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The Making of a Fiscal Shipwreck

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Introduction

Vermont's state budget is about to hit the rocky shores of fiscal reality. In key areas, including unfunded pension liabilities, excessive capital debt, the state budget and human services spending, education funding and soon health care funding, state leaders over recent years have put Vermont's fiscal ship in troubled waters. Given their cumulative effect, the vital question is whether lawmakers will fess up to the need to adjust course in these key areas and save Vermonters from the pending fiscal shipwreck.

Vermont turned away from a safe course in 2009 when House Speaker Shap Smith and then Senator Peter Shumlin led the legislature, over the objections of Governor Douglas, and overrode the Governor's budget veto. With that veto override, the legislature abandoned the fiscally moderate legacies of Governor's Snelling, Dean and Douglas. Their decision set Vermont on a course of unsustainable spending, chronic underfunding, hidden cost shifts, higher taxes and a "kick the can down the road" approach to problem solving.

But, as Governor Kunin learned, casting a blind eye toward fiscal responsibility is not a fiscally or politically sustainable strategy. In the end, like it or not, economic realities prevail, resulting in painful outcomes for both Vermonters and fiscally-impaired politicians.

Unless an approach of moderate growth linked to underlying economic growth is restored to Vermont state finances, the legislature's excesses will swamp Vermont's fiscal ship, leaving Vermonters adrift in a stagnant economy and without safe harbor.

Let's look at some of Vermont's biggest fiscal imbalances.

State Employees' and Teachers' Pensions – Underfunding Grows, Pensions at Risk

Each year, by law, the Governor must report on the status of the state's pension funds. While Treasurer Beth Pearce publicly downplays these funds' problems, the latest reports clearly indicate otherwise.

In September, 2000, in part because of Vermont's effort to properly fund its pension funds, the state received its best in New England AA+ rating from Standard and Poor's. For fiscal 2012, however, the required actuarial analysis of the state employees' and teachers' pension funds finds them respectively funded at 77.7 percent and 61.6 percent of recommended Government Accounting Standards Board levels. These 2012 funding levels compare unfavorably to the 79.6 percent and 66.5 percent levels reported for the prior year, fiscal 2011, and highly unfavorable to the 92.6 percent and 88.4 percent levels existing for fiscal 2000, the last year of my tenure as Vermont's Finance Commissioner.

For fiscal 2013, the actuarial experts recommended $111.5 million and $141.5 million respectively be added to the state employee and teachers' pension and retirement benefit funds to cover expenses and guide the funds toward compliance with GASB standards. But, Treasurer Pearce and Governor Shumlin recommended only $77.1 and $73.1 million respectively. The Treasurer rationalizes her approach as similar to paying down a mortgage. Unfortunately, by shortchanging these funds each year, the principal owed on the "mortgage" grows, rather than diminishes, putting future retiree benefit payments, and the state's bond rating, at risk.

Voices of wisdom have been raised regarding the "kick the can down the road" approach of our current leaders. For example, David Coates, a CPA and former partner in the firm KPMG and Lisa Ventriss of the Vermont Business Roundtable recently penned an opinion editorial published in VT Digger highlighting these same concerns.

Hopefully Treasure Pearce going forward will be a more vocal and tenacious advocate for fiscal restraint and fiduciary responsibility and recommend proper funding of the state employees' and teachers' pension funds. Her failure to speak "truth to power" to the Governor and Legislature regarding the underfunding of these pension responsibilities is not good for state employees, for our teachers or for our bond rating (see below).

Capital Debt – Bond Rating at Risk

Similar to the required pension report discussed above, each year the Capital Debt Affordability Committee must issue a report offering guidance on Vermont's level of bonded debt. The most recent report, issued September 2013, makes clear that circumstances are taking a turn for the worse. For example, last year the Wall Street rating agency Standard & Poor's (S&P) revised its outlook on Vermont's general obligation debt rating of AA+ to "positive" from "stable." But, according to S&P's report:

> "*The outlook revision reflects the potential for us to raise the rating if the state continues to make progress in improving its annual pension funding levels, strengthening its annual pension funded ratios, and increasing its budget reserve.*"

As can be seen from the above discussion, Vermont has not made progress in improving pension funding levels and ratios. In fact, they have deteriorated. Also, a recent study by muni-bond investment firm Eaton Vance rating state unfunded pension and capital debt liabilities as a percent of Gross State Product (GSP) puts Vermont at 30th from the best - well into the bottom half - among the 50 states. The Eaton Vance analysis does not include a state's unfunded retirement healthcare obligations, which are substantial in Vermont.

Further, the Legislature's recent increases in bonded debt authorizations are becoming problematic. The Debt Affordability Report notes: "For the period, 2004-2015, the biennium issuance has approximately doubled, and the compound annual growth rate in debt authorizations during this period has been 6.5 percent." And further, "The State's aggregate net tax-supported principal amount of debt increased from $504.0 million as of June 30, 2012 to $546.0 million as of June 30, 2013, an increase of 8.3 percent."

Such growth rates are not sustainable and the Debt Affordability Committee report "red flags" this growing problem. The report says:

> "Combined with the assumption that the State will issue $84,625,000 during fiscal year 2014, $84,880,000 for fiscal year 2015 and $79,950,000 in each fiscal year from 2016-2024, *Vermont's projected debt per capita is projected to exceed the projected Moody's median for its Peer Group during fiscal years 2015-2021.* Based upon a very preliminary analysis, this implies that to stay in compliance with the debt per capita guideline the State would need to otherwise decrease its current and future issuances to approximately $134,760,000 for the fiscal year 2016-2017 biennium and $67,380,000 annually in years 2018- 2024. **<u>This corresponds to a $25.140 million or 15.7 percent reduction compared to the current 2014-2015 biennium authorization</u>**. "(Emphasis added)
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> "The implied result of this preliminary analysis rolling forward the 2013 Moody's figures for the Peer Group to 2014 is that the State would need to decrease its fiscal year 2016-2017 biennium issuance to $107.65 million, and $52,250,000 annually in years 2018- 2024. **<u>This corresponds to a $52.25 million or 32.7 percent reduction compared to the current 2014-2015 biennium authorization.</u>** "(Emphasis added)

As with pension underfunding, State Treasurer Beth Pearce must become a "table pounding" advocate for fiscal constraint in order to protect Vermont's AA+ bond rating she inherited from the responsible fiscal management over the past 24 years by the Snelling, Dean and Douglas administrations.

The State Budget – Growing Faster than the Economy

From fiscal year 2008 to the present, the state budget has grown by $1.13 billion from $4.1 billion to $5.23 billion. That's an increase of 27.5 percent%. Increasing federal funds fueled some of this growth, but more than a half-billion dollars ($534.8 million) of the increases has come directly out of the pockets of Vermonters through higher income taxes, health care taxes, property taxes, and gas taxes, among others. In contrast, during the same period, Vermont's economy as measured by Gross State Product has grown by only 13.6 percent, from $24.3 billion to a projected $27.6 billion.

Yet, despite these higher taxes, the legislature's own fiscal staff reports "roughly $55 million in one-time funds that were used to build the FY 2014 budget still remains a good proxy for the shortfall that (the Legislature) will have to address." On top of this $55 million, there's certain to be additional spending pressures associated with inflation, federal fund cutbacks, and demands by politically influential special interest groups for higher levels of funding.

How the Legislature and Governor created this problem is easy to understand.

First, during the 2009 legislative session, the Legislature wanted to spend more than Governor Douglas and enacted their own budget over his veto. This action increased state spending by 7 percent and vested near complete power over fiscal decisions in the Legislature, then and now controlled by a super majority of one political party.

Simultaneously, given recessionary pressures on the state budget, the Legislature (led by fiscal moderates Representative Donna Sweaney and Senator Diane Snelling) initiated an effort called "Challenges for Change" to reform state spending practices. The "Challenges for Change" process had identified over $79 million in potential savings for fiscal 2011 and over $161 million for fiscal 2012.

Certainly not all of these savings opportunities could be achieved. However, if only 50 percent were implemented, the State's current budget problem would not exist. Additionally, the Douglas Administration had initiated a program of "Tiger Teams" offering additional millions of dollars in savings opportunities and operational improvements in state government.

Unfortunately, at the request of the Shumlin Administration, "Challenges for Change" was abandoned in 2011. With almost $1 billion available in federal stimulus funds to temporarily prop up state spending, Governor Shumlin, Speaker Smith and other legislative leaders chose to grow the state budget at an excessive rate using "one-time" federal stimulus funds while avoiding the politically difficult leadership required to implement cost saving reforms.

Now that the "one-time" federal stimulus funds have been spent, our legislative leaders find themselves at the end of the road, holding the can they've been kicking.

Human Services Spending: Higher Spending, Few Results

A primary focus of "Challenges for Change" was yielding both savings <u>and</u> better results for Vermonters needing help through "client centric results-based budgeting" at the Agency of Human Services.

For years, Vermont's human service programs have operated with a poorly integrated and tough to manage "stove pipe" system. There's health care help here, home heating and weatherization assistance over there, food subsidies around the corner, child care credits and child support collections down the hall, education and job training across the street, mental health services at your neighborhood non-profit, the earned income tax credit a few towns over at the Tax Department, and so on, and so on and so on.

In the early-1990's, human services leaders like Con Hogan attempted to integrate the management of these services to maximize their leverage in moving Vermonters out of poverty. A key focus of this effort was to replace the then aging ACCESS computer platform with a new computer system that allowed a "common view of the client" and supported the coordinated management of benefits across all programs. Sadly, human service lobbyists helped kill this effort in the legislature, in part because they feared it a breach of confidentiality if state human services employees could view a complete profile of a client's benefits rather than just the amounts delivered by their particular "stove pipe". They didn't see that savings from such a reform could be reinvested in better services for Vermont's most vulnerable. Back then and even now, the "stove pipe" delivery system has clout in the Legislature and ACCESS, now a software relic, is still utilized.

In fiscal year 2000, the human services budget was $863.1 million and, according to the U.S. Census Bureau, the percentage of Vermonters at or below 125 percent of poverty was 15.9 percent. Since fiscal 2000, the human services budget has grown at the high annual rate of 6.8 percent to $2.2 billion and now absorbs over 40 percent of total state spending. According to the U.S. Census Bureau, the percentage of Vermonters at or below 125 percent of poverty was 16.1 percent in 2011, the most recent year for which data is available. Despite many, many years of higher budgets, Vermont still has persistent, chronic and frequently multi-generational poverty. Without reforms to our "stove pipe" delivery system, this is not likely to change.

During recessions, family budgets and business budgets are combed for savings and reinvestment opportunities. Given the above track record, and the obligation to improve government operations generally, forward-looking reforms like "Challenges for Change" are a prudent response to recessionary pressures. Unfortunately, such reforms and the Snelling, Dean and Douglas traditions of sustainable spending were among the first victims of a one-party supermajority at the State House.

Now that state leaders have thrown reforms and budgetary principles overboard, taxpayers are exposed to the "budget gap" left in their wake.

Education Spending - The Most Expensive, but Not the Best

At $1.46 billion, education spending is the second largest area of state spending next to human services. Vermont's education spending per pupil is among the highest in the nation and 55 percent above the national average. Our pupil to teacher ratio is the lowest in the nation at 9.8 to 1. These statistics appear good for kids, but in reality obscures a top-heavy and unsustainable bureaucracy that prevents significant reforms like universal pre-K, investments in teachers' salaries, improved pension funding, more effective classroom spending and relief from increasing property taxes. Read Campaign for Vermont's detailed report Putting Children First for more on this topic.

The current system allows local school districts to establish school budgets while the legislature has the responsibility to adjust statewide property tax rates to pay school district bills. Three tax rates provide 67 per cent of the revenue to the education fund: the residential property tax rate, the non-residential property tax rate, and the income-sensitized residential tax rate.

Last year school districts increased their budgets statewide by 5.1 percent (over $70 million) even though the number of school children continues to decline. This spending increase, after adjusting for additional revenues from non-property tax sources, called for an average 3.9 percent increase across the three state property tax rates. However, in setting these three school tax rates last year, the legislature treated some taxpayer more harshly than others. They raised the effective residential tax rate by 6.8 percent and the non-residential tax rate by 4.4 percent. However, the effective income-sensitized residential rate went up by only 7/10ths of one percent. Since about 70 percent of homeowners are subject to the benefits of income-sensitivity, most people voting to increase school budgets were protected by the legislature from a proportional and fair share increase in their taxes.

Many legislators think their approach is both good public policy and good politics as most voters get a relatively free ride when school spending goes up while remaining property owners get hammered. In essence, fairness in our education funding system has been corrupted by legislative favoritism. Further, despite numerous attempts by some legislators, the Legislature has refused to engage in meaningful reforms to Vermont's education funding system. The combined lobbying of the NEA, the Vermont Superintendents' Association and the Vermont Principals' Association well protects the current system.

That's why our independent, non-partisan policy organization proposed a series of education reforms to improve results and better serve children. Our proposals are paired with a detailed analysis of current investments and results that underscore the opportunities for academic and administrative improvements in the current system.

Specifically, the Campaign for Vermont plan would reduce more than $160 million in administrative and inefficient operations in favor of investments in early childhood education and more integrated classroom resources to improve student achievement. The proposal also calls for boosting teacher pay by up to 20 percent, while containing property taxes and enhancing the influence of local school boards.

In the interim, if fairness and transparency are priorities, legislative leaders could announce today that all state wide school tax rates will be raised proportionally to the rate of spending increase collectively approved by school districts. Further, the Tax Commissioner, in her December statutorily required recommendation on school tax rates for the coming year could also, on behalf of the Shumlin Administration, support this concept of fairness across all property tax types. This simple pronouncement would warn school boards that all taxpayers in their districts will shoulder a fair share of statewide increased school spending while the Legislature might focus on embracing meaningful reforms.

Health Care – Taking On More Water

Not long ago, health care reformers promised lower costs and universal coverage based on per capita health care costs in other industrialized countries. But what's unfolding before the eyes of Vermonters is a system of monopolies and oligarchies which almost guarantee higher prices and restricted benefits.

Vermont's Green Mountain Care Board (GMCB) has endorsed a so-called health insurance "market place", Vermont Health Connect (VHC). But contrary to the vision of President Obama of a dynamic market, only two selected and heavily regulated vendors, BC/BS VT and MVP, are allowed to sell products at Vermont's market. Complimenting this dictated top-down approach to insuring Vermonters is the growing consolidation of health care suppliers at Fletcher Allen and Dartmouth Hitchcock.

Between these five entities, the Green Mountain Care Board, Blue Cross/Blue Shield, MVP, Fletcher Allen and Dartmouth Hitchcock, state leaders may be creating the Vermont equivalent of a health care system that is "too big to fail."

With these few but large and powerful players dominating Vermont's healthcare system, there is little opportunity or incentive for innovation should their efforts over time not be in the best interest of the health of Vermonters or the economy of the state. As is often the case when power is centralized, their special interests can more readily trump the public interest. Real alternatives no longer exist and taxpayers are on the hook to fund Montpelier's mistakes, inefficiencies and any corruption in the system.

Governor Shumlin is already asking for $1.6 billion in taxes, most likely a payroll tax, to fund his "reforms." The final task on the path to single payer over the next three years is further monopolization by roping into the system the health care revenues of labor unions, ERISA entities like IBM and General Electric, among others, and the centralization of health care power in Vermont will be complete, as will taxpayers' responsibility as guarantor to fund it all.

With health care reform that spends more money rather than saves money as originally promised piled on top of pension underfunding, excessive capital debt, the state budget gap and excessive education spending, Vermont is sailing at high speed toward rocky and dangerous fiscal waters. Vermonters need to look to the future with eyes wide open for the dangers ahead.

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