CONTROLLER'S MONTHLY REPORT #3

RON KNECHT, NEVADA STATE CONTROLLER

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Nevada's Budget Challenges: The Balanced Plan for Growth

The first two Controller's Monthly Reports (CMRs) addressed state spending and revenues. This one presents a state General Fund budget proposal that I developed with Assembly Majority Whip Jim Wheeler, a group of Assembly members and some excellent professionals and public-spirited citizens. Nevada Revised Statutes 227.110(2) provides: "The State Controller may recommend such plans as he or she deems expedient for the support of the public credit, for promoting frugality and economy, and for the better management and more perfect understanding of the fiscal affairs of the State." We launched this Balanced Plan for Growth: A Budget for the New Nevada, discussed below, to serve the voters, taxpayers and broad public interest.

1) Balanced Plan addresses both revenues and spending: The Balanced Plan starts with the $6.3-billion base revenue forecast of the Economic Forum for fiscal years 2016 and 2017 (FY16 and FY17) and adds additional non-tax revenues. On the other end, it starts with the $7.3-billion of spending proposed by Governor Brian Sandoval and carefully reduces that amount at the individual account level while securing the values sought via his spending proposals. It yields a $6.9-billion proposed budget that is a work-in-progress vehicle with which to forge a consensus. The $6.9-billion Balanced Plan budget would increase current spending of $6.6-billion by 2.45%/year (in current-dollar terms), which is less than the rate of growth of Nevada's economy. So, it is a small step toward fixing Nevada's spending problems discussed in CMR#1 and the excess size of state and local government. By working both the revenue and expenditures sides equally, it is truly a balanced plan.

2) No new or increased taxes: The Balanced Plan eschews the $438-million Business License Fee and its successor, the Commerce Tax, both of which were proposed by the Governor as variations on a gross receipts or margins tax. In addition, the Balanced Plan allows temporary increases in sales taxes, business license fees and payroll taxes to expire as scheduled. These taxes were passed in the wake of the Great Recession in 2009 and were extended in the 2011 and 2013 Legislatures when hoped-for increases in revenues failed to materialize due to the very tepid economic recovery. Instead of allowing these taxes to expire, Gov. Sandoval proposed to make them permanent. By eschewing tax increases and new taxes, the Balanced Plan gained a major advantage over all other tax and budget proposals presented this session: It alone would require only simple majorities (22 votes in the Assembly and 11 votes in the Senate) to pass. The Commerce Tax finally adopted by the Legislature and signed by the Governor was estimated to yield $120-million of revenues in FY16 and $60-million of net annual revenues thereafter, due to its interaction with the Modified Business Tax. So, the Commerce Tax adds 1.6% ($120-million) to the general fund on a continuing basis, versus the 18.7% ($1.15-billion) total tax increase adopted.

3) Balanced Plan secures the goals of Nevadans: The primary public-policy goal is to leave Nevada's children a much better world of prosperity, freedom and opportunity, as previous generations did for today's citizens. As discussed in CRM #1 and #2, this goal requires two main things: 1) economic and effective management of public services, especially Nevada's poorly performing schools; and 2) reining in the excesses of public spending, taxes

and regulation to restore the traditional vibrant economic growth that has been lost due to the continued growth of those excesses for about 60 years. The Balanced Plan funds existing and new categorical K-12 programs highlighted by Gov. Sandoval, and by providing local flexibility in the allocation of funds to those programs, it reaps savings in expenditures. By eschewing new and increased taxes and growing state spending slower than the economy, it takes a direct first step to reining in the excesses of government spending and taxing. It shows that avoiding tax increases is not only possible, but also essential to the future wellbeing of our children.

4) **A work in progress to start a constructive, timely process:** The Balanced Plan is fully respectful of the roles and contributions of both the Governor and Legislature. It is presented constructively as a work in progress, not a take-it-or-leave-it finished product for an up-or-down vote. Via the plan, we seek to promote a process of deliberation, collegiality and compromise to avoid the stalemates of past difficult budget legislation, especially the 2003 session that required two special sessions to resolve. By offering the Balanced Plan before the mid-point of this Legislative session and inviting constructive criticism and variations on our proposals, we believe we may avoid the hardening of positions and lack of meaningful negotiation that ends in May/June breakdown. A key point is that the Balanced Plan does not rely on simplistic across-the-board cuts or merely whacking out major programs on the expenditures side. Similarly, it uses a wide palette of modest revenue measures, instead of simplistic tax hikes or new taxes. Thus, quite the opposite of a brute-force approach, the Balanced Plan is closely tailored, moderate in nature and reflects the extensive and detailed work that produced it. It was constructed by judiciously increasing or restraining the Governor's recommended expenditures based on careful examination of prior trends versus current requests at the individual account level.

5) **Securing the K-12 educational benefits sought by the Governor:** Nevada K-12 schools do not produce acceptable student achievement levels: their test scores are lower than those of most other states and nations with modern economies. So, Nevada has in recent years adopted categorical programs including class-size reduction, full-day kindergarten, early childhood education, and many other areas. The state now spends $550-million every two years in these special programs, but with no significant improvement to show. Gov. Sandoval proposed an increase of $12-million to sustain current programs, plus $365-million more in new categorical spending in his budget. Instead of specific amounts going to each category, the Balanced Plan consolidates all these existing and proposed amounts for county school districts into block grants to give each district the flexibility to tailor its spending among all the categories to best satisfy the needs of each school. Douglas County's needs differ from those of Clark County, which differ from those of Elko County, etc. (A growing academic literature, for instance, now finds that class-size reduction programs produce few positive results relative to the large expenditures required to sustain them.) The block-grant feature is similar to one proposed by the Governor in 2011. Because block-granting allows flexibility for local districts to tailor their spending to their specific needs, it allows reduction in the total proposed spending on the combined existing and new categories. However, the Balanced Plan still increases the total allocation to all of them by $62-million over current levels.

Among the sunset taxes that will expire, a temporary increase in the Local School Support Tax (LSST) of $389-million goes to local school districts, not to the state General Fund. To cover this loss, the Balanced Plan adds that amount to the state's General Fund appropriation to the local districts. In sum, the Balanced Plan provides $2.836-billion to local school districts for FY16 and FY17, versus the $2.866-billion they received in FY14 and FY15 from both the General Fund and the LSST increment that expires in June. This nominal 1% cut under the Balanced

Plan is roughly a cut in real per-student funding of 5% - a small fraction of the 23% increase that K-12 has gotten since 2004, an increase that (as noted above) has not improved student achievement. The next CMR will address K-12 education further and suggest no- and low-cost reforms to boost student achievement, instead of continuing to throw ever more money into a non-responsive and under-performing school system from which union bosses are able to enrich themselves (problems noted in CMRs #1 and #2).

6) Higher Education: The Balanced Plan keeps most of the Nevada System of Higher Education whole at FY15 levels, including all support to undergraduate programs at the University of Nevada, Reno and the University of Nevada, Las Vegas as well as community colleges. By contrast, the Governor's proposal cuts support for Western Nevada College by $5.0-million and that for Great Basin College by $5.5-million. The plan also retains the Governor's recommendation to fund a new medical school at the University of Nevada, Las Vegas. In all, the Balanced Plan recommends $992-million for the support of public higher education in FY16 and FY17, a $21-million increase over the legislatively approved budget for FY14 and FY15 of $971-million.

7) Health and Social Services: Nevada state spending in this area, including amounts supported by federal funds, has increased 37% in real terms per person over the last decade -- more than spending in any other area, even K-12 education. Enrollments in federal entitlement programs such as Medicaid, Temporary Assistance to Needy Families, and the Supplemental Nutrition Assistance Program (food stamps) continue to increase six years after the end of the Great Recession. Although federal funds support most of these programs, entitlements continue to be a key driver of state spending not supported by federal dollars. Medicaid has grown to become the second largest expenditure in the Nevada state budget. Although eligibility expansion has attracted more federal dollars to support the program, the number of Medicaid enrollments has nearly doubled from about 300,000 in early 2013 to almost 600,000 today. While much of the cost of Medicaid expansion is currently covered by increased federal funding, we need to plan ahead for the 2017-2019 biennium when this federal support will begin to decline.

The Balanced Plan meets Nevada's current obligations to cover all eligible beneficiaries of Medicaid, consistent with the Governor's recommendations. As one cost-control measure, the Balanced Plan proposes to hold provider reimbursements constant at current rates. This measure saves $60-million over the Governor's recommendations for FY16 and FY17.

8) Information technology deferred maintenance and support: Since the onset of the Great Recession and resulting sever budget constraints, many state agencies have been operating with legacy information technology and related systems that are obsolete and now cause high staffing levels and costs, while delivering poor service. Some of these systems are no longer supported by the vendors who provided them, leaving agencies at significant risks for breakdowns, service interruptions and additional costs if they are not replaced or upgraded soon. State spending to address this serious problem has been deferred for as long as six years now, and it cannot reasonably be further deferred. So, the Balanced Plan adopts the $20-million funding proposed by the Governor to partially address this problem (akin to deferred maintenance).

9) Employee furloughs: State employees were required to take furloughs of 96 hours per year (one day a month) resulting in 4.6% cuts in income beginning in 2009, and later to absorb pay cuts of 2.3% with furloughs of 2.3%. In 2013, the pay cuts were restored, but the 2.3% furloughs have continued to today. Due to these cuts, state employees' incomes in recent years have been diminished to a degree similar to that of taxpayers as a whole, whose incomes fell nearly 8% from 2008 to 2010 before rebounding slowly back to

their prior levels in 2014. With taxpayer incomes back to their previous levels, it is reasonable to restore state employee pay to its previous levels. So, recognizing the work ethic and productivity of the majority of state workers, the Balanced Plan proposes to end state employee furloughs and fully restore merit pay for classified employees.

10) Revenues: To bridge the gap between the $6.92-billion in proposed spending and the $6.16-billion in available revenues, as projected by the Economic Forum, the plan restores some previous or expiring measures and creates new, cost-saving innovations.

Transfer from local governments funded by reduced PERS spending: The Balanced Plan recognizes the growing strain that benefits for state and local public employees are placing on taxpayers. These spending increases are unsustainable and provide no benefit to taxpayers but instead only to employees. Further, there is an inequity between the treatment of state employees and employees of local governments who participate in the Public Employees' Retirement System. Although local government employees already earn more in base pay than their peers in state employment and the private sector, most bargaining groups also do not contribute toward their own retirement, while state employees are required to match the employer contribution out of their paychecks.

The Balanced Plan moves local-government employees halfway to parity with state employees by authorizing local officials to require that non-public-safety personnel contribute seven percent of pay toward their own retirement and public-safety personnel contribute 10 percent of pay toward retirement. State employees already contribute 14 percent and 20 percent of pay, respectively, into their PERS accounts and these contributions are matched dollar-for-dollar by state taxpayers. Under the plan, local-government employees would still receive a three-for-one match into their retirement accounts from local taxpayers.

Thus the Balanced Plan allows local governments to realize cost savings without an impact on service availability, but it also requires them to deposit an amount equal the estimated savings available from employee contributions into the Distributive School Account for disbursement to local school districts. These deposits will be offset by reduced General Fund appropriations to the DSA in the same amounts by the State. This mechanism allows the state to meet its financial obligations and finance improvements in education while holding local governments harmless. Using conservative assumptions, we estimate that this change will generate $742-million for the DSA in FY16 and FY17, and General Fund appropriations will be reduced equivalently thereafter.

Sweeps of closed programs and excessive reserve levels: The Balanced Plan also includes closure of several small, nonessential programs and a sweeping of reserve accounts associated with those programs. Some continuing programs' excess reserves would also be swept. These measures are expected to yield $39-million in FY16 and FY17.

Continued mining-tax prepayments, suspension of some deductions, and room-tax diversion: The Balanced Plan extends the prepayment of mining taxes, as first approved in the 2009 Legislature and continues the suspension of deductions for health and industrial insurance premiums in the calculation of the Net Proceeds of Minerals tax liabilities. We expect these policies to yield $31-million in revenue in FY16. In addition, the Balanced Plan continues diversion to the Distributive School Account of the 3% room tax increment imposed in 2009 pursuant to Initiative Petition 1. This diversion yields $308-million in FY16 and FY17 for the general benefit of public schools.

Re-directing local revenues and shortfall in FY16: As discussed above, local-agency savings from requiring their employees to contribute to retirement in amounts at least equal to their employers' contributions are expected to total $742-million for the DSA for K-12 education in FY16 and FY17. All the new revenues discussed above are added to the Economic Forum forecast of basic revenues in Table 2 below, raising total revenues from $6.155-billion in FY16 and FY17 to $6.967-billion. Comparing that latter figure to the expenditures of $6.918-billion shown in Table 1 shows a two-year surplus of $49-million. Addressing each fiscal year, FY16 revenues of $3.416-billion in fall short of expenditures of $3.445-billion by $29-million. On the other hand, FY17 revenues of $3.501-billion exceed expenditures of $3.477-billion by $78-million. Hence, the two-year surplus of $49-million is verified and the FY16 shortfall must be addressed, demonstrating that the Balanced Plan is, as advertised, a work in progress.

The graph below shows state General Fund spending over the last four years, plus the proposals for the next two years of the Governor and the Balanced Plan. The Balanced Plan spending amounts are reasonable increases similar to those of recent years and in line with the growth of the state economy. The Governor's proposal, on the other hand, would involve a clear acceleration of public spending, which would not serve the public interest.

Table 1: Biennial Spending Plans: Historical and Balanced Plan for Growth Versus Governor's Recommendations

	Actual		BPfG	Gov Rec
	2012-13	2014-15	2016-17	2016-17
Elected Officials & Special Purpose Agencies	$201,793,140	$211,793,805	$247,802,098	$267,058,448
Finance & Administration	82,027,900	92,299,033	70,544,815	86,592,015
Education:				
Higher Education	947,404,930	974,032,866	997,895,828	1,064,916,983
K-12	2,328,288,134	2,547,636,208	2,828,448,186	2,881,652,889
Commerce & Industry	79,893,575	95,127,595	74,316,856	127,914,675
Human Services	1,937,719,315	2,051,646,273	2,038,399,331	2,190,302,378
Public Safety	582,003,399	579,095,048	609,607,235	631,704,974
Infrastructure	45,479,680	44,466,393	50,486,207	64,011,001
Total	**$6,204,610,073**	**$6,596,097,221**	**$6,917,500,556**	**$7,314,153,363**

Notes:

1. Elected Official funding for FY16-17 includes increases for replacement of obsolete computing programs and other IT needs.
2. Gov Rec proposals for Finance & Administration in FY16-17 includes $10.1 million in "special appropriations" eliminated by the Balanced Plan for Growth.
3. Gov Rec proposals for Commerce & Industry include $17 million for Catalyst Fund and $9 million for Knowledge Fund that are eliminated by the Balanced Plan for Growth.

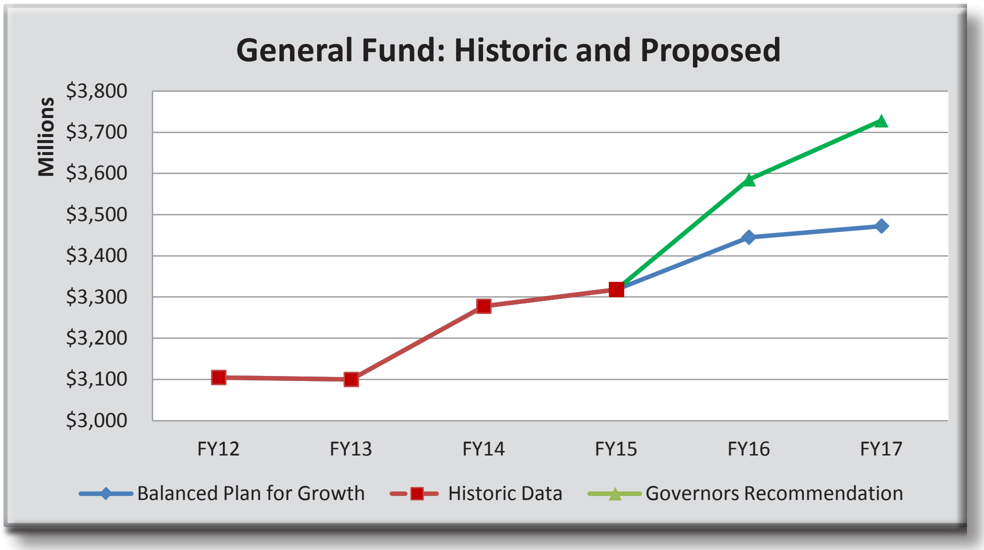

Table 2: Balanced Plan for Growth Revenue Chart

	FY15 - Actual	FY16	FY17
Economic Forum Projection (Revenue Base)	$2,979,843,943	$2,989,236,235	$3,165,980,185
"Sunset" Taxes	233,886,380	0	0
Fund Sweeps	0	36,432,331	2,444,622
Mining deductions and pre-pay (extend AB 561 and SB 493 from 2011 through FY17)	0	31,011,000	0
Local PERS Savings	0	359,237,029	382,587,436
Total	**$3,213,730,323**	**$3,415,916,595**	**$3,551,012,243**

Ron Knecht, Nevada State Controller

Geoff Lawrence, Nevada Assistant Controller

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