005 and FY2006 respectively.

Other General Fund Pressures

In addition to the budget pressures posed by Medicaid, there are several other areas that place a significant amount of fiscal pressure on the budget.

General Inflationary Pressures

1) Pay Act - The FY2005 cost of the Pay Act has already been appropriated. The ongoing pressure this places on the budget will need to be incorporated into the FY2006 budget. The GF portion of this is $5-6 million. In addition, negotiation of a new contract with state employees will be underway and will require funding in FY2006 and FY2007

2) Health Insurance - One-time surplus funds were used to offset both Pay Act and health insurance premium increases in FY2004 and half of FY2005. The underlying growth rate in premiums is 15%. In FY2006 and subsequent years, the budget will need to absorb these cost increases.

Human Services (other than Medicaid)

1) Corrections – The corrections caseload has continued to grow substantially. In FY2000, 1,610 people were incarcerated. In FY2005 the projected number is 2,102, a growth rate of 30% or 5.5% annually. In addition, the parole, probation, and sanctioned populations continue to grow. The GF budget for The Department of Corrections has gone from $63.5 million in FY2000 to a request for $94.9 million in FY2005, a 49.5% increase or an average of just under 10% annually for the past 5 years.

2) SRS Childcare Slots – For the past two years, this appropriation has required a $2.3M budget adjustment to keep pace with the demand for services. The GF spending for childcare has grown from $5.8 million in FY2000 to a FY2005 request of $11.1 million, a 91% increase or 13.9% per year on average. This fiscal trajectory could result in additional FY2006 and FY2007 pressure.

3) Mental Health – The caseload and case severity continue to grow in mental health programs. The FY2004 gap was bridged using $600k of one-time risk pool funds. This adjustment will need to be annualized and addressed in FY2005, increasing the base for FY2006.

4) Tobacco Fund Revenue - Revenue received under the master settlement is expected to decline slightly in FY2005. FY2006 revenue is dependent on adjustments that may further erode this revenue base. In FY2005, $2.4M of one-time tobacco funds are used to support what may be ongoing needs. This includes backfilling FY04 one-time federal funds increasing tobacco programs, as well as support of substance abuse programs.

5) LIHEAP – The LIHEAP (fuel assistance) program has traditionally relied solely on the allocated federal funds for this program. In FY2004, spending also includes carry-forward federal funds of $2 million. Additional GF support is also under consideration. In FY2005, there is likely to be significantly less carry-forward federal funds available to support the benefit. The GF and Weatherization special funds may be under pressure for maintenance of benefit levels in FY05 and beyond.

Natural Resources

1) ANR Special Funds - The FY2005 Administration budget proposal uses GF to support Fish and Wildlife ($1.4m) and Forest and Parks ($0.5m) operations because the revenue levels in these special funds are not keeping pace with base budget growth. This is the first time in recent years that significant GF has been used in these areas. A deficit in the Fish & Wildlife special fund is now projected even after the infusion of GF.

2) Clean & Clear - The Clean & Clear proposal sets expectations for a multi-year project that will cost $104 million. The first year of funding relies on federal grants and a combination of ongoing and on one-time GF and special funds.

Transportation Overview

The Administration's proposed FY2005 transportation budget relies on $13 million from non-recurring sources:

- **$6 million in one-time reversions from local highway programs**
    - If the legislature concurs with this proposal, one time funds are generated by paying future commitments as they become due.

- **$2.1 million in one-time money from statutory equipment maintenance funds**
    - In FY2005, the AOT Central Garage Equipment Maintenance fund would normally receive $2.1 million. The administration is proposing to forgo that standard payment for equipment maintenance for FY2005.

- **Use of $5 million from the Capital Bill**
    - In itself Capital Bill demand exceeds resources

Transportation infrastructure needs in Vermont continue to exceed available resources. The demand for resources will outstrip the federal funds and state funds currently or projected to be available. In addition, new federal funds that become available will require an increased state match. State transportation funding issues include:

- **Paving -** Maintenance of existing paved roads at the medium scenario which essentially is designed to maintain the status quo would require a $93 million annual investment (AOT 2/17 report). For FY2005, the Administration has proposed spending $33 million – the largest amount in three years. The shortfall between need and expenditure is likely to make future costs higher.

- **Bridges** – A large number of Vermont's bridges are near or above the 40 and 80 year age limits and need substantial reconstruction or replacement. Timely performance of this work so as to minimize future costs would require annual appropriations for state and interstate bridges of $59 million. Current spending for this purpose is $ $18 - $21 million. Additional monies are required for local bridges. (AOT 2/17 report).

- **Major projects –** Currently active major projects have an estimated $157 million remaining cost with another $508 million or more in approved projects not yet underway. Over the past 5 years, an average of $32 million a year has been expended on large projects. At this pace, it would take 15-20 years to complete the projects on the current list. The Administration's proposed $55 million FY2005 funding level would be difficult to sustain with current resources. However even at this funding level existing project completion would take ten years.

- **Town highway programs –** For the past four years we have not met the statutory requirement to increase town funding. The town transportation systems are aging and face a similar stress to that of the state system.

Capital Bill Pressures

Vermont's capital plan indicates capital bill pressures of approximately $100 million per year from FY2005 through FY2008. This year, the Capital Debt Affordability Committee increased capital spending limits to $41 million up from $39 million in FY2004. However, for the second year in a row, after transportation spending, only $36 million is available for traditional state capital bill needs. For FY2005 there were $92 million in requests for the capital bill.

The administration proposal for the $41 million in capacity will create difficult decisions some of these are:

- **School Construction Aid – potentially $4 million in requests postponed to FY2005 -** For the first time since the moratorium demand was met, current year school construction obligations are under funded: The state is obliged to fund at least 30% of approved projects. If state funds are not available when the town spends the money, the town borrows and pays the interest in anticipation of state funds. In recent years one-time money has helped to meet state school construction obligations. This year school construction obligations likely to be due in FY2005 are $7.9 million. The administration proposes funding of $4 million.

- **Technical Center funding $4.3 million below requests–** State technical center aid will be a major source of demand on the capital bill. In FY2005 Brattleboro requested $5 million of the remaining $8 million in obligations. The Administration proposed funding level for Brattleboro is $700,000. The Chittenden and North Country demands are yet to be identified but in total are estimated to range $40-65 million. Tech centers have historically have been funded at 100%. Current law now says that the state will fund technical centers at 50%, with the exception of the above three centers which are anticipated 100% state funding.

- **Higher Education allocation reduced $1 million -** Traditionally roughly $3 million and $1 million allocations have rotated between UVM and the state colleges with the allocations switching annually. The Administration FY05 proposal breaks this tradition by allocating $2.1 million to UVM and $1 million to state colleges.

- **VT Public Television $400,000 request unfunded -** VPT is converting to statewide digital broadcasting as legally required. There are federal matching funds that have been awarded but are contingent on state matching funds. Since FY1999 the state has made annual appropriations towards this mandated statewide digitalization project. The administration proposed no funding this year. This year the funds would be used for a Burlington channel on Mt. Mansfield. The remaining federal funds to be matched at 60/40 are $1.2 million. The original VPT request was for $870,706 however they have modified the request to $400,000 for FY05.

State Fund Deficits

While Vermont continues to have a strong fiscal position as compared to other states, a number of special fund, internal service fund, and trust fund deficits exist which have a negative impact on our fiscal health. In differing ways, the deficits present challenges for the state fiscal situation:

1. Fee for space - The facilities operation revolving fund FY 05 starting deficit (Conf. proposal) $6.7 million

In FY2002 Vermont created a new system for paying for state owned and occupied buildings. Rather than appropriate directly to the Department of Buildings and General Services for building maintenance, departments were billed based on the square feet that they occupied. In this way, true costs of departmental space needs were reflected in their budgets.

During program start up departments were not billed the full cost of their occupancy, leading to a fund deficit that grew and has been carried forward. Through FY2004 the deficit has grown as follows:

7/1/2001 Program began with deficit	($2,000,000)
7/1/2002 FY2002 closing deficit	($5,600,000)
7/1/2003 FY2003 closing deficit	($9,600,000)
7/1/2004 Est. additional deficit ($600,000) (Pay Act shortfalls, electricity)	($10,200,00)

Deficit after legislative reductions	(10,200,000)
2004 Big Bill reduction appropriation	$3,000,000
Conference 2004 BAA deficit reduction	$500,000
FY2004 Deficit after reductions	($6,700,000)

2. VISION – The financial management systems development special fund VISION starting deficit FY2005 (Conf. proposal) $8.5 million

In FY2000, Vermont began development of a new financial management system known as VISION. The total system cost was anticipated to be $20 million, which would be deficit-financed by assessments to users over time. As of the close of FY2003, the remaining deficit was $11 million. The FY2004 budget proposed a $2 million deficit reduction, and the conference budget adjustment proposes a further $500,000 reduction leaving $8.5 million. This deficit is allocated between the GF and TF at 83% and 17% respectively. This deficit has been reduced by infusions of one-time funds and modest annual assessments to departments. Elimination of the deficit would take 14 years at the current $660k assessment rate. In FY2005, additional costs for an upgrade are estimated at $3-4 million which will increase the deficit on a one time basis and add nearly 7 years to the pay down.

3. Teachers Retirement Fund under-funding

Through FY2003, the Vermont Teachers Retirement System total funding level has continued to improve, reaching of 89.6% of full funding based on actuarial value of fund assets. This the highest level in 12 years. However, the rate of increase has declined and in FY2004 there is a strong possibility that this trend will reverse and we will see a decline in funded levels. This change is due to increased actuarial cost projections and prior-year market losses not yet reflected in actuarial funding. The actuarial analysis is designed to smooth changes over five years.

State appropriations to the teachers retirement system have also been below the Retirement Board's actuarial-based requests. As a percentage of the request, state appropriations reached a high of 93.2% in FY2000. Due to a higher FY2004 actuarial-based request and level funding of the appropriation, the FY2004 appropriation represents 49% of the actuarial request. In FY2005 the Administration again proposes level funding of the actuarial request which would fund 46.9% of the request.

<u>State funding of teachers retirement over the past five years</u>

2005 Administration recommend	$20,446,282	46.9% projected
2004	$20,446,282	49.1% request
2003	$20,446,282	72.3% request
2002	$20,446,282	92.3% request
2001	$19,143,827	91.3% request
2000	$18,586,240	93.2% request

4. State Workers Compensation Fund – potential cost pressure

The state workers compensation fund is a self-insured fund that covers state employees. As of the close of FY2003 there was a fund liability of $16 million. Current fund resources were $8.6 million as of the close of FY2003. Agencies will see a 12% increase in premiums in FY2005 to begin to improve the funded ratio (Private sector increases are running closer to 20 – 24%). In FY2005, the state hopes to increase assets by $500,000. A number of claims management strategies may also mitigate claims. A nurse case manager program initiated by the legislature last year is helping to control costs. Overall, worker's compensation is likely to be a future departmental budget pressure.

The administration and the Senate have proposed using one time money to address these deficits ($5 million and $2.25 million respectively). The administration and the House have proposed using contingent funds to address the deficits. The administration recommendation is that deficit reduction be the first priority use of contingent revenues.