

Fiscal Issues in West Virginia

Introduction

This document provides a brief review of government finance, outlines some of the major fiscal issues facing West Virginia, outlines major tax reform issues for the State, provides a summary of FY2004 budgeted State expenditures, and provides some additional analysis of government employment trends.

Government goods and services are generally provided to individuals and businesses in exchange for taxes, the price paid to receive a service. The laws of supply and demand apply to both private goods and public goods. Demand for goods and services rise when prices fall and vice versa. However, unlike the private sector, public sector goods and services are generally provided to an individual regardless of whether or not the individual fully paid or even partially paid for such good or service. Some individuals (e.g., certain interstate travelers) never pay for the use of a public good (e.g., Interstate 81 in the Eastern Panhandle). In other cases, government may act on behalf of individuals who do not possess the means to pay for key services (e.g., medical care). Some individuals and businesses may pay more for government goods and services than they receive back in order to subsidize the cost of government goods and services for others. In certain cases, demand for government services (e.g., free medical care under Medicaid) can become insatiable. Government's response options to insatiable demands for service are generally limited to direct tax increases, a transfer price solution (e.g., decrease medical payments to service providers who shift the extra cost to others), or a rationing of the service.

In the United States, three separate levels of government, the federal government, state government and local government, collectively provide a package of public goods and services in exchange for taxes. Local governments tend to be most accountable to Taxpayers with regard to a balance between taxes levied and services provided, and the federal government is least accountable. The ability to redistribute taxes collected from one individual Taxpayer for use in providing services to another individual increases significantly from the local government level to the state government level to the federal government level. West Virginia and its citizens collectively receive far more federal government service dollars than is paid by West Virginia citizens in taxes -- at the expense of other states such as Connecticut. Some county boards of education (e.g., Lincoln County) receive far more State aid dollars than the county generates in State tax dollars. The more closely a Taxpayer associates a tax paid with a government service provided, the more scrutiny given such service.

Local government fiscal responsibility varies greatly from one state to the next. In the United States, local governments generate roughly 38% of all state-local tax revenue. Local government plays a bigger than average role in New Hampshire, where local governments generate roughly 50% of total state-local tax revenue. Local government plays a much smaller than average role in West Virginia, where local governments generate only 23% of total state-local revenue (17% after removal of the State-set regular

education property tax levy). Local governments play a much smaller role in government finance in West Virginia than in any other state.

Major Financial Issues in West Virginia State Government

With a constitutional balanced budget constraint, state government has far less capacity to influence private sector economic development than the federal government. If a state government regularly balances its budget without resorting to financial gimmicks, minimizes its unfunded liabilities, minimizes risks to future budgets, achieves and maintains a top rating from bond rating agencies, and minimizes its regulation and taxation of private sector activities in a responsible fashion, then that state government will maximize its impact upon economic growth. This section outlines four of the major financial issues currently facing State government policymakers.

- 1) Medicaid expenditures are growing faster than state-local tax revenues in all 50 states. On the national level, this expenditure is expected to grow by roughly 11% per year. Most of the expected growth is due to increased service demands. Services to senior citizens and disabled persons consume roughly 75% of all expenditure dollars. The number of senior citizens is growing due to the aging of the baby boom generation and to an ever-increasing life expectancy level. With the exception of a small-scale estate recovery mechanism, medical services provided under Medicaid are provided free-of-charge to the individual. Federal rules govern the Medicaid program, and it is very difficult for states to depart from those rules. West Virginia's share of this program's cost is quickly approaching \$500 million.
 - a. The Federal Government must be a player in designing a long-term comprehensive solution to this problem.
 - b. In the short-term, the Medicaid funding problem is the principal factor leading most states to a gambling expansion solution.

- 2) Many state and local governments are struggling with unfunded defined benefit pension obligations. In West Virginia, the State Teacher's Defined Benefit Plan represents the most under-funded teacher's retirement plan in the country. The State has a plan to fully fund this plan over the next 30 years through increased contributions that gradually rise from more than \$285 million in FY2004 to more than \$730 million in FY2034. Major contributing factors to pension obligation deficits include a failure by some past policymakers to provide scheduled state matching fund payments during tight budget years prior to 1990, lower than expected returns on investment, and a trend of ever-increasing life expectancy. When the federal government established the social security system in the late 1930s, the average life expectancy was around 65 years of age. The current life expectancy for individuals living in the United States is now more than 77 years of age. Several local government pension systems also suffer from management structures (e.g., a three member decision-making group consisting of the police chief, the fire chief and the mayor) that encourage the addition of new enhanced benefits (e.g., cost-of-living adjustments) without consideration of long-term cost.

- a. The pension obligation problem can be eased over time by following the lead of the private sector in the gradual conversion of pension plans from defined-benefit plans to defined-contribution plans. The State of West Virginia has already made progress in this area with the establishment of new defined-contribution pension plans for teachers and police officers.
 - b. The current payment schedule for the under-funded teacher's retirement system will tend to crowd out other discretionary expenditures over time. However, the State could save roughly \$1.75 billion over the next 30 years, if additional funds become available to convert the payment schedule into a flat annual payment amount. The flat annual payment schedule would require an additional allocation of roughly \$110-\$120 million next fiscal year. If a flat payment rate were established, other programs (e.g., Higher Education) would no longer face the prospect of being gradually crowded-out in future years.
 - c. Local government pension finance problems cannot be adequately addressed until there is local pension management reform to remove incentives to increase benefits without regard to their cost. These local finance problems eventually become problems for the State.
- 3) Contrary to popular misconception, a "bloated level" of government employment is not a major problem in West Virginia. West Virginia has the second lowest State and local government employee payroll per capita in the country. However, the State offers certain employees the unique benefit of free health care insurance for a period following retirement based upon the employee's number of unused sick days. The cost of this unique benefit will mushroom over time as baby boomers begin retiring in mass. This benefit will effectively reduce the State's ability to provide future government services, and will effectively reduce the State's ability to provide future pay raises to employees.
 - a. Future costs can be reduced, if the State chooses to aggressively retreat on this benefit offer.
 - b. Future costs within this area can be reduced, if the State successfully encourages prospective retirees to delay their retirement until they near the age of 65. Medicare becomes the primary insurance carrier at age 65.
- 4) The State's worker's compensation program has a significant unfunded liability, imposes higher than average premium rates, and pays higher than average benefits per covered worker. In West Virginia, the percentage of State personal income attributable to worker's compensation is thirteen times the national average. The cost of the current program places West Virginia at a competitive economic disadvantage with other states and other countries.
 - a. Recent reform legislation should help ease future burdens, if upheld by the courts.
 - b. The State is examining the possibility of converting its current program into a private program over time.

- c. Conversion to a private program will only work if the governing rules set by the State and interpreted by the courts provide a friendly environment to the private insurer.

Tax Reform Issues in West Virginia

When it comes to government finance, there is no such thing as a perfect tax structure. Indeed, most individuals view true tax reform as a change that provides them with some relief from the payment of current taxes. Any discussion of tax reform should be centered on the objectives and principles of a “good” tax structure.

A “good” tax structure should comply with six separate, but often competing, objectives. The distribution of the tax burden should be fair and equitable with similarly situated Taxpayers paying similar amounts of tax. Taxes should be imposed in an efficient way to minimize interference with economic decisions in otherwise efficient markets (i.e., broad-based, low-rate taxes are generally preferable to narrowly applied taxes with high rates). The tax system should be competitive with those of other jurisdictions. If the system offers investment incentives, those investment incentives should minimize interference with the equity of the system. The tax structure should produce reliable revenues that facilitate the use of fiscal policy for stabilization and growth objectives. The tax system should permit fair administration and should be easily understandable to the Taxpayer. Finally, the tax system should be designed with simplicity, so that administrative and compliance costs are minimized.

Two principles of taxation have gained prominence in modern thinking: the ability-to-pay principle and the benefits principle. Under the ability-to-pay principle, those who have the means to pay for services should pay more than those without the means to pay for services. The personal income tax and corporate net income tax best embody the ability-to-pay principle (i.e., those with higher income will pay a greater rate of tax than those with lower income). Under the benefits principle, tax payments closely match the value of government services. General examples of benefit-type taxes include the motor fuel excise tax (a fee for the use of roads), consumer sales tax and property tax. Tax system competitiveness and fiscal efficiency may be compromised in those jurisdictions that rely too heavily upon ability-to-pay taxes for government finance. However, tax system equity or fairness may be compromised in those jurisdictions that rely too heavily upon benefit-based taxes for government finance. Individual demand for government services tends to be greater in those jurisdictions that rely too heavily upon ability-to-pay taxes (e.g., federal government). In contrast, the imposition of a relatively heavier tax burden associated with a benefit-based tax on lower income residents for the benefit of programs consumed by all residents, including higher income individuals, (e.g., subsidized college tuition) may be seen as unfair or inequitable.

Ability-to-pay taxes can be modified to more closely reflect a benefits-based tax (e.g., imposition of a lower income tax rate on income above certain levels), and benefit-based taxes can be modified to more closely reflect an ability-to-pay tax (e.g., sales tax exemption for groceries). However, such modifications can often compromise the tax

system's overall efficiency, equity, competitiveness, simplicity, understandability, stability or reliability. Efforts to turn a benefit-based tax into an ability-to-pay tax can often backfire. For example, the property tax rate imposed upon homeowners within West Virginia is one-half of the tax rate imposed upon all other real property within the State. Presumably, the reduced tax rate on homeowners was designed with the ability-to-pay principle in mind. However, lower income residents have a greater tendency to rent their housing, and those rents include an embedded property tax imposed upon landlords at a rate that is double the rate paid by the better-off homeowner. With the exception of the income tax, all direct taxes on business activity should ideally be benefit-based, even though there is always a temptation to tax a business based upon its size (i.e., the big out-of-state corporation should pay more than small in-state business philosophy).

There are three major types of taxes, taxes imposed upon income, taxes imposed upon general consumption and taxes imposed upon property. Nationally, these types of taxes collectively account for roughly 90% of all state-local tax revenue. However, in West Virginia, these types of taxes account for less than 80% of all State-local tax revenue. In addition to the three major types of taxes, other taxes generally include various license fees and various narrow-based business privilege taxes.

John Shannon, a renowned expert in the area of state and local public finance, often described state and local tax systems as three-legged stools. An optimal tax structure contained three strong legs with nearly equal weights given to the property tax, the sales tax and the income tax. When the total taxes imposed by all 50 state governments and all local governments are combined, the property tax, the sales tax (including selective sales and excise taxes on motor vehicles, motor fuels, alcohol, tobacco and public utility services), and the income tax (including both the personal income tax and the corporate net income tax) account for roughly 29%-property tax, 31%-sales tax and 29%-income tax of total taxes collected. In West Virginia, the property tax, the sales tax and the income tax account for roughly 20%, 32% and 27% of total taxes collected, respectively.

How does the West Virginia State and local tax system measure up to the objectives and the principles behind a good tax system? The West Virginia tax system's biggest long-term problem is its lack of adequate base capacity necessary to finance the various services desired by the residents of the State. Relative to population size, the West Virginia private sector economy (i.e., the tax base), as measured by private sector gross state product per capita, is only two-thirds of the size of the national average private sector gross state product per capita. However, West Virginia residents generally demand services (e.g., education, health care, police protection) that are on par with government services received by residents of other states. In addition, this limited tax base is further strained by the various limitations of a constitutionally imposed property tax. The property tax revolt in West Virginia (i.e., Tax Limitation Amendment of 1932) predated the much more publicized California property tax revolt by more than four decades, and generally imposed maximum tax rates for four separate classes of property that still apply to this day. Following the enactment of this amendment to the State Constitution, government service responsibilities began migrating from tax-limited local government units to the State government. Today, financial responsibility for state and local

government services is more heavily concentrated at the state level in West Virginia than in any other state. The increased pressure to finance services at the State level combined with a much lower level of tax capacity has resulted in significant stress upon State income taxes, State sales taxes and various miscellaneous State business privilege taxes and license fees. In this environment, the State of West Virginia has great difficulty competing with other states in the area of competitive tax structure.

The Governor's Commission on Fair Taxation, Recommendations to the Governor (1999) and related materials provide a significant amount of research, data and recommendations on the subject of tax reform within West Virginia. Tax reform solutions may vary from study to study, but the underlying problems remain unchanged. The following outline represents a brief evaluation of six major taxes currently imposed within West Virginia:

1) Local Property Tax

- a. The local property tax, a tax on the assessed value of both real property and tangible personal property, provides an inadequate level of revenue support for State and local finance.
- b. The share used for local functions, other than education finance, (i.e., 32.6%) is far less than optimal. Property tax administration would improve if local governments kept a bigger share of total receipts.
- c. The local share is not necessarily evenly split between county governments and municipal governments. For example, roughly 60% of the Kanawha County Commission's property tax revenues are attributable to property located within the limits of various municipalities within the County. However, most county services (e.g., police protection) are provided to residents and businesses outside of the municipal boundaries. Municipalities within Kanawha County receive only 31% of total budgeted County-municipal property tax revenues. The current structure promotes sprawl, as Taxpayers within municipalities subsidize services for those in unincorporated areas.
- d. The property tax represents the largest source of tax revenue from businesses both nationally and in West Virginia. However, by some estimates, nearly two-thirds of all property taxes paid nationwide is attributable to residential properties, but less than one-fourth of property taxes paid in West Virginia is attributable to residential properties. Even though the property tax is a relatively small source of total revenue in West Virginia, the overall property tax burden on capital-intensive businesses located within the State is high relative to other states.
- e. West Virginia is one of no more than five states currently imposing property taxes upon manufacturing inventories (Freeport inventories are exempt from tax). Effective tax rates on manufacturing inventories and other business inventories are higher in West Virginia than elsewhere.
- f. Effective tax rates on business personal property, including equipment, machinery and inventory are high in comparison with other states. The most significant recommendation of the Fair Tax Commission was the

elimination of most personal property taxes. High taxes on personal property discourage capital formation and business development within the State.

- g. Residential property taxes are among the lowest in the country. In West Virginia, the typical annual property tax on a \$60,000 home (assuming that the home is correctly assessed at 60% of fair market value) is \$435 for a non-homestead exemption home, \$193 for a homestead exemption home occupied by someone with moderate to high income, and \$73 for a homestead exemption home occupied by someone with low to moderate income. More than 30% of all owner-occupied homes within the State are eligible for the homestead exemption, a partial to full tax exemption, available to those over the age of 65 and permanently disabled persons. For comparison purposes, the typical annual property tax on a \$60,000 home in New Hampshire and Vermont is closer to \$5,000.
- h. The current property tax structure heavily promotes residential development and population maintenance over business development, and may be a contributing factor to a smaller than average size private sector economy in West Virginia.
- i. The current property tax structure encourages municipalities to seek business properties and highways for annexation purposes rather than residents. The tax yield on residential properties falls far short of the cost of associated government services.
- j. The tax structure recommended by the Fair Taxation Commission would not have eased the State's over reliance upon State revenues to pay for state and local government services. Under certain scenarios, State control would actually increase. For practical reasons, the Commission decided not to seek any increase in local residential property taxes as part of its overall plan.

2) Local Municipal Business and Occupation Tax (Local B&O)

- a. The Local B&O tax is a business privilege tax based upon gross receipts imposed at various rates on most business activities within a municipality.
- b. In West Virginia, the Local B&O tax generally accounts for more than 60% of total municipal tax revenues, the property tax generally accounts for less than 28% of total tax revenues and most of the remaining tax revenues are attributable to public utility taxes and hotel-motel taxes. Nationally, sales and gross receipts taxes combined account for only 26% of total municipal tax revenues, and most of that revenue is attributable to retail sales taxes. Property taxes account for roughly 53% of total municipal tax revenues, personal income taxes account for 10% of municipal revenues and excise and license taxes account for the remaining 11%. There is no authority for local retail sales taxes or local personal income taxes in West Virginia.
- c. The Local B&O tax is a pyramiding gross receipts tax on business activity ranging from the manufacturing of a product, to the wholesale distribution of a product to the retail distribution of the same product.

- d. The Local B&O tax discourages business formation within municipalities, especially for the manufacturing sector. For some businesses, the Local B&O tax either represents the single largest tax paid in West Virginia or the second largest tax paid after the local property tax.
- e. One of the original objectives of the Fair Taxation Committee was to find replacement taxes for the Local B&O tax. However, the Local B&O tax is such a large component of municipal finances that replacement taxes based upon either retail sales or personal income would have to approach rate levels currently charged by the State. The final recommendations of the Commission call for granting local governments the authority to impose local option sales and income taxes, but falls short of recommending an outright repeal of the Local B&O tax.

3) Consumer Sales Service and Use Tax (Sales Tax)

- a. West Virginia's current 6% Sales Tax comes closer to representing an optimal tax than sales tax structures in most other states. This retail consumption-based tax is imposed upon a broad base that includes sales of both goods and many services. In addition, West Virginia offers several exemptions designed to eliminate tax on business inputs for businesses engaged in the activities of agriculture, manufacturing, mining, transportation, transmission, communications and public utilities.
- b. The most commonly discussed reform for sales taxes involves the extension of those taxes to service activities. West Virginia already taxes more service activities than any other state with the exception of Hawaii, New Mexico and South Dakota.
- c. The Fair Taxation Commission recommended extending the current sales tax base to most professional and personal services (e.g., services provided by public accountants, lawyers, beauticians and manicurists).
- d. The Fair Taxation Commission recommended the elimination of various out-dated state public utility gross receipt taxes (e.g., State B&O tax and telecommunications tax) in favor of extending the Sales Tax to sales of electricity, natural gas, water and telecommunications services.
- e. The Fair Taxation Commission recommended the elimination of the 5% Privilege Tax on automobiles and other vehicles in favor of extending the Sales Tax to such sales.
- f. Absent federal legislation requiring collection of tax by remote vendors, states will experience some gradual erosion of tax revenues associated with "tax-free" sales to in-State consumers from out-of-state remote vendors.

4) Personal Income Tax

- a. West Virginia's current Personal Income Tax comes closer to representing an optimal tax than personal income tax structures in many other states. The personal income tax's ability-to-pay tax structure piggybacks off of statutory and regulatory federal personal income tax definitions for federal adjusted gross income. West Virginia tax rates are generally competitive

with most other states, and the tax forms are easier to understand and complete than forms in many other states.

- b. West Virginia imposes tax on some people with income below the poverty line. In addition, the current mechanism to relieve low-income people from taxation, the \$10,000 exclusion, is highly inequitable for those whose income is slightly greater than the \$10,000 cut-off. The cost of providing total income tax relief for those at or below the poverty level in an equitable manner is significant (e.g., nearly \$40 million under one alternative plan). The Fair Taxation Commission recommended the elimination of all of the various special income tax exclusions for certain public sector retirees and people over the age of 65 in favor of a significantly higher income exclusion level designed to shield those with income below the poverty guideline from income tax.
- c. Special income tax exclusions for some, but not all, pensions create equity problems for the tax system. Equity problems sometimes lead to litigation. Everyone would like to be treated like a policeman or fireman when it comes to excluding pension income from personal income tax. However, the State lacks the capacity to provide broad-based pension income tax exclusions.

5) Corporation Net Income Tax (Corporate Tax)

- a. In West Virginia, the Corporate Tax is imposed at a rate of 9% on federal taxable income apportioned and allocated to the State. The average tax rate for all 50 states is closer to 7%. This tax currently yields less than \$100 million per year.
- b. Due to complexity, proper administration of corporate income taxes requires significant resources at both the federal and state level.
- c. West Virginia is one of only 15-16 states conforming to temporary federal bonus depreciation for new investments made between September 11, 2001 and December 31, 2004.
- d. As of January 1, 2003, the effective tax rate on the State's manufacturing industry was generally reduced from 9% to 4.5% with the addition of the new Manufacturing Investment Tax Credit.
- e. West Virginia could eventually enhance its Corporate Tax revenues by adopting combined reporting unitary filing requirements. However, tax administration costs would rise significantly in the process.
- f. The Fair Taxation Commission recommended replacing the Corporate Tax with a value-added tax structure.

6) Business Franchise Tax

- a. In West Virginia, the Business Franchise Tax is business privilege tax imposed at a rate of 0.7% on the apportioned balance sheet net equity of corporations and partnerships. This tax currently yields roughly \$110 million per year. The tax base of net equity is narrow in comparison to tax bases of similar taxes imposed in Kentucky (equity and debt), North

Carolina, Tennessee, Louisiana and Pennsylvania. However, the tax rate generally exceeds rates imposed by other states.

- b. Prior to current budget problems, Pennsylvania was in the process of phasing-out its franchise tax.
- c. West Virginia uses revenue from the Business Franchise Tax and a myriad of other business privilege taxes to help compensate for the revenue shortcomings of the local property tax.
- d. West Virginia state taxes would be more competitive if the State could find a way to eliminate this tax.
- e. The Fair Taxation Commission recommended replacement of the Business Franchise Tax with a value-added tax structure.

Focus on Fiscal Year 2004 Budgeted Expenditures

With the power to make its own currency, the Federal Government has the ability to stimulate the economy through deficit spending policies. Deficit spending can be any combination of tax decreases and expenditure increases resulting in total expenditures exceeding total revenues. Deficit spending generally helps to stimulate an economy during periods of cyclical downturn.

Unlike the Federal Government, state and local governments must generally adhere to a balanced budget policy where total expenditures never exceed total revenues. Whenever tax revenues decrease during cyclical downturns, state and local governments must often respond with budget cuts and tax increases [i.e., policies that exacerbate the downturn] to maintain fiscal balance.

Some State government programs are counter-cyclical with costs rising during cyclical downturns. For example, unemployment compensation and Medicaid costs tend to rise during downturns as the State assists families that have lost jobs or income. These counter-cyclical programs enhance the difficulty of balancing a budget during a cyclical downturn. The State also has very limited flexibility when it comes to certain program expenditures such as debt service, Medicaid, and retirement contributions.

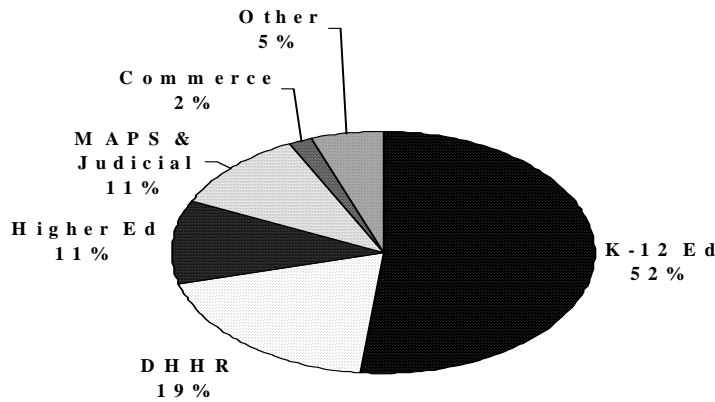
Figure 1 on the following page illustrates General Revenue Fund appropriations by broad function category for fiscal year 2003-2004.

Public Education [K-12 Ed] receives more than half of all General Revenue Funds, or \$1.57 billion out of a total of roughly \$3.034 billion. The majority of these funds [i.e., roughly \$1.5 billion] is distributed directly to the 55 county boards of education under the annual State aid to schools formula. Most of State aid funds are for salaries and benefits for teachers and school service personnel. As part of a 40-year financing plan, the funding includes a contribution of more than \$302 million to teacher pensions, including nearly \$250 million toward the State's nearly \$5 billion un-funded Teachers Retirement System liability. At the conclusion of Fiscal Year 2003-2004, the State still has another 30 years remaining on its financing plan for the un-funded retirement liability. Under the current payment plan, the required funding for this liability rises by roughly 3.2 percent

per year until it reaches an amount of roughly \$730 million in Fiscal Year 2033-2034. The un-funded liability payment represents the single largest mandatory increase required in the Fiscal Year 2004-2005 budget. According to preliminary calculations, the State needs to increase its contribution by an estimated \$42.5 million next fiscal year. This level of increase is equivalent to a 1.4 percent increase in total General Revenue Funds. If General Revenues fail to increase by 1.4 percent next year, reduced spending elsewhere must fund the mandatory contribution increase.

Figure 1

GRF Appropriations \$3.034 Billion in 2003-04



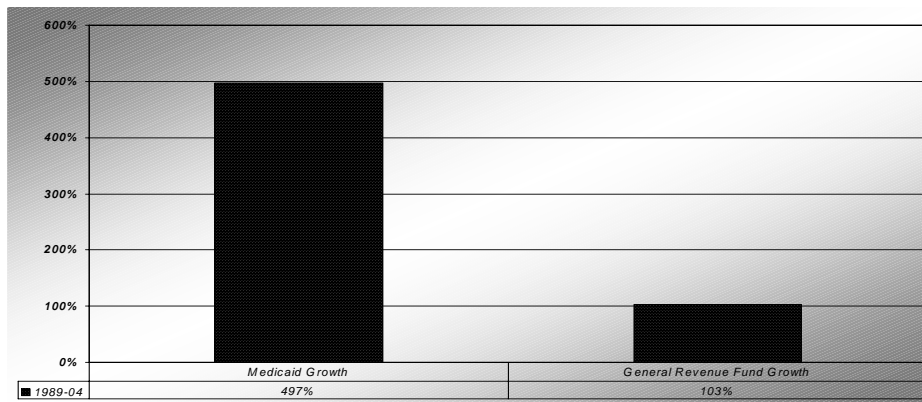
The Department of Health and Human Resources [DHHR] is allocated slightly more than 19 percent of total General Revenue, or nearly \$580 million. Major DHHR expenditures funded at least partially with General Revenue include various State health care facilities, Medicaid, family support services, social services, and public health services. State Medicaid matching funds account for roughly \$255 million of expenditures, and represent the single largest General Revenue Fund expenditure for this Department. In addition to General Revenue, the State uses special health care provider taxes, special reserve funds and lottery revenues to fund its share [i.e., roughly \$440 million] of the \$1.9 billion Federal-State Medicaid program. These special revenues help provide supplemental funding to a program that is growing much faster than overall revenues [See Figure 2 on the following page]. The DHHR allocation does not include roughly \$7 million in expenditures for the Children’s Health Insurance Program [CHIP], a program administered under the Department of Administration’s budget.

In addition to the Medicaid program and CHIP program, DHHR operates several health care facilities under its Bureau for Behavioral Health and Health Facilities. These

facilities include: Hopemont Hospital, Lakin Hospital, Marion Health Care Hospital, Mildred Mitchell-Bateman Hospital, Pinecrest Hospital, Welch Emergency Hospital and William R. Sharpe Hospital. In the Governor’s recommended budget for FY2004, DHHR was to receive \$92.2 million for these facilities and related programs.

Figure 2

Medicaid Costs Rise Faster Than General Revenues



Higher Education [Higher Ed] is allocated slightly more than 11 percent of total General Revenue, or nearly \$343 million. Public colleges and universities use most of these funds for faculty and support staff salaries.

The State allocates nearly 11 percent of total General Revenue to the public safety and the judicial functions of government [Military Affairs and Public Safety (MAPS) & Judicial]. Major expenditure categories include roughly \$100 million for correctional facilities, \$77 million for the State Police, \$74 million for the Supreme Court, \$28 million attributable to public defender services, and \$27 million for juvenile services. For budget purposes, public defender services expenditures are allocated to the Department of Administration. However, such services are classified as part of MAPS & Judicial in this analysis.

Commerce is allocated nearly 2 percent of total General Revenue, or nearly \$53 million. The West Virginia Development Office receives roughly \$24 million of these funds. Other major expenditure areas include more than \$12 million for the Division of Natural Resources, nearly \$6 million for the Office of Miners’ Health, Safety, and Training, roughly \$3.5 million for the Geological and Economic Survey, nearly \$3 million for the Division of Labor, and nearly \$3 million for the Division of Forestry.

After allocations of funds for K-12 Ed, DHHR, Higher Ed, MAPS & Judicial and Commerce, less than \$150 million remains for all other functions. These remaining

functions include roughly \$42 million for the operations of the executive offices of Governor, Agriculture Commissioner, Attorney General, Auditor, Secretary of State and Treasurer. The operations of the Legislature consume nearly \$27 million. Education and the Arts accounts for another \$26 million for the functions of the Library Commission, Division of Culture and History, Rehabilitation Services and Educational Broadcasting Authority. Remaining funds are attributable to Tax Administration [\$21 million], Environment [nearly \$9 million], Transportation [nearly \$8 million], and Senior Services [less than \$1 million].

Focus on State and Local Government Employment

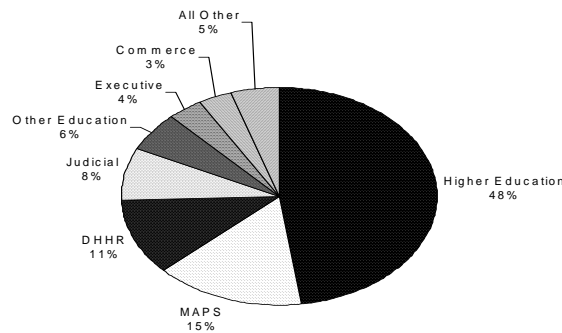
Some measure the size of government by the number of government employees. As of December 31, 2003, there were 15,812.30 full-time equivalent employees funded out of the State’s General Revenue Fund, and total payroll was \$572,197,984.82. Figure 3 illustrates General Revenue Fund payroll by major function. Note that public education employees are treated as local government employees and are not included in the State payroll numbers. Higher education accounts for roughly 39 percent of all employees and for 48 percent of all General Revenue Fund salaries. The next biggest share is attributable to public safety functions, such as State Police [5.5% of total salaries] and the Division of Corrections [6.8% of total salaries]. The Department of Health and Human Services [DHHR] has roughly 2,358 full-time equivalent employees funded out of the General

Figure 3

Distribution of General Revenue Fund Payroll Dollars

Source: State of West Virginia – Position Management System

\$572.2 Million Payroll as of 12/31/2003



Revenue Fund, and most of these employees are either with the Bureau of Behavioral Health and Health Facilities or with the Bureau for Children and Families. The Judicial Branch accounts for roughly 8 percent of total payroll or \$44.4 million. Public Education and Education and the Arts (i.e., Other Education) account for \$33.2 million in payroll. All other General Revenue functions, including Executive and Commerce, account for the remaining payroll of roughly \$68.3 million.

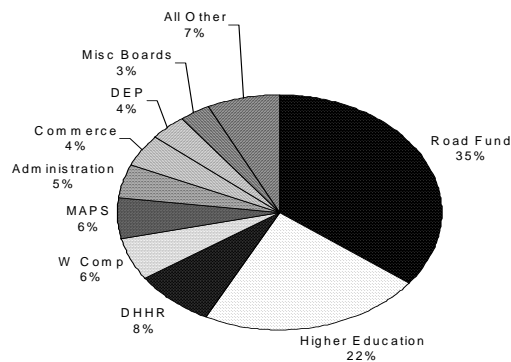
As of December 31, 2003, there were 14,312.85 full-time equivalent employees funded out of various special revenue funds with a total payroll of \$461,732,026.05. Figure 4 illustrates the distribution of special revenue payroll funds. Among other sources, special revenues include State Road Fund taxes [i.e., gasoline excise taxes, registration fees and privilege taxes], college tuition and fees, hunting and fishing fees, Worker's Compensation Premiums and fees for the operation of various regulatory boards and commissions (e.g., Public Service Commission).

Figure 4

Distribution of Special Revenue Payroll Dollars

Source: State of West Virginia – Position Management System

\$461.7 Million Payroll as of 12/31/2003



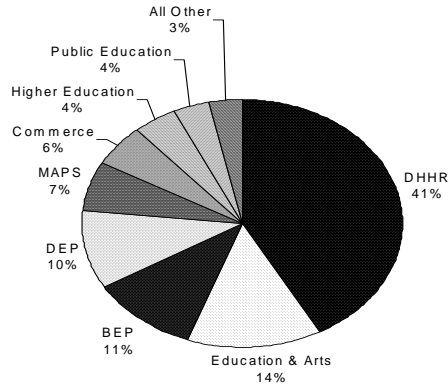
As of December 31, 2003, there were 4,051.07 full time equivalent employees funded out of federal funds with a total payroll of \$130,153,716.28. Figure 5 illustrates the distribution of federal payroll dollars.

Figure 5

Distribution of Federal Revenue Payroll Dollars

Source: State of West Virginia – Position Management System

\$130.2 Million Payroll as of 12/31/2003

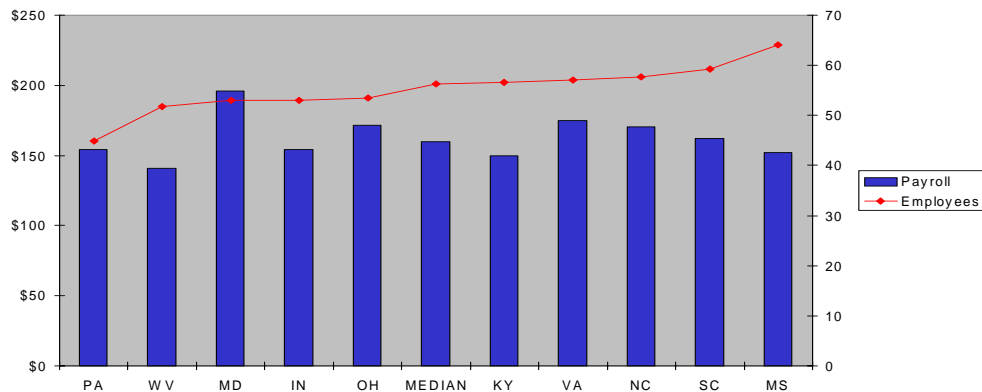


How does West Virginia State and local government employment and payroll compare with other states? The United States Census Bureau offers comparative information on state and local government employment on their website at www.census.gov, including a recent publication, *Government Employment March 2002*. According to this survey, there was an average of 54.64 full-time equivalent state and local government employees per 1,000 U.S. residents in March 2002, and total monthly state and local government payroll was \$183.1 per capita. West Virginia ranked 10th lowest among the 50 states with 51.72 state and local government employees per 1,000 residents. In terms of payroll, West Virginia ranked 2nd lowest with a per capita monthly payroll of \$141.07. West Virginia government per capita payroll was nearly 23 percent below the national average, but the State's overall per capita income was nearly 25 percent below the national average. States with a higher than average cost of living [e.g., Alaska and California] tend to have a higher than average per capita government payroll expenditure and vice versa. Figure 6 illustrates comparative payroll and employment information for West Virginia, Indiana, Kentucky, Maryland, Mississippi, North Carolina, Ohio, Pennsylvania, South Carolina and Virginia.

Figure 6

March 2002 Per Capita Payroll and Full-Time Equivalent Employees Per 1,000 Residents

Source: U.S. Census Bureau, *Government Employment March 2002*: Issued October 2003



Due to economies of scale, states with larger than average population tend to have below average state and local government employment per capita and vice versa. For the March 2002 survey, the states with the lowest number of government employees per 1,000 residents include Nevada [44.16], Pennsylvania [44.97], Florida [48.18], Arizona [49.00], Rhode Island [49.49], Michigan [50.65], Massachusetts [51.17], California [51.31], Illinois [51.35], and West Virginia [51.72]. The States with the highest number of government employees per 1,000 residents include Wyoming [83.33], Alaska [80.00], Nebraska [66.24], New Mexico [64.58], Kansas [64.34], Mississippi [64.14], Louisiana [62.50], New York [62.32], North Dakota [60.88] and Vermont [59.94]. Sixteen states, including West Virginia employ between 50 and 55 full-time equivalent government employees per 1,000 residents. The median level of state and local government employment per 1,000 residents was 56.22. West Virginia falls more than 8,000 full-time equivalent employees below the median.

The following table compares the size of state and local government employment in West Virginia with surrounding states, the 50-state median and the national average. Based upon a population of 1,800,975, West Virginia employs 5,258 fewer full-time equivalent state and local government employees than the national average. However, West Virginia employs 12,156 more full-time equivalent employees than Pennsylvania's benchmark. Over the years, Pennsylvania generally has the least number of full-time equivalent state and local government employees per capita. Large states, such as Pennsylvania, should greatly benefit from economies of scale with regard to government employment needs.

State	Full-Time Equivalent Employees Per 1,000 Residents	Calculated Change in Number of WV FTE's to Equal Size of Other State
West Virginia	51.72	0
Kentucky	56.54	+ 8,680
Maryland	53.00	+ 2,305
Ohio	53.46	+ 3,133
Pennsylvania	44.97	- 12,156
Virginia	57.12	+ 9,725
50-State Median	56.22	+ 8,104
National Average	54.64	+ 5,258

The overall difference between Pennsylvania and West Virginia is roughly 6.75 full-time equivalent employees per 1,000 residents using 2001 population data. The biggest difference in per capita full-time equivalent employees between Pennsylvania, West Virginia and the national average is in the area of K-12 Education. Pennsylvania employs 4.15 fewer full-time equivalent K-12 education employees per 1,000 residents than the national average and 4.27 fewer full-time equivalent K-12 education employees per 1,000 residents than West Virginia. Private schools play a more important role in Pennsylvania. In addition, public schools tend to be bigger in size, and there is no constitutional requirement involving adequate school finances or financial equity among schools in Pennsylvania. The second biggest difference is in the area of state-run hospitals. Pennsylvania operates less government run health care institutions than either West Virginia or the nation as a whole. Pennsylvania employs 2.18 full-time equivalent employees per 1,000 residents fewer than the national average and 1.12 full-time equivalent employees per 1,000 residents fewer than West Virginia in this area. In West Virginia, state and local government employment in the area of streets and highways is 1.31 full-time equivalent employees per 1,000 residents higher than in Pennsylvania. The largest remaining area of lower government employment in Pennsylvania is in the area of higher education. Pennsylvania employs 1.31 fewer full-time equivalent employees per 1,000 residents than the national average and 0.99 fewer full-time equivalent employees per 1,000 residents than West Virginia. In the area of liquor control, Pennsylvania employs 0.21 more full-time equivalent employees per 1,000 residents than West Virginia due to State-operated retail liquor stores in Pennsylvania. West Virginia employs 0.86 more full-time equivalent employees per 1,000 residents than Pennsylvania in the area of financial administration due largely to the State-run Workers' Compensation Program in West Virginia.

The following table compares per capita payroll costs associated with state and local government employment in West Virginia with surrounding states, the 50-state median and the national average. These payroll costs do not include insurance and retirement benefits. Based upon a population of 1,800,975, West Virginia's per capita payroll for March 2002 was \$141.07, and the annualized payroll per capita was \$1,692.84. West Virginia has the second lowest payroll per capita in the country [Arkansas has the lowest per capita payroll in the country at \$1,665.36]. West Virginia's annual state and local payroll costs would have to rise by approximately \$187 million to reach Kentucky's benchmark. The benchmarks for other states tend to be much higher. Cost-of-living variances around the country have a major impact upon variances in per capita payrolls.

State	Annualized Payroll Per Capita	Calculated Change in WV Payroll Costs to Equal Size of Other State
West Virginia	\$1,692.84	\$ 0
Kentucky	\$1,796.88	+\$ 187,373,000
Maryland	\$2,354.28	+\$1,191,237,000
Ohio	\$2,054.64	+\$ 651,593,000
Pennsylvania	\$1,853.28	+\$ 288,948,000
Virginia	\$2,099.04	+\$ 731,556,000
50-State Median	\$2,050.50	+\$ 644,137,000
National Average	\$2,197.20	+\$ 908,340,000

Differences in per capita employment levels may also be attributable to variances in government responsibilities from one state to another. For example, some states may operate government-owned electric power generating facilities. Other states may operate their own retail liquor establishments, or their own worker's compensation program.

Government employment generally rises whenever new programs are created or existing programs are expanded. If government employment reduction is the objective, the elimination of programs is key to a reduction in employment.