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COMPETITIVENESS BRIEF

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I-601: The Tie that No Longer Binds

THE BOTTOM LINE

With passage of SSB 6078, lawmakers drastically altered what remained of the Initiative 601 spending limit. While elements of SSB 6078 may be said either to improve or to weaken the state's expenditure limit, the net result is this: the TEL created by SSB 6078 is rendered ineffective because of the measure's failure to correct fundamental defects. If Washington voters want a strict amendment, then they will have to rely on the initiative process once again.

Twelve years after voters adopted Initiative 601, the 2005 Legislature gave it an extreme makeover. With SSB 6078, lawmakers substantially recast the state's primary tax and expenditure limitation (TEL), implicitly inviting the public to consider whether this alternative satisfies voter expectations.

In its early years, I-601 reinforced fiscal discipline and kept state spending in check, mitigating the effect of the boom-then-bust cycle of the late 1990s and early 2000s. As time passed, however, the limit imposed less restraint, rhetorically honored but of scant substance. And with passage of SSB 6078, it little resembles the initiative passed by the voters.

The Legislature's action revives two questions considered by the voters in 1993: Should there be legal constraints on government's fiscal powers? And, if so, what combination of tax and expenditure limitation works best?

In this WashACE report, we examine the general public policy implications of TELs and the possible consequences for the state's economic competitiveness. As we have noted previously, budget sustainability and fiscal stability bear directly on the business climate (see WashACE, Jan 2005 and May 2005). The presence and nature of a state TEL affects the Legislature's ability to raise taxes, increase spending, and manage the state budget. TEL advocates argue that, by restricting lawmakers' fiscal discretion, limitations encourage priority setting consistent with the Priorities of Government budget process; opponents say that restrictive TELs starve critical programs essential to maintaining and enhancing our quality of life, including our economic vitality. While evidence can be marshaled to support either side, it seems clear that a properly constructed limitation strengthens fiscal accountability without compromising essential services.

BACKGROUND

In November 1993, when voters endorsed Initiative 601 in response to tax increases passed by the Legislature earlier in the year, tax and expenditure limits were enjoying a populist heyday. The era might be considered the second wave of the contemporary tax revolt. Angry Californians set the first wave in motion with Proposition 13 in 1978.

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"After a decade of dormancy, the tax revolt is back," wrote Dean Stansel in 1994. "Fed up with rapidly rising state budgets Americans are increasingly taking matters into their own hands" (Stansel, 1994). He noted that Connecticut and North Carolina enacted TELs for the first time in 1991 (two other states modified theirs that year) and by 1994 five others – including Washington – had followed suit. By early 2005, some form of TEL existed in thirty states (NCSL, 2005).

Our state's 1993 TEL campaign featured two competing initiatives, each with a different approach. As noted in the Washington Research Council's analysis, the initiatives shared a common background: "The dramatic rise in state spending over the last decade and the major increase in taxes, fees and tuition enacted by the Washington Legislature during the last session have provoked vigorous campaigns to place new legal constraints on the growth of government" (Archer et al, 1993).

The second wave of TELs has given researchers plenty to consider. The results across the nation have been mixed. Here in Washington, Initiative 601 defenders decry the legislature's radical amendment of the measure, while opponents say the limits imposed by the initiative fail to allow government spending to keep pace with service demands. Essentially, the positions of the respective camps have changed little since the summer and fall of 1993.

In 1999, Irv Lefberg analyzed Initiative 601 for the University of Washington's Institute for Public Policy and Management. Lefberg notes that in the 1990s, the state experienced the effects of the national recession, fluctuating aerospace employment, two gubernatorial changes, and a change in parties controlling both houses of the Legislature. Given these factors, he concludes, "Untangling the impact of the initiative from the effects of political and economic change is virtually impossible…" (1999, p. 3).

Nonetheless, it makes sense to consider how the state budget fared in the early post-601 years. Lefberg finds that, for the state general fund, "actual 1999-01 appropriations were significantly smaller than what would have been expected based on pre-601 spending trends" in major areas of state spending (1999, p. 16). A number of factors came into play – some political, some demographic, some policy. Unquestionably, though, Lefberg observes: "As intended by its supporters, I-601 has clearly imposed constraints on state government spending" (1999, p. 23).

Within a few years, the state legislature would slip those constraints.

UNDOING THE TIES THAT BIND

A well-intentioned effort to correct what many analysts viewed as a flaw in the drafting of I-601 substantially weakened – some would say destroyed – the limit. The original language of the initiative provided that the limit must be lowered if general fund costs or revenues are transferred to other accounts (RCW 43.135.035.4). If, on the other hand, costs and revenues were transferred from other accounts to the general fund, the limit remained fixed. The asymmetry, called a "one-way street," worked against efforts to pull dedicated funds, earmarked taxes, and the like into the general fund.

So, in 2000, the Legislature amended I-601 to create a two-way street, al-

lowing the limit to be raised to reflect transfers of costs or revenues from other accounts to the general fund. The amendment enjoyed bipartisan support. Soon, however, down the two-way street rumbled a truckload of transfers having the sole purpose of boosting the spending limit. As the Washington Research Council pointed out in 2001, however, the problem had less to do with the drafting of the Legislative amendment than it did with the willingness of the legislature and Governor to exploit the provision to boost spending.

As it happened, the problem of spending above the limit – or increasing the limit to enable spending – paled with the recession that began in 2001. Slow revenue growth effectively limited the state budget for several years. In 2002, the Legislature amended I-601 to allow lawmakers to raise taxes by a simple majority vote. While the tax increases were relatively minor, the precedent demonstrated the ease with which the initiative's statutory requirements would be waived to increase taxes.

In 2003, lawmakers confronted a $2.4 billion budget shortfall. Working within a Priorities of Government framework established by Gov. Gary Locke, a Republican Senate and Democratic House crafted a balanced budget without significantly increasing taxes (WRC, 2002). Plenty of money was transferred among accounts, the I-601 limit bounced around, but the intent of the initiative was preserved.

This year, Initiative 601 got its extreme makeover in SSSB 6078. Lawmakers again suspended the supermajority requirement (this time until June 30, 2007) in order to raise taxes by simple majority vote and changed the spending limit. Rather than the I-601 formula adopted by the voters, which allowed spending to increase by a "fiscal growth factor" based on population and inflation, the new legislation adopted a factor based on personal income growth. SSSB 6078 also extended the limit beyond the state general fund to embrace some "near general fund" accounts.

Before examining SSSB 6078, it might be helpful to understand what has been discovered nationally about tax and expenditure limits in the last decade.

THE NATIONAL EXPERIENCE

The National Conference of State Legislatures says, "… no two TELs are exactly alike in their design and characteristics," though they all share the same general goal of limiting taxes and spending outlays (2005). NCSL identifies four types of TEL: expenditure limits, revenue limits, appropriations limited by the revenue estimate, and "hybrids or combinations." Most of these include exceptions and exemptions.

While NCSL does not consider voter approval and supermajority requirements to be traditional TELs, its analysis recognizes that these measures can limit taxing and spending. Three states (Colorado, Missouri, and Washington) require voter approval for some tax increases, and sixteen states impose supermajority votes.

Economists Dale Bails and Marie A. Tieslau categorize TELs along with line-item veto power, balanced budget requirements, and super-majority voting requirements, calling them "budgetary constraint mechanisms,"

one of three categories of fiscal discipline mechanisms (Bails & Tieslau, 2000). The other two are administrative constraint mechanisms (e.g., term limits, bill introduction limits, and the length of the budget cycle) and direct democracy mechanisms (e.g., initiative and referendum).

EXAMINING EFFECTIVENESS OF TELS

Generalizing about the effectiveness of tax and expenditure limits is a lot like generalizing about diet and exercise. Some plans work a lot better than others and some don't work at all.

Michael New has examined the academic literature and finds that, while most past studies found that TELs "have little impact on state budgetary outcomes," the research typically ignores the incentives of the political groups that design the TELs. "If these incentives are properly taken into account," he says, "a different story is likely to emerge" (2003, p. 3). For example, New cites the relative weakness of TELs passed by legislatures and says, "… it is not clear that legislators have the incentive to reduce their autonomy by placing meaningful constraints on their own behavior (2003, p. 3). Citizens, acting through the initiative process, are more likely to want to control spending, he says. The different incentives may explain the difference in the effectiveness of TELS among the various states.

New also faults much of the early research on state TELs for focusing on a small number of states for a short time, for failing to consider all factors influencing state budgets, or for recognizing the differences among TELs (2001, p. 3-5).

Phyllis Resnick of the CPEC Center for Tax Policy evaluates TELs on the relative restrictiveness of their various provisions. Her criteria include the method of codification, how the limit was approved, how the limit is calculated, what the limit applies to, treatment of surpluses, provisions for waiving the limit, and supermajority requirements. She concludes that the most restrictive TELs would be constitutional, stem from a citizen initiative, limit both revenues and expenditures, limit growth to population plus inflation, require surplus revenues to be returned to the citizens, require citizen approval to waive the limit, and require a supermajority vote to approve tax increases (2004, p. 7). Colorado's 1992 Taxpayers Bill of Rights (TABOR), a constitutional limit tied to a population-plus-inflation formula that can only be overridden by a vote of the people, is the nation's most restrictive. A recent study by the Center on Budget and Policy Priorities points out that Colorado's tax and expenditure limit is the only one in the country with the combination of the most restrictive type of legal authority, growth formula, and provisions for a temporary override of the limit (Bradley and Lav, 2005, p. 2).

Bails and Tieslau, with their more expansive view of budgetary constraint, find that "states that have adopted tax or expenditure limitations, states that provide their citizens with the initiative process, and states in which term limits have been implemented face significantly lower levels of per capita state and local spending" (2000, p. 271). An analysis by Robert Krol finds that tax and spending limits work most effectively in combination with other fiscal restraints. "Limits on taxation and spending, the power of governors to veto and reduce state spending on a line-by-line basis, and balanced-budget rules all have the intended effect, reducing state spending, taxes, and debt" (1997, p. 305).

New concludes that TELs passed by citizen initiative "establish lower limits for budgetary growth, are more likely to mandate refunds of surpluses, and have fewer loopholes than their counterparts enacted by state legislature" (2003, p. 27). He uses a statistical model to analyze budget data from 49 states (Alaska is excluded) from 1972 through 2000. Controlling for demographic and economic fluctuation, he finds that legislative TELs are less effective than those passed by citizen initiative.

SSB 6078

Although proponents argued that SSB 6078 would reaffirm and strengthen Initiative 601, it does neither. The revised TEL differs dramatically in several particulars from that endorsed by the voters in 1993: It replaces the population plus inflation growth factor with a new one based on a 10-year rolling average of personal income; it extends the limit from the general fund to include several related funds; and, it suspends the supermajority requirement for legislative votes to increase revenues.

Overall, the SSB 6078 limitation is much less restrictive than I-601, as is the general rule with initiatives adopted by the legislature rather by citizen initiative.

Personal Income Growth Factor. Most important, the personal income growth factor grows much faster than the I-601 formula of population plus inflation. An early estimate by the Office of Program Research (OPR) – the nonpartisan central staff of the House of Representatives – shows that SSB 6078's growth factor would permit nearly $1 billion more in spending in the 2007-2009 biennium than would be possible under the I-601 formula. This finding is consistent with the national research. Stansel's 1994 research concluded that "… one of the reasons many studies have found TELs ineffective is that so many TELs are linked to personal income growth – which is hardly a restrictive limit" (1994, p. 15).

Critics of the population plus inflation formula used by I-601 and Colorado's TABOR consider the restrictive provision "deeply flawed" because it does not capture accurately the rising costs of government programs (Bradley, Johnson & Lav, 2005). Health care costs, a major expense of state government, often increase much more rapidly than general inflation. Further, these critics contend that states face increased service pressures because of changing demographics and the devolution of federal responsibilities.

These arguments were advanced in Olympia as proponents rejected the I-601 formula for the more liberal growth factor. For example, the chairwoman of the Senate Ways and Means Committee said, "We feel the new limit will be more realistic and we'll use the suggestion from the economists that our budget grow no faster than the economy grows, no faster than personal income grows" (Ammons, 2005).

Unsurprisingly, economists can be found on both sides of the issue. Economist Barry Poulson, a TEL advocate and close observer of the Colorado TABOR, says effective limitations should "impose a stringent limit on the revenue that governments can keep and spend, such as the sum of inflation and population growth" (Poulson, 2004b). A personal income formula would be "too generous" (Uhler & Poulson, 2004).

The national debate played out in Washington in 1993, as proponents of Initiative 602 endorsed a personal income factor, while I-601 backers opted for the more stringent cap. No clear signal can be read in the voters' endorsement of I-601 over I-602, however, because although I-602 had a more liberal growth factor, it also called for a repeal of the tax increases passed by the legislature earlier in the year. So I-602 was at once more liberal and more conservative than I-601.

Extension of Cap to Related Funds. Commonly, when people speak of the state budget, they have in mind the state general fund. That's where most of our major taxes land and where most of the legislature's discretionary, non-capital spending takes place. Yet there are a number of "near general fund" accounts, dedicated funds supported by earmarked taxes that interact closely with the general fund. Deficits in these accounts often must be filled with general fund dollars; surpluses can easily be transferred to the general fund. As the Washington Research Council observed in 1996, "Tighter general fund constraints under I-601 will increase pressure to push spending to dedicated accounts. … Shifting revenue sources from the general fund to dedicated accounts can provide a means of circumventing the Initiative 601 limit" (p. 5).

Most analysts advise that TELs should cover as much spending as possible. "No government function, such as education, should be permitted to remain outside the TEL, and there should be no earmarking of a specific revenue source for a designated government function" (Uhler & Poulson, 2004).

SSB 6078 brings the Health Services Account, Violence Reduction and Drug Enforcement Account, Public Safety and Education Account, the Water Quality Account and the Student Achievement Fund under the spending limit. Underscoring the legislature's problem in getting control of state spending, however, is the omission of the new Education Legacy Trust Account established just this year – yet another "near general fund" account supported by earmarked taxes (cigarette and estate). Even as lawmakers attempted to rationalize the spending limit by capturing general spending, they created another account outside the general fund and unlimited by their amended expenditure cap.

The extension of the spending cap to additional funds, flawed as this effort is, would nonetheless appear to be a strengthening of I-601. Yet, the legislation begs the question of why allow the dedicated funds to exist at all. Why not consolidate them, with their revenue sources, into the general fund?

Although the extension of the cap to these near general fund accounts may mitigate the effects of the "two way street," SSB 6078 also attempts to close the loophole. After July 1, 2007, the legislature will no longer be able to inflate the limit by transferring revenues into the general fund. Program costs and the ongoing revenue to support them must be transferred together, eliminating the asymmetry that allowed lawmakers to manipulate the limit.

Supermajority Vote. SSB 6078 suspended – from the day it was enacted to June 30, 2007 – the requirement for a two-thirds supermajority vote of each house to raise taxes. The suspension was necessary to allow lawmakers to pass tax increases this session on a simple-majority vote. (The bill had an emergency clause associated with this provision to allow it to take effect immediately and not be subject to a referendum.) Statutes – even statutes

requiring supermajority votes for certain actions – can be amended by simple majorities.
Legislators similarly suspended the supermajority requirement to allow a simple majority to pass a tax increase for the 2001-2003 biennium. The June 30, 2007 deadline will allow lawmakers to increase taxes by simple majority during the construction of the 2007-09 budget, which will be written during the spring of 2007.

A supermajority requirement does more than simply make it more difficult to raise taxes, although it certainly does that. As important, it requires lawmakers to work cooperatively in responding to a fiscal crisis. To gain a supermajority, budget drafters must involve members of the minority party in developing the state's fiscal solution. That bipartisan approach clearly was envisioned when I-601 was enacted.

CONCLUSIONS

With passage of SSB 6078, lawmakers dramatically altered what remained of the Initiative 601 spending limit. While elements of SSB 6078 may be said either to improve or to weaken the state's expenditure limit, the net result is this: the TEL created by SSB 6078 is rendered ineffective because of the measure's failure to correct fundamental defects. Barry Poulson found that TELs are most effective in their early years and tend to weaken over time (1992, p. 37-40, 131-133). Certainly, that's true of Initiative 601. If Washington voters want a strict amendment, then they will have to rely on the initiative process once again.

Washington, of course, does not permit constitutional amendment by initiative. For the first two years after it is adopted, an ititiative can only be amended by a supermajority of both houses of the legislature; after that, a simple majority is sufficient. So the primary clout of the initiative resides in lawmakers' belief that the initiative represents the strong policy preferences of the public. It's important that the initiative be clear and unambiguous.

The three critical elements of a TEL include:

- *The base to which it is applied.* The broader the base, the more effective the TEL. The proliferation of dedicated accounts makes a TEL that applies solely to the general fund less effective.

- *The fiscal growth factor.* The formula of population plus inflation used by I-601 is more stringent than the SSB 6078 personal income factor.

- *Procedural requirements to raise taxes.* Initiative 601 required a supermajority vote to raise taxes for spending within the expenditure limit and a vote of the people to permit spending above the limit. Only Colorado and Missouri share the voter approval requirement (NCSL, 2005).

There are a host of other considerations – disposition of funds over the limit, how to handle transfer of responsibilities to other units of government or among state funds, treatment of fee increases – and many of these were handled responsibly by I-601. The challenge here is not creating a new TEL, but recapturing the fiscal discipline endorsed by the voters in 1993. With some modification of I-601 to cover more funds and restrict lawmak-

ers' ability to manipulate the limit with fund transfers, Washington can again have an effective tax and expenditure limitation.

Regardless of the specific provisions of any statutory TEL, it will only be effective so long as the legislature shares the citizens' commitment to fiscal restraint.

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