



Analysis of Fiscal Policy in Nevada

Section 4: General Fund Outlook



Governor's Task Force on Tax Policy in Nevada

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General Fund Outlook

Introduction

The preceding section of this study reviewed and qualified the problems in Nevada's existing fiscal structure, as enumerated in Assembly Concurrent Resolution 1 ("ACR 1"). At their most fundamental, these problems equate to the system's inability to produce sufficient revenue to maintain current service levels, and the likelihood that this imbalance will worsen with time. As noted in previous sections of this report, this issue is neither novel nor unexpected. Questions of fiscal sufficiency are interwoven throughout the State's legislative history; and, as recently as 1988, an Urban Institute/PriceWaterhouse study predicted that Nevada's narrow tax base would lead to fiscal turmoil.¹

It has been said that the first step toward wisdom is to question everything, and the last step is to come to terms with practical reality.² The latter points to the key issue left unanswered in the previous section and the fundamental query underlying this one – *how much?* The primary purpose of this section is to assess the adequacy of the existing general fund revenue structure for financing the current level of public services during the next ten years, or from FY 2001-02 through FY 2010-11. The result is an approximation of the additional revenues required to maintain the *status quo*.

In general, this analysis applies an approach similar to that employed by the United States Congressional Budget Office³ and the 1988 Urban Institute/Price Waterhouse report on Nevada's fiscal structure.⁴ It contains baseline projections that represent a midrange of possible outcomes based on past and current trends and the assumptions that current policies remain the same.

We recognize that considerable uncertainty surrounds these estimates for two reasons. First, future legislation is likely to alter the path of State spending and revenues. In its projections, the Task Force and its technical working group did not attempt to predict legislation – indeed, any attempt to incorporate future legislative changes would

¹ Please see *Section 3: Defining the Problem*.

² George Christoph Lichtenberg (1742-1799).

³ See Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2003-2012*, January 2002.

⁴ *Id.*

undermine the usefulness of this baseline as a benchmark against which policy changes may be measured. Second, Nevada's interdependent economy and fiscal system are highly complex and are affected by countless economic and technical factors. This analysis deals with general trends; actual budgetary outcomes will almost certainly differ from those projected.

The estimates provided herein are based on long-term budget projections. Long-term forecasts involve trend relationships between economic, demographic, and fiscal variables. Please see *Section 1: Economic Overview and Baseline Assumptions*. They **do not** attempt to predict short-term, cyclical movements in the economy. Forecasting short-run volatility (i.e., business cycles) over the long run is generally accepted as being impractical and in many ways a Sisyphean task. Instead, most analysts attempt to capture "average" growth rates over a projection period, effectively smoothing out economic volatility.

The above-mentioned general approach notwithstanding, the State's economic condition at the time this report was drafted is one that cannot be ignored. The tragic events of September 11, 2001, a mild national recession, current and potential military conflicts, and the ensuing economic uncertainty have exposed the vulnerability of the State's fiscal system and have underscored the problems enumerated in ACR 1. The question here is one of recovery, and the speed at which the State's economy and fiscal structure will return to a more "normal" rate of output. Here again, uncertainty abounds and we do not attempt to recreate the short-term projections, such as those used in the budgeting process. Most market observers tend to believe that Nevada will see a continued recovery through 2002 with moderate growth returning late this year or early in 2003.⁵ This assumption is reflected both in the baseline assumptions and the fiscal projections.

⁵ See Smith, H., *Southern Nevada Economic Index Up*, Las Vegas Review Journal. October 2002. http://www.reviewjournal.com/lvrj_home/2002/Oct-18-Fri-2002/business/19870295.html; see also Crowley, M., *Las Vegas Economy: Signs Pointing to Strong Recovery*, Las Vegas Review Journal. July 2002. http://www.reviewjournal.com/lvrj_home/2002/Jul-19-Fri-2002/business/19222739.html; see also Aversa, J. *Economic Recovery Remains Uneven*, Associated Press as Reported in the Las Vegas Sun. October 2002; <http://www.lasvegassun.com/sunbin/stories/archives/2002/oct/17/101700203.html?Economic+Recovery>; Aversa, J. *Greenspan Says Economic Recovery is 'Well Under Way'*; Reuters, Washington Bureau. March 2002. http://senrs.com/greenspan_says_economic_recovery_is_well_under_way.htm; Greenspan, A. Chairman of the Federal Reserve Board, *Federal Reserve Board's semiannual monetary policy report to the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*; July 2002; see also Greenspan, A., Chairman of the Federal Reserve Board, Testimony Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002; www.federalreserve.gov/htm; see also *Regional Outlook*, Federal Deposit Insurance Corporations. Third Quarter 2002; see also Parry, R.T. President and CEO of the Federal Reserve Bank of San Francisco, Presentation to Securities Analyst in San Francisco: *The Economic*

Footnote continued on the following page.

This analysis estimates each of Nevada's general fund revenue and expenditure categories independent of one another. The results are generally summarized herein, with only the most salient of the underlying considerations discussed.

Summary of Findings

Exhibit 4-1 on the following page illustrates the expected long-run balance between State general fund revenues and expenditures. Please also see Exhibit 4A-1⁶ and Exhibit 4B-1⁷ in Appendices 4A and 4B immediately following this overview for a more detailed illustration of revenues and expenditure projections.

In total, revenues are anticipated to grow at a compound annual rate of 3.9 percent during the study period, increasing from \$1.7 billion in FY 2001-02 to \$2.5 billion in FY 2010-11.⁸ Assuming that State government service levels budgeted to exist in FY 2002-03 were to be maintained throughout the study period, general fund appropriations are projected to increase from \$1.9 billion in FY 2001-02 to \$3.2 billion by FY 2010-11. The resulting compound annual growth rate for State appropriations is estimated at six percent.

The imbalance between available revenues and required appropriations is projected to average roughly \$450 million annually during the study period, increasing from \$122 million in FY 2001-02 to \$708 million in FY 2010-11. The projected cumulative general fund shortfall is \$4.6 billion.

Outlook for the Nation and the Region: A Monetary Policymaker's View. October 2002.
<http://www.frbsf.org/news/speeches/2002/021002.pdf>.

⁶ Appendix A provides charts and tables related to general fund revenues.

⁷ Appendix B provides charts and tables related to general fund expenditures.

⁸ The FY 2001-02 figure noted differs from the appropriations specifically cited in the State Appropriations Report and in Section 3. This is due to the fact that some adjustments have been made to a number of state service cost to reflect revenue shortfalls, caseload overruns, and other factors. This is discussed further in the sections that follow.

Exhibit 4-1: State of Nevada General Fund Projections
FY 2001-02 through FY 2010-11
(in millions)

DESCRIPTION	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	Growth: FY 2001-02 to FY- 2005-06	Growth: FY 2001-02 to FY- 2010-11
REVENUES												
Taxes												
Retail Sales and Use	649	671	714	756	797	838	878	916	953	991	5.3%	4.8%
Gaming Taxes and Fees	590	609	625	642	657	672	685	698	710	721	2.7%	2.3%
Insurance Taxes	156	169	181	193	205	217	230	243	257	271	7.0%	6.3%
Casino Entertainment Tax	65	70	75	81	87	93	100	107	114	122	7.6%	7.3%
Excise Taxes	63	65	66	68	69	70	71	71	71	72	2.0%	1.4%
Business Activity Tax	78	80	82	84	85	86	88	89	90	91	2.1%	1.7%
Mining/Property	9	12	12	13	13	13	14	14	14	15	8.4%	5.1%
Other Taxes	5	5	5	5	5	5	6	6	6	6	0.2%	0.1%
Total Taxes	1,616	1,681	1,761	1,841	1,919	1,996	2,070	2,144	2,216	2,288	4.4%	3.9%
Non-Tax Revenues												
Licenses	64	68	72	75	79	83	87	91	94	98	5.5%	4.9%
Fines and Fees	25	26	28	29	31	33	34	35	37	38	5.8%	5.0%
Charges for Service	-	-	-	-	-	-	-	-	-	-	0.0%	0.0%
Use of Money & Property	14	11	23	23	24	25	25	26	26	27	15.1%	7.9%
Other Revenue	27	16	16	17	17	18	18	19	19	19	-10.2%	-3.5%
Total Non-Tax Revenues	129	121	139	145	152	158	164	171	177	183	4.1%	4.0%
TOTAL REVENUES	1,745	1,802	1,900	1,986	2,070	2,153	2,234	2,314	2,392	2,471	4.4%	3.9%
EXPENDITURES												
Constitutional Agencies												
Executive Branch	26	26	28	30	31	33	34	36	37	39	4.4%	4.4%
Judicial Branch	15	16	17	18	19	20	21	22	22	23	6.6%	5.3%
Legislative Branch	19	20	21	23	24	25	26	27	28	29	5.5%	4.8%
Total Constitutional Agencies	60	63	66	70	74	77	81	84	88	91	5.3%	4.8%
Finance and Administration												
Department of Administration	29	40	42	44	47	49	51	53	56	58	12.9%	8.1%
Department of Taxation	13	15	15	16	17	18	19	20	20	21	6.4%	5.2%
Department of Information Services	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Department of Personnel	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Finance and Administration	42	54	58	61	64	67	70	73	76	79	11.0%	7.2%
Education												
K-12 Education	636	714	805	869	922	970	1,013	1,057	1,100	1,144	9.7%	6.7%
UCCSN	347	371	389	408	457	491	509	525	543	561	7.2%	5.5%
WICHE	1	1	1	1	1	1	1	1	1	1	16.6%	9.7%
Department of Cultural Affairs	8	8	9	9	10	10	11	11	12	12	4.5%	4.4%
Total Education	992	1,094	1,205	1,287	1,391	1,473	1,535	1,595	1,656	1,719	8.8%	6.3%
Human Services												
Human Resources - Director's Office	4	4	4	4	4	5	5	5	5	5	4.7%	4.5%
Health Care Financing & Policy	253	287	312	334	356	376	399	425	452	479	8.9%	7.3%
Health Division	17	17	18	19	20	21	21	22	23	24	4.3%	4.3%
Aging Services	8	8	9	9	10	10	11	11	11	12	5.7%	4.9%
Division of Mental Health and Development	89	95	100	106	111	117	122	127	133	138	5.8%	5.0%
Welfare Division	61	76	81	80	79	76	77	79	81	80	6.5%	3.0%
Child and Family Services	65	72	76	80	85	89	93	97	101	105	6.8%	5.5%
Other Human Resources	1	1	1	1	1	1	1	1	2	2	4.1%	4.2%
DETR-Director's Office	1	1	1	1	1	1	1	1	1	1	5.0%	4.7%

Exhibit 4-1: State of Nevada General Fund Projections
FY 2001-02 through FY 2010-11
(in millions)

DESCRIPTION	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	Growth: FY	Growth: FY
											2001-02 to FY- 2005-06	2001-02 to FY- 2010-11
Rehabilitation Division	6	6	6	7	7	7	8	8	8	9	5.1%	4.7%
Employment Security Division	0	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Human Services	504	566	608	641	673	703	738	778	818	855	7.5%	6.0%
Commerce and Industry												
Department of Business & Industry	9	9	10	10	11	11	12	12	13	13	4.4%	4.4%
Department of Agriculture	3	3	3	4	4	4	4	4	5	5	4.4%	4.4%
Gaming Control Board	24	24	26	27	28	30	31	32	34	35	4.3%	4.3%
Public Utilities Commission	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Economic Development & Tourism	4	4	4	4	4	5	5	5	5	5	4.1%	4.2%
Minerals	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Professional and Vocational Boards	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Commerce and Industry	40	40	43	45	47	50	52	54	56	58	4.3%	4.3%
Public Safety												
Department of Corrections	166	172	180	189	202	216	232	247	264	282	5.0%	6.1%
Department of Motor Vehicles	0	0	0	0	0	0	0	0	0	0	4.1%	4.3%
Department of Public Safety	35	36	38	40	42	44	46	48	50	52	4.7%	4.5%
Police Officers Standards and Training	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Public Safety	201	207	218	229	244	260	278	295	314	335	4.9%	5.8%
Infrastructure												
Conservation & Natural Resources	21	22	23	24	25	27	28	29	30	31	4.6%	4.5%
Department of Transportation	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Colorado River Commission	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Infrastructure	21	22	23	24	25	27	28	29	30	31	4.6%	4.5%
Special Purpose Agencies												
Office of the Military	2	2	2	2	2	3	3	3	3	3	5.2%	4.7%
Veterans Affairs	5	4	5	5	5	5	6	6	6	6	1.3%	3.0%
Public Employees Retirement System	0	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Public Employees Health Program	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Peace Officers Standards & Training	-	-	-	-	-	-	-	-	-	-	n/a	n/a
State Industrial Insurance System	-	-	-	-	-	-	-	-	-	-	n/a	n/a
Total Special Purpose Agencies	7	6	7	7	8	8	8	9	9	9	2.2%	3.4%
TOTAL EXPENDITURES	1,867	2,052	2,227	2,365	2,525	2,664	2,790	2,917	3,048	3,179	7.8%	6.1%
BUDGET SURPLUS/(DEFICIT)												
Annual	(122)	(250)	(327)	(379)	(455)	(511)	(555)	(603)	(655)	(708)		
Cumulative	(122)	(372)	(699)	(1,078)	(1,533)	(2,044)	(2,599)	(3,202)	(3,857)	(4,565)		

Notes:

(1) FY 2001-02 and FY 2002-03 appropriations differ from those reported in the Nevada Legislative Report because projections reflect the impacts of program overruns and revenue shortfalls.

General Fund Revenue Projections

General Fund Tax Revenues

Retail Sales and Use Taxes

Nevada's sales and use tax collections are a function of taxable retail sales, which have seen tremendous growth during the past decade. Between FY 1989-90 and FY 2000-01, sales increased by an average annual rate of 7.8 percent, or from \$14 billion to \$32 billion. Please see Exhibits 4A-2 through 4A-3 in the appendix following this text summary.

This rate of growth, while phenomenal, is a bit misleading because it reflects both inflation and population growth. Using employment as a surrogate for population to analyze monthly data, inflation adjusted taxable sales per employee averaged roughly \$2,600 per month, or just over \$30,800 year, between FY 1989-90 and FY 2000-01. Please note that all inflation adjusted figures discussed throughout this report are expressed in constant 2000 dollars. Please also see Exhibits 4A-4 and 4A-5. It is noteworthy that this trend is decisively downward. At an inflation adjusted average of \$28,700 of taxable sales per employee for the fiscal year ending June 2002, the State has reached its lowest per capita collection level since the middle of the 1991-92 recession.

There are a number of reasons why per capita inflation adjusted taxable retail sales have declined during the past two years. These include: less construction activity; a mild economic recession; increasing market penetration by Internet retailers; reduced consumer spending following September 11th; a general spending shift toward services; and a State economy that continues to diversify away from gaming. Sales spikes occurring in 1993-94, 1996-97, and 1999-2000 are closely correlated to the construction and opening of multiple mega-resort casino-hotels.

The outlook for the first two years of the projection period, FY 2001-02 and FY 2002-03, is for moderate growth, reflecting the economy's continued healing, less overall construction activity, and other economic factors. Most market observers anticipate a recovery and more "normal" growth patterns by late-2002 or early-2003.⁹ This

⁹ See Smith, H. *Southern Nevada Economic Index Up*, Las Vegas Review Journal. October 2002. http://www.reviewjournal.com/lvrj_home/2002/Oct-18-Fri-2002/business/19870295.html; see also Crowley, M. *Las Vegas Economy: Signs Pointing to Strong Recovery*, Las Vegas Review Journal. July 2002. http://www.reviewjournal.com/lvrj_home/2002/Jul-19-Fri-2002/business/19222739.html; see also Aversa, J. *Economic Recovery Remains Uneven*, Associated Press as Reported in the Las Vegas Sun. October 2002;

Footnote continued on the following page.

expectation notwithstanding, we remain cautious regarding the continued erosion of the State's sales tax base. Additional construction, employment, and visitation all have the potential to bolster the State's sales tax collections; however, projected growth rates remain below historical averages. Please see Exhibit 4A-6.

During the first five years of the projection period, retail sales and use tax collections are anticipated to grow by an average annual rate of 5.3 percent, declining to an average annual rate of 4.8 percent through the balance of the study period. Please see Exhibits 4A-7 and 4A-8. In inflation adjusted per capita terms, this translates into an average annual decline in collections of 0.2 percent. Please see Exhibit 4A-9.

Gaming Fees and Taxes

There are 14 gaming taxes and fees that contribute to the State's general fund. The most notable of which is the percentage fee levied on taxable gross gaming win ("percentage fees"). In FY 2000-01, percentage fees accounted for nearly 95 percent of all gaming tax collections and 33 percent of all general fund revenues. In terms of overall contribution, revenues from levies imposed on gross gaming win are second only to retail sales and use tax collections.

Percentage fees are a function of gross gaming win. Between FY 1989-90 and FY 2000-01, annual gross gaming win increased from \$5.1 billion to \$9.7 billion, or by 91 percent. Please see Exhibits 4A-10 and 4A-11. That growth notwithstanding, as the State's economy has diversified away from gaming, its per capita revenues have not kept pace. This is a reflection of Nevada's dependence on gaming and the relatively limited fiscal contributions required of expanding non-gaming businesses. This is further evidenced by the fact that per capita state tax revenues have continued to decline, while the State has witnessed one of the largest economic expansions in its history. Please see Exhibits 4A-

[Greenspan Says Economic Recovery is 'Well Under Way'; Reuters, Washington Bureau. March 2002. \[http://senrs.com/greenspan_says_economic_recovery_is_well_under_way.htm\]\(http://senrs.com/greenspan_says_economic_recovery_is_well_under_way.htm\); Greenspan, A. Chairman of the Federal Reserve Board, *Federal Reserve Board's semiannual monetary policy report to the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*; July 2002; see also Greenspan, A. Chairman of the Federal Reserve Board, Testimony Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002; \[www.federalreserve.gov/html\]\(http://www.federalreserve.gov/html\); see also *Regional Outlook, Federal Deposit Insurance Corporations. Third Quarter 2002*; see also Parry, R.T. President and CEO of the Federal Reserve Bank of San Francisco, Presentation to Securities Analyst in San Francisco: *The Economic Outlook for the Nation and the Region: A Monetary Policymaker's View*. October 2002. <http://www.frbsf.org/news/speeches/2002/021002.pdf>.](http://www.lasvegassun.com/sunbin/stories/archives/2002/oct/17/101700203.html?\)

12 and 4A-13. The overall downward trend in inflation adjusted annual collections per capita is clearly illustrated in Exhibits 4A-14 and 4A-15.

Trends in visitation tend to reflect the hospitality industry's business cycles. Peaks occurring in FY 1994-95 and FY 1999-2000 are evident and appear to be influenced by the opening of several mega-resorts during those periods. The acumen and inventiveness of Nevada's business leaders who attract and host tourist and convention travelers should not be underestimated; however, fewer mega-resorts being constructed in the near-term; continued proliferation of gaming into major feeder markets worldwide; and the anticipation of continued population growth put into question any assumption that the gaming industry can be expected to sustain the State's need for additional revenue.

Assuming *arguendo* that the number of visitors per capita was to remain stable during the next decade, State revenue collections will be constant only if visitor spending remains uniform and increases at the rate of inflation. An analysis of existing trends suggests that this is also unlikely.

Nevada has grown from a gaming venue to a multi-faceted entertainment destination, evolving to make shopping, shows, recreation, dining, and conventions integral industry components and major attractions. Surveys of visitor spending and financial reports of the State's largest casino-hotels suggest that tourist spending has been changing along with the economy.¹⁰ In FY 1989-90, gaming revenue accounted for 61 percent of the revenues collected by the State's gaming properties with gross gaming revenues of one million dollars or more. By FY 2000-01, that percentage decreased to 51 percent. Please see Exhibit 4A-16. We recognize that resident spending generates a significant portion of the cited gaming revenue; however, a similar shift in resident spending would only serve to exacerbate this trend.

The proliferation of gaming throughout the United States also has the potential to impact gross gaming win in Nevada. In 2001, every state in the Union, barring Utah and Hawaii, had legalized some form of gaming. Nevada continues to capture an increasingly smaller share of the nation's expanding gaming market. Somewhat analogous to the impact of the Internet on sales and use tax, if consumers opt to spend a greater share of their

¹⁰ *Annual Gaming Abstract*, Nevada Gaming Control Board, Selected Issues, 1990 through 2001; *see also Las Vegas Visitors Study*, Las Vegas Convention and Visitor Authority, GLS Research, Selected Issues 1995 through 2001.

entertainment dollars in venues other than Nevada, taxable gaming win will almost certainly erode.

It is noteworthy that inflation adjusted total revenues for gaming establishments have remained fairly constant, with shopping, food, beverage, and lodging capturing much of the "lost" gaming revenue. These expenditures are taxed, like most other non-gaming expenditures in Nevada, to varying degrees by the State (if at all), with retail sales and use tax being the most significant alternative levy.¹¹ One hundred dollars of taxable gaming revenue generates roughly \$6.13 in State collections. By comparison, one hundred dollars of taxable retail sales generates approximately \$4.25.¹²

This trend in gross gaming revenues (percentage fee collections) is likely to put continued pressure on total gaming tax and fee collections. We anticipate that gaming taxes and fees will grow from \$590 million in FY 2001-02 to \$721 million by FY 2010-11. This results in a compound annual growth rate of 2.3 percent, which does not keep pace with the overall rate of population and economic growth. Please see Exhibits 4A-17 through 4A-19.

Insurance Premium Taxes

Insurance premium taxes are the State's third largest revenue source, accounting for approximately 9 percent of total tax revenues. They are among the fastest growing and most stable of the State's major revenue sources, reporting a compound annual growth rate of 9.4 percent and an inflation adjusted per capita growth rate of 1.2 percent between FY 1989-90 and FY 2000-01. Please see Exhibits 4A-20 through 4A-22.

Population and employment growth characteristics are the most significant factors impacting insurance premium taxes. Over the next decade, the population will continue to age;¹³ the cost of medical care will continue to rise; and consumer demand for the "latest" medical treatments will increase overall consumption.¹⁴ These factors, and several others,

¹¹ Note that lodging taxes are also a significant levy. However, comparatively few lodging tax dollars are allocated to the State and none are directed to the State's general fund. *See* State Transient Lodging Tax, NRS 244.3353 et. seq. and 268.096 et. seq.; *see also Nevada Tax Facts*, Nevada Taxpayers Association, 2001.

¹² Includes both the state sales tax of 2 percent and the local school support tax of 2.25 percent. The latter is a direct offset to the State's general fund obligations.

¹³ *See* Nevada State Demographer's Office, Population Projections by Age Cohort. April 2002.

¹⁴ PriceWaterhouseCoopers, *The Factors Fueling Rising Healthcare Costs*, Prepared for the American Association of Health Plans, April 2002.

lead most analysts to believe that per capita insurance coverage will increase during the foreseeable future.

The projections modeled herein assume an inflation adjusted per capita growth rate similar to historical trends, with total growth in insurance premium taxes between six and seven percent annually. Please see Exhibits 4A-23 through 4A-25.

Casino Entertainment Tax

Generally stated, Nevada's casino entertainment tax is a 10 percent levy placed on the sale of merchandise, food, beverage, and charges for admission at entertainment venues operating within licensed gaming establishments. This remnant of the now repealed Federal Cabaret Tax, is treated separately from other "gaming taxes" because it is not a levy on gaming activities or equipment tax *per se*. Rather, it is a transaction tax on business activities that do not require a gaming license and merely happen to take place within a licensed gaming establishment. This classification notwithstanding, the casino entertainment tax is clearly an additional tax carried by the gaming industry and its patrons.

In the *Gaming Fees and Taxes* subsection, *supra*, the shift in spending occurring at Nevada's major gaming establishments was discussed. This shift, which appears to be resulting in more non-gaming expenditures, also appears to be bolstering casino entertainment tax collections. Taxable casino entertainment sales have been growing at an annual rate in excess of 11 percent for the past several years, making entertainment tax collections among the fastest growing revenue sources in the State. Please see Exhibits 4A-26 and 4A-27.

It is noteworthy, however, that spikes in casino entertainment tax growth appear to coincide with the opening of new casino hotels. The slowdown in new mega-resort construction may lead to slower growth in casino entertainment tax collections. These revenues are expected to increase at an average annual rate of between seven and eight percent between FY 2001-02 and FY 2010-11. Please see Exhibit 4A-28. In inflation adjusted per capita terms, the revenue source is forecasted to grow at an annual rate of 1.5 percent to 2.5 percent. Please see Exhibit 4A-29 and 4A-30.

Excise Taxes

Excise taxes, which include levies placed on liquor and tobacco products, generated \$63.4 million in FY 2001-02, roughly four percent of all State general fund tax

collections. Excise taxes are largely unit-based and do not adjust with the rate of inflation.

The marginal propensity to consume goods subject to excise taxes has been declining during the past several years. The number of taxable gallons of beer, wine, cordials, and hard liquor per employee generally declined during the 1990s. Please see Exhibits 4A-31 through 4A-34. The trend is evident in cigarette sales, which declined from an annual average of 88 packs per capita per year in FY 1996-97 to 78 packs per capita per year in FY 2001-02. Please see Exhibits 4A-35 and 4A-36.

Excise taxes are anticipated to grow at average annual rate of between one and two percent during the next decade. Please see Exhibit 4A-37 and 4A-38. In inflation adjusted per capita terms, however, they are expected to see continued declines. Please see Exhibit 4A-39.

Business License Tax

Nevada's business license tax is a quarterly levy based on a business's number of full-time equivalent employees. The tax is a direct function of state employment, which is projected to grow at an average annual rate of 1.7 percent between FY 2001-02 and FY 2010-11. Business license tax collections are anticipated to follow suit, growing at rates from 1.5 percent to 2.5 percent during the period. Please see Exhibits 4A-40 and 4A-41.

The business license tax is similar to the excise tax on cigarettes discussed in the preceding subsection (i.e., *Excise Taxes*) in that it does not adjust with inflation. The tax is set at \$25 per full-time equivalent employee per quarter; thus, in inflation adjusted per capita terms, this levy will erode over time. Please see Exhibit 4A-42.

Mining Taxes

Nevada's taxes generated from the operation of in-state mining activities have seen sharp declines during the past several years, and a pronounced drop off in FY 2001-02. Low worldwide gold prices and mine closures have all led to decreased aggregate profitability and fewer gross proceeds upon which the State's primary mining levy is ultimately based.

¹⁵ Capehart, T. *Trends in the Cigarette Industry After the Master Settlement Agreement*, United States Department of Agriculture TBS 250-01, October 2001.

Between FY 1989-90 and FY 2001-02, general fund mining tax revenues decreased from \$23 million to \$9 million, or by nearly 59 percent. In inflation adjusted per capita terms, mining taxes have decreased from \$25 per capita to \$4 per capita, or by more than 80 percent. In FY 2001-02, mining taxes accounted for less than one percent of the State's general fund tax collections.

Even with the projected recovery of gold prices, revenues from Nevada's mining taxes are expected to see only moderate annual increases during the next decade. Please see Exhibits 4A-43 and 4A-44. In inflation adjusted per capita terms, an average loss of between two and three percent is forecasted. Please see Exhibit 4A-45.

Other Taxes

Revenues classified as "other taxes" account for just over 0.3 percent of total general fund tax collections in FY 2001-02. They are projected to remain fairly stable at between five and six million annually.

Non-Tax General Fund Revenues

Licenses

In FY 2001-02, licenses accounted for 3.7 percent of the State's general fund revenues, or approximately \$64 million. The most significant of these revenues are commercial recordings and filing fees collected by the Secretary of State, which generated \$36 million in that year -- 57 percent of the State license collection total.

Licenses are anticipated to grow at a compound annual rate of between 4.5 and 5.5 percent during the study period. Rate changes in a variety of fees on business transactions handled through the Secretary of State's office created a revenue growth projection spike in FY 2001-02.¹⁶ Less this aberration, inflation adjusted per capita collections are anticipated to remain relatively constant over the ten-year projection horizon. Please see Exhibits 4A-46 through 4A-48.

¹⁶ Nev. S.B. 577. See also *Nevada Legislative Appropriations Report*, Legislative Analysis Division, Fiscal Analysis Division, FY 2001-02 and FY 2002-03.

Fees and Fines

In FY 2001-02, fees and fines represented 1.4 percent of the State's general fund revenue collections. Civil action fees, state engineering fees, and car rental tax were the only fees and fines to generate more than one million dollars. Car rental fees were the most significant, generating \$19.6 million, or 79 percent of the \$25 million in total fee and fine collections.

The car rental fee was changed by the 2001 Legislature. Assembly Bill 460 increased the State's share of the car rental fee to six percent and provided for quarterly rather than annual payments. This change resulted in a revenue growth spike in FY 2001-02. Overall, the fines and fees are anticipated to grow at a compound annual rate of five percent, with inflation adjusted per capita revenues remaining between \$10 and \$11 throughout the study period. Please see Exhibits 4A-49 through 4A-51.

Use of Money and Property

Use of money and property accounted for \$13.6 million in FY 2001-02, approximately 1.0 percent of the State's general fund revenue total. While there are a number of revenue accounts generally classified as "use of money and property," the most significant is interest. Interest has historically accounted for 94 percent of all use of money and property collections.

Interest, of course, varies with the amount of money held by the State along with the overall condition of the national economy and its financial markets. In periods of recession, interest revenues tend to dip; where the State is generating surpluses, higher-than-average interest returns are generally accrued. This analysis estimates that interest collections will average approximately \$21 million each year, with FY 2001-02 and FY 2002-03 forecasted for relatively fewer overall returns, given existing market conditions. Please see Exhibits 4A-52 through 4A-54.

Other Revenues

Revenues classified as "other" accounted for approximately 1.5 percent of total general fund collections. They are projected to remain fairly stable at between \$16 million and

\$20 million annually. We note, however, that a change in the timing considerations relative to unclaimed property did create a revenue spike in FY 2001-02.¹⁷

General Fund Expenditure Projections

One of the most challenging efforts undertaken by the Task Force was that of estimating the expenditure levels required to maintain State programs during the ten-year projection period. Data availability, data consistency, and a recurring theme of desired program enhancements and/or program cuts created both analytical obstacles and a continual need to distinguish between the structural problems facing the State's fiscal system and the subjective identification of "optimal" public service levels.

We cannot emphasize enough that these two issues are wholly separate. The structural problems of the State will exist with or without new or expanded programs; they will exist with or without program cuts. The latter would merely accelerate the timeframe and depth of the State's revenue shortfall, while the former would merely delay it or moderate its severity. It is a fundamental assumption of this analysis that the policy environment remains static.

A number of State departments and divisions provided service cost forecasts to the Task Force. This information was reviewed in detail to ensure consistency with economic and fiscal variables used throughout the modeling process. Revised estimates were resubmitted to each agency to ensure uniformity of understanding and the reasonableness of the Task Force's projections.

As noted in the introduction to this section, the estimates contained herein are long-term in nature and are *not intended to supplement nor supplant the biennial budgeting process*. To do otherwise would almost certainly provide misleading and inappropriate information, as these long-term estimates attempt to smooth cyclical variations and do not reflect the one-time occurrences that are critical to formulating the State's biennial fiscal plan.

The Task Force used the budgeted spending levels for the 2001-03 biennium as a representative baseline. Again, this analysis does not attempt to make any comment as to

¹⁷ See AB 77, Nev. Leg., 71st Session. Shortening the time period for which property would be considered unclaimed; and thus, increasing collections in FY 2001-02.

whether this level of service is appropriate; rather, its only goal is to estimate the costs required to maintain the budgeted level of state services.

It is noteworthy that between FY 2000-01 and FY 2002-03, the State's general fund budget increased by nearly 20 percent, or from \$1.6 billion to \$2.0 billion.¹⁸ This increase exceeded population and inflation growth by nearly 10 percent and represents the largest two-year increase in State appropriations reported during the study period. At the same time, revenue shortfalls during the past 18 months have led to budget cuts in almost every area of State government, and it is clear that Nevada will not spend to the levels budgeted by 2001 Legislature. Interim actions notwithstanding, it is the approved 2001-03 spending levels that remain the baseline for this analysis, as these data best represent the Legislature's intended service level.

As a baseline, all State expenditures were projected based on population and inflation growth. This analysis was then supplemented with a more detailed, independent review of key programs such as K-12 education, the university and community college programs, Medicaid, welfare, and prison operations. Please see Exhibit 4B-1. Combined, these programs account for the lion's share of State general fund spending.

The breakout analyses were particularly important to the Task Force's efforts due to the interdependence of state revenue sources, caseload factors, market conditions, federal funding levels, and the ultimate role of the general fund. None of these issues are accounted for by merely inflating expenditure levels and adjusting them for population growth, and thus, State spending requirements would tend to be over or understated.

K-12 education provides a good illustration of how these elements come into play in projecting public service costs. K-12 education is only partially funded by the State's general fund. Other sources of revenue used to fund schools include the local school support tax,¹⁹ property tax, annual slot tax, investment income, mineral land leases, federal grants, and several other diverse sources. Nevada's education funding regime, commonly referred to as the Nevada Plan, effectively requires that the general fund supplement these revenue sources to meet a required per-pupil spending level. Thus, if

¹⁸ The FY 2001-02 figure noted differs from the appropriations specifically cited in the State Appropriations Report and in Section 3. This is due to the fact that some adjustments have been made to a number of state service cost to reflect revenue shortfalls, caseload overruns, and other factors. This is discussed further in the sections that follow.

¹⁹ A component of the State's retail sales and use tax. The local school support tax is a 2.25 percent levy.

the non-general fund sources produce revenues exceeding expectations, general fund requirements decline; the opposite has been less likely but also true.

This condition is particularly onerous with regard to the sales tax, a component of which provides revenue directly for education²⁰ and a component of which is the general fund's single largest funding source.²¹ A slowdown in retail sales and use tax collections results in fewer direct education dollars, which then creates a shortfall that must be "made up" by the State's general fund. The general fund, however, must make up the difference with fewer dollars, as it is also reliant on the same underperforming revenue source. This interdependence compounds the impacts of economic downturns at the state level.

Caseload or eligibility profiles are also key to evaluating service costs. While population growth is closely associated with the demand for public services, changes in a region's demographic make-up can strongly influence the ultimate level of services required. Again, using K-12 education as an example, if the number of children per household were to increase from one to two, the cost of education would clearly rise faster than the population growth rate.

Creating customized analyses for selected programs also allowed for particular consideration of market conditions impacting service costs. These factors, including, but not limited to, the rising price tags of health care and electricity, have the potential to make it more costly to provide the same services tomorrow as compared to today. Again applying the K-12 education example, if the cost of power increases at 20 percent per year, assuming the number of students remains constant, the cost of educating each pupil goes up.

Between 1990 and 2002, the consumer price index for all western urban consumers increased by an average of 3.2 percent per year, while the costs of health care increased by 5.1 percent per year.²² The average cost of power increased only 2.9 percent per year during the 12 year period, however, between 2000 and 2001, the Bureau of Labor Statistics reported that energy costs increased by 18 percent, or nearly five times the rate

²⁰ Id.

²¹ State sales tax is a two percent levy.

²² United States Department of Labor, *Bureau of Labor Statistics*, Consumer Price Index Data, September 2002. In addition, the Task Force also recognizes that some group medical costs have been rising at rates well in excess of those reported by the Bureau of Labor Statistics. While the rates may fall more in-line with historical averages over the long run, near-term increases are issues that may require special consideration. See PriceWaterhouseCoopers, *The Factors Fueling Rising Healthcare Costs*, Prepared for the American Association of Health Plans, April 2002.

of overall inflation.²³ We have attempted to take these factors into consideration where possible.

The sections that follow briefly overview the assumptions and analyses used to project the service cost by state function. These functions included constitutional agencies, finance and administration, education, human services, commerce and industry, public safety, infrastructure, and special purpose agencies. Each is discussed below.

Constitutional Agencies

The Constitutional Agencies function, which includes elected officials and offices of the executive, legislative and judicial branches of state government, reported an 11 percent increase in funding between the 1999-2001 biennium and the 2001-03 biennium. These functions, which are budgeted to cost approximately \$62.6 million in FY 2002-03 and account for three percent of total general fund spending, are projected to grow at the rate of population and inflation growth throughout the study period, roughly 4.8 percent per year. Please see Exhibits 4B-1 through 4B-4.

Finance and Administration

The finance and administration function includes those executive branch agencies that control, coordinate, assist and provide services to other agencies and programs in state government.²⁴ Examples include the Department of Administration, Department of Taxation, Department of Information Technology, and Department of Personnel.

Between FY 1992-93 and FY 2002-03, the State's finance and administration appropriations have increased from \$21.5 million to \$54.3 million, or by 9.8 percent annually. In inflation adjusted per capita terms, appropriations remained relatively stable at \$18 per capita during the past decade. Please see Exhibits 4B-5 through 4B-7.

While we have modeled spending levels to remain static in per capita inflation adjusted

²³ Id. It should be noted that we do not anticipate that Nevada's power costs will increase by such high levels throughout the study period; however, there is great uncertainty as to what path Nevada will take regarding who will be the ultimate provider of power and at what cost.

²⁴ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

terms through the balance of the study period, we are cognizant of the fact that the Department of Taxation (the "Department"), in particular, will likely require additional funds to effectively implement existing programs and proposed revenue enhancements. Estimates regarding the level of these costs were unavailable at the time this report was drafted, and were generally construed as being beyond the scope of the Task Force's mandate.

That having been said, the plight of the Department, and in particular its out-of-date information technology infrastructure, is well documented and is undeniably the source of systemic limitations and inefficiencies. We compliment the Department of Taxation for its willingness to do so much with so little, and we urge the Governor and the State Legislature to closely consider the costs of effective administration in fashioning a comprehensive solution to the State's fiscal problems.

Education

Education programs are the single largest beneficiary of state general fund appropriations. They include kindergarten, elementary, and secondary education as well as the university and community college system, WICHE,²⁵ and the Department of Cultural Affairs. In FY 1992-93, education programs received 55 percent of all State appropriations, or \$566 million. By comparison, the 2001 Legislature budgeted education appropriations of \$1.0 billion for FY 2002-03, representing 53 percent of the State's appropriation total and a 10-year average growth rate of 6.2 percent.

University and community college system and K-12 education program funding have been modeled separately and are discussed in the sections that follow.²⁶ The balance of education program funding is projected to increase at rates of inflation and population growth. A summary of historical and projected education expenditures (combined) are provided in Exhibits 4B-8 through 4B-10 in the appendices following this summary.

²⁵ Western Interstate Commission for Higher Education.

²⁶ UCCSN and K-12 education combine to account for more than 95 percent of all State education general fund appropriations; thus, the other programs were not modeled independently.

Kindergarten – 12th Grade Education (K-12 Education)

Salaries

Nevada's spending on K-12 education has been a topic of much debate over the past several years and throughout the Task Force's deliberations. It has also been an area of considerable confusion and misunderstanding due to the complex manner in which education is funded and the political rhetoric accompanying this fundamental public service.

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Benefits

+

Operating Expenses

To estimate the cost of funding public K-12 education programs, the Task Force worked with representatives of the Nevada Department of Education, the school districts, and State Demographer's Office to project school enrollment and to recreate per pupil support funding models (i.e., the distributive school account). Each of the nearly 300 revenue and expenditure line items were treated separately and projected over the study period. We note that these procedures were specifically designed to create a smoothed set of averages, and are very different from the more complex and comprehensive biennium forecasts that must be painstakingly generated by the very diligent and skilled public education staffs at the state and local level.

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Equipment Purchases

+

Transfers Out

-

Less: Revenue Offsets
Federal Revenue
\$0.50 Prop Tax
Government services tax
Franchise Taxes
Other Taxes & Adjustments

Caseload Estimates

The first step in projecting K-12 education costs was to refine caseload estimates, otherwise referred to as the student population, full enrollment or weighted annual enrollment.²⁷ Original projections provided by the State Demographer's Office and the Nevada Department of Education were internally inconsistent. In fact, the State's combined enrollment estimates, which constitute a compilation of the estimates generated by each of the individual school districts, resulted in a number of students exceeding the total count of school-aged children projected by the State Demographer in FY 2008-09 (an impossible condition).

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Basic Pupil Support

Refinements were made to both data sets to achieve the enrollment estimates provided in Exhibit 4B-11. Generally, these estimates anticipate that enrollment levels grow at rates slightly faster than the rate of population growth, reaching nearly 440,000 by the close of

²⁷ It is noteworthy that full enrollment, weighted enrollment, and student population may tend to have different technical meanings. Where necessary, we have distinguished between these groups. The majority of our analyses in this section rely on weighted enrollment, which is an enrollment count that provided partial weighting to kindergarten students.

Basic Pupil Support

FY 2010-11. Please see Exhibit 4B-12.

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K-12 Education Cost Projection

Additional & Special Programs

Estimating the cost of K-12 education properly begins with an analysis of the Distributive School Account (the "DSA") and a review of basic per pupil support. The DSA is the mechanism by which the State provides financial aid to school districts. Essentially, the DSA, in conjunction with the Nevada Plan,²⁸ applies standard formulas to establish a guaranteed level of per pupil support for each of Nevada's 17 school districts.

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Total Funding Requirement

Per pupil support, total state spending on education, and state general fund education appropriations should not be confused with one another, as they each have very different meanings. These terms are briefly described in the paragraphs that follow.

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"Local" Revenues
(Effectively State Levies Earmarked for Education)

Per pupil support is a mathematical formula required by the Nevada Plan,²⁹ and is used to determine a level of state funding for basic education needs. In FY 2002-03, basic support is budgeted to represent roughly 59 percent of the \$2.4 billion in *total state spending on education*. Please see Exhibits 4B-13 through 4B-16.

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"State" Revenues
(Non-General Fund Levies Administered by the State)

The term *total state spending on education* is used to represent the combined total of all revenue sources considered in our analysis (and by the State) in funding education programs. There are more than 20 of them, and some are overlapping. Total state spending on education is something less than *total education funding* because there are a number of local revenues which never enter into the State's education funding calculations. For example, the majority of capital expenditures are funded at the local level, and thus, not reflected. The identification and quantification of these additional revenue sources were beyond the scope of this study.

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State General Fund Obligations

²⁸ The Nevada Plan is the means used to finance kindergarten, elementary, and secondary education in Nevada's public schools. It begins by the establishment of a per-pupil basic support rate. The rate is determined by a formula that considered the demographic characteristics of each school district. In addition, transportation costs are included using 85 percent of the actual historical costs adjusted for inflation according to the Consumer Price Index. A Wealth Adjustment, based on a district's ability to generate revenues in addition to the guarantee is also included in the formula. There are special considerations for special education and kindergarten students. Please see *The NEVADA PLAN for School Finance: An Overview*, Legislative Counsel Bureau, Fiscal Analysis Division, 1999 Session of the Nevada State Legislature. Appendix C.

²⁹ Id.

Total State Spending on Education

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"Local" Revenues Attributed to Basic Support

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"Local" Revenues Outside of the Basic Support Calculation

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"State" Revenues Other than General Fund Appropriations

+

State General Fund Appropriations

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Non-Distributive School Account State Spending

Finally, *state general fund education appropriations* refer to the amount of state education spending derived from its general fund. Historically, this figure has averaged between 23 and 28 percent of total state spending; however, in recent periods, revenue shortfalls threaten to push this figure above 30 percent. Please see Exhibit 4B-17. It is important to understand that given the circular nature of Nevada's education funding regime, the State's general fund is little more than a stop gap funding source used to supplement education funding requirements after all other sources have been exhausted.

Basic per pupil support primarily considers the costs of salaries, benefits, operating expenditures, and equipment purchases. Not surprisingly, salaries and benefits account for the majority of basic per pupil support and total state education funding. Please see Exhibit 4B-18. Inflation adjusted salaries per pupil have declined from \$3,560 in FY 1990-91 to the \$3,360 budgeted for FY 2002-03.³⁰ Total benefits have also reported declines in per pupil terms during the study period. Please see Exhibits 4B-19 and 4B-20.

Projections for education salaries reflect only the rates of inflation and student population growth. The Task Force received testimony and deliberated on the desire of some groups to increase teachers' salaries at an accelerated rate, including the implementation of the "five plus five" plan tentatively proposed by a cooperative effort of the State's superintendents.³¹ While the Task Force recognizes, admires and appreciates the vital role teaching professionals play in the future of our state, to include such an increase in our modeling process would reflect a change in state spending policy. Such policy decisions are clearly the purview of the Governor and the State Legislature.

Education employee benefits include retirement, workers compensation,³² unemployment insurance, Medicare, group medical, and other fringe benefits. Combined, these benefits are budgeted to reach nearly \$375 million in FY 2002-03, a more than 150 percent increase over the \$145 million in benefits reported in FY 1990-91. Rising costs of medical care have put upward pressure on benefits. This is evidenced by the fact that benefits have continued to increase as a percent of salaries, and many teachers and school employees are being required to subsidize health care costs that were once part of their standard benefits package. Please see Exhibit 4B-21.

³⁰ There are a number of factors influencing declines in per pupil salaries. These include, but are not limited to higher student-teacher ratios, differences between inflation growth and salary increases, and fewer expenditures on non-instructional personnel.

³¹ See the State Education *iNVEST* Plan, proposed in draft format to the Task Force in May 2002.

³² Historically referred to as SIIS, however, the industrial insurance system (SIIS) no longer exists.

In inflation adjusted per capita terms, benefits for education employees are anticipated to see growth slightly above the combined rate of student population and inflation growth. This is due primarily to the fact that medical care costs are rising at a rate roughly two percent faster than overall inflation.³³ Exhibit 4B-22 provides a historical and projected overview of benefit costs per pupil in inflation adjusted terms.

The cost of operating the State's school districts includes the costs of power, heat, transportation, textbooks, insurance and more than a dozen other items. Operating costs are budgeted to reach \$191 million in FY 2002-03; however, they have declined considerably in per capita terms during the past several years. Please see Exhibits 4B-23 and 4B-24. In FY 1990-91, inflation adjusted operating costs per pupil were \$550; in FY 2002-03, they are budgeted to reach only \$485 per pupil. Not all costs have declined, however. The cost of electricity has increased from \$81 per pupil (inflation adjusted) in FY 1990-91 to a budgeted \$106 per pupil in FY 2002-03. The costs of heat, textbooks, and instructional supplies have all declined during the study period in inflation adjusted per pupil terms. Perhaps most notable is the decline in spending on textbooks, which decreased from \$51 in FY 1990-91 to less than \$40 in FY 2002-03, a 22 percent decline.

From a projection standpoint, electricity cost is the most pressing of the operating cost issues (the balance being projected based on inflation and student population growth). Nationally, inflation in the cost of power is well documented and remains a clear and present concern for the State's facility-dependent education system. Considerable uncertainty surrounds the ultimate cost of power, given the potentially unstable financial condition of Nevada Power Company;³⁴ consideration of a public power buyout for Southern Nevada; and the future of additional power generating facilities within the State.

Historically, the cost of power in the Western United States has closely tracked the overall rate of inflation.³⁵ During the last two years, however, the cost of electricity has increased well beyond the overall rate of inflation. In recognition of this fact, the State

³³ United States Department of Labor, *Bureau of Labor Statistics*, Consumer Price Index Data, September 2002. In addition, the Task Force also recognizes that some group medical costs have been rising at rates well in excess of those reported by the Bureau of Labor Statistics. While the rates may fall more in-line with historical averages over the long run, near-term increases are issues that may require special consideration. See PriceWaterhouseCoopers, *The Factors Fueling Rising Healthcare Costs*. Prepared for the American Association of Health Plans. April 2002.

³⁴ A subsidiary of Sierra Pacific Resources Corporation.

³⁵ United States Department of Labor, *Bureau of Labor Statistics*, Consumer Price Index Data, September 2002.

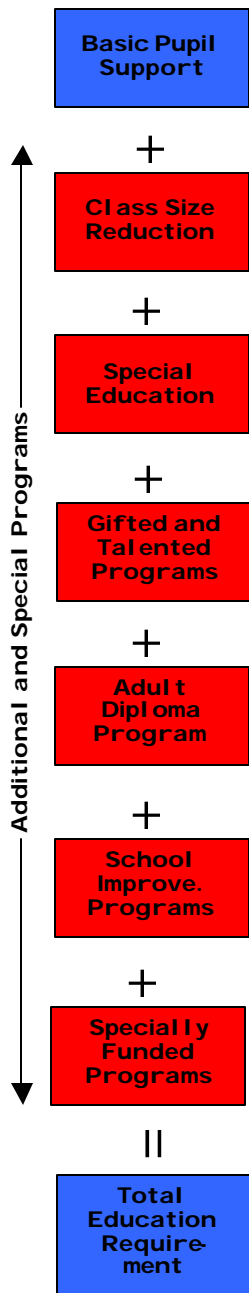
Legislature increased inflation adjusted per pupil spending on electricity from \$92 per pupil in FY 2000-01 to a budgeted \$106 per pupil in FY 2002-03, an increase of more than 15 percent. Through the balance of the study period, we anticipate that the cost of power will slightly outpace the rate of inflation. We note, however, that there is persuasive evidence that a potential public buyout of Nevada Power could lead to an immediate rate reduction of 20 percent or more.³⁶ Should such a reduction actually materialize, our modeled assumptions should be revisited.

In estimating the final level of basic per pupil support, a number of "local and other" revenues are subtracted from the total program cost estimate. While some of these revenue sources are referred to as local (i.e., \$0.50 of property tax), it is important to note that local governments have no control over these levies or their distributions. The onus of collection may lie with local municipalities; however, the State is clearly the beneficiary of these funds. Revenue offsets include certain federal funds, a \$0.50 property tax levy, the governmental services tax, franchise fees, the opening fund balance, and other local revenues and adjustments. Combined, these offsets are projected to account for \$470 million in FY 2002-03, roughly 140 percent more than the \$196 million they generated in FY 1990-91. Please see Exhibit 4B-25.

The property tax, other local revenue, and franchise fee components have all been growing sources of per pupil funding. In FY 1990-91, these revenues accounted for \$970 per pupil (in inflation adjusted terms), or 76 percent of the basic per pupil support offset total. By comparison, in FY 2002-03, these revenue offsets are budgeted to account for \$1,070 per pupil, roughly 90 percent of the combined total. Federal funding³⁷ and available opening fund balances have been variable and declining during the study period. Federal funds, which accounted for an inflation adjusted \$28 per pupil in FY

³⁶ See *Billion-dollar sequel foreseen for Nevada Power rate case*, Associated Press as Reported in the Las Vegas Sun. December 2001; see also *Consumer Advocate criticizes Nevada utility's claims*, Associated Press as Reported in the Las Vegas Sun. October 14, 2002; see also *State blames Nevada Power for utility's financial woes*; Associated Press as Reported in the Las Vegas Sun. October 11, 2002; see also *Nevada Consumer Advocate warns of rate hike*, Associated Press as Reported in the Las Vegas Sun. September 30, 2002; Kaniger, S. *Mulroy: Power bid 'borne out of necessity'*, Las Vegas Sun. October 18, 2002; see also *Sierra hit with new shareholder lawsuit*, Las Vegas Sun. October 2, 2002. Edwards, J. *Nevada Power rate hikes loom, banker warns: Remarks by Morgan Stanley director back water authority's buyout offer*. Las Vegas Review Journal. October 2002; see also Edwards, J. *NEVADA POWER: Utility might face bankruptcy*. March 29, 2002. *SNWA Proposal to Purchase Nevada Power*, letter from Pat Mulroy. August 22, 2002. <http://www.snwa.com/html/news1.html>; see also *Sierra Pacific response to SNWA proposal*, letter from Walt Higgins. September 12, 2002. <http://www.snwa.com/html/news1.html>; see also *Proposal to Purchase Nevada Power*, Presentation to SNWA Board. August 22, 2002.

³⁷ Not all federal funding is accounted for within the State's distributive school account (DSA).



1990-91, were budgeted to account for only \$11 per pupil in FY 2002-03, a compound annual average decline of 10 percent. Please see Exhibit 4B-26.

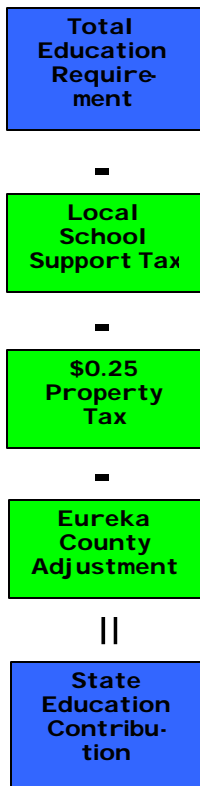
The projection of these revenue offsets is important because, to the extent that they increase or erode in inflation adjusted per pupil terms, the State's general fund obligations will either increase or decrease by a proportionate, yet inverse, sum. In total, we anticipate that these sources of revenue will continue to slightly outpace enrollment and inflation growth, averaging roughly \$1,200 per pupil in inflation adjusted terms through FY 2010-11. Property taxes, franchise fees, and governmental services taxes are all highly stable sources of revenue. The State's commitment to use program fund balances to support education and its ability to secure additional and/or continued federal funding remain uncertain and susceptible to considerable variation throughout the next 10 years.

A number of programs are funded using the DSA but are "outside" of the per pupil support formula; and thus, must be removed from the total funding calculation. These programs include adult education, special education and counseling services, and special transportation. In total, these programs are budgeted to cost \$93 million in FY 2002-03, and are anticipated to grow at the rate of enrollment and inflation growth.

In total, basic per pupil support is budgeted to total \$1.4 billion in FY 2002-03, or \$4,000 per student. This represents a 140 percent increase in aggregate basic per pupil support and a 29 percent increase in basic support per pupil since FY 1990-01. Please see Exhibit 4B-27 and 4B-28. These increases, however, are somewhat misleading. In inflation adjusted terms, basic per pupil support is projected to reach \$3,660 in FY 2002-03, more than \$200 less than the average reported over the past 12 years. Please see Exhibit 4B-29.

Basic per pupil support is not the end of the education funding formula. The next step is to add additional and special program funding to the basic support figure.³⁸ These programs are a part of the DSA distributions, but are sometimes referred to as "outside" the basic support calculations. Included are class size reduction, special education, the adult diploma program, and gifted and talented student programs. School improvement programs such as the Nevada Early Intervention Program, professional development offerings, and remediation programs have also been included at different times since FY

³⁸ These expenditures, sometimes referred to as "one shot" appropriations, represent an allocation for programs that merit inclusion in the overall State budget. However, there should be some concern that funding these programs from budget to budget can cause erratic application of policy or the cessation of a valuable program in which a significant investment of time and money has been made



1989-90. Finally, specially funded programs, including the SMART student records database, the state education technology initiative, distance education programs, and the students-to-careers program are also added to the additional and special programs total.

Combined, these programs are budgeted to total \$214 million, or roughly 15 percent of the basic per pupil support total. Please see Exhibit 4B-30. Additional and special programs have historically represented only six to seven percent of total basic per pupil support. In FY 1999-2000, however, recognition of the State's class size reduction program³⁹ added more than \$82 million to total education program costs. The class size reduction program is budgeted to require \$100 million in FY 2002-03. Projections for these programs reflect the rates of inflation and enrollment growth based on budgeted FY 2002-03 spending levels.

The combined total of basic per pupil support and additional and special programs is referred to as the "total education requirement." This term is also the source of some confusion as it tends to imply a figure representing the combined cost of education programs funded through the DSA. Actually, however, a number of revenue offsets (i.e., governmental services tax, a \$0.50 property tax levy, and franchise fees) are removed from the true funding total in determining basic per pupil support. This figure is merely the total, as yet unfunded. In inflation adjusted per pupil terms, this number has ranged from a high of \$4,380 (FY 1999-2000) to a low of \$4,020 (FY 1994-95). It is budgeted to be \$1.7 billion in FY 2002-03, or \$4,200 in inflation adjusted per pupil terms for FY 2002-03.

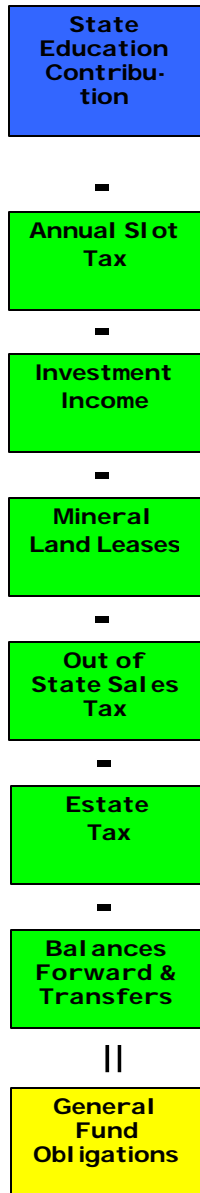
Additional "local" offsets that are not used to calculate basic per pupil support are deducted from the combined total of basic support and special and additional program costs to estimate the State's total funding obligation. Again, it is important to note that while these revenue sources are classified as "local," city and county governments have little or no control over their levy or distribution. They are effectively state revenue sources. These local offsets include the local school support tax⁴⁰ and a \$0.25 property tax levy. The local school support tax is a 2.25 percent component of the State's 6.5 percent retail sales and use tax levy.⁴¹ The tax generates more than \$600 million annually

³⁹ Nevada's Class Size Reduction Program affects only grades 1 through 3.

⁴⁰ The local school support tax is a 2.25 percent retail sales and use tax levy.

⁴¹ Note that the referenced 6.5 percent levy is the base rate. The actual rate in any particular jurisdiction may vary depending on additional local levies.

for Nevada’s education programs, and is the largest single source of education funding. The \$0.25 property tax levy generated an estimated \$120 million in FY 2000-01.



During the past several years, retail sales and use taxes have been a relatively robust source of revenue. As noted in the *Retail Sales and Use Tax* subsection, *supra*, the sales tax base has been impacted by recent economic downturns and there are concerns that the levy’s long-run weaknesses will become more pronounced as the State’s overall rate of growth slows. It is important to note that the local school support tax is merely an offset to a predetermined funding amount (see basic per pupil support and special and additional program discussions, *supra*). Thus, holding all other revenue sources constant, any failure of the local school support tax to meet expectations will require additional, supplemental funding from the State’s general fund. While the funding derived from property taxes is anticipated to remain relatively stable in inflation adjusted per capita terms, funding from the local school support tax is projected to decline slightly through FY 2010-11. Please see Exhibits 4B-31 and 4B-34.

The difference between the basic support calculation and the local revenue offsets is referred to as the “state share” or “state contribution.” These terms tend to be somewhat misleading for the uninitiated because they imply that non-state revenue sources have provided all of education funding thus far in the formula. As noted on multiple occasions previously, such an assertion is far removed from practical reality. This confusion is compounded by the fact that the state general fund contribution is often shown as the first line item in the state share funding computation. In actuality, however, all non-general fund revenue sources are being subtracted from the basic support and additional and special programs funding requirements (less the identified offsets) to determine the remaining “funding gap,” or the State’s general fund obligation. Nevada’s education funding formula is effectively a zero sum game with a predetermined outcome.

Revenues incorporated in the “state contribution” calculation include annual slot tax,⁴² investment income, mineral land leases, out-of-state sales tax collections,⁴³ estate tax revenues, fund balances forward, refunds, and certain interest earnings. In FY 2002-03 these sources were budgeted to account for \$145 million, nearly three times the \$55 million contribution recorded in FY 1990-91. Please see Exhibits 4B-35 and 4B-36. In inflation adjusted per pupil terms, the non-general fund state revenues have provided a

⁴² Annual slot taxes that are used to support education are total collects less \$5 million, less the 20 percent dedicated to the Special Higher Education Capital Construction Fund.

⁴³ Out of state sales are those that cannot be attributed to any particular county.

declining source of revenue, with only the out-of-state sales showing any substantive growth during the past 10 years. Please see Exhibits 4B-37 and 4B-38.

Continued declines are anticipated for these "state" revenue sources. The estate tax has been repealed by the federal government and will be effectively phased out over the next several years; the annual slot tax has been declining in per pupil terms since FY 1989-90, and we see no reason to believe it will diverge from its current course; and out-of-state sales tax suffers from the same erosion problems as the local school support and state sales taxes. As these levies decline, additional funds must be contributed by the State's general fund to maintain existing program levels.

The final step in the State's education funding regime is to fill in the residual gap with general fund dollars. Historically, general fund appropriations to the distributive school account have been between 34 and 40 percent of the identified total funding requirements and 80 percent of the "State's" contribution. Please see Exhibits 4B-39 and Exhibit 4B-40. In FY 2002-03, general fund appropriations were budgeted to be \$648 million. This total represented a 132 percent increase over the \$276 million appropriated in FY 1989-90.

At the end of the fiscal year, the balance remaining is either carried forward to the following year, or it reverts to the State's general fund.⁴⁴ Of the \$313 million which carried forward or was reverted between FY 1990-91 and FY 2000-01, 25 percent was carried forward to fund the subsequent year's education programs and 75 percent was reverted to the state general fund. The average year-end balance was \$28 million, and in only one year (FY 1990-91) was a negative year-end balance reported. Please see Exhibit 4B-41.

Shortfalls in key revenues funding state education programs are anticipated to lead to negative fiscal fund balances at the close of FY 2001-02 and FY 2002-03. The biennium shortfall has the potential to reach more than \$90 million, a sum that must be "made up" by the 2003 Legislature prior to beginning the subsequent biennium's funding cycle. The unexpectedly rocky economic waters which have challenged Nevada during the last 18 months well-illustrate the problems intrinsic to the education funding system's structural integrity. While this funding mechanism may serve to stabilize funding from year to year,

⁴⁴ At the end of the first year of the biennium the balances are carried forward to the second year (or funding from the second year is advanced to the first year in cases of shortfalls, as in FY 2001-02). At the end of the biennium any balances are reverted to the State's general fund. If the shortfall still exists the Legislature is required to provide a supplemental appropriation to make up the difference.

it ultimately results in a deteriorating level of per pupil allocation and magnifies structural and cyclical deficits.

While the DSA is the primary funding mechanism related to education in the State of Nevada, more than \$250 million is also provided to education through federal funding programs, interagency transfers, fund balances forward, and other funds. Please see Exhibit 4B-42.

Combined, these sources represent total state spending on education. Again, we caution that this total does not represent total education funding, nor should these estimates be confused with spending on school "operations." The estimates provided herein include several types of federal funding, interagency transfers, and miscellaneous program funding. For FY 2002-03, total education spending is budgeted to be more than \$2.4 billion. Please see Exhibits 4B-43 and 4B-44.

University and Community College System of Nevada (UCCSN)

The University and Community College System of Nevada ("UCCSN") comprises a number of educational institutions and agencies, including: the University of Nevada, Las Vegas; the University of Nevada, Reno; the office of the Chancellor; state and community colleges; specialty schools; research institutes; and other similar and related entities. Total UCCSN funding budgeted for FY 2002-03 is approximately \$534 million, with roughly 69 percent of the funding total attributable to state general fund appropriations. Please see Exhibit 4B-45. In inflation adjusted per capita terms, UCCSN funding is budgeted to be \$9,530 per student in FY 2002-03, a 17 percent increase over the \$7,940 per student reported in FY 1990-91. Please see Exhibit 4B-46.

UCCSN funding projections were modeled independently at the aggregate level (i.e., for the entire system and not each institution individually). This process was undertaken with the much-appreciated assistance of UCCSN staff, and is described briefly in the sections that follow.

Caseload Estimates

High, mid and low estimates for total student head count and full-time equivalent ("FTE") enrollment were provided to the Task Force by UCCSN staff. These data were compared to population forecasts prepared by the Nevada State Demographer's office; the two data files were quite consistent.

Between FY 1989-90 and FY 2001-02, Nevada has reported a full-time equivalent enrollment count that ranged from 40 to 46 students per 1,000 residents. The mid-case scenario holds this ratio relatively constant through the projection period. In total, full-time equivalent enrollment is anticipated to grow from the 49,600 estimated for FY 2001-02, to approximately 60,400 by the close of FY 2010-11. Please see Exhibits 4B-47 through 4B-49.

UCCSN Cost Projection

UCCSN is funded through a number of fees, grants, appropriations and authorizations. There is more flexibility in the UCCSN funding model than in the K-12 education regime due to the variable nature of student enrollment fees.⁴⁵ In FY 2002-03, these fees are budgeted to represent 20 percent of total UCCSN funding. The State's general fund, however, accounted for the lion's share, representing \$370 million of the \$534 million budgeted, or roughly 69 percent. Please see Exhibits 4B-50 and 4B-51.

It is well documented that the tuition costs for higher education are increasing at rates considerably faster than the rate of inflation nationally and in Nevada.⁴⁶ In fact, tuition has been increasing at between two and three percentage points higher than overall inflation for the last 10 years. This trend is anticipated to continue for the foreseeable future by most experts.⁴⁷ Combined registration and other student fees are projected to grow from the \$109 million figure budgeted for FY 2002-03 to more than \$194 million by FY 2010-11. In inflation adjusted, per FTE enrollee terms, this represents an increase of 23 percent, or from \$1,943 to \$2,400 per FTE. Please see Exhibits 4B-52 and 4B-53.

A second important consideration in the UCCSN funding analysis is the role of the estate tax.⁴⁸ UCCSN has an estate tax endowment, which is a fund from which the base value is generally held for investment and new revenues, including investment proceeds, and are generally available for funding on-going operations. There are three problems with this revenue source: 1) the *Economic Growth and Tax Relief Act of 2001* phases out Nevada's

⁴⁵ Please see reports issued by the Committee to Study the Funding of Higher Education, S.B. 443 (1999).

⁴⁶ See The College Board, Tuition Inflation, <http://www.finaid.org/savings/tuition-inflation.phtml>; see also, reports issued by the Committee to Study the Funding of Higher Education, S.B. 443 (1999).

⁴⁷ See Thompson Financial Network College Dataset; see also The College Board, Tuition Inflation, <http://www.finaid.org/savings/tuition-inflation.phtml>.

⁴⁸ Note that Nevada does not have an estate tax per se, but rather, it has an estate tax pick-up credit. Under federal law, a credit is allowed each state against the federal estate tax, up to a certain amount for each estate. See Nevada Taxpayers Association, *Nevada Tax Facts*, 2001.

estate tax;⁴⁹ 2) the State has opted to spend portions of the base value, eroding the endowments potential to produce future revenues; and 3) weaker financial markets have generated fewer monetary returns on invested capital (base monies).

Changes in federal laws regarding estate taxes are anticipated to result in sharp declines in estate tax credit collections for Nevada and the UCCSN during the next several years. In FY 2000-01, UCCSN's share of Nevada's estate tax credit generated just over \$21 million. Please see Exhibit 4B-54. By the close of FY 2004-05, it is projected to generate only \$1 million. At the same time, however, the State has looked to estate tax for an increasing share of UCCSN funding. The estate tax is budgeted to fund 7.7 percent of the UCCSN's FY 2002-03 costs, 1.6 percentage points higher than the amount reported in FY 2000-01 and 3.0 percentage points higher than the total reported in FY 1997-98. Please see Exhibit 4B-55.

Increasing the UCCSN's dependence on estate tax credit and fewer new revenues being generated from the source and its investment has begun to erode the UCCSN's estate tax endowment. At the close of FY 2000-01, the endowment had an estimated \$123 million. By the close of FY 2002-03, the endowment will total roughly \$74 million. The combination of poor investment performance⁵⁰ and shifting of more than \$27 million from the endowment capital account to the UCCSN's operating account has decreased the value of the endowment by approximately 40 percent.

The more troubling question from a fiscal modeling standpoint is what to anticipate in the coming fiscal years. The State may either choose to use the endowment as it was originally intended, drawing significantly less revenue from it each year, or it may deplete the endowment by continuing to draw on its capital balance. While such a course of action appears contrary to the endowment's intended purpose, the fundamental assumption underlying this analysis forces us to assume the latter. A policy decision was made by the 2001 Legislature to generate \$800 per FTE enrollee from estate tax credit

⁴⁹ The *Economic Growth and Tax Relief Reconciliation Act of 2001* (H.R. 1836) reduces the state death tax credit by 25 percent from present law amounts in 2002, by 50 percent from present law amounts in 2003 and by 75 percent from present law amounts in 2004. Nevada will also lose revenue because of changes to the estate tax exemption, which increases from \$675,000 in 2001 to \$1 million in 2002 and to \$1.5 million in 2004. In 2005 the state death tax credit is repealed, meaning that there will be no Nevada estate tax applicable to the estate of persons who die after December 31, 2004. However, because of delays in the settling of estate tax obligations, Nevada will continue to collect some tax revenue for another year or more. See Legislative Council Bureau, Fiscal Analysis Division, *Revenue Reference Manual*, December 2001.

⁵⁰ Poor performance is related to the overall condition of the financial markets. This is not intended to be commentary on the investment acumen of the UCCSN or its financial advisors.

revenues. This required the increasing capital draws budgeted in FY 2001-02 and FY 2002-03. To maintain the same funding level, the State would have to draw \$35 million from the endowment in FY 2003-04 and \$14.4 million in FY 2004-05. The reason for the decline in FY 2004-05 is the fact that the UCCSN estate tax endowment is fully depleted at that point. Please see Exhibits 4B-56 and 4B-57.

A number of "other" revenue sources are also used to fund higher education. These include federal funds, indirect cost recoveries, operating capital investment income, discretionary funds, indirect training grants, county funds, and miscellaneous revenues. In FY 1997-98, these revenues accounted for \$12.8 million, or 3.3 percent of the UCCSN's funding total. By comparison, in FY 2002-03, budgeted funding from other sources increased to \$13.3 million, but represented only 2.5 percent of the UCCSN's funding total. Please see Exhibit 4B-58. In inflation adjusted per FTE enrollee terms, we anticipate that other revenue sources will decline from \$238 to \$224 per FTE enrollee between FY 2002-03 and FY 2010-11. Please see Exhibit 4B-59.

The balance of UCCSN funding has come, and will likely continue to come, from the State's general fund. As noted above, the general fund has represented a declining share of UCCSN funding since FY 1989-90, when it accounted for roughly 82 percent of the total. By comparison, in FY 2002-03 that figure is budgeted to decline to 69 percent, or \$371 million. The decline is largely attributable to more aggressive increases in student registration fees and charges as well as an increased reliance on estate tax credit revenues. The erosion of the latter and moderate expectations for "other" revenue sources is anticipated to put increasing pressure on the State's general fund. By FY 2006-07, we anticipate that the State's general fund will need to provide 73 percent of UCCSN funding to maintain existing service levels. Please see previously noted Exhibits 4B-50 and 4B-51.

Human Services

Human Services is the second largest of the State's primary functions. It consists of all state agencies providing services directly to the general public, including the Department of Human Resources, aging services, welfare, Medicaid, mental health, child and family

services, the Department of Employment, Training and Rehabilitation, and several others.⁵¹

In FY 2002-03, Human Services was budgeted to account for 28 percent of state spending, or roughly \$542 million. In inflation adjusted per capita terms, human services program costs have outpaced inflation growth by 0.8 percent per year. In FY 2002-03, per capita inflation adjusted costs are anticipated to reach \$226, up from the low of \$194 per capita reported in FY 1993-94. Please see Exhibits 4B-60 through 4B-62. It is important to note that there have been countless policy changes at the state and federal level that have significantly impacted spending in a number of human services divisions, not the least of which is the Health Care Financing and Policy Division (Medicaid and Nevada Check Up) and the Welfare Division, which combine to account for roughly 60 percent of Human Services spending. Moreover, recent economic events have also put upward pressure on the demand for and cost of services administered by the Department of Human Resources. These increases are reflected in the presented near-term caseload estimates.

Costs in both the Health Care Financing and Policy and Welfare Divisions have been modeled independently. The caseload and service cost projections for these programs are briefly discussed in the sections that follow. The balance of Nevada's Human Services programs are projected to grow in proportion to increases in population and reflect overall cost inflation. By FY 2010-11, Human Services programs are projected to reach \$855 million, growing at a compound annual rate of roughly six percent.

Health Care Financing and Policy (Medicaid and Nevada Check-Up)

The mission of the Division of Health Care Financing and Policy ("HCFP" or the "division") is to purchase and ensure the provision of quality health care services, including Medicaid, to low income Nevadans; to promote access to affordable health care; and to maximize Nevada's ability to capitalize on federal health care programs.⁵² HCFP administers a number of programs, including Medicaid, Nevada Check-Up, and the Intergovernmental Transfer Program.

⁵¹ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

⁵² *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

The division accounts for approximately 50 percent of all Health Services spending, or approximately \$275 million annually. HCFP has reported significant growth in both aggregate and in inflation adjusted per capita terms. Program costs are anticipated to increase at roughly 7.3 percent compounded annually, reaching \$480 million by FY 2010-11. Please see Exhibits 4B-63 through 4B-65. A review of caseload growth and program funding data for Nevada Medicaid and Nevada Check-Up are provided below.

Caseload Estimates

Representatives of the Department of Human Resources provided caseload estimates by program to the Task Force.⁵³ These data were reviewed and rebased to ensure internal consistency with other demographic and economic variables used in the modeling process. The revised estimates were then resubmitted to HCFP to ensure uniformity of understanding and that the Task Force's estimates were reasonable.

Caseload projections were made for 11 programs. They included:

- Temporary Assistance to Needy Families Grants ("TANF");
- Temporary Assistance to Needy Families – Related Medicare Recipients;
- Child Health Assurance Programs ("CHAP");
- Aged Programs;
- Blind Programs;
- Disabled Programs;
- Total Qualified Medical Beneficiaries;
- Total Special Level Medical Beneficiaries;
- The County Match Program;
- Child Welfare; and
- The Nevada Check-Up Program.

Where possible, the caseloads for each program were projected based on growth in the population segment eligible to participate in the program. Children's programs, for example, were projected based on increases or decreases in the population under the age

⁵³ Please see March 20, 2002 *Presentation by the Department of Human Resources to the Nevada Tax Study Group*. Provided to the Governor's Task Force on Tax Policy.

of 18.⁵⁴ Exhibits 4B-66 through 4B-76 provide historical and projected caseload estimates by program and estimated eligibility per 1,000 residents.

Assuming no program changes, Medicaid-related caseload growth is anticipated to decrease in the short-run, but remain higher in per capita terms than the average reported during the past 10 years. In FY 1992-93, the Medicaid caseload was reportedly 72,600, or approximately 51 participants per 1,000 residents. In FY 2001-02 and FY 2002-03, the total number of participating persons increased to an estimated 143,500 and 153,000, respectively. Program changes, a number of economic challenges, and an aging population pushed the number of eligible persons per capita up to 55 and 65 in FY 2001-02 and FY 2002-03, respectively, in those years. The Medicaid caseload is anticipated to see declines over the next couple of years as the economy continues to improve; however, the number of participating persons per capita is anticipated to stabilize at around 60, a rate roughly 7 percent higher than historical averages.

While it mirrors the medical benefits and services available to persons eligible to participate in Medicaid, the Nevada Check-Up program stands separate from the other programs outlined above.⁵⁵ Essentially, the Nevada Check-Up program provides medical coverage for children under the age of 18 from families with incomes up to 200 percent above the poverty level. In FY 2000-01, 15,000 children were enrolled in the program, or roughly 26.5 children for every 1,000 persons under the age of 18.

Nevada Check-Up caseload growth is anticipated to increase by double digit rates between FY 2001-02 and FY 2004-05, as more families become aware that these programs are available and apply for coverage. By FY 2004-05, the program is anticipated to approach its equilibrium, servicing just over six percent of the population under the age of 18.⁵⁶ By the close of the study period, FY 2010-11, some 46,000 children are anticipated to be eligible for and participating in the Nevada Check-Up program. Please see Exhibit 4B-77.

⁵⁴ Population by age projections were provided by the Nevada State Demographer's Office.

⁵⁵ See The Balanced Budget Act of 1997, which created the State Children's Health Insurance Program under Title XXI of the Social Security Act.

⁵⁶ Interview with representatives of the Great Basin Primary Care Association. August 2002. Representative stated that between six and seven percent of the population would be eligible to take advantage of the Nevada Check-Up program based on a study they conducted using data provided by Mathematica, Inc. Note also that the Health Services staff also referred the Task Force working group to the organization. Email dated 8/20/02.

Health Care Financing and Policy Cost Projections

Health Care Financing and Policy funding requirements are based on per eligible person cost estimates provided by the Department of Health Resources.⁵⁷ These estimates assumed that the cost per eligible person will remain relatively constant, in inflation adjusted terms, over the next several years. These estimates, however, reflect health care costs rising at the rate of overall inflation. As noted in previous sections, there is substantial evidence that the cost of health care has been rising at roughly 1.9 percentage points faster than the overall rate of inflation; as such, the per eligible cost was adjusted to reflect this more robust growth rate.⁵⁸

Per eligible person estimates were available for TANF, CHAP, aged programs, blind and disabled programs (combined), county match, child welfare, and qualified and special level medical beneficiaries (combined). Caseload cost estimates were also provided for the Nevada Check-Up program, but again, this program was treated independently. In total, the average cost per eligible person for all programs increased from \$3,700 in FY 1991-1992 to the \$4,700 projected for FY 2002-03.⁵⁹ This represents a compounded annual growth rate of roughly 2.5 percent.⁶⁰ Exhibits 4B-78 through 4B-86 illustrate the historical and projected cost per eligible person for all Medicaid programs (combined and individually) as well as the Nevada Check-Up program.

A total cost estimate for Medicaid programs is obtained by combining the projected caseloads by program and the estimated costs per eligible person. In FY 1991-92, Medicaid program costs totaled roughly \$230 million. In FY 2002-03, they are estimated to reach nearly \$725 million, and by FY 2010-11, they are projected to reach nearly \$1.2 billion. Including administrative and other expenses, the cost to maintain current service levels is estimated to be \$1.4 billion in FY 2010-11, approximately 68 percent higher than the amount projected for FY 2002-03. Please see Exhibits 4B-87 and 4B-88.

Not all Medicaid program costs are borne by the State. Federal Title XIX grants, which provide monies to offset Medicaid costs and account for more than 40 percent of all

⁵⁷ Please see March 20, 2002 *Presentation by the Department of Human Resources to the Nevada Tax Study Group*. Provided to the Governor's Task Force on Tax Policy.

⁵⁸ United States Department of Labor, *Bureau of Labor Statistics*, Consumer Price Index Data, September 2002. Series for Medical and Overall Inflation 1990 through June 2002.

⁵⁹ Nevada Check-Up program is excluded from this calculated average.

⁶⁰ Id.

federal grants-in-aid,⁶¹ are projected to contribute an estimated \$460 million in FY 2002-03, or a little more than 50 percent of combined program costs. The amount of money that Nevada receives from the federal government is largely dependent on a mathematical allocation formula referred to as the Federal Medical Assistance Percentage ("FMAP"). The FMAP is a function of several demographic and socio-economic factors such as personal income and population.⁶² Changes in these variables resulting from the 2000 Census and other technical modifications are anticipated to substantially increase Nevada's allocation of Medicaid dollars during the next several years.⁶³

One respected analyst who specializes in federal funds concluded, "The most substantial projected FY 2004 FMAP increases would be experienced by Nevada..."⁶⁴ This is a material issue considering the fact that a one percentage point increase in the FMAP would likely result in an additional \$10 million to the State for Medicaid programs, and Nevada's FMAP is projected to increase from 50 percent in FY 2001-02 to more than 54 percent in FY 2003-04.⁶⁵ Exhibit 4B-89 illustrates Nevada's projected FMAP percentage as well as a projected time series of Medicaid grants-in-aid.

While there are increases in the FMAP percentage that may decrease the State's ultimate funding requirement for Medicaid, there are also factors which may serve to increase it. One of those factors is the transfer of funds from the Human Services Director to Medicaid programs.⁶⁶ Roughly \$55 million is available to be transferred each year. A revenue surplus allowed as much as \$95 million to be shifted into Medicaid programs to address rising costs (FY 2000-01). By the close of FY 2002-03, however, this surplus is projected to be fully depleted. With no alternative revenue source, the general fund will likely be required to supplement these revenues if existing service levels are to be maintained. Please see Exhibit 4B-90.

⁶¹ Federal Funds Information for States, *Issue Brief 02-26 Preliminary FY 2004 FMAPs*. April 24, 2002.

⁶² Federal Funds Information for States, *Issue Brief 02-26 Preliminary FY 2004 FMAPs*. April 24, 2002; *see also* Federal Funds Information for States, *Issue Brief 01-04 Population Shifts Will Affect Federal Medical Assistance Percentages*. January 2001; *see also* Federal Funds Information for States, *Issue Brief 02-24 Preliminary FY 2003 FMAPs*. April 25, 2001; *see also* Federal Funds Information for States, *Issue Brief 01-53 2003 FMAPs: A Trail of Broken Promises*. September 25, 2000; *see also* Federal Funds Information for States, *Issue Brief 01-56 2003 FMAPs: Bureau Meets Their Match*. October 19, 2001.

⁶³ *Id.*

⁶⁴ Federal Funds Information for States, *Issue Brief 02-26 Preliminary FY 2004 FMAPs*. April 24, 2002.

⁶⁵ *Id.*

⁶⁶ GL 4750. *See also* Please see March 20, 2002 *Presentation by the Department of Human Resources to the Nevada Tax Study Group*. Provided to the Governor's Task Force on Tax Policy.

In addition to the illustrative considerations briefly outlined above, nearly 100 Medicaid program-related revenue and expenditure categories were projected through the balance of the study period. This analysis would not have been possible without the data and expertise provided by the skilled and diligent staff and management of the Department of Human Resources. Revenue requirements remaining after all other sources were exhausted were assumed to be borne by the State's general fund. The general fund has historically accounted for between 27 and 33 percent of all Medicaid program spending. This percentage is expected to decline in the early years of the study period, as the State benefits from an increased federal matching percentage, and then level off at approximately 31 percent by FY 2010-11. Total general fund requirements are anticipated to grow from \$270 million to \$450 million, or at a compound annual rate of 6.3 percent, between FY 2002-03 and FY 2010-11. Please see Exhibit 4B-91.

The Nevada Check-Up program, which is similar to Medicaid programs, but stands alone for budgeting and analysis purposes, has historically received roughly one-third percent of its funding from the State's general fund. This percentage is expected to remain relatively stable during the foreseeable future. Increases in program participation and medical inflation outpacing that of overall inflation are anticipated to translate into a 9.6 percent annual growth rate in required general fund appropriations. By FY 2010-11, the Nevada Check-Up program is anticipated to require \$32 million in general fund appropriations, roughly double the amount budgeted for FY 2002-03. Please see Exhibit 4B-92.

Welfare Programs

In FY 2001-02, Nevada's welfare programs accounted for approximately 12 percent of Human Services' general fund appropriations and roughly 3.3 percent of the State's appropriations total. The Welfare Division is charged with administering the delivery of cash grants and food stamps, enforcing child support, administering employment and training programs for welfare recipients, distributing child-care funding, and determining eligibility for Nevada's Medicaid programs.⁶⁷ While the Welfare Division administers a number of programs, the Temporary Assistance to Needy Families ("TANF") program, accounts for the largest share of State general fund welfare appropriations. As such, it is the primary focus of this analysis.

⁶⁷ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

Changes in program availability, federal funding, eligibility requirements, and the overall health of the economy makes welfare cost estimates challenging. Legislation currently pending in the United States House of Representatives and Senate appear to support the presumption that the status quo will be maintained,⁶⁸ and Congress recently extended existing TANF programs through December 2002. Conversations with the Welfare Division's staff and management also suggested a continuation of generally similar programs and funding through the next several years is considered likely. Caseload and cost projections for TANF are provided in the sections that follow.

Caseload Estimates

Between FY 1989-90 and FY 2000-01, the number of TANF recipients per 1,000 residents has varied from a low of 8.3 in FY 1999-2000 to a high of 25.2 in FY 1994-95. The average during the period was 18.1. Welfare reform in the late 1990's established a new funding regime and made several legal changes that reduced the number of persons eligible for TANF benefits and shortened the length of time those benefits could be received. The impacts of these changes on Nevada's caseloads are clearly illustrated in Exhibit 4B-93.

Recent economic events, including a mild recession beginning in March of 2001 and statewide layoffs following the tragedies of September 11, 2001, resulted in an increasing share of residents applying for welfare benefits. TANF caseloads were budgeted to reach 17,800 in FY 2001-02 and 18,400 in FY 2002-03. The actual reported caseload estimate for FY 2001-02 was 32,700 and the revised projections for FY 2002-03 topped 34,000. In per resident terms, the caseload, which had dropped to 8.5 in FY 2000-01, increased to nearly 15 in FY 2001-02.

Nevada's TANF caseload is anticipated to peak during FY 2002-03, declining thereafter to a stabilized rate of between 9 and 10 participants per 1,000 residents. We note, however, that the outcome of national welfare reform initiatives has the potential to greatly impact the number of persons eligible for and participating in these programs.

⁶⁸ See House Resolution 4737 Personal Responsibility, Work, and Family Promotion Act of 2002 (Engrossed as Agreed to or Passed by House); see also House Resolution 4737 Personal Responsibility, Work, and Family Promotion Act of 2002 (Reported in Senate).

Welfare Cost Projections

Welfare reform in the late 1990's proved to be beneficial to the State of Nevada. In its most general terms, funding from the federal government was frozen in the form of annual block grants, with an additional population-based adjustment for high growth states.⁶⁹ Annually, Nevada receives a \$44 million block grant to be used for welfare programs.⁷⁰ The population adjustment adds an additional three to four million dollars annually.⁷¹

As the number of TANF recipients decreased between FY 1996-97 and FY 2000-01, Nevada had increasingly more federal dollars with which to provide welfare programs to needy families. Some monies were saved, some were redirected, and some were used to implement new and expanded programs. The cost per TANF recipient increased significantly between FY 1997-98 and FY 2000-01, from \$1,870 to \$3,100 per participant. And, many of the dollars placed in reserve have been depleted in response to the overwhelming demand experienced during the past 18 months. Please see Exhibit 4B-94. Discussions with Welfare Division staff and management suggest that the cost per recipient for existing TANF programs will be roughly \$2,700 to \$2,800 for existing programs during the current biennium (e.g., FY 2001-03). We have adjusted this value to reflect inflation, and used it for the basis of our projections.

The benefits of federal welfare reform (and funding) will naturally erode with time. Holdover regulations promulgated to allow Congress's continued debate on the merits of additional reform have left Nevada in an increasingly disadvantageous position. For FY 2001-02 and FY 2002-03, Nevada's federal grant population adjustment will likely go unchanged from the \$3.7 million allocated in FY 2000-01. The population, on the other hand, has continued to increase, as have the State's welfare rolls. Moreover, discussions with Welfare Division experts regarding the likely outcome of pending legislation suggests that existing funding levels are "the best that can be expected," reserving the

⁶⁹ Interview with Welfare Division Staff, August 2002. Recent developments suggest that efforts headed by Sen. Harry Reid may result in some additional funding for Nevada's welfare programs by the close of 2002. This would likely come in the form of revised population-based funding, and could result in between \$1 million and \$3 million annually. If these efforts were to be successful, our modeled assumptions would need to be revisited.

⁷⁰ Note that, to receive federal funding, the State is required to provide \$27,188,122 each year for TANF programs. This represents 80% of 1995 State spending under the previous program.

⁷¹ Id.

possibility for potential declines associated with increasingly limiting conditions for participation in welfare programs.

The result of this assumption implicitly requires additional general fund appropriations to maintain existing service levels. Where historically general fund appropriations have represented between one-quarter and one-third of total program funding, they are projected to account for 40 to 50 percent of the TANF program funding total through FY 2010-11. Please see Exhibit 4B-95.

Additional state appropriations notwithstanding, anticipated declines in the overall caseload will likely result in declines in the level of state welfare funding per capita. Maintaining existing programs is anticipated to cost the State roughly \$76 million in FY 2002-03, increasing to only \$80 million by 2010. In inflation adjusted per capita terms, this is a decline from \$30 per capita to \$22 per capita. Please see Exhibit 4B-96.

Commerce and Industry

The State's commerce and industry function is comprised of those state agencies responsible for licensing or regulating various businesses and financial activities operating within the State of Nevada.⁷² Accounting for just over two percent of the 2001-03 biennium general fund appropriations, commerce and industry functions include the Department of Business and Industry; the Department of Agriculture; the Nevada State Gaming Control Board; the Public Safety Commission; the Commission on Economic Development; and the Commission on Tourism.

General fund appropriations for commerce and industry functions are budgeted to be \$40.1 million in FY 2002-03. They have grown at a compound annual growth rate of 2.2 percent since FY 1992-93, and are projected to increase at the rate of inflation and population growth through the balance of the study period. By FY 2010-11, total commerce and industry-related appropriations are expected to reach \$58.4 million, with an average annual growth rate of 4.3 percent. Please see Exhibits 4B-97 through 4B-99.

⁷² *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

Public Safety

The State's public safety function includes the Department of Corrections,⁷³ the Department of Motor Vehicles, and the Department of Public Safety.⁷⁴ Combined, these functions are budgeted to receive general fund appropriations totaling \$207 million in FY 2002-03, roughly 10 percent of the statewide total.

Between FY 1990-91 and FY 2002-03, public safety appropriations have increased by 146 percent or from \$84 million to \$207 million. In inflation adjusted per capita terms, this appears to equate to a very stable growth trend, at between \$82 and \$83 per capita at each end of the referenced period. Policy changes, program differences, and other variables have led to a more dynamic trend than these bookend statistics might tend to imply. Please see Exhibits 4B-100 through 4B-102.

Combined, general fund appropriations allocated to all public safety functions are anticipated to increase by 5.8 percent per year, reaching \$335 million by FY 2010-11. The Department of Corrections, which operates Nevada's prison system, receives the majority of these appropriations. Corrections account for 53 percent of all state public safety spending and receive roughly 84 percent of all public safety general fund appropriations.

The Department of Corrections is a major function of state government and has been modeled independently. An overview of caseload and spending estimates is provided in the sections that follow. The balance of the State's public safety functions is projected to grow at the rate of population and inflation growth.

Department of Corrections

The Department of Corrections ("Corrections") administers the State's diverse prison and correction system. In 2002, a *Study Committee on Corrections* was created to examine Nevada's correctional programs and make recommendations on how to bring them into line with nationally accepted principles and standards.⁷⁵ After six months of study and

⁷³ Formerly the Department of Prisons.

⁷⁴ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. 71st Legislature, September 2001.

⁷⁵ Report to Governor Kenny C. Guinn, *The Study Committee on Corrections*, October 2002.

analysis, the Committee released its report in October 2002. The report made a number of meaningful recommendations that presumably will increase the effectiveness and efficiency of the State's correctional system should they be implemented.⁷⁶

This important body of work notwithstanding, our analysis does not assume any changes in policy or practice with regard to the State's correctional programs. In FY 2002-03, the State's cost per inmate was \$19,600. At an inmate population of 10,800, total program funding was approximately \$212 million. Caseload and service costs projections are discussed in turn below.

Caseload Estimates

The Nevada Department of Corrections retains the services of the Institute on Crime, Justice and Corrections at George Washington University (the "Institute") to produce 10-year state prison population forecasts.⁷⁷ The latest set of projections was released in March of 2002 and is for the years 2002 through 2012.⁷⁸ These data were used in our analysis and suggest moderate declines in the State's prison population per capita in the early years of the study period. Please see Exhibits 4B-103 through 4B-105.

Between 1991 and 2002, the State's inmate population reportedly grew from 6,000 to 10,600, or at a compound annual rate of 5.3 percent. In per resident terms, this resulted in a relatively stable ratio of inmates per 1,000 residents. During the 11-year period, the inmate population per 1,000 residents ranged from a low of 4.5 (1993) to a high of 5.1 (1998). The Institute's projections suggest a decline in this ratio to 4.6 through 2005, with an increase to roughly 5.0 by 2011. By the close of the study period, Nevada's prison population is projected to reach 13,800.

Department of Corrections Cost Projections

Department of Corrections' cost estimates were based on the historical cost of housing the inmate population each year, with emphasis on per inmate costs budgeted for FY 2002-03. In FY 2002-03, the cost per inmate was budgeted at \$19,600. In inflation

⁷⁶ Id.

⁷⁷ Naro, W., *Nevada Department of Prisons Ten-Year Prison Population Projections: 2002-2012*. The Institute on Crime, Justice and Corrections at George Washington University. March 2002.

⁷⁸ Note that the prison population projections are for calendar years and not fiscal years.

adjusted terms, this translates into \$17,950 per inmate and is down roughly \$200 from the \$18,200 per inmate reported in FY 1999-2000. Please see Exhibit 4B-106.

Discussions with Corrections' officials and a review of related literature in the area indicates that the service cost per inmate may rise at a rate faster than inflation, given the existing level of deferred maintenance, the rising cost of power, the aging of the inmate population, increases in health care costs, and the "ominously" low levels of inmate services provided in Nevada. While detailed information on all of these areas was not readily available, there appears to be ample evidence supporting the assertion that the cost of administering the State's corrections system will rise faster than the overall rate of inflation.⁷⁹

To maintain existing service levels, Nevada Department of Corrections' costs are anticipated to increase to \$349 million by FY 2010-11, with the State's general fund accounting for approximately 81 percent of that figure (\$282 million). Please see Exhibit 4B-107. On a per inmate basis, this reflects an average cost of \$25,600 in the final year of the study period.

Infrastructure

The infrastructure functions of the State include those agencies responsible for Nevada's capital assets and natural resources.⁸⁰ Included are the Department of Transportation, the Colorado River Commission and the Department of Conservation and Natural Resources.⁸¹ In FY 2002-03, general fund appropriations allocated to these functions are budgeted to reach \$21.6 million, a little more than one percent of the statewide total.

Infrastructure appropriations have increased at a compound annual growth rate of roughly 2.4 percent, or from \$17.1 million in FY 1992-93 to the \$21.6 million budgeted for FY 2002-03. In inflation adjusted per capita terms, infrastructure appropriations have actually declined from \$14 per resident to \$9 per resident. This is not to say that state spending on

⁷⁹ See Prison Health Services, Inc. *White Paper on Health Care Costs, New Parameters for Partnerships in Correctional Health Care*; see also Report to Governor Kenny C. Guinn, *The Study Committee on Corrections*, October 2002; see also United State's Department of Justice Federal Prison System Cost Per Inmate 1975 through 2003 (showing costs per inmate rising at rates faster than inflation since 1998). http://www.usdoj.gov/jmd/budgetsummary/btd/1975_2002/2002/html/page117-119.htm; see also Keith, R. *Checking up on prison health care*. March 2001. <http://www.lib.niu.edu/ipo/ii010323.html>.

⁸⁰ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division, 71st Legislature, September 2001.

⁸¹ *Id.*

these important programs has been reduced; rather, other sources of revenue (i.e., gas taxes) have supplemented these programs and lessened the burden on the State's general fund. Please see Exhibits 4B-108 through 4B-110.

In maintaining existing programs, we assume that infrastructure appropriations will grow at the same rate as population and inflation. As such, total appropriations are anticipated to reach \$31 million by FY 2010-11, representing a 10-year compound annual growth rate of 4.5 percent.

Special Purpose Agencies

Special purpose agencies are those that have a specialized function or have a different statutory relationship to the executive branch than most other agencies.⁸² Included are the Public Employees' Retirement System, the Public Employees Benefits Program, the Office of the Military, and the Office of Veterans' Affairs.⁸³ Budgeted general fund appropriations for special program agencies were \$6.5 million in FY 2002-03, roughly 0.3 percent of the State's general fund appropriations total.

General fund appropriations to special program agencies have increased significantly during the past several years. In FY 1992-93, total appropriations were \$1.2 million. This is only about one-sixth the figure budgeted in FY 2002-03, and represents a compound annual growth rate of 19 percent. These increases, however, are largely tied to changes in program policy reported during the period.⁸⁴ As such, special program agency appropriations are anticipated to increase at the rate of population and inflation growth through FY 2010-11. Please see Exhibit 4B-111 through 4B-113.

⁸² *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division, 71st Legislature, September 2001.

⁸³ *Id.*

⁸⁴ *Nevada Legislature Appropriations Report*, Legislative Counsel Bureau, Fiscal Analysis Division. Selected installments for FY 1989-90 and FY 1990-91 through FY 2001-02 and FY 2002-03.