The Noose Tightens:

WASHINGTON STATE'S LOOMING FISCAL CRISIS*

For the second consecutive year, budget writers are scrambling as the legislative session opens to reconcile state spending with a popular tax measure. A combination of luck, optimistic assumptions, and a booming economy allowed the Legislature to cope with Referendum 49 last year. This year lawmakers will wrestle with Initiative 695's much larger price tag.

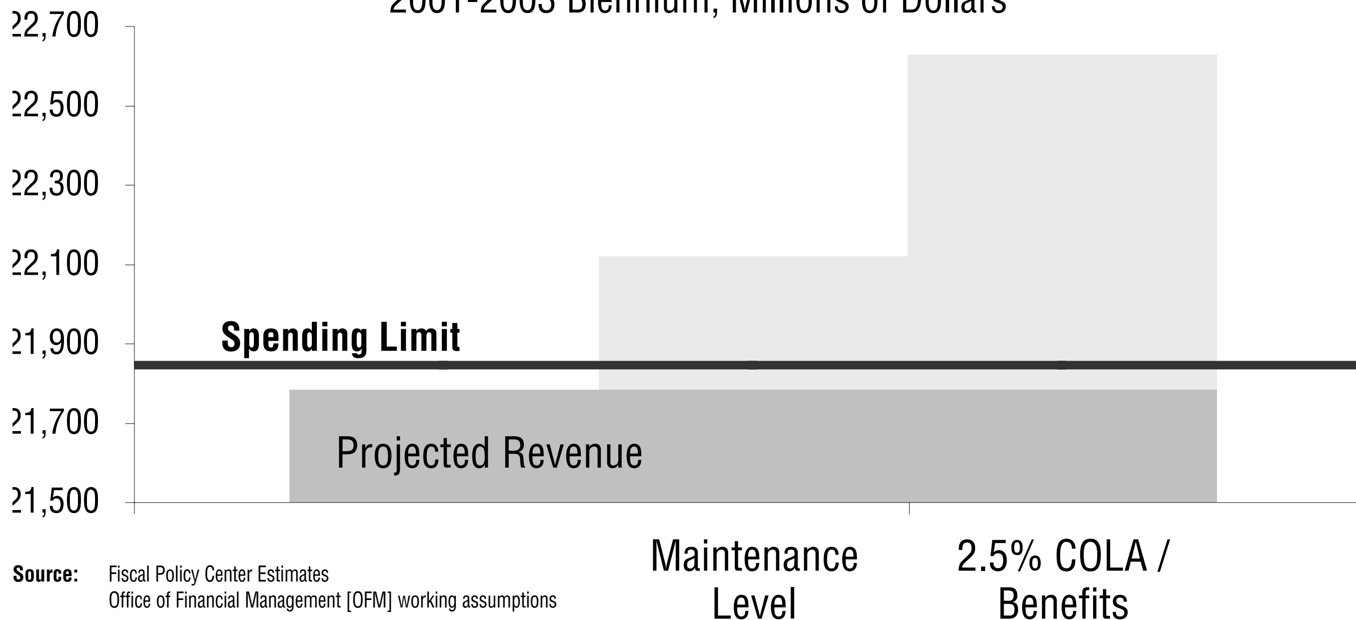
Nonetheless, the challenges of the 2000 session undoubtedly pale in comparison with what awaits legislators next year. Not only does the state face the prospect of general fund revenues less than the spending limit, but key budget drivers will price the minimal maintenance of current government service levels above the spending limit. Factoring in annual 2.5 percent cost-of-living and benefit adjustments for state employees and public school teachers will require more than a half billion in spending in excess of the 601 limit and outstrip projected revenues by an even larger margin [FIGURE A].

State budget actions in recent years have been anything but bold. This paper seeks to place the tough choices that await the Legislature this year and next in the context of 1999 budget deliberations.

Budgeting by Formula

Six years under Initiative 601 has brought a degree of compliance that even the measure's sponsor thought improbable. Since passage in November 1993, the Legislature has approved a series of tax reductions, in essence forgoing revenue in excess of

FIGURE A



Source: Fiscal Policy Center Estimates
Office of Financial Management [OFM] working assumptions

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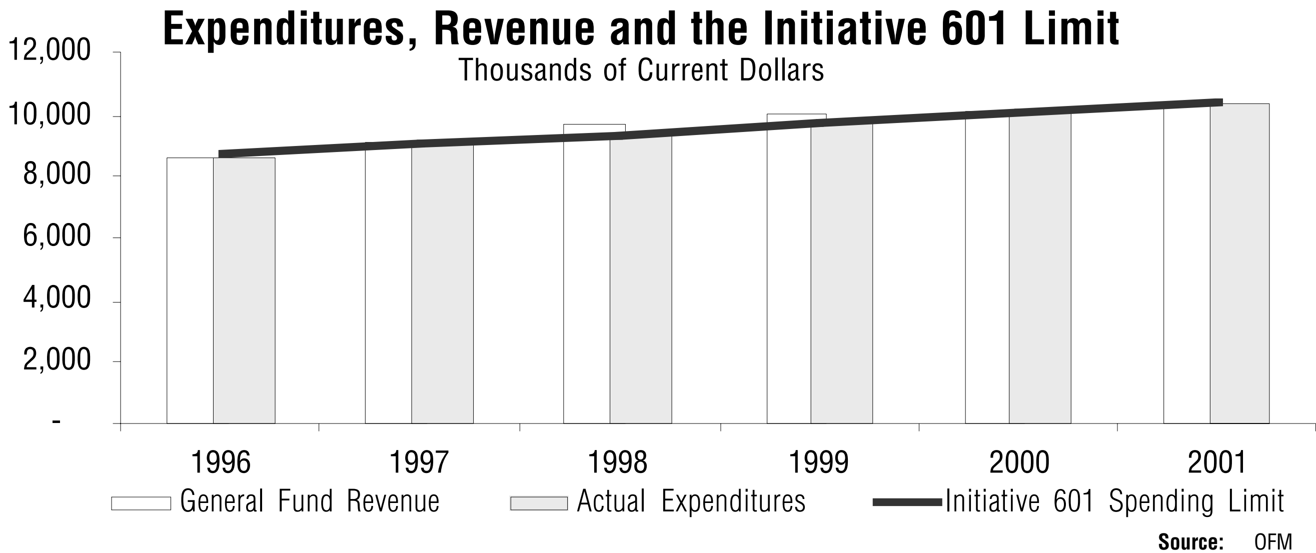
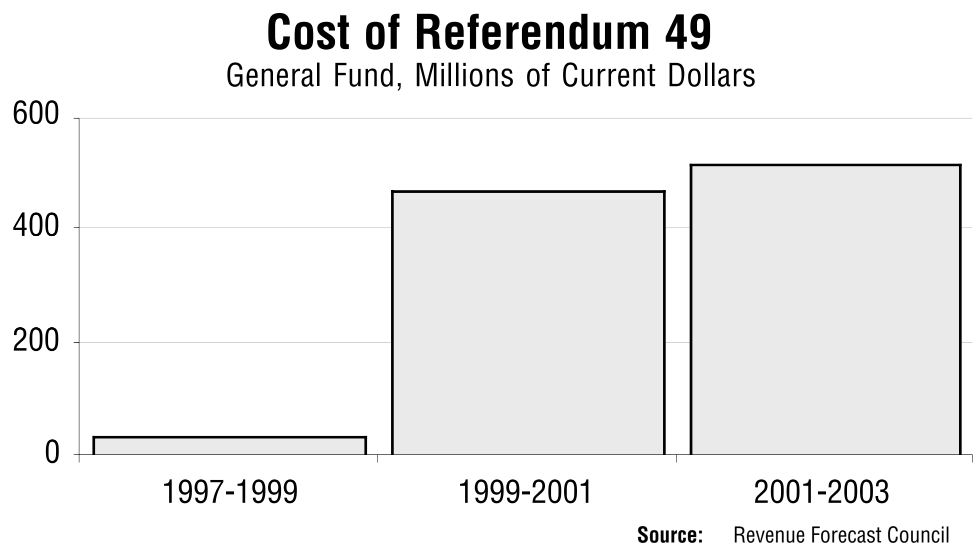
Figure B



the spending limit [Figure B]. A booming economy and corresponding revenue growth has funded tax relief rather than government spending. Government reserves grew initially under Initiative 601, but declined in the last biennium as a percentage of the general fund as tax levels have mirrored the spending limit.

Figure C



Explicitly limited by the cap, spending from the state general fund has been determined by the spending limit. While initial biennial budgets have fallen short of the limit by larger amounts, a series of supplemental budget actions have raised final spending levels to the effective limit. Applicable only to general fund expenditures, there has nonetheless been no significant action to subvert the spending limit through other budget accounts.

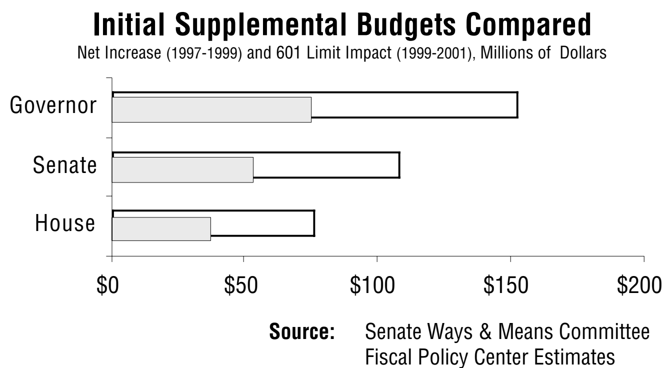
Responding to Referendum 49

As the 1999 session opened, it appeared that tax receipts and not the Initiative 601 spending limit would constrain general fund expenditures. Referendum 49 re-allocated $469 million from the general fund for 1999-2001 [Figure C] to service a $1.9 billion five-year program in transportation bonds, leaving projected state revenues several hundred million dollars under the spending cap. Governor Locke's budget, unveiled before the session, called for the state to spend $406 million in unrestricted reserves — effectively covering the Referendum 49 shortfall. Locke also counted on $193 million in welfare caseload reductions and $157 million in tobacco settlement funds to come within $60 million of the Initiative 601 spending limit.

The product of a Republican Legislature enacted by popular vote over Locke's objections, Referendum 49 made a one-time exception to Initiative 601. The dedication of general fund revenues to transportation would not reduce the spending limit as Initiative 601 requires of fund transfers. This flexibility exposed major philosophical differences between the parties.

Work on the 1999-2001 budget started with consideration of the 1997-1999 supplemental budget, particularly important since adjustments to actual spending in the current biennium determines the spending limit in subsequent years. The Governor proposed a supplemental budget with net spending increases of $75.1 million for 1997-1999, increasing the 1999-2001 spending limit by $152 million.

FIGURE D



Budget writers in both houses rejected the Governor's plan to spend up to the 601 limit for the 1997-1999 biennium because they planned on spending less in the 1999-2001 biennium — Democratic leaders motivated to maintain reserves, Republicans interested in restraining growth in government. The Senate approved a supplemental budget with a net increase $21.8 million less than the Governor's; soon thereafter House Democrats and Republicans reached agreement on a supplemental budget $15.9 million lower [FIGURE D].

The Rosy Scenario

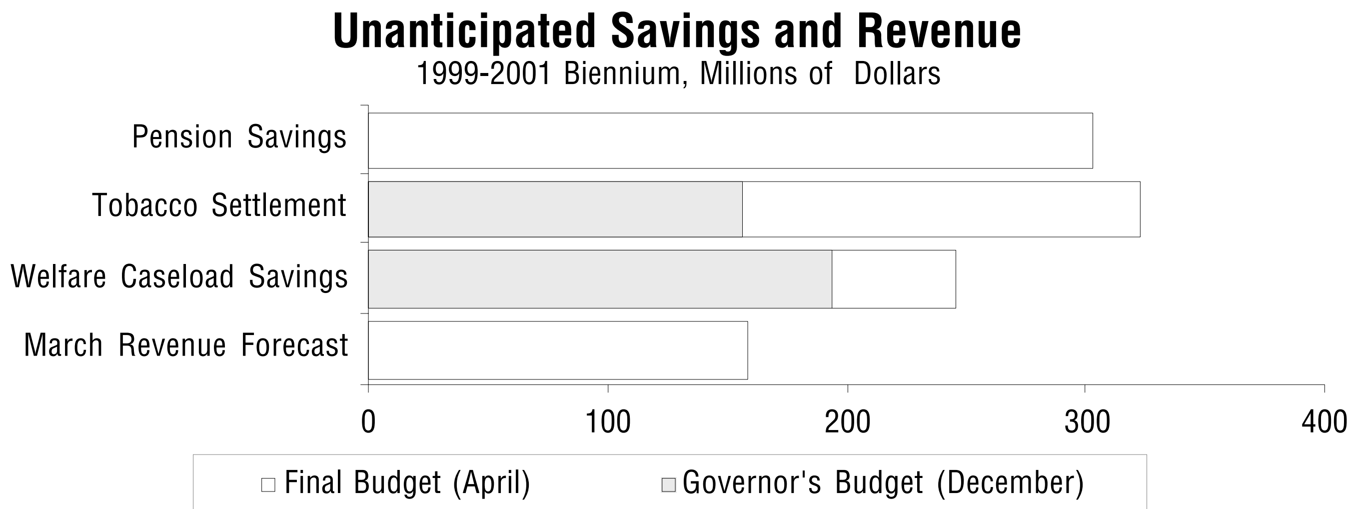
Reminiscent of late 1980s delays in state budget decisions to take advantage of revised projections, the 1999 legislative session brought a steady stream of good news [FIGURE E].

- The March revenue forecast reflected a $159 million increase in anticipated 1999-2001 tax receipts;

- Estimated tobacco settlement payments for the 1999-2001 biennium climbed to $323 million, double the revenue projected by the Governor's budget;

- A surging stock market carried higher than expected returns on state investments, and spurred more optimistic long-term economic growth assumptions. As a consequence

FIGURE E



employee pension costs declined $307 million from 1997-1999 to 1999-2001.

- Welfare caseloads continued to decline, yielding projected savings of $246 million, $53 million more than anticipated by the Governor's budget;

The state opened the biennium with a considerable windfall in Temporary Aid to Needy Families (TANF) dollars. Federal welfare reform replaced individual awards to recipients through the Aid to Families with Dependent Children program (AFDC) with TANF block grants to the states. With TANF funding levels set independent of actual caseloads, declining caseloads allowed the state to substitute federal for state dollars. By the time the final budget was approved, some $246.2 million of state general fund dollars were replaced with federal welfare funds in the WorkFirst program alone.

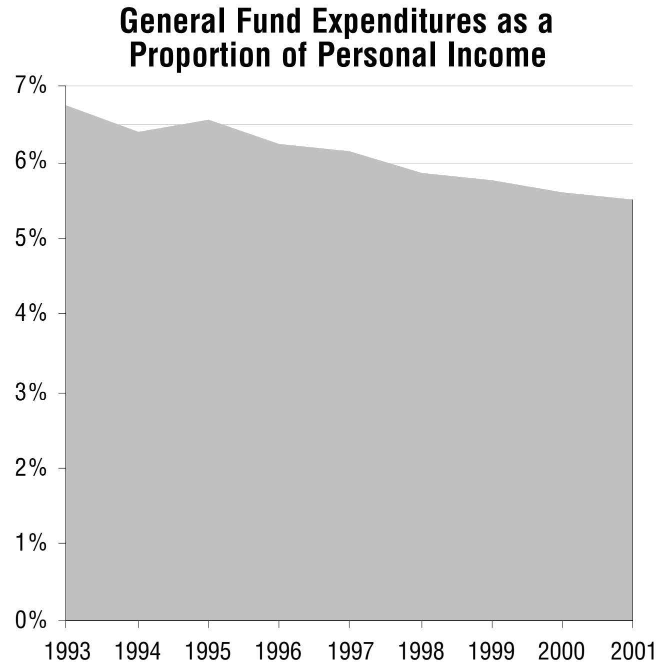
Impasse and Defection

The continuing windfall shift in revenues eliminated the need to dip into reserves to spend up to the spending limit; Democratic leaders coalesced around doing just that. Twin budget proposals, necessitated by split control of the House, emerged $240 million apart. Agreement on the supplemental budget collapsed with the need in the House Democratic plan for maximum 1997-1999 spending to adjust upward the 1999-2001 limit. The two-handled gavel jokingly employed by co-Speakers Clyde Ballard and Frank Chopp to open the session seemed entirely appropriate as negotiations broke down and progress on a host of non-budget issues ground to a halt.

Senate Democrats intervened with a budget of $20.575 billion, portrayed in the media as roughly splitting the difference between House Republicans and Democrats. In reality, the budget was premised upon maximum spending in the supplemental budget, preserving the ability of the Legislature to augment 1999-2001 expenditures in subsequent supplemental budgets.

House Republican leaders opposed the Senate plan, but lost two members of their caucus: Representatives Tom Campbell and Don Carlson voted for a slightly modified version of the Senate budget.

Figure F



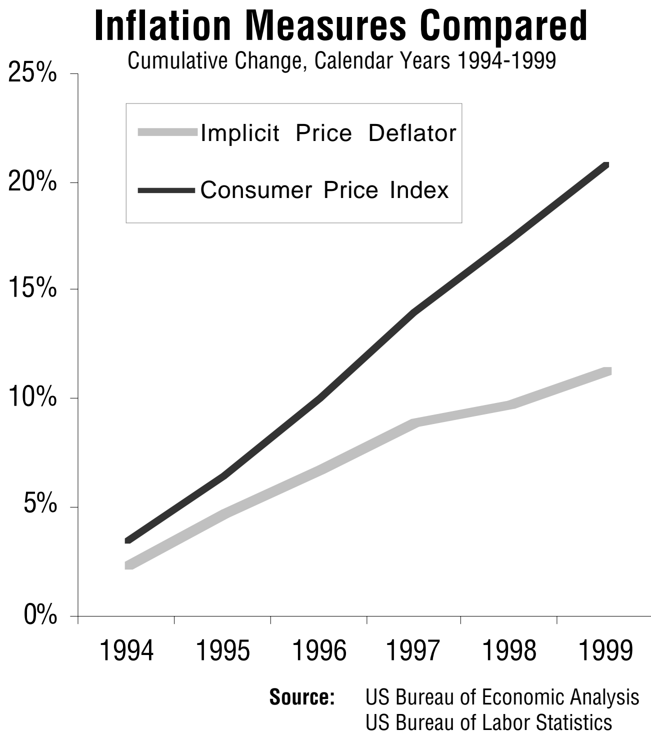
Source: OFM, US Bureau of Economic Analysis

Shrinking Size of Government

Even with passage of a Democratic budget, government is declining as a proportion of the state economy [Figure F]. Over the past decade budget shortfalls and Initiative 601's self-imposed constraints have decreased agency funding and state employee salaries. Initiative 601 has driven government spending below a constant measure adjusted for population and inflation by employing a lower measure of inflation. Use of the Implicit Price Deflator rather than the Consumer Price Index has reduced permissible spending under Initiative 601 by $1.2 billion for the 1999-2001 biennium [Figure G].

Conversely, the use of three-year lagged averages of population and inflation statistics has boosted the spending limit as a consequence of a remarkable period of disinflation. The coming years, however, will see reduced spending limit

Figure G



growth as the difference between current and past inflation closes and reverses [Figure H].

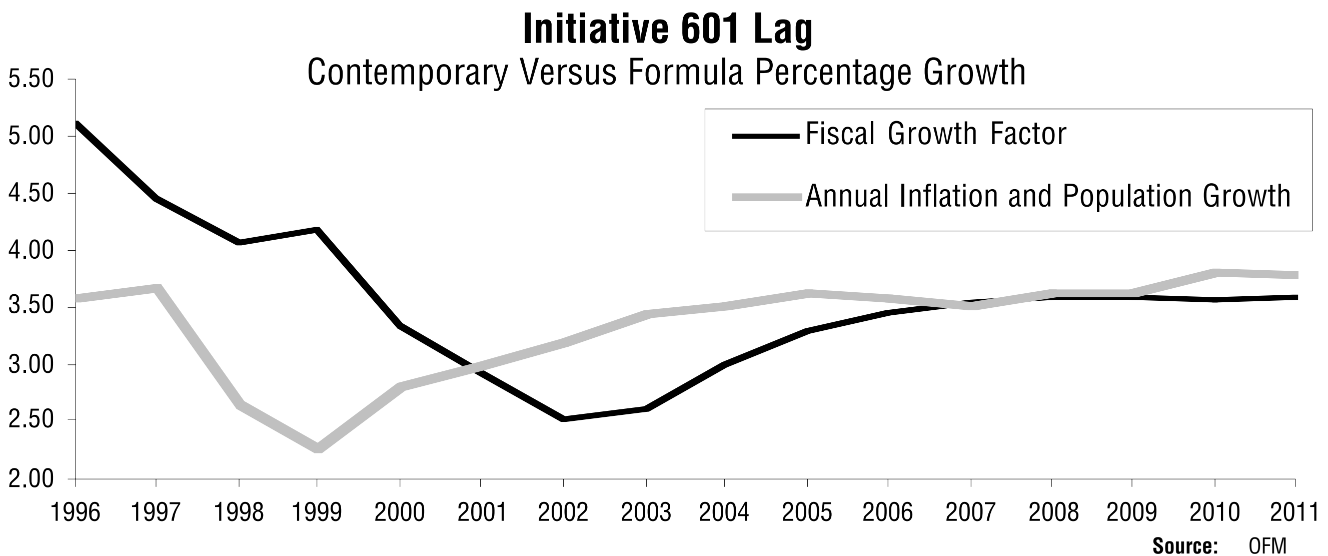
The consequences of such funding reductions are difficult to ascertain. The largest, and most prominent in budget deliberations, has been employee compensation. Salaries, particular for K-12 teachers, received significant attention in the 1999-2001 budget, but will be unable to keep up with the Consumer Price Index in the long run given the structure of Initiative 601. Moreover, wage levels for private sector employees and the rate of personal income growth will continue to rise an order of magnitude faster than state employee wages.

The Cost of $30 License Tabs

Revenue loss under Initiative 695 is compounded by the measure's referendum requirement on future tax increases and silence on accounting for mitigating fund transfers under Initiative 601. Initiative 695 also affords policymakers little time to act: the Motor Vehicle Excise Tax was abolished effective January 1, 2000 – six months into the 1999-2001 biennium – at an immediate cost of $1.2 billion to state and local government. An additional $1.8 billion in revenue is foregone for the 2001-2003 Biennium.

With strong political support for many of the programs previously funded by the MVET, the Legislature is expected to make some effort to offset these cuts with other revenue sources. Even if the Legislature does not aid local governments, the $1.9 billion transportation bond authorized under Referendum 695 necessitates some response. Perhaps the simplest approach,

Figure H



replacing lost revenue with an increase in the state gasoline tax, would now be subject to voter approval and incumbent delay and potential rejection.

With the Governor, the entire House or Representatives, and half of the Senate up for election in November, it seems likely that lost MVET revenues will be absorbed to some extent by existing tax sources. Indeed, proponents of the measure called for use of state reserves to cover lost state revenues, and argued that cities and counties had similar surpluses to offset the losses.

Only the state general fund offers the discretion and size to provide funding of this magnitude. Use of general fund revenues necessitates surplus. With spending constrained by Initiative 601, revenues have exceeded permitted spending under the limit, making possible a series of tax reductions since 1993. This trend may not continue in the short term — undoubtedly reflecting the removal from the general fund of taxes with relatively high revenue growth rates like the MVET. Current revenue projections anticipate revenue in excess of the spending limit for Fiscal Year 2000, but not for 2001, or the 2001-2003 Biennium. Existing revenue sources will exceed the spending limit in the long term, but there appears to be little immediate help available.

Even if such excess revenues existed, Initiative 601 complicates their expenditure. Under the initiative, transfers of general fund revenues to other budgets result in a downward revision to the spending limit of the same amount. Use of general fund dollars would thus reduce spending capacity elsewhere in an explicitly zero-sum game. Referendum 49 transferred MVET revenue from the general fund last year, but included a limit adjustment exemption. Initiative 695 eliminates MVET revenue outright and contains no such exemption. Indeed, recent

Supermajority requirements of Initiative 601

Initiative 601 as written requires a two-thirds majority of the Legislature to exceed the spending limit, but a simple majority of the Legislature should be adequate to approve such spending or outright repeal of the measure.

Approved by the narrowest margin of any Initiative to the people since 1930, Initiative 601 election results were certified in December 1993. Under the Washington State Constitution, initiatives cannot be amended without a two-thirds vote of the Legislature for a period of two years — so from December 1993 to December 1995 any change to Initiative 601 required such a margin. After this two year period elapsed, however, the initiative is the same as any other statute, and can be modified by a simple majority vote.

Initiative 601 requires super-majority margins, but in the end it is just a statute, subject to amendment or repeal by a simple majority like any other. According to state constitutional law scholars, approval by the Legislature of expenditures in excess of the cap without repealing the initiative would simply supersede it.

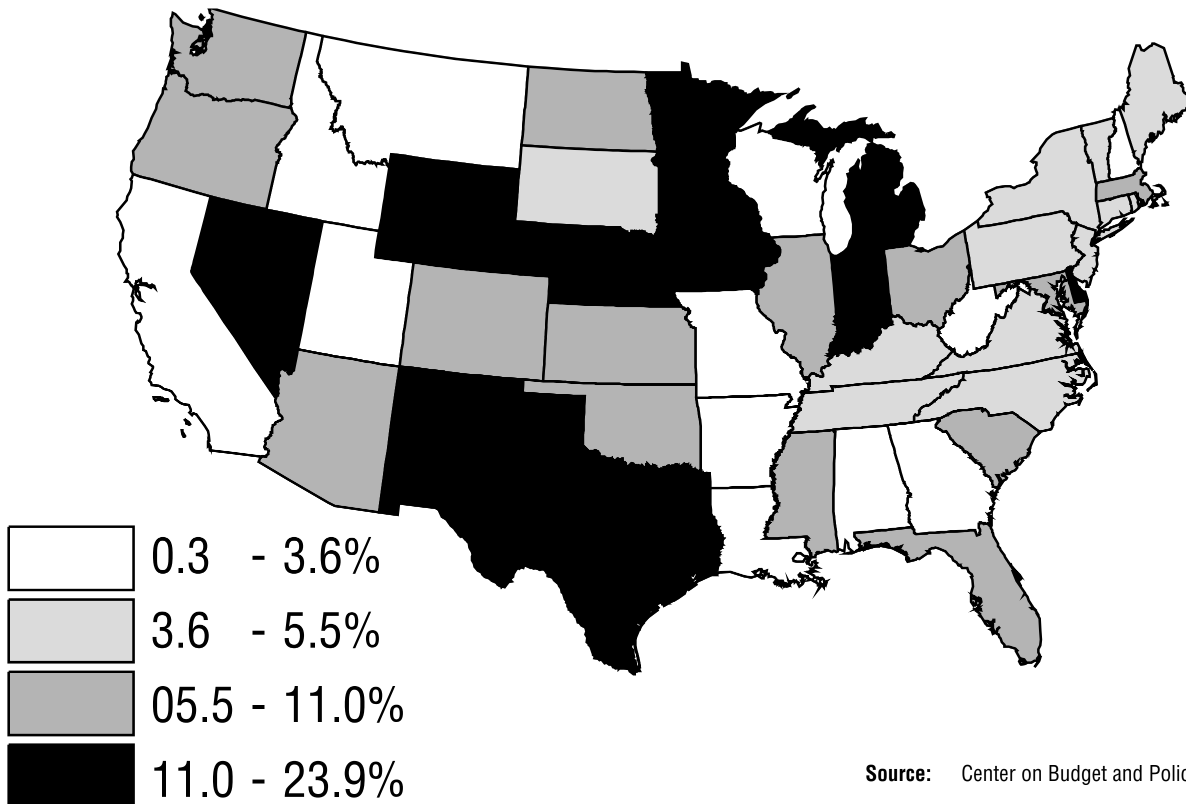
Referendum 49 contained a provision re-enacting Initiative 601, theoretically establishing a second period of supermajority amendment requirement from December 1998 to December 2000. Such limitation, if applicable, would constrain actions to repeal, amend, or supersede the initiative. Opinion is divided on whether re-enactment by reference does indeed shield Initiative 601 from simple-majority amendments for a second two year period.

Regardless of any special status derived from passage of Referendum 49, Initiative 601 remains subject to constitutional challenge. The spending limit's supermajority provisions are held by many legal experts to be inconsistent with Article II of the Washington State Constitution which specifies the requirements for passage of legislation. The only case to raise these issues before the supreme court – Walker v. Munro – was sidestepped on technical grounds in 1994.

FIGURE I

State Reserves as a proportion of General Fund Expenditures

Fiscal Year 1999, General and "Rainy Day" Emergency Reserve Funds



Source: Center on Budget and Policy Priorities

analysis by the business interest funded Washington Research Council suggests that even conservative critics of Initiative 695 will oppose offsetting adjustments to Initiative 601.

1998 Revisited

In December 1998, Governor Locke called on the Legislature to spend over $400 million in reserves to absorb the lost revenue transferred by Referendum 49. Last month the Governor proposed spending over $600 million in reserves to partially offset Initiative 695 and other new policies . Locke shows philosophical consistency, although ironically the reserves would not currently be available under the assumptions of his past budget. Indeed, like last year, there is some hope that the revenue picture will continue to improve.

The question of necessary or optimal budget reserves is inadequately addressed in the public finance literature. Paucity of supporting arguments has not stopped proponents from arguing for large "rainy day" funds, typically by citing a rather arbitrary five percent annual reserve reported in the *Wall Street Journal*.

Analysis by the nonpartisan Center on Budget and Policy Priorities projects a general fund revenue shortfall of $1.048 billion in the event of a recession of the national severity of the early 1990s during Fiscal Years 2001, 2002, and 2003. While this figure does not represent a worse case scenario, there is little support for reserves in excess of this amount.

Among other states, Washington state has relatively high reserves [Figure I]. The gap is expected to

increase over the course of this biennium in the face of a national trend toward smaller reserves and emergency fund balances. Locke's budget proposal pegs reserves at $575 million, just over five percent of annual general fund expenditures. The median state reserve is 5.56 percent.

As with last year, the willingness of the Legislature to dip into reserves will be the deciding factor. While Republican leaders advocate tax cuts and maintaining reserves, it is not clear that they have the votes to again stalemate the House of Representatives. Moderate Democrats that opposed spending down reserves in 1999 seem to view Initiative 695 as warranting emergency measures, while there has even been talk of only limited mitigation, leaving voters to face reductions on their own.

The Coming Crisis

Just as Initiative 695 raised questions about general fund revenue levels and capacity under the spending limit, the Legislature's response this session will have equally important ramifications for the 2001-2003 Biennium. Preliminary projections suggest that the cost of simply maintaining current programs – without even adjusting salaries for inflation – will exceed the spending limit by $275 million [Figure A].

The Legislature thus faces two problems with any supplemental action to the 1999-2001:

- Given projected revenue, reserves are needed both to respond to Initiative 695 and basic needs in the 2001-2003 biennium.

- Any fund transfer not exempted from Initiative 601 would reduce spending capacity even further.

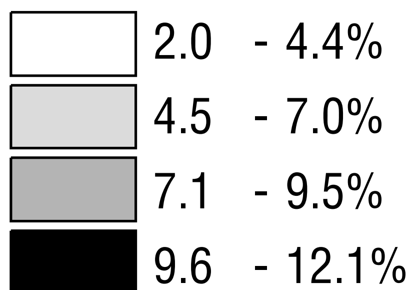
Given the impact of Initiative 695, it seems likely that any supplemental budget will by necessity spend down reserves. With Initiative 601, however, the constraints are political. Clearly further shifts of general fund revenues without exemption from Initiative 601 would exacerbate the 2001-2003 budget outlook. In an election year, there may nonetheless be a desire to let the next Legislature deal with such problems.

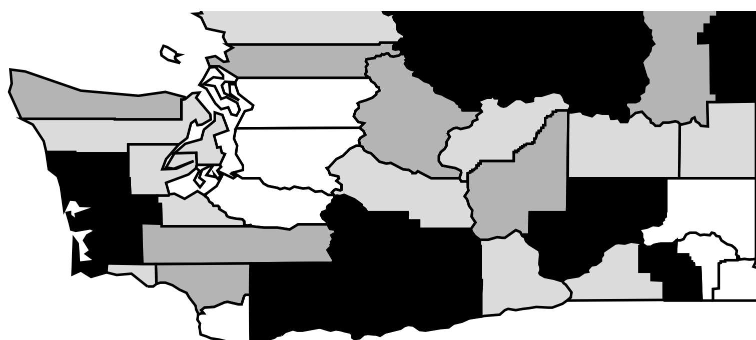
Things may be much worse, however. Even this view for the next biennium is premised upon a healthy economy and a continuation of remarkably low welfare caseloads. While there is no particular reason to expect recession, Human Services costs will not be dispatched by the Legislature with same ease as last year.

Figure K

Seasonally Adjusted Unemployment

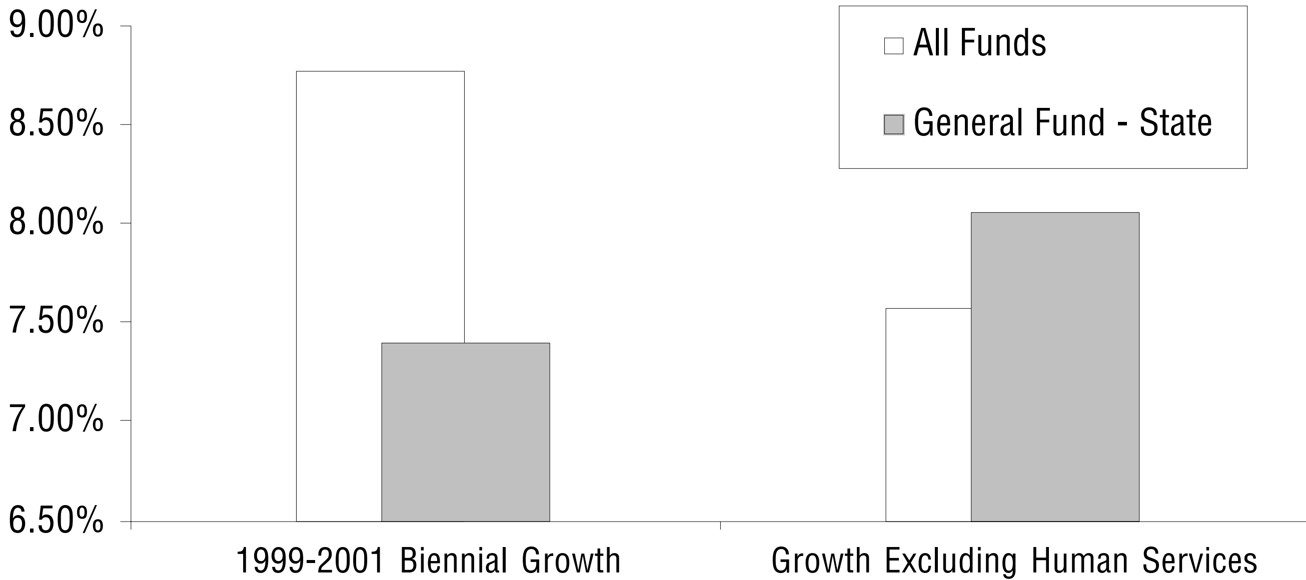
Calendar Year 1998





Source: Washington State Employment Security Division

Figure J



Fitting Human Services into the budget

The 1999-2001 budget came under the spending limit by shifting human service costs out of the general fund. Total state expenditures grew faster than the state general fund (8.77 to 7.39 percent, respectively), but this difference was entirely attributable to human services expenditures outside of the general fund [Figure J].

Most of this shift is in turn accounted for by funds from the tobacco settlement and the TANF surplus. Neither of these revenue sources can be expected to sustain growth in the next biennium. In fact, a reduction in TANF funds can be expected.

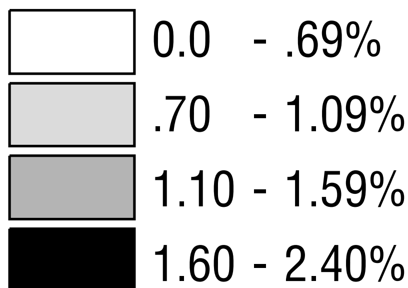
Federal Assistance

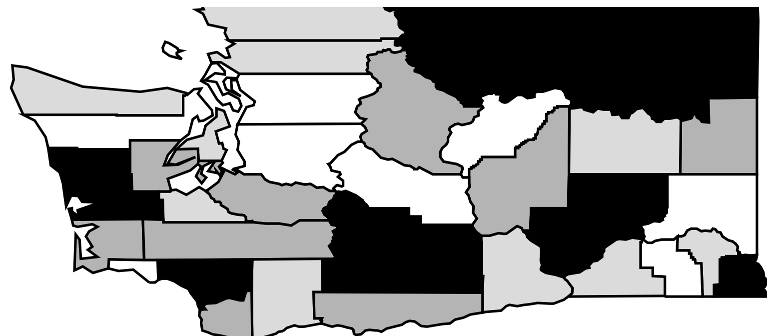
Recessions in the past brought with them federal dollars. Under AFDC, poor families with children

Figure L

TANF recipients as a proportion of total population

November 1999, WorkFirst Count by Service Center





Source: Washington State Department of Social and Health Services

received assistance in equal parts from federal and state sources, regardless of the number of families receiving benefits.

In 1996, however, AFDC was replaced by TANF. The TANF program, instead of funding a constant share of program costs, provides yearly block grants to states for assisting low-income families. Under TANF, if Washington state exhausts its federal block grant during a particular year, it will be responsible for all further funding for family benefits and services for the remainder of the year.

The strong economy and falling caseloads have instead left Washington state with a surplus. Through fund shifts, much of this surplus has been indirectly transferred into state general fund reserves. In the event of a recession that led Washington state to exhaust its block grant during a particular year, the TANF surplus from previous years could be used to cover the shortfall – flexibility that would be reduced with the expenditure of reserves.

In any case, the current surplus in TANF funds is unlikely to survive the next biennium. Fully aware of the surplus created by block grants in the face of declining caseloads, Congressional Republicans have repeatedly proposed reallocation of block grant funds.

In order to make the federal budget conform with tight spending targets, last September the House Labor-HHS-Education appropriations subcommittee approved recission of $3 billion in TANF block grants for Federal Fiscal Year 2000, with the stated but unbinding intent of restoring the funds in Fiscal Year 2001. Last March the Senate appropriations committee proposed a similar strategy to divert $350 million in TANF dollars to fund emergency hurricane spending.

Negotiations with the President restored full funding, but there is little doubt that the expiration of current TANF funding authority after Fiscal Year 2002 will bring renewed efforts to reduce federal spending. Although such reductions would likely increase the 601 limit, they would exacerbate Washington state's general fund revenue shortfall, potentially making such adjustments meaningless.

Families that remain on welfare

Although caseloads have fallen substantially, the families that remain pose significant challenges to the WorkFirst program. The cost of serving these families, which typically face the largest barriers to employment, will be substantial, requiring intensive employment training and placement services that likely exceed the state's current resources.

Moreover, the need for self-sufficiency is compounded by the five-year lifetime limit on welfare which will start terminating benefits for Washington families in August 2002. This heightens both the need to move more families to self-sufficiency now and the potential need for stopgap measures during the 2001-2003 biennium if families fall short.

Beyond caseload reductions

Despite the robust economy, Census data reveal more than 20,000 children remain poor in Washington state even after food stamps, school lunches and housing benefits are counted as income. In addition, the basic Census indicator that measures the depth and severity of child poverty has failed to improve since 1995.

The Census data supports concern that welfare caseload reductions alone do not constitute welfare reform success. Rather, permanent return to the work force is needed to bring about permanent reductions in child poverty.

From this perspective, caseload decline achieved by imposing immediate "full-family" sanctions should not necessarily be regarded as successful reforms. To some extent, sanctioning a family

by cutting the family off welfare entirely (i.e., terminating benefits for children as well as their parents) represents a failure of the state to connect the adult to work or work preparation activities.

A state that persists in working with a parent who is not complying with work activities and ultimately gets the parent to participate has succeeded in furthering a key objective of welfare reform — promoting job preparation and work. State sanction policies and procedures that lead to participation rather than termination are more likely to achieve that objective. Washington state's reduction to 80 percent Maintenance of Effort funding levels – the federally imposed minimum – suggests that today's strong caseload reductions may be tomorrow's increased costs.

Welfare caseloads in the face of recession

The caseload reductions to date have been experienced with a remarkably robust economy; even a small adjustment in the business cycle would shift caseloads upward. Washington state is presently experiencing a 30-year low in unemployment, even after enacting one of the highest minimum wages in the country.

A strong relationship exists between economic performance and welfare caseloads. Unemployment and welfare caseloads are strongly correlated (r = .68) on a county basis [FIGURES K AND L]. Moreover, an analysis of 1994 AFDC data reveals that changes in county unemployment rates over the past five years account for 38.2 percent of the decline in welfare caseloads.

Key Findings:

Every budget maintenance level projection since the passage of Initiative 601 has forecast trouble ahead, only to disappear as budget-writing began in earnest. Short of an 11th hour miracle, this string of good luck is unlikely to carry through the 2001-2003 biennium, suggesting tax receipts will constrain budget writers more than the spending limit.

In the long term, education funding needs (particularly class size and teacher salaries) and transportation shortfalls created by Initiative 695 must be reconciled with human services and health care insurance costs. This outlook – over the next decade – is even less optimistic.

More immediately, action by the legislature to further reduce general fund revenues, through tax reductions or General Fund coverage of Initiative 695 cuts, will leave the state poorly positioned for the coming biennium. In particular, such spending choices must be understood as indirect shifts of TANF surplus and tobacco lawsuit settlement funds.

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