Iowa Fiscal Partnership

BACKGROUNDER

January 16, 2009
www.iowafiscal.org

A Budget Crisis Primer

From Shortfalls to Cuts — How We Got Here in 2009

Each year, the Governor proposes a budget to the Legislature and the public at the beginning of the legislative session. This budget is for the upcoming fiscal year, which runs from July 1 to June 30 of the following year. For instance, Governor Culver proposed the Fiscal Year 2009 budget in January 2008, then the Legislature debated this budget and eventually passed its own version of a plan for state spending and revenue. By the time the Legislature adjourned in May 2008, the FY2009 budget was ready to be implemented on July 1, 2008.

Iowa's budget picture has changed markedly since July 1, 2008. As the new General Assembly begins work at the State Capitol, lawmakers not only must work on the next budget (for FY2010), but they face the prospect of changes in the current FY2009 budget as well. The Governor has moved to address some of Iowa's changed budget picture with his own authority to make across-the-board cuts — ordering a 1.5 percent cut in December — but is limited in what he can do without the Legislature's consent. What happened to bring Iowa to this point in January 2009?

The state budget is built on anticipated revenues that are estimated by the state Revenue Estimating Conference (REC), which meets four times a year to update its forecasts of how the state coffers are doing. When evaluating the health of a state's revenue situation, and therefore of its budget, there are two important points of comparison. First, how is revenue (measured in year-to-date tax receipts) doing compared to the previous fiscal year? Second, and more importantly, how does this revenue compare to the estimates that were used during the previous legislative session to build the state budget for the current fiscal year?

Figure 1 below shows how the picture of the health of state revenues has evolved over the past year. In December 2007, the REC estimated that the state would bring in $6.14 billion in revenue during FY2009.[1] The Legislature began the 2008 session using this figure as a benchmark for its budget decisions. Before the session was over, in April 2008, the REC met again and returned a slightly higher

[1] The REC estimates revenue for each type of state tax as well as other receipts that flow into state funds (such as interest, fees, liquor profits, and racing and gaming receipts). They also estimate other factors affecting available revenues, including the size of transfers from other funds (the largest of which is the state lottery) and how much the state will pay in refunds. The bottom line revenue estimate is "net general fund receipts" or "net receipts plus transfers," which totals receipts and transfers, subtracts refunds, and also accounts for net "accruals" which is a term for revenues or expenditures that have been incurred but not yet paid out or received. "Net receipts plus transfers" is the amount of money available to support the general fund, which provides most, but not all, of the services of state government. Appropriations made each year by the Legislature to support state government activities come out of the general fund.

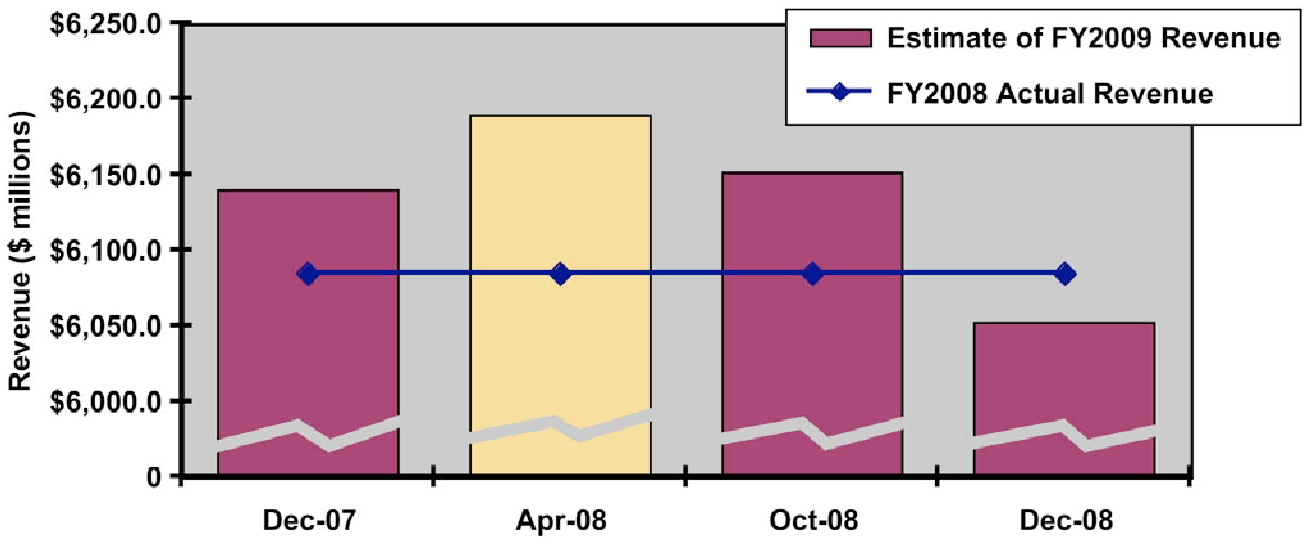
The Iowa Policy Project
20 E. Market St.
Iowa City, IA 52245
(319) 338-0773 • www.iowapolicyproject.org

CHILD & FAMILY POLICY CENTER
1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

estimate of $6.19 billion for FY2009, 1.72 percent higher than FY2008 revenues. This estimate (light shaded bar in Figure 1) was used to guide the Legislature's final FY2009 budget decisions.

However, by October 2008, the REC's estimate for FY2009 revenues was 0.61 percent lower than the one that had been used to build the state budget in April. A few weeks ago, the December 2008 estimate returned an even lower figure for FY2009 revenues that was a full 2.22 percent below April's estimate and, for the first time, also half a percent below the actual revenue collected in FY2008.

Figure 1. Recent Estimates Paint Picture of Declining State Revenue



Source: Revenue Estimating Conference

Revenues always have to be compared to expenditures in order to understand the health of the state budget. The state is limited by law from appropriating more than 99 percent of available funds when it sets the budget for the upcoming fiscal year. The remaining 1 percent of available funds, in addition to any of the 99 percent that is not appropriated, goes into the state's reserve funds. Table 1 shows how the Legislature appropriated about $6.13 billion in spending in the FY2009 budget, slightly less than 99

Table 1. FY2009 Budget at the Close of the 2008 Legislative Session

	Subtotals (millions)	Totals (millions)
Revenues		
Dec. 2007 REC Estimate	$6,140.0	
April 2008 REC Adjustment	$49.1	
Other Revenue Adjustments	$14.0	
Available funds	$6,203.1	$6,203.1
Spending		
Appropriations	-$6,133.0	
Reversions	$12.5	
Net spending	-$6,120.5	-$6,120.5
Ending balance		**$82.6**

Source: Legislative Services Agency, Fiscal Services Division percent of the total available funds, which would leave a $70.1 million surplus.[2] When anticipated reversions were added (an estimate of the amount of appropriated funds that would end up not being spent), the projected budget surplus grew to $82.6 million. These surpluses were transferred out of the general fund into other state funds, including the "rainy day" funds that make up Iowa's reserves.

So, what happened between the end of the 2008 legislative session and now that triggered decisions by the Governor to impose budget cuts? Simply put, revenues have not matched the estimates that were developed in April 2008 that set limits on FY2009 spending.

Table 2 shows changes in revenues and expenditures between the start of the fiscal year in July 2008 and the December 2008 revenue estimates that triggered spending cuts by the Governor. The biggest change in the budget over this period is that December revenue estimates for FY2009 were $151 million lower than the April estimates that were used to set the baseline for the budget.

While the national recession brought about plunging revenues, it also played a role, along with historic natural disasters, in the budget crisis by producing unanticipated increases in expenditures. Table 2 shows that the cost of Medicaid has increased by $47 million since July 1, as Iowans felt the impact of a downturn in the economy. As people get laid off during a recession, their incomes decrease and they frequently also lose their job-based health coverage. This means that more people meet income eligibility thresholds for Medicaid assistance, which automatically increases state costs for providing these essential services. In addition, by December 2008, natural disasters had already cost $18.5 million in un-budgeted expenditures, referred to as "standing appropriations adjustments."

Table 2. Declining Revenues Drive Switch from Surplus to Deficit in FY2009

Revenues	Subtotals (millions)	Totals (millions)
Available funds	$6,203.1	
Revenue adjustment (Dec. 2008 REC)	-$151.1	
Revised estimate of available funds	$6,052.0	$6,052.0
Spending		
Net appropriations (budget passed May 2008)	-$6,133.0	
Standing appropriations adjustments	-$18.5	
Estimated Medicaid supplemental	-$47.0	
Reversions	$12.5	
Revised estimate of spending	-$6,186.0	-$6,186.0
Revised end of year balance		**-$134.0**

Source: Legislative Services Agency, Fiscal Services Division.

In total, these numbers indicate that there is about a $217 million difference between the budget that was expected when FY2009 began and what has actually occurred this fiscal year. About $151 million of that difference is due to changes in revenue, and about $66 million of the difference is due to changes in state costs. These changes mean that the state now faces a $134 million budget shortfall. Another way of

[2] Data in the tables throughout this report are estimates from the Legislative Services Agency's (LSA) Fiscal Services Division. This information can be found online at http://staffweb.legis.state.ia.us/lfb/. See: "Estimated Condition of the General Fund," 6 May 2008; "Summary of FY2010 Budget and Department Requests," December 2008; "State of Iowa FY2009-FY2010 Budget Overview," presentation to the Senate Appropriations Committee, 14 January 2008.

understanding this change is to look at the difference between an $82.6 million surplus and a $134 million deficit: again, the difference is about $217 million.

The complete picture of FY2009 revenues will not be known until after the fiscal year ends in July, but when the REC finds that the state is actually not bringing in the amount of revenues that was predicted, revisions must be made to plans for state spending and revenue collection. The state, unlike the federal government, cannot run a deficit but must balance its budget. As a result, the Governor has ordered immediate spending cuts. State law mandates that spending cuts made by the Governor during the middle of the fiscal year be uniform across departments.[3] Legislative action can then amend these cuts, as long as the budget is balanced and the state does not run a deficit.

Table 3 shows that the Governor has taken several actions to respond to mid-year deficits. In early December 2008, freezes on hiring and travel for state employees, as well as cuts to the state universities, reduced anticipated spending by $40 million. Across-the-board cuts of 1.5 percent at the end of December saved an additional $90.7 million. The Governor has requested that legislators exempt portions of the public safety budget from his across-the-board cuts and approve his proposal to de-appropriate $37 million approved to fund a new state office building. If these actions take place, the new balance for the state budget will be a surplus of approximately $33.7 million.

Table 3. FY2009 Spending Cuts Anticipate Additional Revenue Shortfalls

	Subtotals (millions)	Totals (millions)
Revised end of year balance		**-$134.0**
Mid-year spending adjustments by Governor		
Selective cuts in early December (including hiring and travel freezes, cuts to state universities)	$40.0	
1.5% across-the-board cuts	$90.7	
Proposed de-appropriation of state office building funding	$37.0	
Total spending cuts	$167.7	$33.7
New balance		**$33.7**

Source: Legislative Services Agency, Fiscal Services Division

The Governor's spending cuts were in excess of the shortfall projected by the December 2008 REC. It is likely that further downward revisions to FY09 revenue estimates will occur at the next REC meeting in April; therefore, the Governor's order to cut spending in excess of the current deficit may prevent additional cuts this spring. Making spending cuts in the middle of the fiscal year is particularly difficult for state agencies, given that they have already spent approximately half of their budgets. A 1.5 percent cut could end up amounting to a 3 percent cut in their remaining budgets for the six months between December 2008 and June 2009, when the FY2009 fiscal year ends.

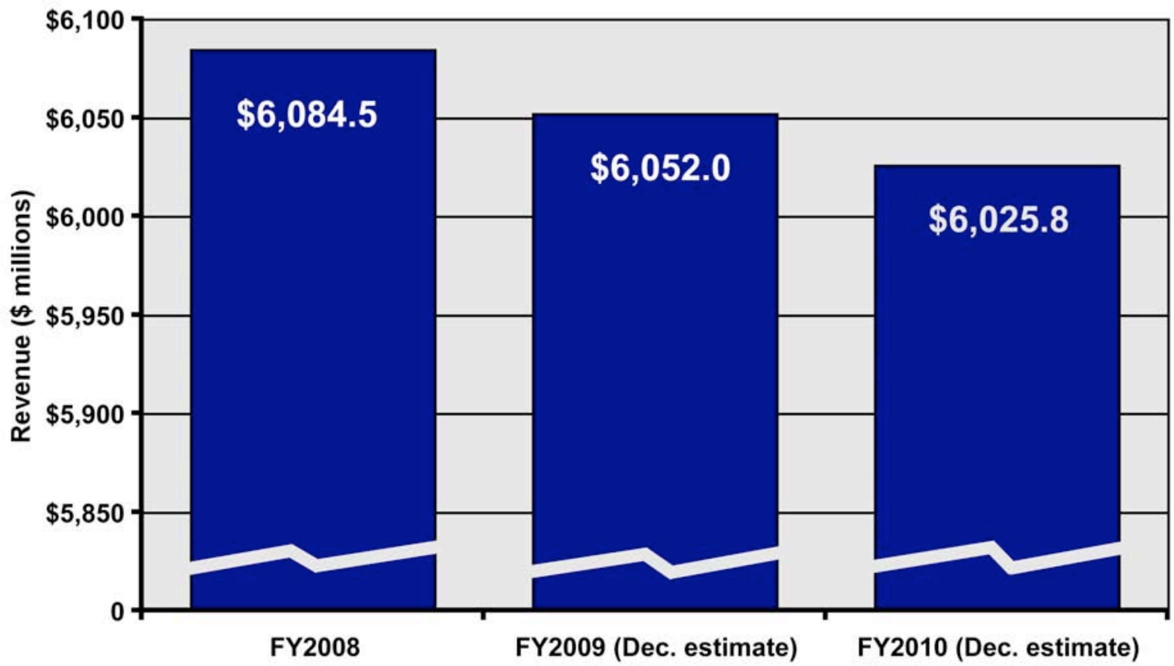
What can we expect for Fiscal Year 2010?

Starting in January 2009, the Legislature will also be making spending choices for the FY2010 budget, which will take effect on July 1, 2009. Figure 2 illustrates the evolving picture of FY2010 revenues.

[3] Iowa Code 8.31

While in October 2008 the REC originally forecast FY2010 revenues at $6.16 billion, they revised these estimates downward to $6.03 billion when they met in December and also predicted that FY2010 revenues would be lower than those for FY2009.

Figure 2. FY2010 Revenues Now Look Worse than FY2009



Source: Revenue Estimating Conference (December 2008)

The Legislative Services Agency has produced estimates of the anticipated and built-in expenditure increases that are now expected to be part of the FY2010 budget. These expenditure increases (over and above the level of FY2009 appropriations) are expected to total $611.5 million. Increases in spending include both “built-in expenditures” ($453.3 million), which are expenditures associated with multiyear appropriations or entitlement programs, and “anticipated expenditures” ($158.2 million), which are projected increases in costs that state departments estimate they will incur in the next fiscal year.

The Legislative Services Agency also explains that built-in expenditures are those that will occur In FY2010, unless legislative action is taken to change the standing appropriation. Anticipated expenditures, on the other hand, require legislative action to occur and, if they are not funded through legislative action, will require reductions in state agency budgets in order to cover the anticipated expenditures. The increase in Medicaid costs is an example of a built-in expenditure because these costs increase automatically as more Iowans become eligible for the program. An example of an anticipated expenditure increase would be higher salary costs resulting from collective bargaining negotiations because these expected costs have not yet been covered by legislative appropriations.

Table 4 shows that the December 2008 estimate of declining revenue for FY2010, combined with the estimated spending increases, produces a budget shortfall of $718.7 million. When the 99 percent expenditure limitation is taken into account, the shortfall amounts to $779 million.

Table 4. Lower Revenues Mean $779 Million Budget Gap in FY2010

	Subtotals (millions)	Totals (millions)
Revenues		
Dec. 2008 REC Estimate	$6,025.8	$6,025.8
FY2010 Estimated Spending		
FY2009 Appropriations	-$6,133.0	
Built-in Expenditures	-$453.3	
Additional Anticipated Expenditures	-$158.2	
Estimated Total Spending	-$6,744.5	-$6,744.5
Budget shortfall (disregarding expenditure limitation)		**-$718.7**
Expenditure limitation		$5,965.5
Estimated total spending		-$6,744.5
Budget shortfall with expenditure limitation		**-$779.0**

Source: Legislative Services Agency, Fiscal Services Division.

The Governor and the Legislature must now make adjustments to revenue and spending choices that will produce a balanced budget for FY2010. Unfortunately, estimates of available revenue compared to estimates for anticipated and built-in expenditures do not tell the whole story of the task facing Iowa lawmakers. The expenditures built into Iowa's tax code through tax credit programs and legislative changes profoundly shape the state budget without being subject to the ongoing scrutiny faced by appropriations. Table 5 uses data from the Department of Revenue and the Legislative Services Agency to show the general fund impact of the state's most expensive tax-credit programs and recent changes to the state tax code. Some of these impacts will increase dramatically between FY2009 and FY2010 as programs grow in size or tax changes are phased-in.

Table 5. Spending Through the Tax Code Set to Grow Dramatically, FY2009-FY10

	General Fund Impact		
Tax Credit Program or Legislative Action	FY2009	FY2010	Growth in Impact, FY2009-FY2010
Enterprise Zone Program Tax Credit	-$62,236,305	-$68,623,727	10.3%
High Quality Jobs Creation Program Tax Credit	-$59,738,384	-$87,589,149	46.6%
Research Activities Tax Credit	-$62,658,946	-$74,695,734	19.2%
Social Security and Senior Filing Threshold Tax Changes (2006)	-$36,965,000	-$58,453,000	58.1%

Source: Iowa Department of Revenue, "Tax Credits Contingent Liability Brief," December 8, 2008; Legislative Services Agency, "Future General Fund Revenue Impact of Enacted Legislation," November 26, 2007.

For instance, the Research Activities Tax Credit program, which allows companies with qualifying "research activities" in Iowa to claim a refundable credit above and beyond their corporate income tax liability, will cost the state over $62 million in FY2009 in revenue that would otherwise have flowed into the general fund. Between FY2009 and FY2010, this cost is expected to jump almost 20 percent, to over $74 million. One of the largest changes that will occur over the next year is through the continued phase-in of the special tax treatment accorded to wealthy Iowa seniors in 2006 legislation. Lost revenue will increase by 58 percent between FY2009 and FY2010, rising to over $58 million. All told, the incremental costs of the built-in increases in the four tax expenditures shown in Table 5 are projected to contribute almost $68 million to the budget shortfall in FY2010.

What about the rainy day funds?

The Cash Reserve Fund (CRF) and the Economic Emergency Fund (EEF), often referred to as Iowa's "rainy day funds," are reserved for nonrecurring, emergency expenditures by state law.[4] State law also limits the amount of money that may be saved in these funds. The larger of the two funds is the Cash Reserve Fund, which may carry a total balance equal to 7.5 percent of the adjusted revenue estimate for the current fiscal year. The EEF may carry a balance equal to 2.5 percent of the adjusted revenue estimate for the current fiscal year. Taken together, Iowa's reserve funds can contain up to 10 percent of revenue available during the fiscal year.

Table 6. Iowa's Rainy Day Funds Are Full in FY2009, Will Shrink in FY2010

	FY2009 (millions)	FY2010 (millions)
Available funds	$6,203.0	$6,025.8
Total potential reserve funding (10% of available funds)	$620.3	$602.6
Cash Reserve Fund (7.5%)	$465.2	$451.9
Economic Emergency Fund (2.5%)	$155.1	$150.6

Source: Legislative Services Agency, Fiscal Services Division

The maximum statutory amount was in fact met in Iowa's rainy day funds when the Legislature created the FY2009 budget. Some of the total balance in the rainy day funds was carried forward from the previous fiscal year, and the remainder was transferred into the funds from the FY2009 general fund surplus.

Since the REC's FY2010 revenue estimates are lower than the FY2009 estimates, the total balance of the state's rainy day funds when the FY2010 budget is created will be lower than they are now. Balances in these funds that exceed the statutory requirements are transferred into another reserve fund, called the Senior Living Trust Fund.

[4] Sections 8.55 and 8.56 of the Iowa Code deal with the EEF and the CRF, respectively.