The Fiscal Focus

An update for Vermont Legislators from the Joint Fiscal Office

December 2003 Volume 9. No. 3

Ed Tax Rate Reduction

On December 1st, in accordance with Section 5 of Act 68, the Commissioner of Taxes recommended that the FY 2005 base homestead education tax rate and the uniform nonresidential education tax rate be reduced by five cents to $1.05 and $1.54, respectively. He further recommended that the education tax for income-sensitized taxpayers be reduced from 2% to 1.9% of household income.

Act 68, the education finance reform law passed last session, requires the Commissioner to recommend an adjustment to the education tax rates if there is a projected balance in the Education Fund in excess of the 5 percent stabilization reserve. The most recent Education Fund outlook projects an excess balance of about $25 million in FY 2005. This is a one-time reduction. Each year a determination is made depending on the level of the surplus as to whether the base rate of $1.10 for homestead property and $1.59 for nonresidential property can be adjusted. Current projections for future years indicate that a similar reduction may be possible in FY 2006.

The projected surplus is due primarily to higher than anticipated statewide growth in real estate values and slower growth in school spending. During the session, growth in real estate values was anticipated to be 7.6% in FY 2005; the current projection is for nearly 10% growth. School spending was also anticipated to grow by 4.5% in FY 2004; actual growth was only 4%. For future years, projected growth in school spending has been revised to 4% annually. If school districts spend more, due to the tax reductions occurring in FY 2005, the ability to offer this reduction in future years could be diminished.

The legislature will consider this recommendation and other implementation issues in January. ❖

Revenue Update

After five months of revenue collections, the General Fund has received $366.7 million, which is more than 6% greater than the collections for the same period last year. The expectation was that the General Fund would receive $348.3 million through November; therefore, actual collections are exceeding the forecast by $18.4 million.

The personal income tax accounts for approximately half of the excess collections, with actual revenue of $176.0 million compared to a forecast of $166.4 million. The strongest component of the personal income tax has been routine withholding from earned income.

General Fund performance is summarized in the following table:

General Fund Revenue ($ millions)

Cumulative	July	Aug	Sept	Oct	Nov
Target	67.0	125.2	214.5	286.1	348.3
Actual	73.2	131.8	225.6	306.6	366.7
Difference	6.2	6.6	11.1	20.6	18.4

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Dear Legislator,

This is the third 2003 issue of THE FISCAL FOCUS. It is intended as a nonpartisan update prepared by the fiscal office staff to keep legislators informed of events during the off-season. As your staff, we believe it is important for a citizen legislature to be kept abreast of local, state, and federal financial developments while the General Assembly is adjourned. This update is sent to all House and Senate members.

It is important for us to understand what topics interest you so we can incorporate them into future issues. If you have any comments or suggestions, please let us know.

Joint Fiscal Office Staff

VT: In the National Context

A recent study by NCSL reported that across the country states have worked to close budget gaps. In November 2002 (FY 2003), 40 states had budget gaps and in November 2003 (FY 2004), only 10 states have budget gaps. Vermont does not have a budget gap. In addition, FY 2004 projected year-end balances for all states are 4.2%. In Vermont the stabilization and caseload reserve combined are projected at or above 6.5%.

A year ago in November, 38 states had concerned or pessimistic revenue outlooks. This November, only 17 states had negative outlooks. Vermont's revenues have been exceeding forecasts.

The future fiscal outlook is uncertain. Medicaid costs continue to rise. Federal funds are slowing as Congress addresses the deficit. New federal mandates, including the No Child Left Behind Act and Homeland Security, will exert added financial pressures. ❖

Federal Transportation Funds

The Federal Transportation Act, TEA 21, is up for renewal. The bill, known as SAFE TEA, has not yet reached the Senate floor, and its financing is uncertain. Congress is contemplating a short extension of the current transportation funding act. Initial reports from our Congressional delegation indicate that Vermont may see additional federal transportation funds when reenactment of the transportation bill does take place. ❖

Federal Funds Update

The remaining seven appropriations bills for federal fiscal year (FFY) 2004 have been combined into a $328 billion omnibus bill (H.R. 2673), which was approved by conference committee on November 25, 2003. The bill totals $820 billion of which $328 billion is discretionary spending. The House adopted the FY 2004 omnibus appropriations bill on December 8, 2003. The Senate is expected to pass the bill in late January 2004. Programs are funded at FY 2003 levels by a continuing resolution through January 31.

The bill includes an across-the-board cut of 0.59%. The cut would apply to all FY 2004 discretionary appropriations, with the exception of those in the defense, military construction, and supplemental appropriation bills. The cut applies to energy/water, homeland security and interior bills, which already have been enacted and include major grants to states and to FY 2004 advanced funding contained in prior year appropriations.

After the across-the-board cut, funding for discretionary programs would increase by 3% while mandatory programs would increase by 11% in FY 2004. The mandatory program increase is primarily driven by Medicaid while many other mandatory programs, TANF and SSBG for example, are held flat.

The discretionary programs that will see significant increases include Title I education for the disadvantaged, special education, Pell grants, consolidated health centers, Section 8 housing assistance, highway programs and select homeland security grants. There are significant cuts in funding for justice programs as well as innovative education programs, drug-free schools and refugee assistance. When the total first responder appropriations in homeland security, department of justice and department of health are analyzed collectively, there is a 6% reduction in the FY 2004 omnibus bill.

The FY 2004 federal deficit current projection is $480 billion. This amount does not include the impact of the new Medicare bill and may improve or worsen depending on economic impacts on revenue outcomes. However, to put this amount in perspective, the total for discretionary funding in the federal

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FY04 Budget Pressures

Although the Legislature has not received the Governor's proposed budget adjustment there are several areas of the budget that the Joint Fiscal Office has identified as being potential candidates for adjustments. A summary of the significant pressures is listed below.

- The Department of Social and Rehabilitation Services is experiencing an increase in demand for child care slots. The potential impact is upwards of $2 million.
- The Vermont State Hospital has been decertified by the federal government for not meeting specific criteria. The lost federal community rehabilitation and treatment funds could amount to as much as $2.3 million. These lost federal funds will have to be replaced with state funds.
- The Vermont State Hospital will have to make some investments of state funds in order to make improvements needed to regain federal certification. The amount of state investment could reach upwards of $1.4 million.
- In the Corrections area, despite the opening of Springfield, the demand for out-of-state beds is still high. This is estimated to cost an additional $1.4 million.
- The Administration is proposing to reduce the appropriation for the Pay Act significantly. More information will be available as the House Appropriations Committee meets in December to discuss the Budget Adjustment.
- The Budget Stabilization Reserve fund needs approximately $3.6 million to bring it up to the statutory level by the end of the fiscal year.
- There remains a deficit of $9.0 million in the Financial Management System Development Fund and $5.0 million in the Facilities Operations Revolving Fund.

Last June the Legislature put aside $11.9 million in the general fund surplus reserve to address FY 2004 budget adjustment pressures. In addition, revenues for FY 2004 are exceeding forecasts which may provide additional resources. ❖

Revenue Update (continued)

The Transportation Fund continues to exceed the forecast for the fifth straight month. With actual collection of $84.9 million compared to an expectation of $82.3 million, the fund is up $2.6 million.

Purchase and use tax collection account for the entire excess with actual collections of $29.4 million compared to an estimate of $26.6 million. This source of revenue has increased more than 10% compared to the same period last year.

Transportation Fund performance is summarized in the following table:

Transportation Fund Revenues ($ millions)

Cumulative	July	Aug	Sept	Oct	Nov
Target	12.9	31.4	49.4	68.3	82.3
Actual	16.2	35.0	51.4	71.2	84.9
Difference	**3.3**	**3.6**	**2.0**	**2.9**	**2.6**

Finally, the Education Fund is on course for achieving the official forecast for FY 2004. Actual collections from non-property tax sources total $37.4 million compared to expectation of $36.9 million.

Education Fund performance is summarized in the following table:

Education Fund Revenues ($ millions)

Cumulative	July	Aug	Sept	Oct	Nov
Target	6.8	13.7	22.1	29.9	36.9
Actual	7.5	12.9	23.5	31.8	37.4
Difference	**0.7**	**-0.8**	**1.4**	**1.9**	**0.5**

In January, after six months of collections data, the state and legislative economists will review these figures and advise the Emergency Board on a revised official revenue forecast.

Federal Medicare Bill

On December 8, 2003, President Bush signed the "Medicare Prescription Drug, Improvement, and Modernization Act of 2003". This act provides coverage for prescription drugs for all Medicare beneficiaries and makes several other substantial changes in the Medicare program. This act will have significant programmatic and financial effects in Vermont. Depending on federal actions and state policy decisions, financial effects range from approximately break-even to a substantial reduction in Medicaid spending.

Coverage
Pharmacy coverage is complex. For beneficiaries over 150% of poverty (about $13,500 a year for an individual, $18,200 for a couple), there is a $250 deductible. The beneficiary is responsible for 25% of the next $2,000 in spending, while the program pays 75%. The beneficiary pays the next $2,850. After $5,100 of total spending ($3,600 by the beneficiary), the program will pay 95% of costs. Beneficiaries will also pay a $35 per month premium. All of these amounts are indexed to the rate of growth of pharmacy spending.

Beneficiaries below 135% of poverty who are not eligible for full Medicaid benefits ("dual-eligibles") and who meet an asset test (under $6,000 for an individual and $9,000 for a couple) will pay a $2 copay for generic drugs and a $5 copay for brand drugs. There will be no premium.

Beneficiaries between 135% and 150% of poverty will pay a $50 deductible, 15% of costs up to $5,100 in total spending, and a $2 copay for generic drugs and a $5 copay for brand drugs. The premium will be based on a sliding scale.

For dual-eligibles, the only cost sharing will be $1 for generics and $3 for brand. Currently, state Medicaid programs provide pharmacy coverage for these populations. Although the Medicare program will provide coverage in the future, states will be required to remit to the federal government an amount equal to 90% of what they would have spent to provide this benefit in 2006. This projected spending level will increase at the rate of pharmacy inflation, while the percentage will decline by 1.67% per year, to 75% in 2015 and subsequent years.

Operation and Administration
Coverage will begin January 1, 2006. Prior to this date, beneficiaries will be eligible for discount cards sponsored by Medicare (which may have an enrollment fee). Beneficiaries below 135% of poverty will receive a $600 annual subsidy, attached to their discount cards. They will be responsible for 10% coinsurance (5% if below 100% of poverty).

There are several options for administration of coverage. The first is as part of a comprehensive private plan ("Medicare Advantage"). This will be similar to the Current Medicare+Choice approach, under which HMOs or other private entities are responsible for all care in exchange for a premium paid by the Medicare program. The second option will be a stand-alone pharmacy benefit, offered by organizations that assume financial risk. The final option, if an insufficient number of risk-bearing entities emerge, will be for private-sector administration, with the Medicare program continuing to assume financial risk.

Other Changes
The act makes several other changes to the Medicare program, including increased private-sector competition, increased reimbursement for physicians and rural providers, and funds to encourage private entities to enter the Medicare market and to encourage employers to continue to provide pharmacy benefits for retirees.

Effects in Vermont
One of the most significant changes in Vermont will be in the state's pharmacy assistance programs (VHAP Pharmacy, VScript, and VScript Expanded). Expenditures for VHAP Pharmacy and VScript qualify for federal Medicaid dollars under the state's 1115 waiver, which expires on December 31, 2003. An application for extension has been filed.

The act forbids the use of federal Medicaid funds to "wrap around" the Medicare pharmacy benefit. If the waiver is extended for another three years, the state will be able to operate these programs without change. However, if this component of the waiver is not approved, the state will need to determine if it wishes to provide coverage at current program levels using state dollars (a substan-

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Medicare (continued)

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tial increase in spending from current levels) to provide partial benefits at current spending levels, or to eliminate the state programs, placing a substantial financial burden on beneficiaries.

Currently these three programs provide comprehensive coverage for which beneficiaries pay a premium based on income (from $13 to $35 per month). Although it is difficult to place a value on the Medicare pharmacy benefit because of its complexity, for the average Medicare beneficiary the benefit is about 50% of the cost of drugs. If the state chooses to provide coverage with state dollars, spending on these programs will increase by several million dollars. If the state chooses not to continue this coverage at all, savings will be in excess of $10 million.

State spending to provide pharmacy coverage for dual-eligibles is currently about $20 million. At statutory growth rates, in 2006 the state will send to the federal government about $4 million less than it would have spent on providing coverage. Actual savings will depend on how actual growth in 2004 and 2005 compare with statutory projections.

Other effects in the state will be a small increase in provider tax revenue due to increased hospital reimbursement, the possibility of increasing DSH (disproportionate share hospital) payments, and the need to change the statutes that govern Medicare supplement insurance, since the new act does not permit these plans to offer pharmacy benefits. The state may also have to make changes in the information systems that are used to administer the Medicaid program to implement these Medicare changes. ❖

Federal Funds (continued)

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budget is $434 billion. While the deficit did not have much of an effect on federal funding in FY 2004, an election year, what the deficit will mean for future federal funding is a concern to all states. ❖

Retirement Funds Update

The Teachers' and State Employees' Retirement Systems continue to experience the impact of the market declines in recent years. In both funds the market value of assets is lower than the reported "actuarial" value, which is designed to smooth market gains and losses. The Government Accounting Standard Board's GASB 25 is designed to adjust the market value for short-term fluctuations. Where market growth is rapid, the measure "smoothes" that growth so not all the market value is counted. Where the market value is falling, not all of the decline is included, and the actuarial value of assets exceeds the market value. An older measure, known as GASB 5 takes into account year-to-year fluctuations and compares actual market value to the Pension Benefit Obligations at a given point in time.

The Teachers' Retirement System: The fund's assets are at a level sufficient to cover about 90% of its obligations under the actuarial value of assets (GASB 25) and 85% using a market value (GASB 5). Its funded ratios are as follows:

	GASB 5	GASB 25
2003	84.1%	89.6%
2002	90.5%	89.5%
2001	104.7%	89.0%

In FY 2003, the Teachers' Fund return on invested assets was 5.60%. The future funding assumptions are built on an assumed return of 8%, still above current returns.

As fund market performance has been weak, the required level of actuarial funding increased. The FY 2004 request grew 47% and FY 2004 appropriated funding represents only 49% of this request.

The State Employees' Retirement System: The fund's assets are at a level sufficient to cover between 94% and 97% of its obligations under both the above measures. Its funded ratios are as follows:

	GASB 5	GASB 25
2003	94.5%	97.5%
2002	99.8%	97.4%
2001	109.1%	93.0%

In FY 2003, the Employees' return on invested assets was 4.60%, again below the assumed 8% rate of return. ❖

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Joint Fiscal Committee Meetings

On November 6, 2003 the Legislative Joint Fiscal Committee met and took the following actions:

- Reviewed revenue and budget trends and issues that will impact the upcoming session discussed elsewhere in this newsletter;
- Considered progress on completion of state audit and urged parties to work toward a mid-December finalization;
- Reviewed implementation issues for Act 68 and key elements for an implementation bill which will be taken up early in the legislative session;
- Reviewed cost issues arising out of changing the Windsor Facility to a women's prison, related changes to the role of the Dale facility and the new 80-bed treatment facility;
- Approved a Federal Emergency Management Agency Grant of $932,163 for flood damage in Bennington, Orange, Windham and Windsor counties; and
- Reviewed and approved the Joint Fiscal Committee Budget for FY 2005. ❖

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