Bridging the Gap

An Analysis of Governor Kaine's Outgoing 2010-2012 Biennium Budget

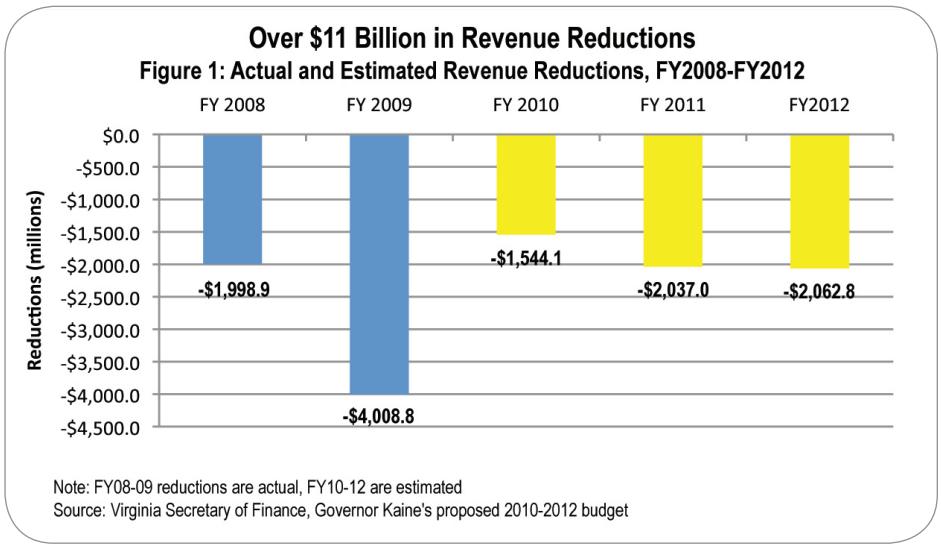
By Michael Cassidy, Sara Okos and John McInerney

Governor Tim Kaine's final budget proposal reflects the problems facing Virginia in the current economy: As the needs of Virginians have grown during the recession, the state has fewer resources to address these needs.

Continued job losses have meant lost wages and health care for many Virginians. Education needs have grown as more children enroll in public schools and workers go back to school for re-training. Yet, the resources needed to pay for these public services have been declining as the recession has brought declining revenues from income, sales, and corporate taxes. As shown in Figure 1, revenues are down more than $4 billion in the biennium, and when coupled with required spending increases in core services, the total budget shortfall for the 2010-2012 biennium grows to about $4.5 billion.

It is clear that this problem is too big to solve with any one solution. A more balanced approach uses multiple strategies to balance the state budget and still meet people's needs in the current economy. This is a better alternative to relying heavily on spending cuts and failing to meet current needs as well as forfeiting investment in our economic future.

The budget proposal presented to the General Assembly on Dec. 17, offers a strongly balanced approach to tackling these tough problems. To be sure, the budget proposes significant cuts in services such as education, health care, public safety, and transportation. These all are on top of the substantial reductions already made to these services in prior budget cuts made since the Great Recession began in 2007.
But in addition to cuts, the Governor's budget also includes important proposals to close corporate loopholes, eliminate costly tax expenditures, use Rainy Day Funds, and revise Virginia's income tax system to raise revenues.

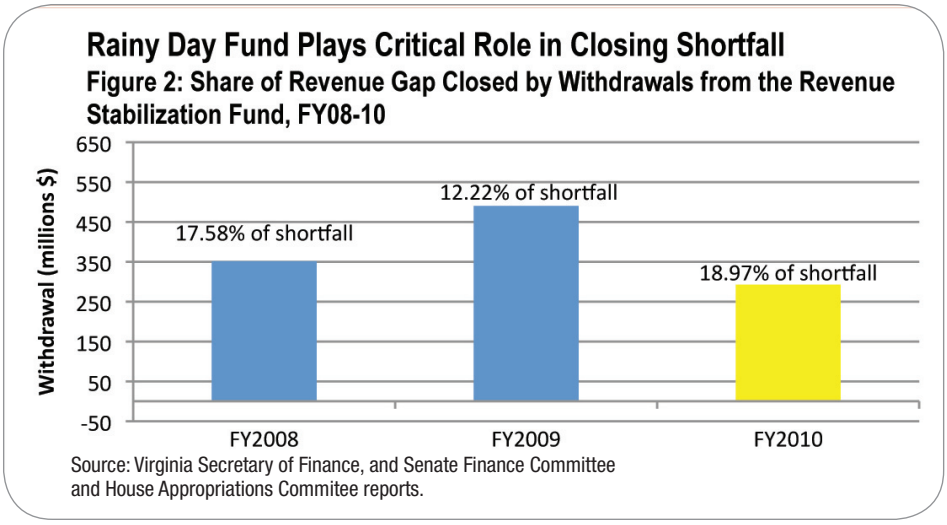


As new Governor Bob McDonnell comes into office in January and the General Assembly returns for its next legislative session, grappling with these proposals will be a top priority. As the saying goes, the Governor proposes, but the General Assembly disposes. Governor Kaine's proposals provide important pathways forward for the state to both address the state's budget woes and continue to meet the needs of Virginians across the state while not undermining education, health care, and transportation systems. Such cuts would leave the state poorly positioned when prosperity returns.

Use of the Rainy Day Fund

Governor Kaine has proposed withdrawing $292.9 million from the state's Revenue Stabilization Fund (known as the Rainy Day Fund) to help close the $1.5 billion gap in the current fiscal year.

Given the continued strain on Virginia's economy, a withdrawal of this magnitude is



entirely appropriate. The Rainy Day Fund was built for the very purpose of helping to stabilize Virginia's economy when state revenues fall short of expectations. Drawing down these reserve funds is critical to avoiding additional cuts to core services at the time when Virginians need them most. To preserve the balance of the Rainy Day Fund at the expense of valuable public programs, such as health care and education, could actually worsen the conditions of the Commonwealth's economy.

Revenues

Eliminating Virginia's Dealer Discount Program. Virginia's Dealer Discount program allows retailers to keep a portion of the state sales tax they collect from consumers. This discount was created to compensate for the cost and burden of keeping records and transmitting tax revenue to the state. However, the program has become outdated because electronic data transmission imposes little to no cost for retailers.

Virginia is an outlier in terms of its Sales Tax Dealer Discount program. Of the 26 states in the country that provide compensation, 13 put a ceiling on the amount any individual store or chain can receive. Virginia's program has been operating without a ceiling, and as a result, ranks sixth in the nation for the total dollar amount "skimmed" from sales taxes. By eliminating the discounts received from the state's retail establishments, Governor Kaine estimates that the state can bring in roughly $61 million per fiscal year.

Decoupling from federal "qualified production activities" income deduction. Governor Kaine has also proposed decoupling from the domestic production deduction, a corporate tax break created by the federal government in 2004. This provision allows companies to claim a tax deduction based on profits from "qualified production activities," an extremely broad category that goes well beyond manufacturing to include such diverse activities as food production, filmmaking, and utilities — a substantial share of Virginia's corporate income tax base. Since 2004, Virginia has allowed this deduction from the state corporate tax because Virginia conforms its state income tax code to the federal code. However, because of the revenue losses, 20 other states have already chosen to decouple from this particular federal deduction. Governor Kaine's proposal is estimated to save the Commonwealth about $55 million in FY 2011.

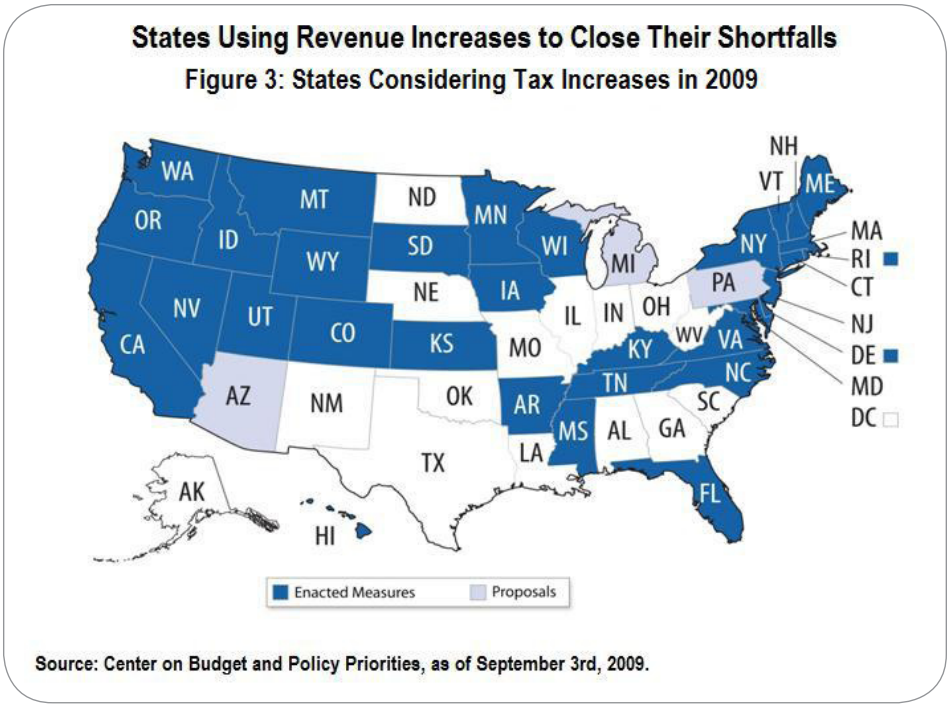
Eliminating the Car Tax Reimbursement and Income Tax Rate Increase. Governor Kaine proposes eliminating the state reimbursement to localities under the Personal Property Tax Relief Act (PPTRA, known as "car tax relief") by the full $950 million per year that the state has been reimbursing localities. Since passage of PPTRA, the state has continually struggled to generate sufficient revenue to pay for this local tax relief, while also maintaining an adequate level of state services. Eliminating this relief effort frees up the $950 million needed annually to fund this program.

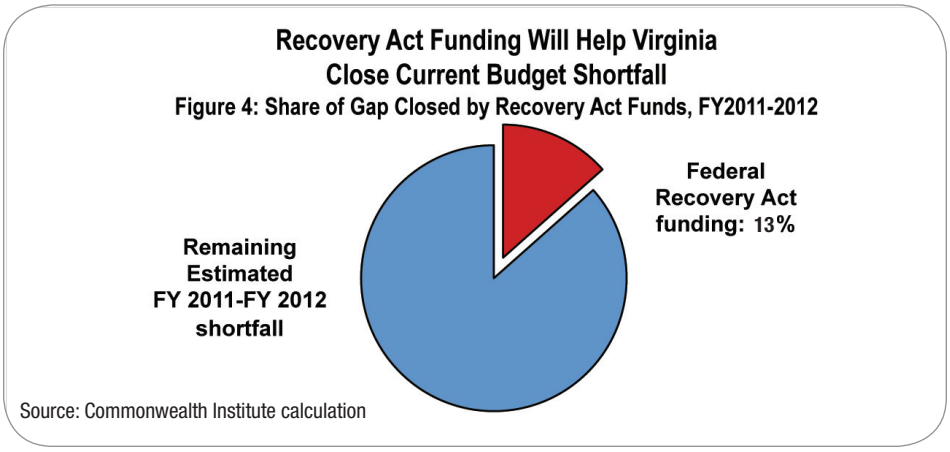
In recent years, as the cost of car tax relief grew, Virginia froze the rollback of the car tax at 70 percent under Governor Warner, and capped the size of the reimbursements made to localities at $950 million going forward. Like Governor Warner's decision to cap reimbursement, Governor's Kaine's new proposal is a recognition that the state can no longer afford the current level of relief without putting education, health care, public safety and transportation at risk.

Localities have already been hit hard by state budget cuts with more than $50 million in cuts from the state in direct aid to localities and a reduction of 13 percent for the major part of local budgets: K-12 education. The implosion of the housing market and localities' limited taxing authority only complicate the fiscal challenges for Virginia's local governments.

The Governor acknowledged the fiscal dilemma posed by eliminating the state reimbursement to localities for car tax relief. To make up for the lost revenue from the state, localities would likely face the choice of increasing car tax bills for residents. To address this dilemma, Governor Kaine offered a new deal to localities: Eliminate the car tax fully and they could gain access to a new pool of money at the state level funded by a new 1 percent surcharge on income. This increase in the tax rate would be distributed to localities that agree to eliminate their car tax altogether. The Governor estimates that the 1 percent surcharge will bring in $1.6 billion in FY 2011 and $2 billion in FY 2012, which will be distributed to localities using the existing car tax reimbursement methodology.

In essence, this proposal would raise the income tax in order to pay for state services, including aid to localities. The formula for distributing this aid to localities would





be the value of cars in the locality. On the positive side, it's an income tax increase so the elimination of the car tax would be financed in a way other than cutting needed public services or raising revenues through something like a sales or cigarette tax that tend to be regressive and disproportionately hit low and middle-income families. This proposal would also allow Virginia localities access to the income tax as a source of needed revenue. Up until now, localities have essentially been blocked from implementing an income tax as a source of revenue for services.

Linking the distribution formula to the current car tax relief formula, however, is not the ideal way to distribute aid to localities since it probably does not track need in communities as accurately as other measures. In addition, this approach seems to permanently lock in this revenue for aid to localities, instead of building in flexibility for the greatest state needs.

Other States Consider Revenue Options

Virginia is not alone in its consideration of revenue measures to close the budget shortfall. Over the course of this past year, at least 35 states have considered tax increases. As of early December, 29 had enacted revenue increases for 2010. States' inclusion of revenue as part of the solution to closing budget gaps illustrates the need for a balanced approach during these tough times of rising need and declining revenue.

American Recovery and Reinvestment Act Helps Reduce Shortfall

The federal American Recovery and Reinvestment Act passed in February 2009, provided Virginia with approximately $4.8 billion in new federal funding to help refuel the state's economy and lessen the impacts of state budget shortfalls. The state received

approximately $1.3 billion in increased federal support for Medicaid and $1.2 billion in increased funding for education and other critical state spending needs. The infusion of federal funding through the Recovery Act helped Virginia close a $4 billion shortfall in last year's budget and will continue to play a significant role in closing the current budget gap.

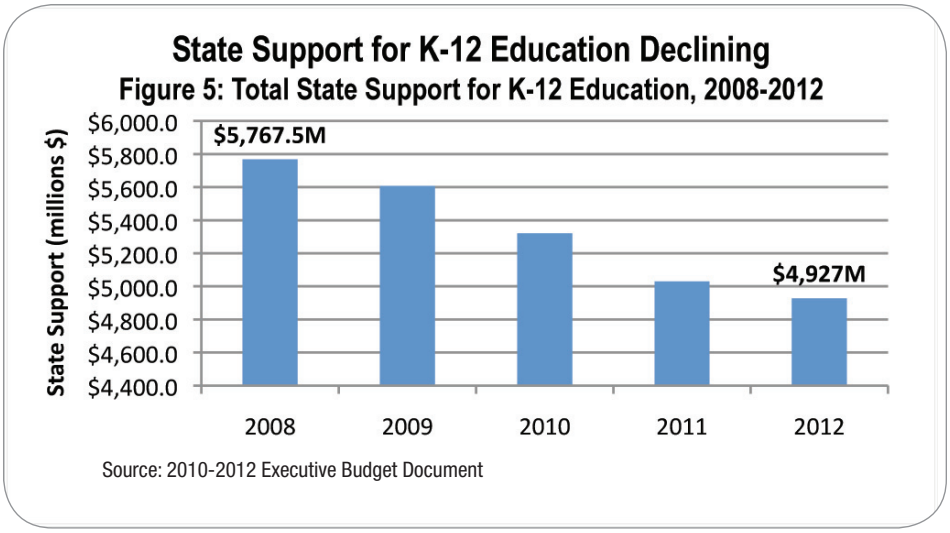
While the majority of Recovery Act funding has been allocated, a significant portion remains for the first two quarters of the next biennium budget period. Virginia will likely be able to access over $360 million in federal reimbursements for Medicaid, nearly $300 million in federal support for K-12 education, and approximately $35 million in increased federal funding for higher education. However, unless Congress approves more funding, the current Recovery Act money phases out by the end of 2010.

The increased federal assistance under the Recovery Act will help reduce Virginia's expected FY 2010-FY 2012 budget shortfall. The almost $700 million in available Recovery Act funding represents 13 percent of the estimated shortfall. Without the increased federal support, Virginia's budget and fiscal outlook would be even more severe.

Education

K-12. Governor Kaine has proposed a series of technical changes to the K-12 funding formula (known as the Standards of Quality) that substantially reduce the amount of funding for education. As shown in Figure 5, the state's General Fund investment in K-12 education has declined from $5.7 billion in 2008 to just under $5 billion in 2012.

One of the most significant changes comes from the formula's treatment of administrative and support staff. Governor Kaine proposes capping the state funding for K-12 support staff positions (similar to a proposal he made last year), at an estimated savings of $300 million per year. During the 2009 session, the General Assembly considered this same proposal to cap state funding for support staff rather than fund school support personnel under the existing formula that looks at the costs of these services. Because this proposal marked a major change in the Standards of Quality, the General Assembly requested that the Virginia Board of Education study the issue.



> **In a recession, the needs of families grow at the same time that the state has fewer resources to help them.**

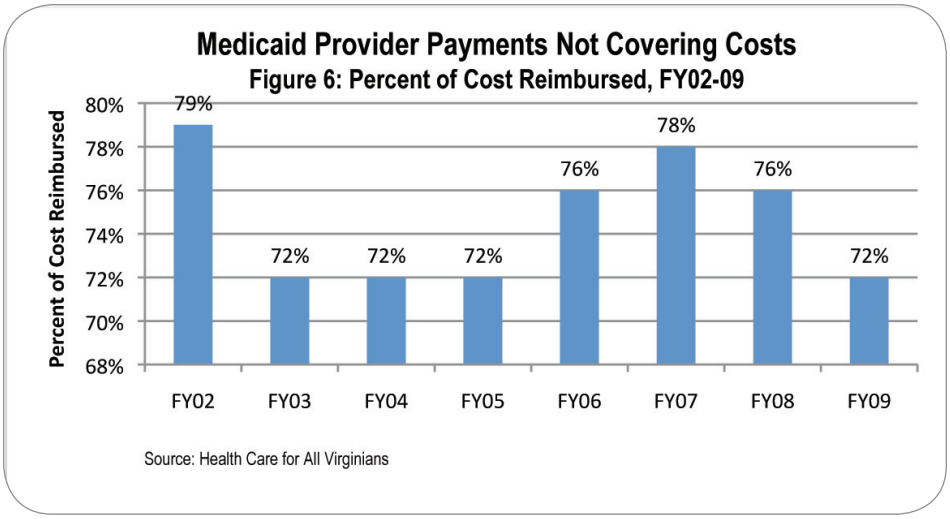
Upon examination and with public comment, the Board of Education concluded that the across-the-board support staff cap lacked an educational justification. While the proposal has been defended by the assertion that the cost of support staff has been rising faster than the cost of instructional staff, this argument is based on a funding error made back in 1993. In reality, growth in the cost of instructional staff has exceeded that of support staff. This type of change in the funding formula represents a permanent and structural change in the way Virginia funds K-12 education and, ultimately, lowers the quality of education ensured by the state.

In addition to the change in the funding formula for administrative and support positions, Governor Kaine proposes altering the state share of health care costs to reflect actual employee plan participation. This change saves the state slightly more than $134 million per year.

The Governor also proposes delaying the update of the composite index until fiscal year 2012. The composite index serves as a measure of localities' ability to pay for public education. This delay saves the state about $39 million in fiscal year 2011.

Higher Education. The Governor proposes cuts to higher education of $240 million during the biennium. Four-year universities face a 4-percent reduction in fiscal year 2011 and a 15-percent reduction in fiscal year 2012, while the impact is slightly less severe on two-year institutions, which face a 3-percent reduction in fiscal year 2011 and a 13-percent reduction in fiscal year 2012. All other institutions of higher education face the same reduction schedule as four-year institutions.

These reductions in state assistance to the state's institutions of higher education will likely lead to new tuition and fee hikes by the state's colleges and universities. Some schools, such as the College of William & Mary, Christopher Newport University, and Mary Washington University, have already imposed mid-year tuition increases. These tuition increases — some as high as 11 percent per year — place enhanced financial demands on Virginia's students and families. These increases may push higher education just out of reach for many middle- and low-income students.



Health Care

As large numbers of Virginians lose their jobs and the health care coverage that often goes with it, the demands on our state's public insurance programs, Medicaid and FAMIS (for children), grow. Due to the high cost of health care services in general, this uptick in demand means substantial increases in the state's budget. Virginia maintains strict eligibility requirements to enroll in these programs, leading to spending that is the 48th lowest in the country, on a per capita basis. Despite these limits, costs for the programs will rise in the coming two-years covered by the Governor's budget proposal.

Virginia has benefited from federal Recovery Act resources for Medicaid, which has already provided Virginia with almost $1 billion in increased federal support. But this extra funding will only last through a portion of the upcoming two-year state budget. More than $360 million in Recovery Act support is expected for Virginia in the first half of FY 2011. But the federal money and the "maintenance of effort" requirement that has protected Medicaid eligibility from reductions will run out at the end of December 2010.

This decrease in federal funding, combined with an increase in utilization during the economic downturn, requires an additional $1.8 billion to fund basic required Medicaid services during the 2010-2012 biennium budget period. Governor Kaine's budget would also make approximately $419 million in Medicaid cuts over the biennium. This will reduce support for health care providers, the elderly and disabled, and other Virginians in need of health care services and coverage.

Medicaid Eligibility Reductions/ Enrollment Freezes

The Governor's budget would freeze or limit eligibility in several Medicaid waiver programs, including:

- Closing enrollment for one year (beginning in January 2011) in most of the Home and Community-Care waivers. The waiver programs impacted are: the Elderly and Disabled with Community Direction waiver; Day Support Waiver for People with Mental Retardation; Individual and Family Developmental Disabilities Support waiver; Alzheimer Assisted Living waiver; and the Intellectual Disability/ Mental Retardation (ID-MR) waiver ($17 million).
- Reducing the income eligibility limit for certain nursing home or long-term care residents from 300 percent Supplemental Security Income (SSI) to 275 percent SSI ($53.3 million).
- Indefinitely delaying the addition of 400 MR waiver slots and 67 Individual and Family Development Disabilities and Support Waiver slots per year that were approved in FY 2009 ($39.2 million).
- Eliminating podiatry and optometry services for adults in Medicaid ($1.7 million), and limiting annual visits for physical, occupational and speech therapies ($335,000).

While certain spending reductions may be necessary in the current economic climate, the General Assembly should carefully

examine each eligibility restriction and seek to limit the impact on Virginians in need. These optional Medicaid services provide vital assistance to the elderly, disabled, and low-income families.

Medicaid Provider Payments Decline

The Governor proposed $228 million in Medicaid provider reductions and inflationary freezes. These reductions include:

- Withholding Medicaid payment inflationary adjustments for Virginia's hospitals ($76 million).
- Freezing nursing homes' Medicaid payment rates at FY 2010 levels ($29.5 million).
- Freezing Disproportionate Share Hospital (DSH) payment rates at FY 2010 levels ($20.4 million).
- Reducing Home and Community-Based waiver services by 5 percent ($36 million).
- Cuts in funding for safety net organizations and providers, including the Virginia Health Care Foundation, the Virginia Association of Free Clinics, the Fan Free Clinic, and the Jeanie Schmidt Free Clinic.

In addition, a provider assessment on Intermediate Care Facilities for the Mentally Retarded would be implemented, creating a savings of $12.7 million for the General Fund. This change would also increase federal Medicaid reimbursements by about $12.5 million.

Reducing or freezing payment rates to providers that treat Medicaid patients will save the state money; however, it could have a detrimental affect on access to care in Virginia. Already, hospitals in Virginia only receive 72 percent of the total cost in treating Medicaid patients. Nursing homes already lose about $12 per day for treating a Medicaid patient. Further reductions in payments to these providers will produce further financial strain and could impact their ability to treat low-income Virginians, especially in rural areas.

Key Children's Health Provisions in FAMIS

The Governor proposes increasing Medicaid eligibility for pregnant women from 133 percent of the federal poverty level (FPL) to 185 percent of FPL. This change would bring Virginia into compliance with the requirements of the federal Children's Health Insurance Program Reauthorization Act (CHIPRA) that requires states to maintain Medicaid eligibility for pregnant women at least at 185 percent FPL if they cover pregnant women in their children's health program at higher incomes (up to 300 percent of FPL). Beginning in 2009, Virginia covers pregnant women in the FAMIS program up to 200 percent of FPL. In addition, the Governor proposed:

- Increasing funding for FAMIS by about $12 million to account for increased use and inflation. Virginia has access to significantly increased federal reimbursements for the FAMIS block grant program from CHIPRA and will receive more than $22 million in additional federal payments over the biennium.
- Requiring that all applicants to FAMIS provide a Social Security number to verify citizenship. CHIPRA requires citizenship documentation for all those seeking children's health coverage, but offers a Social Security verification method as a state option. Providing Social Security numbers will allow the state to more quickly verify citizenship and enroll children in the program.

Temporary Assistance for Needy Families (TANF)

TANF use has increased by at least 11 percent during the current economic downturn. Such an increase has put a strain on the state's funding of basic TANF services in the block grant program.

To meet the needs and spending requirements in TANF, the Governor's budget reduces or eliminates most non-mandatory TANF spending. In recent years, as TANF enrollment has fallen, the state has been able to use funds within the block grant to fund other needed services for low-income families. But increased caseloads in the core program means that funding for these other services will be reduced. Non-mandatory TANF spending would be reduced by $21 million under the Governor's budget. Core TANF spending would be maintained, but critical services provided by many third-party direct service providers would be reduced. In some cases, such as the Healthy Families program and grants to local domestic violence programs, the Governor proposes to replace these lost federal TANF dollars with state General Fund money in order to maintain program funding.

The budget proposes to increase the TANF benefits program funding for areas such as cash assistance, employment services, and child care by approximately $14 million federal dollars. In addition, the budget proposes to increase funding using state dollars for the Unemployed Parents Cash Assistance Program by $7.2 million in 2011.

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The Commonwealth Institute is supported by generous grants from The Annie E. Casey Foundation, the Public Welfare Foundation, , The Moriah Fund, The Meyer Foundation, and The Bernard and Audre Rapoport Foundation. The work of this report could not have been completed without their support. We thank them for their support but acknowledge that the findings and conclusions presented in this report are those of the authors alone, and do not necessarily reflect the opinions of the foundations.

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