an overview of the Initiative 601 spending limit

* Based on and excerpted from *Changing the Rules of the Game: Washington Fiscal Developments Before and After Initiative 601* (November, 1999.)

Despite approval by a razor-thin margin, Initiative 601 has radically reshaped Washington's budget process. Built with relatively few loopholes and the slowest growth rate of any state tax or expenditure limitation in the country, Initiative 601 has coincided with a significant decline in state general fund spending as a proportion of the economy.

The spending limit has undergone two major changes in recent years. In 1998, Republican legislators re-enacted the spending limit to avoid losing spending capacity after transferring general fund revenues to transportation under Referendum 49. Last year, House Bill 3169 inserted a "two-way street" provision, allowing considerable flexibility in adjusting the limit for a variety of fund transfers. The result of each amendment has been higher spending, but the limit formula has remained intact.

Passage of Initiative 732, tying teacher salaried to inflation, will likely bring much bigger changes. Reductions in real per-student funding, primarily through constrained teacher salaries, have aided maintenance of the spending limit. In the coming years, the Legislature will have to choose between retrenchment of government services on a mammoth scale or repeal of the spending limit.

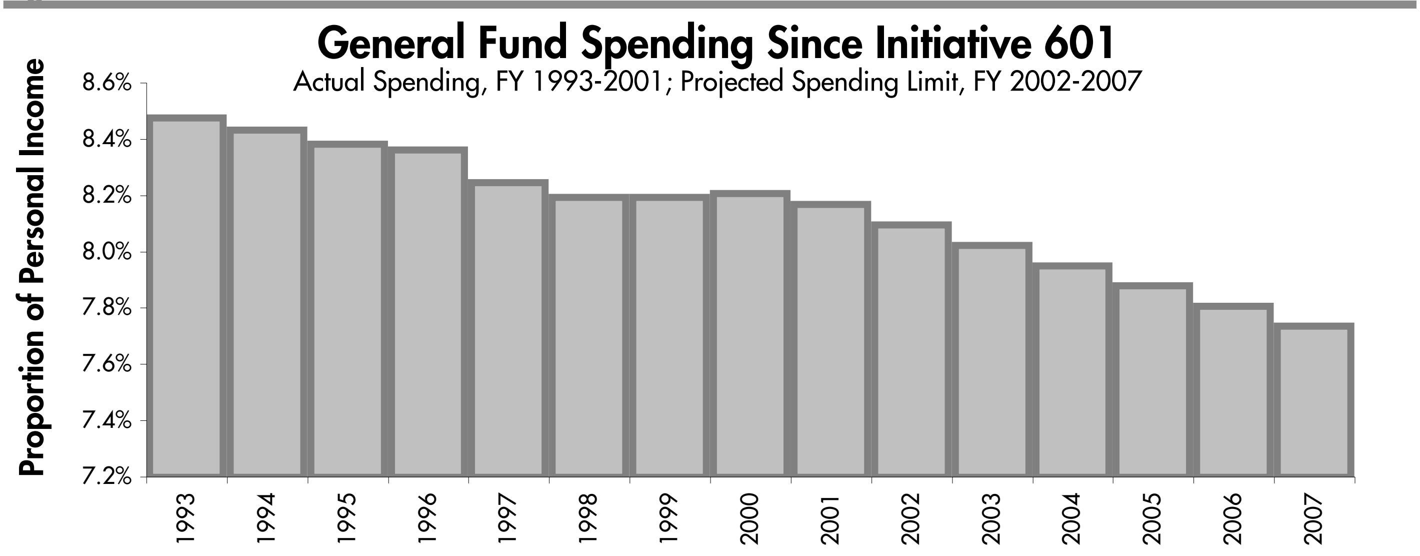
Over the past decade Washington state government finances have been shaped by several key economic, demographic, and political factors:

• An economic boom in the late 1980s provided the resources to increase discretionary state spending for health care, the expansion of handicapped, bilingual, and other special education programs, and the enhancement of training options in the state's welfare program.

• A national recession, followed by large layoffs in the aerospace industry, slowed the Washington economy in the early to mid 1990s, making it difficult to sustain spending patterns that began in the 1980s. This resulted in a combination of tax increases and budget cuts in the 1993-95 Biennium.

• A resurgence of economic growth in the late 1990s, lower inflation, a voter-approved expenditure limit (Initiative 601), and changes in political control of the legislature resulted in slow spending growth for the remainder of the decade. The period also included a series of large tax reductions enacted in the 1994 through 1999 legislative sessions.

Figure 1



Major Provisions of Initiative 601

There are five key provisions of I-601 affecting state government spending and taxes.

• Initiative 601 establishes annual limits on General Fund state expenditure growth based on a three year average of inflation and population growth, called the Fiscal Growth Factor. The Fiscal Growth Factor is lagged, i.e., based on the past. For example, the fiscal growth factor for FY 2000 is the average of inflation and population growth for fiscal years 1998, 1997, and 1996. The spending limit uses a national inflation measure called the implicit price deflator which has been much lower than Washington-specific inflation estimates like the Seattle-Tacoma-Everett Consumer Price Index.

• Initiative 601 requires that the spending limit be adjusted for fund shifts – e.g., the spending limit is reduced when revenues or program costs are shifted from the General Fund to other state budget accounts.

• Initiative 601 requires that when actual expenditures fall below the spending limit, that future limits be based on the lower amount. This is called re-basing.

• Initiative 601 establishes an Emergency Reserve Fund (or rainy day account) of revenues collected in excess of the spending limit.

• Initiative 601 requires a 2/3 majority of both houses of the Legislature to increase revenues.

It is important to add that although Initiative 601 requires reductions to the General Fund spending limit when General Fund revenues or program costs are shifted to other funds, it does not explicitly restrict spending from other funds or formally restrict growth in the transportation budget, for example. Limiting General Fund expenditures indirectly limits the growth of the Capital budget, since bonding capacity is capped by statute at 7 percent of General Fund spending.

Implications of the Initiative 601 Formula

The basic premise of the limit is that state spending can and should be determined by growth in the number of people needing services (as represented by total population growth) and by changes in the cost of providing those services (as represented by general inflation). Inflation plus population growth comprise the Initiative 601 Fiscal Growth Factor. This premise misses some important details that can produce actual growth pressures higher or lower than the Fiscal Growth Factor.

Figure 2

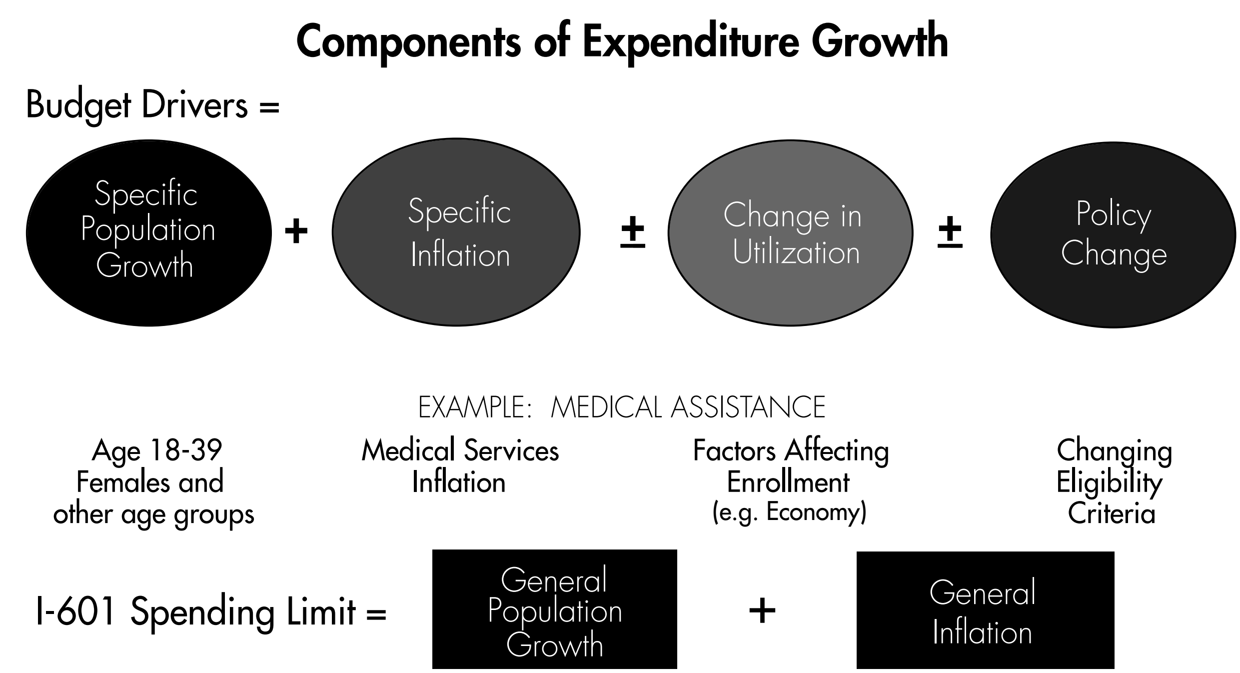


Figure 3

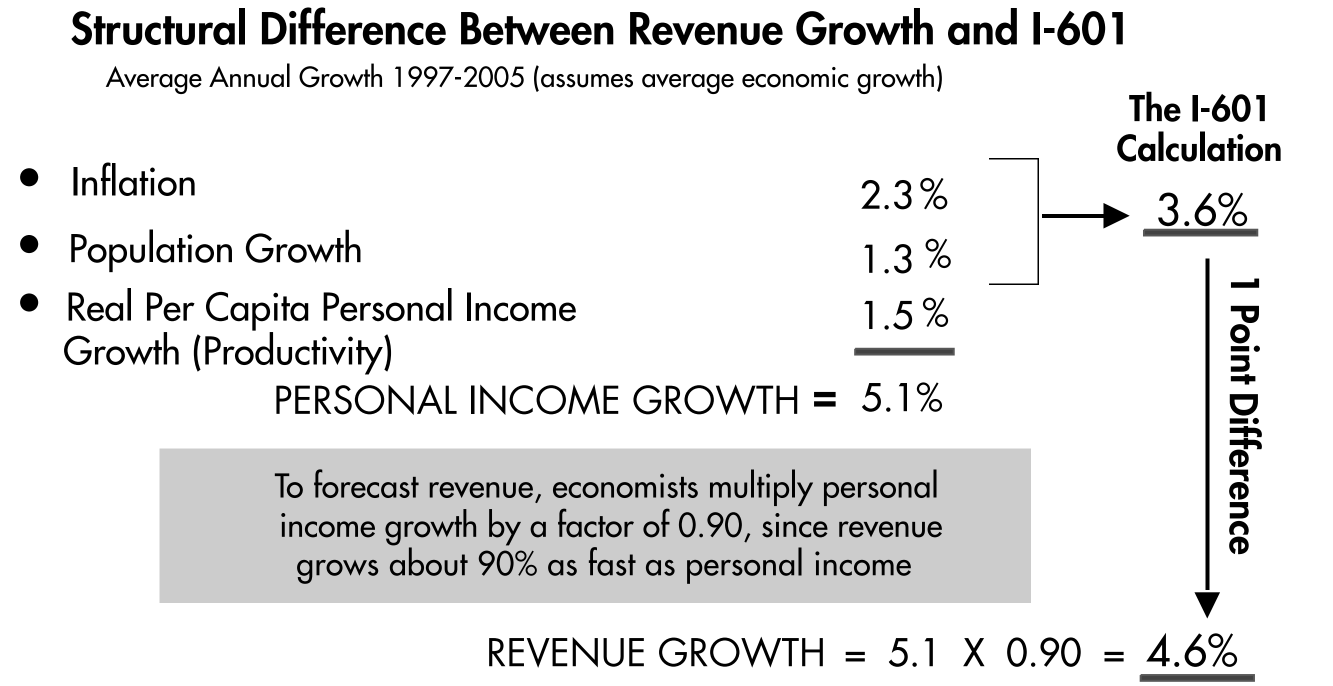


Figure 2 compares the I-601 spending limit with the components of actual spending growth. There are four basic differences between the I-601 limit and actual budget pressures:

• I-601 limits growth on the people side of the equation to growth in total population. In reality, budgets are driven by growth in the specific populations served by state government, such as the school age 5-17 population. At various times, growth in the populations typically served by government can be higher or lower than total population growth.

• I-601 limits growth on the price side of the equation to growth in the general price level of the economy, or general inflation. In reality, special inflation, — inflationary pressures for specific government services, such as health care — can be higher or lower than general inflation. Special inflation is not entirely uncontrollable, and is influenced by budget policy.

• The I-601 formula does not explicitly address policy changes affecting program costs. In order to increase access to the state's regular medical assistance program under I-601, for example, savings or productivity gains would have to be realized in the medical assistance budget or elsewhere in the state budget. Policy changes can, of course, also result in lower spending.

• The I-601 formula does not explicitly address changes in the **utilization** rates of programs and services. Due to economic conditions or factors affecting health, for example, enrollment demands in the medical assistance program can grow faster or slower than the populations typically served by the program.

Inflation and population growth, representing relatively uniform pressures on spending, do capture and explain a large part of the variation in spending. They also provide a good baseline for budget construction, and a reality check on the rate of expenditure growth.

The Fiscal Growth Factor falls somewhat short of adjusting the expenditure limit for general inflation and population growth. By using the Implicit Price Deflator for personal consumption expenditure, a residual statistic from GDP estimates, the Fiscal Growth Factor incorporates lower inflation computations than those reported by market-basket measures such as the Consumer Price Index.

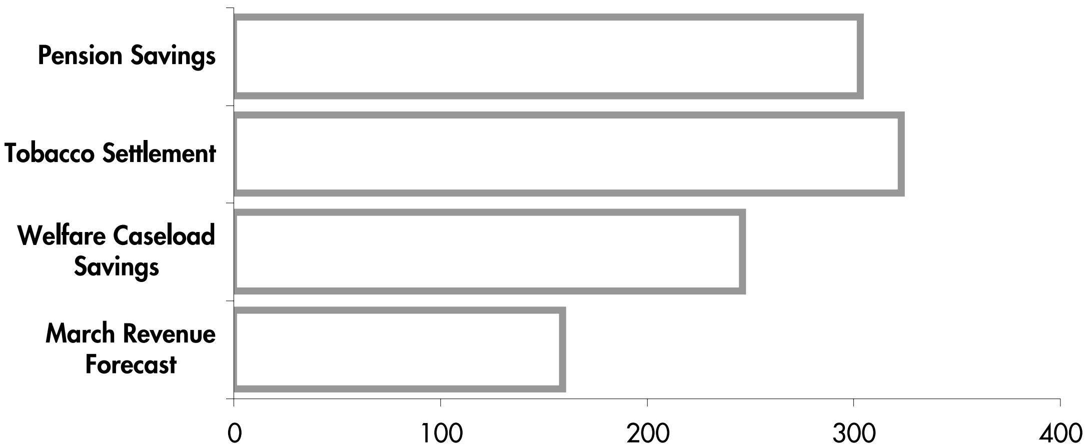
The formula itself also understates the combined effect of inflation and population growth by adding rather than multiplying these two factors. As a consequence, the formula reflects the cost of population growth without adjusting for contemporary inflation.

Compared with Economic and Revenue Growth

Another feature of the I-601 formula concerns the relation-

Figure 4

Unanticipated 1999-2001 Savings and Revenue
Millions of Current Dollars



ship between government spending and general economic growth. I-601 allows state government spending to grow by the rate of inflation and population growth; whereas the state economy grows by these factors plus the effect of productivity gains in the economy. As a result, a basic implication of I-601 is that over time, state government will shrink as a share of the state economy.

Since revenues grow at almost the same pace as the general economy, a related implication of the I-601 formula is that if the tax system is unchanged, growth in general revenues will also, over time, exceed growth in the spending limit. Under an assumption of average economic growth, revenues are expected to grow about 1 per cent per year faster than the spending limit over the long term. Figure 3 shows this relationship.

Living Within the Limit

At least five factors have helped spending growth stay within the constraints of I-601:

• Welfare reform and a substantial reduction in public assistance program caseload growth.

• A reduction in medical services inflation and other cost savings in health care with the implementation of managed care practices.

• A slowdown in salary growth for state employees.

• Additional unexpected revenues (the tobacco lawsuit settlement) which helped fund health care programs outside the General Fund.

• Unprecedented returns on pension investments which (at least temporarily) reduced required public contributions to state retirement funds.

The outlook for state finances depends heavily on whether these or similar factors which helped accommodate Initiative 601 constraints can be maintained or replicated in the future, or whether new savings can be found.

It is also likely that some gains in state government productivity (not to be confused with productivity gains in the general economy) have acted as a budget balancer over the past several years, slowing down growth in spending without necessarily affecting services. Productivity gains will be a key factor in how the state handles budgetary challenges in the future.

As in the case of private sector firms that provide services, state government has looked to technology to slow down growth in labor costs. Productivity gains have apparently been realized in the provision of fairly routine state services, such as tax collections, check distributions, and some public information activities.

However, there are limits to productivity gains in state government. Conventional measures of productivity imply higher ratios of students to teachers or children to caseworkers, outcomes that would likely be unacceptable to most parents and public officials.

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