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POLICY BRIEF

A snapshot of the state's budget outlook

With an adopted 19% increase in spending, the total 2019-21 budget will still spend more than the 2017-19 budget no matter what lawmakers do.

By Jason Mercier,
Director, Center for Government Reform

June 2020

Key Findings

1. Washington's current 2019-21 budget is $53.3 billion. This level of spending is $8.6 billion, or 19% higher, than the 2017-19 budget.
2. Although the fundamentals of Washington's budget process are strong, the decision to enact large spending increases has put additional pressure on the ending fund balance and reserves.
3. Realizing there is no recession-proof tax structure, Washington's tax base and economic activity has produced substantial revenue growth prior to the global COVID pandemic and subsequent government restrictions on economic activity.
4. Washington voters have already rejected 10 straight income tax proposals.
5. Every state in the country and the federal Internal Revenue Service (IRS) unequivocally states a capital gains tax is an income tax.
6. There are serious budget implications of relying on a highly volatile capital gains income tax in a recession.
7. Acting early to reduce spending will help reduce the size of the problem for the next state budget (2021-23).
8. Facing a budget deficit in 2010, then Governor Chris Gregoire issued a proclamation to reopen state employee contracts.
9. Among the actions lawmakers should take immediately is to freeze new spending increases, rely on the state's emergency reserves and encourage federal officials to provide flexibility for the original CARES Act funding.
10. It is important these reductions happen while avoiding tax increases that would further burden families and employers as they try to recover from the government-imposed economic restrictions.

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Introduction

Washington's economic outlook has dramatically changed due to the global COVID pandemic and Governor Inslee's subsequent order in March to lock-down the state economy.

When the 2020 legislative session opened in January, the state was in the midst of strong economic growth leading to the opportunity for tax relief. Instead, lawmakers used that tax growth to increase the state budget even higher. Then the global COVID pandemic turned the state's financial outlook upside down. Washington's current 2019-21 budget is $53.3 billion. This level of spending is $8.6 billion, or 19% higher, than the 2017-19 budget.

This paper provides a snapshot of historical state spending and revenue growth, the projected budget deficit created by the economic lock-down policy, and options to help lawmakers address the budget deficit.

Substantial budget deficit projected

According to the state's official June 17 revenue forecast, nearly a $9 billion reduction in revenue from prior estimates is now projected through 2023. From the June 2020 forecast:

> "The June GF-S revenue forecast has been reduced by $4.5 billion in the current biennium and $4.4 billion in the next. Over half of the decrease is from declining sales taxes. The forecast of GF-S revenue for the 2023-25 biennium has been decreased by $4.5 billion."

A revenue reduction of this size is not a surprise realizing a majority of economic activity in the state has been shutdown by the governor's "Stay Home" orders for several months.

Washington's overall budget process is sound

While a deficit of this size is concerning, it is important to remember that Washington's budget process is sound. Washington relies on a generally stable mix of tax sources (relative to other states) and has a budget framework that requires a constitutionally protected reserve account (with automatic deposits) and a four-year balanced budget restriction to help reduce the impact of "bow wave spending." As noted by the state's recent credit rating from Standard and Poor's in 2019:[1]

> "Good recent economic growth relative to that of the nation and a sales tax-based revenue structure that has demonstrated less sensitivity to economic cycles than income tax-reliant states . . .
>
> "Washington's revenues have historically exhibited less cyclicality than others (due in part to the lack of a personal income tax) . . . we have observed that capital gains-related tax revenues are among the most cyclical and difficult to forecast revenues in numerous other states . . .
>
> "In general, we consider Washington's approach to financial management strong, as reflected in our Financial Management Assessment (FMA) and budget management scores. Well-established economic and revenue forecasting, and increasingly refined debt management practices and oversight, served the state's credit quality well during the recession and its aftermath. Forward-looking state policies facilitate budget practices we view as prudent, including minimal reliance on payment deferrals or other one-time responses to anticipated budget gaps."

Though there are many concerns with the state's tax structure, the stability of it due to a strong reliance on property and consumption taxes is well known. This is in contrast to the roller-coaster experience of our income-tax-dependent neighbors in Oregon and California.

As noted by Oregon's state economist Josh Lehner:[2]

> "The state's reliance on personal and corporate income taxes makes its revenue more volatile than other states'[sic], according to the report. This is because personal and corporate revenues are more closely tied to the business cycle, meaning large swings in business and investment income will result in swings in tax revenue as well."

Fitch Ratings also recently warned about California:[3]

> "California's exposure to economic and revenue cyclicality is among the highest of the states, driven primarily by economically sensitive PIT [Personal Income Tax] receipts. California's revenue expectations are likely to be sharply reduced by the economic slowdown and by continued stock volatility, given the significance of capital gains taxes. Capital gains, which have generated approximately 15% to 17% of total PIT in recent years, fell 78% in the Great Recession."

The Tax Foundation also notes:[4]

1 "State of Washington; Appropriations; General Obligation," S&P Global Ratings, August 28, 2019, at https://www.tre.wa.gov/wp-content/uploads/2020ABT-R-2020AB-SP-2019.08.28-Report.pdf

2 "Ore. Tax Revenue Expected To Drop $2.3B Due To Pandemic," by Daniel Tay, Law 360, May 21, 2020, at https://www.law360.com/tax-authority/state-local/articles/1275487/ore-tax-revenue-expected-to-drop-2-3b-due-to-pandemic

3 "Fitch Rates California's $1B GO Bonds 'AA' and $121MM Lease Rev Bonds 'AA-'; Outlook Stable," Fitch Ratings, April 14, 2020, at https://www.fitchratings.com/research/us-public-finance/fitch-rates-california-1b-go-bonds-aa-121mm-lease-rev-bonds-aa-outlook-stable-14-04-2020

4 "Income Taxes Are More Volatile Than Sales Taxes During an Economic Contraction," by Jared Walczak, Tax Foundation, March 16, 2020, at https://taxfoundation.org/income-taxes-are-more-volatile-than-sales-taxes-during-recession

“As a general rule, income taxes are more volatile than consumption taxes, as can be seen from aggregate state tax collections during and immediately after the Great Recession.”

Realizing there is no recession-proof tax structure, Washington’s tax base and economic activity has produced substantial revenue growth prior to the global COVID pandemic and subsequent government restrictions on economic activity. Here are the revenue collections and projections as of the February 2020 state revenue forecast:

General Fund-State, Education Legacy Trust Account and Opportunity Pathways Account (Cash basis)
February 2020 - Billions of Dollars

07-09 Biennium	$30.254	.3%
09-11 Biennium	$28.586	-5.5%
11-13 Biennium	$31.116	8.8%
13-15 Biennium	$34.305	10.2%
15-17 Biennium	$39.05	13.8%
17-19 Biennium	$46.081	18.0%
19-21 Biennium	$52.339	13.6%

Large recent state spending increases

Although the fundamentals of Washington’s budget process are strong, the decision to enact large spending increases has put additional pressure on the ending fund balance and reserves needed to weather even a nominal recession, let alone the unprecedented economic climate we are currently experiencing. Washington’s current 2019-21 budget is $53.3 billion. This level of spending is $8.6 billion, or 19% higher, than the 2017-19 budget due to decisions by lawmakers and the Governor. Here are the historical state spending increases as reported by www.fiscal.wa.gov:

Statewide
Expenditure History - Operating
Funds Subject to Outlook (NGF-O)
(Dollars in Thousands)

	2007-09	2009-11	2011-13	2013-15	2015-17	Final 2017-19	Enacted 2019-21
⊞Legislative	154,856	145,583	134,436	135,242	149,341	152,475	194,153
⊞Judicial	243,709	222,860	221,371	241,689	269,103	289,964	340,797
⊞Governmental Operations	566,365	473,505	467,753	529,572	563,470	602,460	766,204
⊞Other Human Services	7,137,731	6,274,355	6,729,297	6,886,534	6,863,046	7,552,016	10,637,039
⊞DSHS	4,780,223	4,441,639	4,545,034	4,946,284	5,534,607	6,498,532	6,469,997
⊞Natural Resources	512,247	360,199	298,942	260,775	289,757	351,731	500,460
⊞Transportation	80,965	73,410	77,417	69,014	82,361	92,915	126,118
⊞Public Schools	12,942,831	12,945,292	13,549,500	15,265,522	18,122,604	22,654,762	27,248,209
⊞Higher Education	3,516,215	3,090,908	2,731,171	3,083,559	3,552,665	3,711,185	4,051,203
⊞Other Education	181,295	161,170	159,916	202,288	342,241	222,477	69,744
⊞Special Appropriations	1,998,358	2,195,175	2,331,010	2,023,177	2,436,298	2,555,086	2,906,277
Total	**32,114,794**	**30,384,095**	**31,245,848**	**33,643,658**	**38,205,492**	**44,683,604**	**53,310,201**

The largest policy areas of spending increase enacted by lawmakers were in K-12 education and human services. State spending has increased 66% since 2007-09.

Why an income tax is not the answer

Predictably, some are calling for the legislature to try to tax our way out of the COVID recession by imposing an income tax on capital gains. Based on the recent comments of budget writers in the Senate, however, those discussions are better suited for the long-term, in a regular legislative session, versus debating a major new tax during any special session.

Sen. Christine Rolfes (D-Bainbridge Island), the chair of the Senate Ways and Means Committee, was asked by TVW if an income tax would be on the agenda for a special session.

Sen. Rolfes said:[5]

> "The kind of traditional discussion about 'let's pass an income tax,' people need to know it takes 2/3 of the legislature and a vote of the people. Conversations about a capital gains tax, very likely would be a legal battle about is that an income tax or is it a sales tax or what kind of tax is that? I as a budget writer, I don't look at that kind of policy as something that will dig us out of a hole in the next year. It's something that we might want to look at as part of a long-term reform policy."

An income tax remains highly unpopular. Washington voters have already rejected 10 straight income tax proposals.[6] Also, every state in the country and the federal Internal Revenue Service (IRS) unequivocally says a capital gains tax is an income tax.[7]

According to the IRS:[8]

> "This is in response to your inquiry regarding the tax treatment of capital gains. You ask whether tax on capital gains is considered an excise tax or an income tax? It is an income tax. More specifically, capital gains are treated as income under the tax code and taxed as such."

Legal objections aside, there are serious budget implications of relying on a highly volatile capital gains income tax in a recession.[9]

Sen. Mark Mullet (D-Issaquah), the chair of the Senate Financial Institutions, Economic Development and Trade Committee, recently said in a speech to the Bellevue Chamber of Commerce:10

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5 "Inside Olympia -- Special Edition," TVW, May 19, 2020, at https://www.tvw.org/watch/?clientID=9375922947&eventID=2020051071&startStreamAt=788&autoStartStream=true

6 "Income Tax Ballot Measures," Washington state Secretary of State, accessed on June 3, 2020, at https://www.sos.wa.gov/elections/research/income-tax-ballot-measures.aspx

7 "State Revenue Departments Describe Capital Gains Income Taxes," by Jason Mercier, Washington Policy Center, April 10, 2017, at https://www.washingtonpolicy.org/library/docLib/statedorscapitalgainsincome-1.pdf

8 "IRS letter to Congressman Newhouse," U.S. Department of Treasury, September 25, 2018, at https://www.washingtonpolicy.org/library/docLib/IRS-Response-Newhouse-Capital-Gains-Tax-1.pdf

9 "State tax officials across country agree – capital gains income taxes are extremely volatile and unpredictable," by Jason Mercier, Washington Policy Center, blog post, September 30, 2019, at https://www.washingtonpolicy.org/publications/detail/state-tax-officials-across-country-agree-capital-gains-income-taxes-are-extremely-volatile-and-unpredictable

10 "Dollars & Sense: Washington State's Budget," Bellevue Chamber of Commerce, webinar, May 12, 2020, at https://www.youtube.com/watch?v=WDrLvD2kt_U&feature=youtu.be&t=1425

> "The real challenge the legislature has is that I don't think there is a way you can tax your way out of this because every industry in the state has been really decimated . . . California is freaking out because they do have a capital gains tax and that's their first line item that they are saying they think is going to get completely annihilated."

To Sen. Mullet's point, here is what California Governor Gavin Newsom (D) said in his recent COVID-19 budget proposal:[11]

> "Personal income tax revenues are revised downward by almost $33 billion due to a decline in all income sources, but particularly wages, proprietorship income, and capital gains . . . Forecasting revenues associated with capital gains is subject to significant uncertainty because realizations are heavily dependent upon stock market performance and when taxpayers choose to buy or sell stock."

As for spending policy changes, California's Governor said:

> "Collective bargaining negotiations will commence or continue with all of the state's bargaining units to reduce pay by approximately 10 percent, relative to June 2020 pay levels."

Sen. Mullet is correct that we cannot tax our way of this COVID recession and that a capital gains income tax is not the solution.

Options to fix the 2019-21 state budget deficit

When lawmakers next address the budget situation they will need to make many difficult decisions. Acting early to reduce spending will help reduce the size of the problem for the next state budget (2021-23). Among the actions they should take immediately is to freeze new spending increases, rely on the state's emergency reserves and encourage federal officials to provide flexibility for the original CARES Act funding.

Preventing planned spending increases from going into effect is the most effective way lawmakers can reduce the deficit, because it does not involve cutting current spending levels in existing programs.

As for new spending increases, state employees are scheduled to receive a 3% pay raise on July 1.[12] A 3% pay raise also took effect last July. With the state facing a massive budget deficit, the governor should immediately reopen the state employee contracts to cancel the new 3% pay raise before it takes effect. Canceling these pay increases would save $266 million this year, with four-year total savings of $798 million.[13]

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11 "California budget proposal," Governor Gavin Newsom, May 14, 2020, at http://www.ebudget.ca.gov/FullBudgetSummary.pdf

12 "Employee compensation - 2019–21 Budget & Policy Highlights," Washington state Office of Financial Management, 2019-21 budget proposal, accessed on June 3, 2020, at https://www.ofm.wa.gov/sites/default/files/public/budget/statebudget/highlights/budget19/19-21-compensation.pdf

13 Email from Amanda Cecil, Sr. Fiscal Analyst, Washington state Senate Ways and Means Committee, May 14, 2020.

According to RCW 41.80.010(5):[14]

> "If, after the compensation and fringe benefit provisions of an agreement are approved by the legislature, a significant revenue shortfall occurs resulting in reduced appropriations, as declared by proclamation of the governor or by resolution of the legislature, both parties shall immediately enter into collective bargaining for a mutually agreed upon modification of the agreement."

Rather than wait for the new Fiscal Year to start on July 1, the governor should act now to secure those budget savings. Facing a budget deficit in 2010, then Governor Chris Gregoire issued a proclamation to reopen state employee contracts.[15]

The governor has already announced several other actions to reduce state spending. On May 13 he signed a directive to freeze state hiring, personal service contracts and equipment purchases.[16] The Director of the Office of Financial Management (OFM) also sent agencies a memo asking them to identify a combined $1.9 billion in savings options.[17]

From the OFM May 13 memo to state agencies:

> "In an unofficial update to the state's revenue forecast, the state's chief economist projected that revenue collections over the next three fiscal years will be about $7 billion lower than was forecast less than three months ago. The unofficial revenue update on April 30 is based on incomplete data, and we won't have official projections until the next state revenue forecast in June.
>
> It is clear, however, that we must start taking steps now to confront this fiscal crisis. Even using all of the reserves, if the unofficial forecast holds true, we estimate the state would still face a $4.1 billion shortfall over the next three years.
>
> Therefore, I am directing agencies to identify operating budget savings options from their fiscal year 2021 appropriations. OFM's immediate combined savings options target is $1.9 billion."

Facing a massive budget deficit and record private sector unemployment, now is not the time for the governor to give out pay raises. This includes the scheduled pay increases for elected officials. Although a bipartisan group of lawmakers asked the state salary commission to cancel those pay raises, there are limited options due to the process outlined by a 1986 constitutional amendment creating the commission.[18] Lawmakers can, however, voluntarily donate part or all of their pay to the state general

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14 "RCW 41.80.010 - Negotiation and ratification of collective bargaining agreements," Washington state legislature, accessed on June 3, 2020, at https://app.leg.wa.gov/rcw/default.aspx?cite=41.80.010

15 "Proclamation by the Governor – Collective Bargaining – 10-6," Governor Chris Gregoire, November 18, 2010, at https://www.digitalarchives.wa.gov/GovernorGregoire/proclamations/pr_10-06.pdf?

16 "Directive 20-05 - Freezing Hiring, Personal Services Contracts, and Equipment Purchases," Washington state Office of Financial Management, May 13, 2020, at https://www.governor.wa.gov/sites/default/files/20-05%20-%20Hiring-PS%20Contracts-Purchasing%20%28tmp%29.pdf

17 "Immediate actions to capture operating budget savings," by David Schumacher, Director, Washington state Office of Financial Management, May 13, 2020, at https://ofm.wa.gov/sites/default/files/public/legacy/agencycommunications/FY2020/ImmediateActionstoCaptureOperatingBudgetSavings_0.pdf

18 "Legislative letter to Washington Citizens' Commission on Salaries for Elected Officials – pay raises," by various lawmakers, April 20, 2020, at https://www.washingtonpolicy.org/library/docLib/Salary-Commission-request-letter-with-signatures.pdf

fund by filing a form with the Office of the State Treasurer.[19] No change in law or policy is needed for an elected official to decline taking a tax-funded salary.

Ultimately, the state constitution should be amended to abolish the state salary commission. As should also occur with state employee compensation, these decisions should be made by the legislature in the budget writing process and not be placed off limits from legislative decision-making.

Along with reducing planned spending increases (like pay raises) and using the emergency reserves, there remains the possibility of additional federal funding flexibility. While there is currently fierce debate in Congress about whether there should be additional state and local federal COVID-19 funding, it is important that national officials relax the restrictions placed on the original $150 billion in relief funds.

Let states put federalism to work and allow local elected leaders to make the best decisions possible for their communities as they respond to the economic devastation caused by the global COVID-19 pandemic. Washington Policy Center continues to call on federal leaders to provide this flexibility for the original CARES Act funding that Congress passed earlier this year.[20]

Conclusion

Although Washington's overall state budget process is sound, government restrictions shutting down the state's economy for several months have drastically reduced the expected rise in tax collections. This economic problem occurs at a time of significant state spending increases over the last few years. Using the emergency reserves and requesting federal officials provide flexibility for CARES Act funding would help solve part of the budget deficit. State officials also need to take action to reduce new spending increases. It is important these reductions happen while avoiding tax increases that would further burden families and employers as they try to recover from the government-imposed economic restrictions.

19 "Donate to the State of Washington, Washington state Treasurer's Office, accessed on June 3, 2020, at https://www.tre.wa.gov/news/donate-to-the-state-of-washington/

20 "Put federalism to work with COVID-19 relief funds," by Jason Mercier, Washington Policy Center, blog post, April 28, 2020, at https://www.washingtonpolicy.org/publications/detail/put-federalism-to-work-with-covid-19-relief-funds

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If you have any comments or questions about this study, please contact us at:

Washington Policy Center
PO Box 3643
Seattle, WA 98124-3643

Online: www.washingtonpolicy.org
E-mail: wpc@washingtonpolicy.org
Phone: (206) 937-9691

Jason Mercier is the Director of the Center for Government Reform at Washington Policy Center and is based in the Tri-Cities. He has served on the boards of the Washington Coalition for Open Government and Verify More, and was an advisor to the 2002 Washington State Tax Structure Committee. Jason is an ex-officio member for the Tri-City Regional Chamber of Commerce and serves on the Chamber's government affairs committee. He worked with lawmakers in 2008 to create the state's renowned budget transparency website www.fiscal.wa.gov and has been a champion for many of the state's important budget reform tools including the four-year balanced budget requirement adopted in 2012. In 2010, former Governor Gregoire appointed Jason as WPC's representative on her Fiscal Responsibility and Reform Panel. Jason is also a member of the State Tax Advisory Board for the Tax Foundation. He has testified numerous times before legislative committees on government reform issues, and his op-eds regularly appear in newspapers around the state, including The Seattle Times and Tri-City Herald. Jason also provides a regular TV update for KVEW (ABC Tri-Cities) and can be heard frequently on several radio stations including KOMO, KVI, KONA, KXLY and KIRO.