

March 16, 2001

Revenue Forecast Brings Good News, But Will It Last?

This morning the state forecast council released higher than expected revenue projections, suggesting that the budget will not be further undermined by a slowing economy. The announced increase of \$10 million in resources available to budget writers comes two weeks after the largest downward revision in predicted personal income in 12 years.

INCOME AND REVENUE

While income is understood to drive tax collections, the short term relationship between the two is less exact. Dramatic shifts in personal income, in absolute terms or relative to expectations, can produce unexpected changes in expenditure and savings behavior. Washington relies more than any other state on consumption taxes, and is particularly sensitive to changes in the economy.

Today's revenue forecast covers a period of 27 months. Although subject to considerable volatility, this duration has historically corresponded well with income trends. Since 1985, the state forecast council has undertaken nine sets of biennial revenue projections. Changes in personal income have

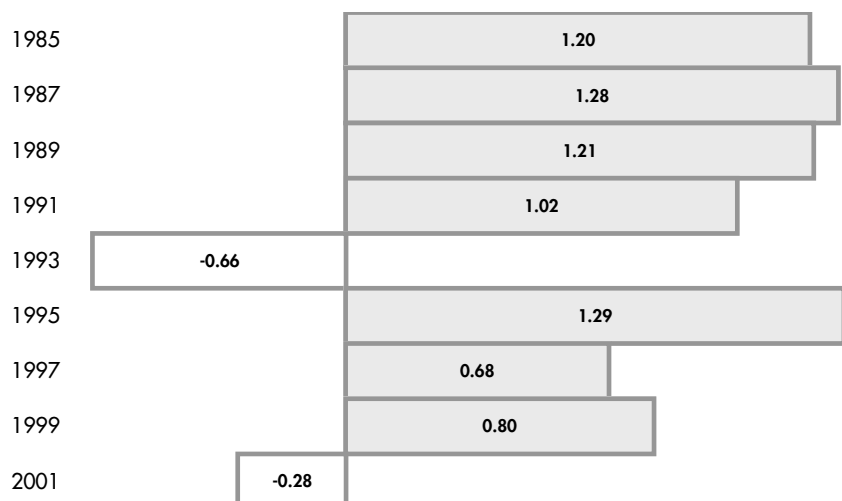
Change in Projected Personal Income Growth

March 2001 Economic Forecast compared to November 2000 Economic Forecast



Difference Between Forecasted Revenue and Personal Income

Ratio of standard score of change in weighted composite of projected personal income and forecasted revenue



Note: Personal income weights derived from Fisher Ideal index of one quarter and one-year lagged consumption effect. A negative ratio signifies relative income and revenue shifts in opposite directions.

explained 91 percent of the variance in revenue in all but one biennium – 1993-1995.

DEVIATING FROM THE MODEL

The forecast council uses an econometric model to predict tax revenues, inputting a variety of economic data. The forecast is ultimately managed by state economist Chang Mook Sohn, subject to approval by the Revenue Forecast Council, composed of legislators and the Governor’s budget and revenue directors.

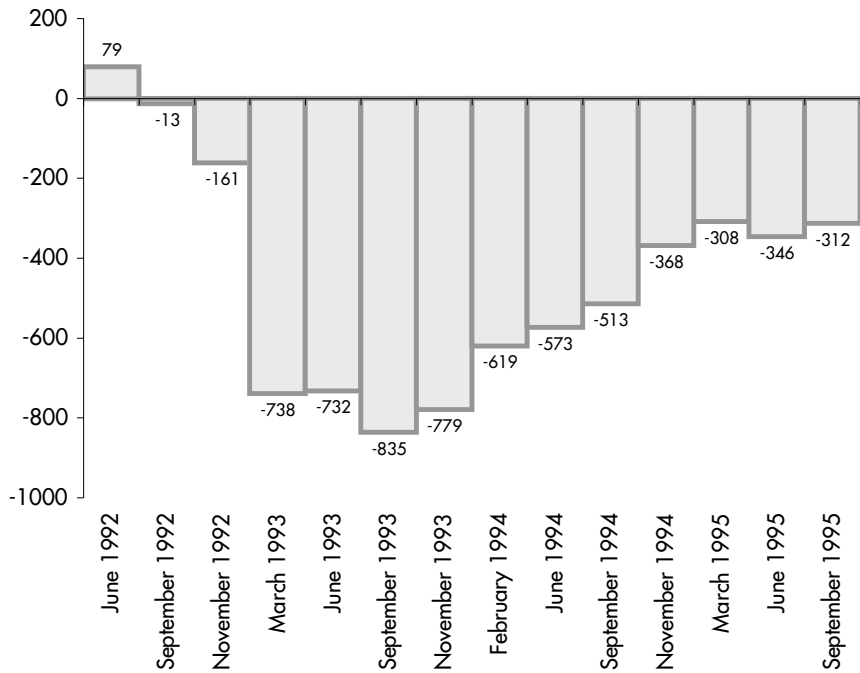
Adjustments can be made to the model’s prediction by substituting different economic and non-economic assumptions. In response to economic trends, the current baseline forecast remains relatively high, but equal probability has been assigned to a \$934 million lower pessimistic scenario.

PAST EXPERIENCE

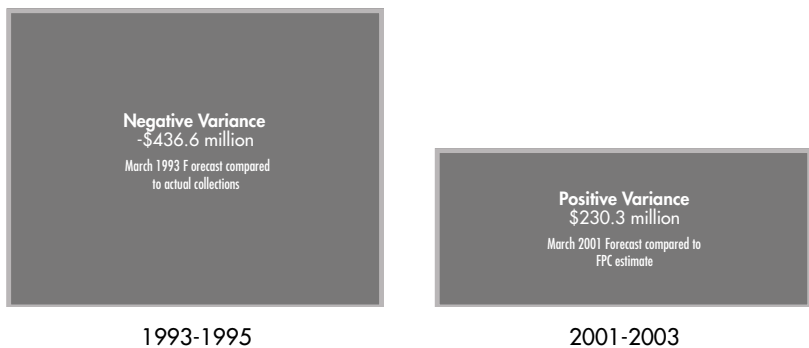
The 1993-1995 biennium is noteworthy as the only past forecast cycle characterized by significant deviation of the revenue projection from figures predicted by anticipated personal income levels. The forecast council has a strong reputation for accuracy; the March 1993 forecast, however, proved to be at least \$436.6 million below ultimate tax collections (excluding non-economic factors like legislation).

Had the forecast proven more accurate, \$717.5 million in general fund tax increases approved in the spring of 1993 likely would have been scaled back, as would over a billion dollars in spending cuts. The state’s political history may have changed in other ways, affecting Initiative 601, approved by a razor-

Cumulative Economic Changes to 1993-1995 Revenue Forecast

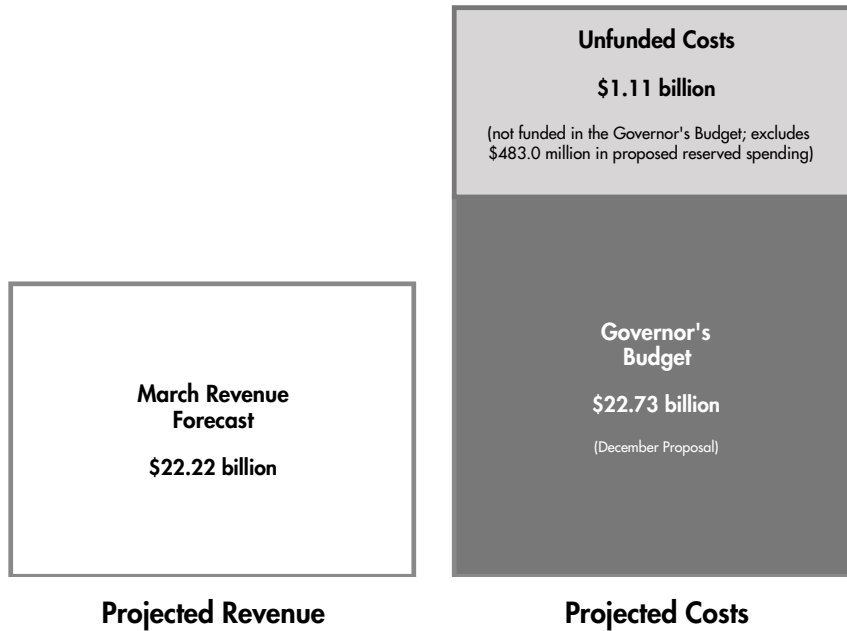


1993 and 2001 Forecast Variance Compared



2001-2003 Resources and Costs

State General Fund, Millions of Dollars



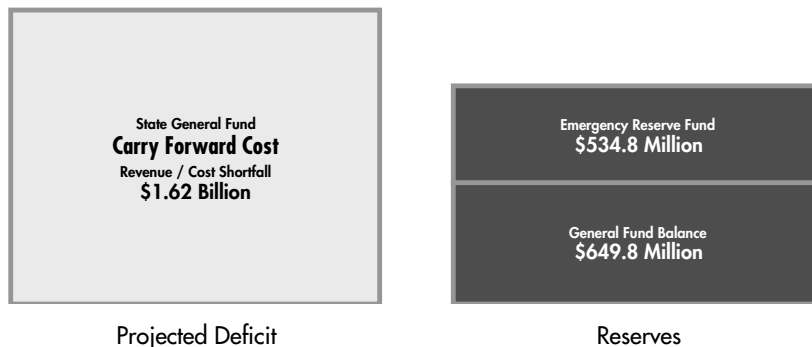
Unfunded Carry Forward Costs

Governor's Budget (December 2000 proposal), Millions of Dollars

Human Services Reductions	270.0
Pension Contribution Reductions	194.8
Teacher/State Employee Health Benefit Costs	60.0
K12 Teacher Cost-of-Living Adjustments	111.2
State Employee/Vendor Cost-of-Living Adjustments	129.6
Higher Education Enrollments	36.5
February Caseload Revision	308.0
Expenditure of Reserves	483.3
Total	1,593.4

Projected 2001-2003 Deficit and Reserves

Millions of Current Dollars



thin margin November, 1993, or the dramatic transformation of the legislature in elections the following year.

CURRENT FORECAST SIMILARITIES

Like the 1993 forecast, today's announcement deviates significantly from the revenue level implied by personal income trends – the Fiscal Policy Center estimates that it is roughly \$230.3 million higher than what purely economic factors predict. Unlike 1993 the variance is positive – forecasting *more* revenue than a simple income model, while 1993 projected *less* revenue than the economic model.

The current forecast also comes with other mitigating factors. Federal earthquake aid, for example, may spur increased economic activity and higher tax collections. Conversely, wealth effects from the precipitous drop in technology stocks will undoubtedly impact Puget Sound housing and construction markets. Like 1993, uncertainty about national trends creates an environment where significant revenue revisions are almost inevitable.

PROJECTED DEFICIT

Based on new revenue numbers and cost estimates, the general fund carry forward budget for 2001-2003 totals \$23.84 billion, or \$1.59 billion over revenue.



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