public finance notes

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The Evans School of Public Affairs

Washington's Cycle of Boom and Bust

Public budgeting in Washington has never been for the faint at heart. The state has been beset by periodic budget crises, producing emergency tax increases and spending cuts that could have been avoided with adequate budget reserves.

Governor Locke has proposed reducing state reserves by more than half over the next biennium. Twice in the last 20 years the state has depleted reserves as the economy slowed, leaving inadequate resources to weather a recession. Under the Governor's budget, a downturn in the economy would create the worst crisis since 1981-1983, when the state's bond rating was reduced and the sales tax extended to groceries in order to balance the budget.

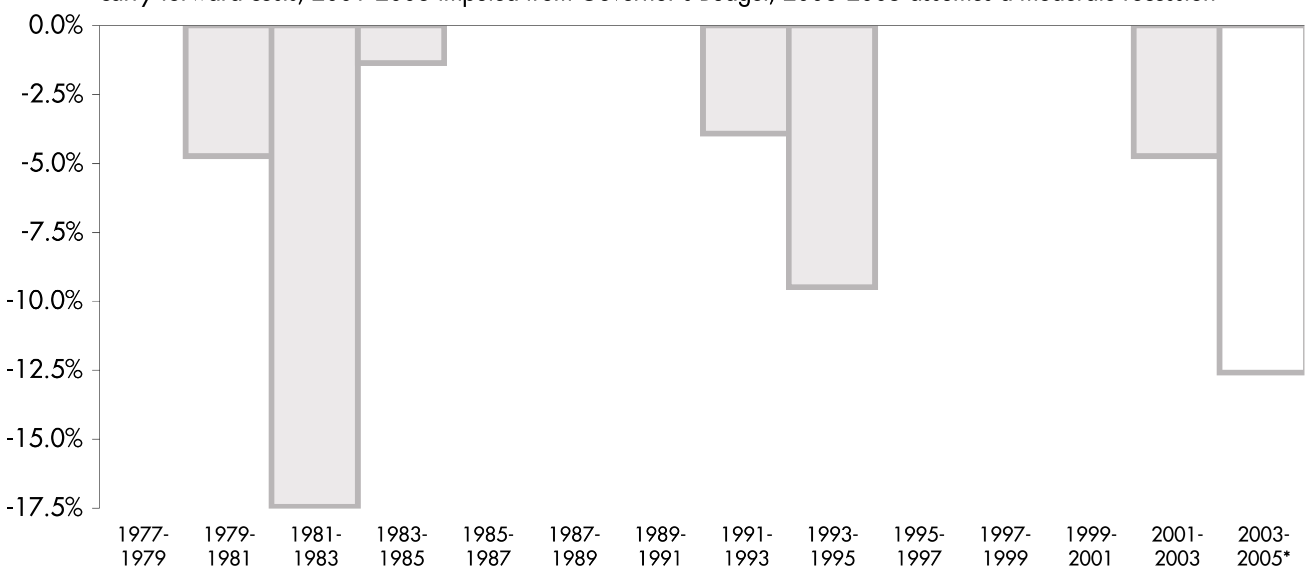
Economic Stability

Lack of diversification and cyclical demand for aircraft and wood products gave the state decades of erratic tax collections. Spikes in aerospace employment dramatically affected the economy throughout the 1960s and 1970s, and contributed to recessions in the early 1980s and 1990s.

More recently, the economy has proven less dependent on aircraft manufacturing. In the last two years Boeing has reduced Washington employment by 25.9 percent. Offset by a booming technology sector, the loss of these jobs had relatively little impact on state revenues. With the state's heavy reliance on the sales tax, however, a downturn across the economy would produce a precipitous drop in revenue.

Historic Budget Shortfalls and a Hypothetical 2003-2005 Recession

Revenue Shortfalls as a Proportion of General Fund Appropriations; 1991-1993 and 1993-1995 based on carry-forward costs; 2001-2003 imputed from Governor's Budget; 2003-2005 assumes a moderate recession



Revenue Projections

Much of the severity of the 1981-1983 budget crisis, particularly the need for radical mid-budget correction, can be traced to overly optimistic revenue projections. Institution of an independent forecast council has protected the state from political interference, but does not make the task any easier.

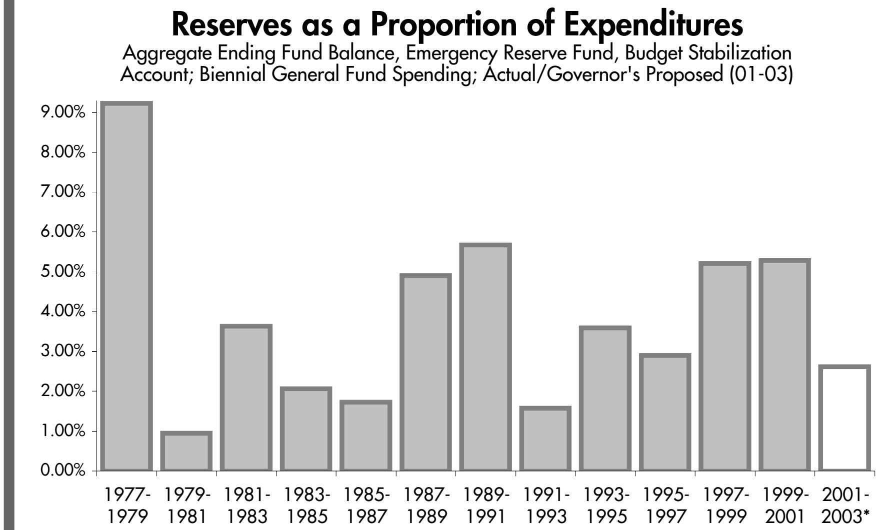
Premised upon assumptions about economic activity over the next 30 months, relatively small developments could still have a significant impact on revenue projections. When the forecast council revises its projections in March, a change of $250 million or more would not be unusual. While the current forecast assumes that the economy will slow, further reduction appears likely.

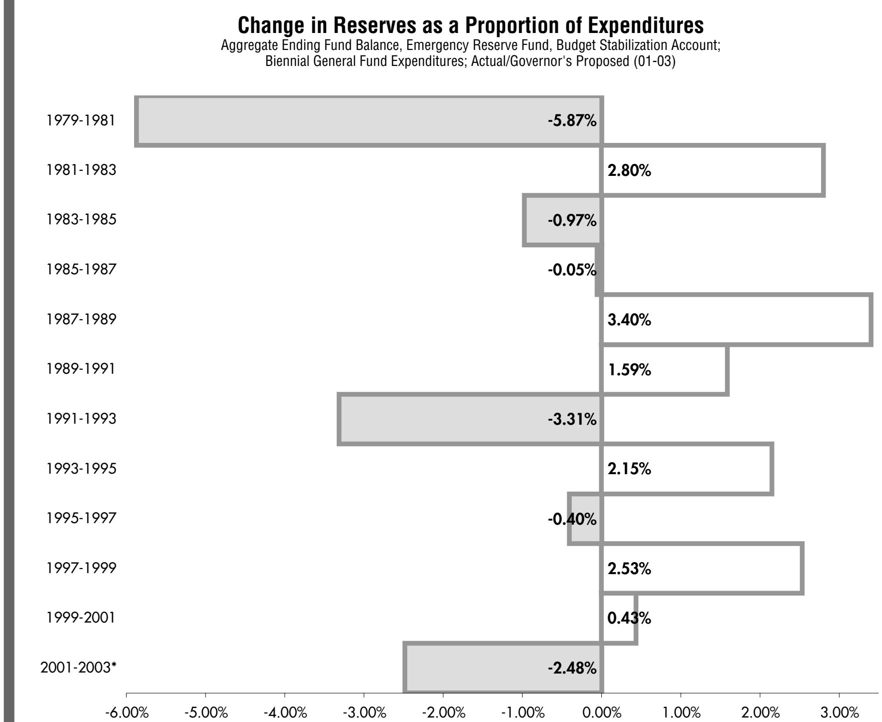
Non-Recessionary Deficit

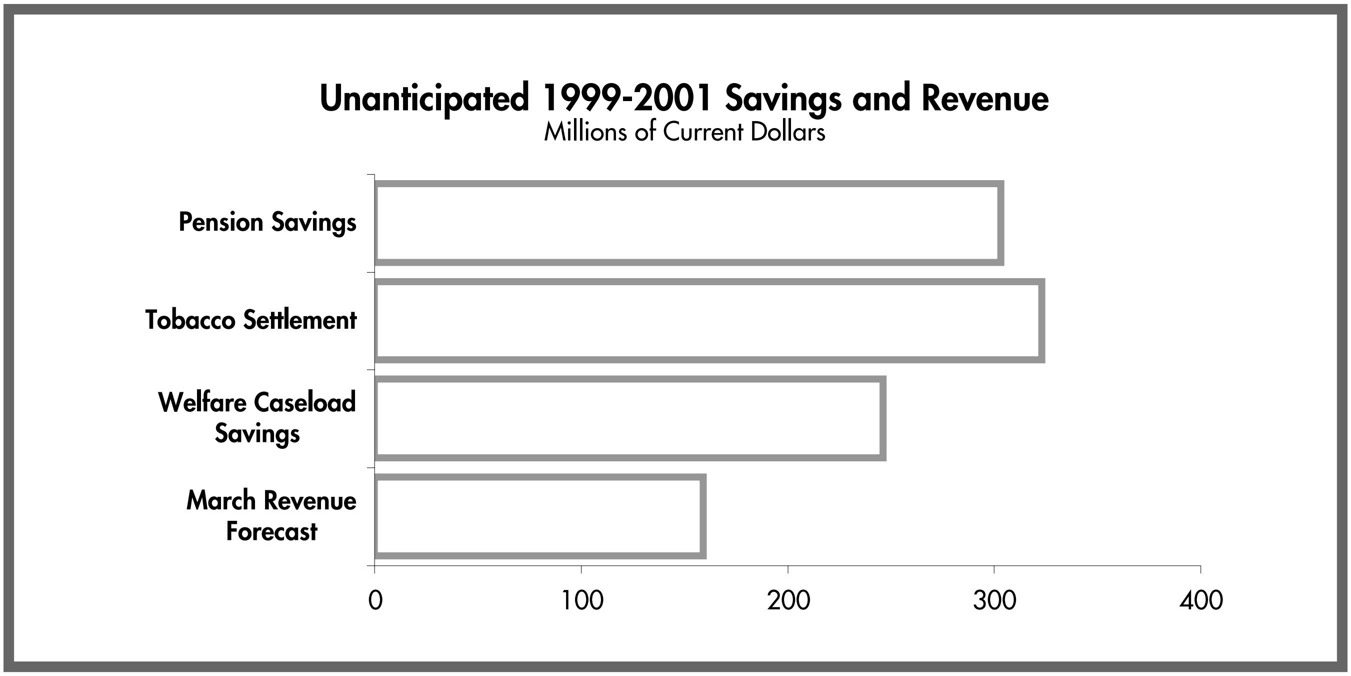
This is the third consecutive year the Governor has proposed spending reserves in response to progressively larger budget shortfalls. Each has been the product of policy changes -- tax cuts -- rather than unforeseen economic developments.

With unemployment at a 30-year low, there is no budgeting rationale for a deficit. Current shortfalls will only intensify as the result of a recession, and short of extraordinary economic growth, state reserves will be depleted during the 2003-2005 biennium without spending cuts or tax increases.

The Governor's budget contains $270 million in reductions, and even more in unfunded carry-forward costs, but after three budget cycles of Initiative 601-imposed austerity, there are no easy cuts.







Borrowed Time

Since passage of Initiative 601 in 1993, the state has cut spending in order to fund tax cuts. If not for the tax reductions, the state would have an additional $2.4 billion in the 2001-2003 biennium, and would be well prepared to deal with a recession.

For years, the cost of these tax cuts — and of maintaining current programs — has put the state on a collision course. A budget shortfall was averted two years ago with an unanticipated $1.0 billion boost in state revenues. The stock market provided record returns on pension funds, welfare caseload dropped as the state approached full-employment, and the tobacco lawsuit settlement and a booming economy provided additional revenue.

This biennium offers little hope of new revenue. A lackluster stock market threatens to boost pension costs, welfare caseloads will almost certainly grow, and success in reducing cigarette sales will also trim industry restitution payments. Coupled with an adverse March revenue forecast, the budget crisis may intensify even without a recession.

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