Washington Research Council

Policy Brief

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Gov. Inslee Proposes a 22.3 Percent Spending Increase for 2019–21

Briefly

Gov. Inslee has proposed a historically large 2019–21 operating budget that would increase spending from funds subject to the outlook (NGFO) by $9.973 billion (22.3 percent). Of that spending, $6.415 billion is the cost of continuing current services and completing implementation of the K–12 spending required by the state Supreme Court's McCleary decision. Current resources are enough to fund that maintenance level.

The governor proposes $3.557 billion in new policy changes. These include funding collective bargaining agreements reached with state employees, increasing allocations for school support staff, altering limits on local levies, implementing a new special education funding structure, and increasing funding for state hospitals and homelessness programs.

To help fund the $54.634 billion spending proposal, Gov. Inslee proposes a tax package that would increase revenues by $3.689 billion. If enacted, 2019–21 revenues would increase by 17.2 percent over 2017–19. (Current revenues are already expected to increase by 9.2 percent.) The package includes a 9 percent capital gains tax and a 67 percent increase to the business and occupation tax on services.

The proposal would leave $2.789 billion in total reserves at the end of the biennium, and it would balance over four years. However, the budget would dedicate $2.090 billion of the new revenues to the education legacy trust account, thereby avoiding an extraordinary revenue growth deposit to the rainy day reserve fund. The high level of spending along with this revenue diversion make the sustainability of the proposal questionable. But this represents just an opening bid: Typically, the Legislature appropriates less than the governor proposes, and legislators have indicated that the tax package as proposed probably won't be enacted.

Funds Subject to the Outlook (NGFO)

In recent years, legislative fiscal committee staffs have based budget presentations on a synthetic "account" that rolls up the general fund–state (the state's primary budget account) with the education legacy trust account and the opportunity pathways account, because they believe that it better reflects the entire budget situation. Previously called the near general fund–state plus opportunity pathways (NGFS+), it is now more simply called "funds subject to the outlook" or the near general fund–outlook (NGFO). (Under the four-year balanced budget requirement, a positive ending balance is required in the current biennium on an NGFO basis.)

Gov. Inslee has proposed a 2019–21 operating budget that would increase spending from funds subject to the outlook (NGFO) by $9.973 billion (22.3 percent). This would be a historically large spending increase, following years of substantial spending increases (as documented in our recent paper, "Washington Spending Review: Spending Up 44 Percent Since Pre-Recession Peak"). To help fund the $54.634 billion proposal, Gov. Inslee proposes a tax package that would increase revenues by $3.689 billion (7.4 percent).

This policy brief describes the governor's preferred budget, but he is required by law to present a budget that balances within existing resources (RCW 43.88.030). (The law also allows him to offer an alternative budget that uses new revenues.) Under the governor's current law budget, NGFO spending would total $51.073 billion, a 14.4 percent increase over 2017–19 appropriations. His current law budget would not fund many of the major policy items in his preferred budget, and it would suspend levy equalization and the state need grant for four years. The current law budget would fund the collective bargaining agreements with state employees.

Balance Sheet

Revenues. Gov. Inslee's proposal would increase revenues by a net of $3.689 billion over the November 2018 revenue forecast. He proposes a capital gains tax, an increase to the business and occupation (B&O) tax on services, and changes to the retail sales and B&O taxes related to a recent U.S. Supreme Court decision regarding online sales.

Other Resource Changes. Gov. Inslee would transfer $249 million to the NGFO from other accounts. These include $140.0 million from the public works assistance account to the education legacy trust account (ELTA), $46.0 million from the disaster response account to the general fund–state (GFS), $20.0 million from the treasurer's service account to the GFS, and $38.7 million in loan repayments from the school employees' insurance account to the GFS.

Spending. Maintenance level spending (the cost of continuing current services, adjusted for caseload, inflation, and enrollment changes) is estimated to be $51.077 billion in 2019–21—an increase of $6.415 billion (14.4 percent) over 2017–19. Gov. Inslee proposes adding $3.557 billion in new policy changes on top of that.

Reserves. The proposal would leave an unrestricted NGFO ending balance of $572 million in 2019–21. Gov. Inslee does not propose making any withdrawals from the budget stabilization account (BSA, or the rainy day reserve fund) in 2019–21, though much of the increase to the B&O tax on services would be diverted from the GFS to avoid an extraordinary revenue growth deposit. The BSA's ending balance would be $2.217 billion. Total reserves at the end of 2019–21 would be $2.789 billion, slightly lower than the $2.838 billion in total reserves anticipated by the official November 2018 outlook.

Table 1: NGFO Balance Sheet (Dollars in Millions)

	2017-19	*2019-21*
Beginning Balance	1,149	1,460
Revenue		
November 2018 Revenue Forecast	45,799	50,002
Governor's Proposal		
Capital Gains Tax		**975**
B&O Tax on Services		**2,612**
Wayfair		**123**
Budget Driven and Other Revenue		**(21)**
Total Revenue	*45,799*	*53,691*
Other Resource Changes		
Transfer to Budget Stabilization Account	(438)	(490)
Transfer to BSA (Extraordinary Revenue Growth)	(1,575)	
Transfer from BSA (Extraordinary Revenue Growth)	1,078	
Other Enacted Fund Transfers	162	
Prior Period & CAFR Adjustments	85	41
Governor's Proposal		
Additional 1 Percent Transfer to BSA		**(16)**
Fund Transfers		**249**
Total Other Resource Changes	*(688)*	*(216)*
Total Resources	*46,260*	*54,934*
Spending		
2017-19 Appropriations	44,661	
Governor's Proposal		
Actual/Assumed Reversions	**(195)**	**(272)**
Maintenance Level Changes	**208**	
2019-21 Maintenance Level		**51,077**
Policy Changes	**127**	**3,557**
Total Spending	*44,800*	*54,362*
Unrestricted Ending Fund Balance	1,460	572
Budget Stabilization Account Balance	1,638	1,606
Transfers from GFS and Interest Earnings	2,054	595
Transfer to the GFS	(1,078)	
Transfer to the Pension Stabilization Account	(925)	
Appropriations from the BSA	(41)	
Governor's Proposal		
Appropriations from the BSA	**(43)**	
Additional 1 Percent Transfer to BSA		**16**
Projected BSA Ending Fund Balance	1,606	2,217
Total Reserves	*3,066*	*2,789*

Revenue Details

The November 2018 revenue forecast estimates that 2019–21 revenues will be $50.002 billion, an increase of 9.2 percent over 2017–19. Since the February 2018 forecast (on which the 2018 supplemental budget was enacted), estimated revenues for 2017–19 and 2019–21 are up a combined $1.735 billion. (WRC 2018b)

Gov. Inslee proposes increasing 2019–21 revenues by 17.2 percent over 2017–19, almost doubling the revenue increase expected under current law. Notably, the governor's budget does not include a carbon tax, which was included in other recent budgets, or a property tax reduction, which has been discussed by a number of legislators.

Capital Gains Tax. The governor's proposal would impose a 9 percent tax on capital gains above $25,000 for individuals and $50,000 for joint filers. The tax would not apply to residential real estate sales, retirement accounts, assets sold due to eminent domain, certain livestock sales, certain agricultural land sales, certain timber sales, and sales of certain personal property used in business. Businesses would be allowed a B&O tax deduction for any revenue that would be subject to both the B&O tax and the capital gains tax, to avoid double taxation. The proposal would increase GFS revenues by a net of $975.6 million in fiscal year 2021 and $2.141 billion in 2021–23. The budget documents note, "the actual amount collected from this tax would be expected to vary from year to year depending on fluctuations in the financial markets. The state can manage these fluctuations through careful budgeting" (OFM 2018). In December 2016, Gov. Inslee proposed a 7.9 percent capital gains tax for the 2017–19 budget; at that point, he would have created a "school investment reserve fund" to hold any collections over $900 million a year to help manage the volatility of capital gains taxes (WRC 2017a). No such mechanism was included in the proposal this year.

B&O Tax on Services. Gov. Inslee proposes increasing the B&O tax rate on services and other activities from 1.5 percent to 2.5 percent (67 percent) and the B&O tax rate on contests of chance from 1.63 percent to 2.63 percent (61 percent). This would increase NGFO revenues by $2.612 billion in 2019–21 and $3.018 billion in 2021–23. The governor made a similar proposal in 2017–19 as well (WRC 2017a).

Although B&O tax receipts are traditionally deposited mainly in the GFS, the governor's proposal would deposit $522 million of the 2019–21 increase in the GFS and $2.090 billion in the ELTA. According to the Office of Financial Management (OFM), this dedication to the ELTA would be permanent, to help fund basic education. This appears to be a purposeful effort to avoid a payment to the BSA, as we discuss below.

Wayfair. In June 2018, the U.S. Supreme Court held that states can require out-of-state sellers to collect and remit sales taxes sold to their residents (South Dakota v. Wayfair Inc). In 2017, the Legislature had enacted EHB 2163, which requires remote sellers and others to either collect and remit sales taxes or notify Washington customers that they owe taxes and report Washington customer information to the Department of Revenue. The budget proposal assumes that changes to state sales tax law will be made to conform with the U.S. Supreme Court's decision (and it assumes changes will be made to other tax areas for consistency). This would increase 2019–21 revenues by $92.8 million due to changes made to the retail sales tax and $30.2 million from changes made to the B&O tax.

Graduated Real Estate Excise Tax (REET). The governor would make the real estate excise tax rate graduated. Currently, the state rate is 1.28 percent on sales of real property. Under the proposal, the rate would be 0.75 percent for properties with selling prices of less than $250,000; 1.28 percent for properties with selling prices between $250,000 and $1.0 million; 2.0 percent for properties with selling prices between $1.0 million and $5.0 million; and 2.5 percent for properties with selling prices of $5.0 million or more. These changes are estimated to increase non-NGFO revenues by $402.0 million in 2019–21 and $436.8 million in 2021–23. The increased revenues would be dedicated to the motor vehicle account, for use in replacing highway culverts that block fish passage.

Spending Details

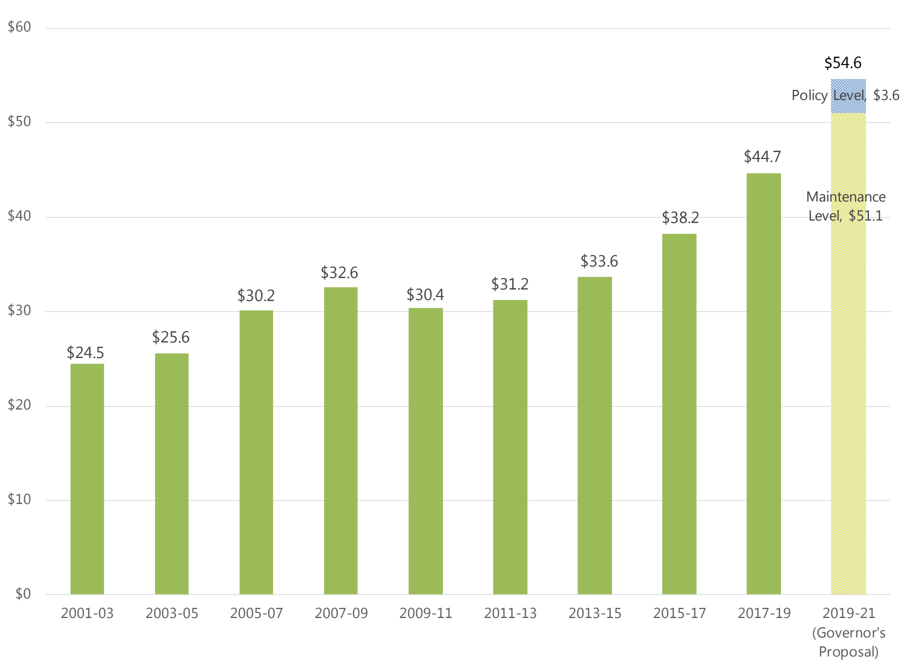
NGFO spending increased 16.9 percent from 2015–17 to 2017–19 (WRC 2018c). As estimated in the governor's proposal, the 2019–21 NGFO maintenance level is $6.415 billion (14.4 percent) higher than enacted 2017–19 appropriations. This substantial maintenance increase is largely due to the fact that the school employee salary increases (required under the state Supreme Court's McCleary decision on school funding) are fully implemented for a complete biennium for the first time. Note that the state's already-available resources are enough to fund the maintenance level (ERFC 2018).

On top of that, Gov. Inslee proposes policy changes that would increase NGFO spending by $3.557 billion. Altogether, his proposed budget would increase NGFO spending by 22.3 percent over 2017–19. The NGFO spending amounts discussed below are proposed policy changes.

Public Schools. Gov. Inslee's proposal would shift $2.300 billion of public schools funding from the GFS to the ELTA, in conjunction with the direction of the B&O tax revenues to the ELTA to avoid rainy day reserve deposits.

It would spend $155.9 million to increase allocations for nurses, social workers, psychologists, and guidance counselors in elementary and middle schools. This is something that was included in Initiative 1351 (approved by voters in 2014 but not implemented). The 2017 McCleary funding bill (EHB 2242) specifically declined to fund I-1351 as part of basic education and declared that future operating budgets could fund it as an enrichment (WRC 2017b). Gov. Inslee's budget proposal specifies that these enhanced staffing levels would be within the program of basic education (thus forcing future legislatures to fund it or risk another McCleary-style lawsuit).

Chart: Spending from Funds Subject to the Outlook (Dollars in Billions)



The proposal would spend $94.5 million to begin phasing in the new special education funding structure proposed by the Office of Superintendent of Public Instruction (OSPI). In its 2019–21 budget request, OSPI proposed a tiered special education cost multiplier that would "reflect the intensity and duration of special education services delivered to students with disabilities" (OSPI 2018).

The governor's proposal would provide $645.6 million to implement the School Employees Benefits Board (SEBB). As part of the McCleary response, school employee health care was consolidated in the SEBB. Under the governor's proposal, benefits would be provided at a rate of $1,170 per employee per month in fiscal year (FY) 2020 and $1,195 per employee per month for FY 2021.

Finally, his budget would increase local effort assistance payments by $213.6 million. This would be done along with an increase to local levy limits in calendar year (CY) 2020 so that districts would be able to levy property taxes up to 28 percent of their revenues. This is a complete reversal of the new levy system established under the Legislature's response to McCleary, back to the same system that is in place in CY 2018 (and has been in place since 1997). Under legislation passed in 2017, the levy limit is set to change to $1.50 per $1,000 of assessed value or $2,500 per pupil (whichever is less) in CY 2019.

(Incidentally, OSPI's budget request would have allowed districts to levy property taxes up to 22 percent of their revenues. In addition, OSPI proposed an 8 percent capital gains tax. Half of the collections would have been spent on K–12 programs and half would have been used to reduce the state property tax.)

Higher Education. The budget would provide $103.3 million to guarantee state need grant funds for all eligible students in school year (SY) 2021–22 and reduce the waitlist in SY 2019–20 and SY 2020–21. (The governor would re-name the state need grant the "Washington College Promise Scholarship.")

For the University of Washington (UW), the budget would spend $14.0 million to support the operations of Harborview Medical Center and the UW Medical Center. The budget would provide $10.8 million to complete funding for 240 students at the Washington State University (WSU) medical school. Within higher education, $28.0 million would be provided for a new statewide system of career connected learning, known as Career Connect Washington.

The budget documents note that compensation and central services costs at the higher education institutions are higher than estimated increases in tuition, which has been capped at 2 percent since SY 2017–18. To address this, the budget would increase funding by $25.5 million for UW, $9.8 million for WSU, $2.5 million for Eastern Washington University (EWU), $2.6 million for Central Washington University (CWU), $2.4 million for The Evergreen State College (TESC), $2.4 million for Western Washington University (WWU), and $19.1 million for the Community and Technical College System (CTCS).

Additionally, the budget would fund program enhancements and student support services at the institutions: $8.8 million for UW, $6.2 million for WSU, $2.2 million for EWU, $2.1 million for CWU, $1.1 million for TESC, $3.1 million for WWU, and $26.4 million for CTCS.

Department of Social and Health Services (DSHS). The proposal would spend $82.1 million to maintain operations at the state psychiatric hospitals and $59.4 million to increase the rate for community residential service providers. It would also fund the collective bargaining agreements with adult family home workers ($37.6 million) and individual providers of in-home care ($72.4 million), and provide parity for in-home care providers who are employed by agencies ($21.3 million).

Because a settlement agreement was reached in Trueblood et al v. Washington State DSHS in 2018, fines in the case are suspended, saving $96.0 million. In the case, DSHS was found to be unconstitutionally delaying competency evaluations and restoration services for jailed individuals (DSHS n.d.). To begin implementing the agreement, the budget

Table 2: NGFO and All Funds Appropriations (Dollars in Thousands)

	2017-19 Biennium		2019-21 Biennium: Maintenance Level		2019-21 Biennium: Governor's Proposal	
	NGFO	All Funds	NGFO	All Funds	NGFO	All Funds
Legislative	166,592	194,781	179,084	203,531	179,954	208,671
Judicial	289,218	372,713	299,956	358,393	352,218	430,714
Governmental Operations	543,004	4,175,900	577,602	4,185,783	797,602	4,647,490
DSHS	6,418,005	14,141,800	6,029,869	13,058,118	6,636,366	14,115,272
Health Care Authority	4,662,347	19,160,021	5,858,952	21,739,643	6,080,873	22,375,857
Other Human Services	2,853,320	6,163,607	4,070,668	7,937,977	4,585,655	8,824,786
Natural Resources	341,509	1,918,445	333,006	1,933,393	476,181	2,162,952
Transportation	94,295	225,808	100,571	229,595	121,625	256,188
Public Schools	22,691,351	24,786,560	26,896,237	28,937,246	28,113,208	30,155,588
Higher Education	3,713,656	14,506,977	3,919,098	15,043,469	4,357,582	15,773,027
Other Education	223,408	481,251	56,689	129,512	69,343	141,714
Other Appropriations	2,664,520	2,906,965	2,754,793	2,912,399	2,863,337	3,067,235
Total	**44,661,225**	**89,034,828**	**51,076,525**	**96,669,059**	**54,633,944**	**102,159,494**

would appropriate $59.8 million for DSHS.

Health Care Authority (HCA). The proposal would provide $55.0 million to restore savings that will not be realized in the Healthier Washington project (an integrated model for physical and behavioral health care). Appropriations would increase by $26.0 million to implement the Trueblood settlement agreement. The budget would provide $37.0 million for about 130 community long-term inpatient beds (for individuals on 90- and 180-day commitments that have been provided at the state hospitals) and $56.6 million to increase primary care rates for Medicaid beneficiaries. It would save $49.4 million by eliminating a Medicaid rate increase.

Other Human Services. In the Department of Children, Youth, and Families, the budget proposal would spend $38.5 million to expand the Early Childhood Education and Assistance Program (ECEAP) by 2,385 slots and $12.6 million to increase the ECEAP rate by 6 percent. (ECEAP is a program for families at or below 110 percent of the federal poverty level and for children with special needs.) Additionally, the budget would provide $30.1 million for 1,907 slots in a new preschool program for families with incomes up to 200 percent of the federal poverty level and $38.8 million to create a universal home visiting and newborn assessment program. The budget would also increase spending by $54.9 million to fund the collective bargaining agreement with family child care providers.

Employee Compensation. The governor's budget would fund collective bargaining agreements the Office of Financial Management reached with state and higher education employees, and it would extend those agreements to non-represented employees. Generally, the agreements include a 6 percent wage increase over two years. The state would continue to pay 85 percent of the health care premium, and the rate would be $977 per employee per month in FY 2020 and $978 per employee per month in FY 2021. Additionally, there would be a 3 percent pension increase for Public Employees' and Teachers' Retirement Systems Plan 1 retirees. The NGFO cost of these agreements would be about $490 million.

Other. Spending for the Department of Commerce would be increased by $92.8 million to provide housing assistance to the homeless. Funding for debt service on new projects would be $50.3 million. Employment Security Department spending would increase by $33.1 million for a grant program to create new career connected learning opportunities.

2019 Supplemental

Gov. Inslee also proposed a 2019 supplemental to the 2017–19 budget. It would increase 2017–19 spending by $334.3 million. Of that, $207.6 million is maintenance changes and $126.6 million is from new policies. Some of the major policy items include: $26.6 million to restore savings that will not occur in the Healthier Washington project; $43.1 million to maintain spending at the state psychiatric hospitals; and $14.4 million for emergency fire suppression costs in FY 2019.

Under the proposal, revised 2017–19 NGFO appropriations would be $44.996 billion. Additionally, the governor would appropriate $42.7 million from the BSA to fund wildfire suppression costs from the 2018 fire season.

Outlook

The governor's proposed 2019 supplemental would leave total reserves of $3.066 billion in 2017–19 ($125 million lower than anticipated in the November outlook). Total reserves in 2019–21 would be $2.789 billion ($49 million lower than anticipated in the November outlook).

No extraordinary revenue growth deposit to the BSA would be required in 2019–21. However, as noted above, a substantial portion of the revenues from the increase in the B&O tax rate on services is dedicated to the ELTA rather than the GFS, excluding them from the calculations of constitutionally-required deposits to the BSA. (Each year, 1 percent of general state revenues must be transferred to the BSA, and each biennium, three-quarters of any extraordinary growth in general state revenues must be transferred to the BSA. The ELTA is not part of general state revenues.) If all the revenues from the B&O tax increase were deposited in the GFS, a $1.5 billion extraordinary revenue growth BSA deposit would be required in 2019–21. This would cause the governor's budget to be out of balance (the unrestricted NGFO ending balance in 2019–21 would be negative by about $950 million, instead of the estimated $572 million).

According to OFM, the 2019–21 proposal would balance over four years. The estimated 2021–23 unrestricted NGFO ending balance would be $598 million and the BSA balance would be $2.936 billion. Total reserves in 2021–23 would be $3.534 billion. The Economic and Revenue Forecast Council will adopt an official outlook based on the governor's proposal later this month.

Comment

Spending related to the McCleary decision has dominated budgets of the past several years, leading to pent-up demand for new spending in areas outside of K–12 (WRC 2018c). Public schools spending makes up about 66 percent of the 2019–21 maintenance level, as the enormous impact of McCleary is fully felt for the first time.

This isn't the first time Gov. Inslee has proposed a very large tax package. He has done so in each of his biennial budget proposals, but his tax packages have been the high-water mark compared to subsequent legislative revenue proposals. Senate Ways & Means Chair Christine Rolfes said, "His tax increases will be taken up by the Legislature, but they're probably more ambitious than the Legislature will be able to pass" (O'Sullivan 2018).

Similarly, the Legislature is unlikely to pass a budget that spends as much as Gov. Inslee has proposed. Each of his spending proposals has been higher than the budget that was ultimately enacted. (For example, the adopted 2017–19 budget appropriated $2.987 billion less than Gov. Inslee had proposed.)

With significant increases in previous biennia and the likelihood of an economic downturn sometime in the future, we previously recommended a cautious approach to the 2019–21 spending level (WRC 2018c). A few other concerns arise from the governor's proposal. First, the governor would completely reject the Legislature's recent work to limit local school levies and return to the system that spawned the McCleary lawsuit. Doing so could put the state on a path to the next McCleary. As we wrote in 2016, one reason for the school funding lawsuit was that when state funding dropped in the past, local levies made up the difference. Limiting local levy reliance so that the state could not shirk its paramount duty in the future was a key part of the McCleary solution. (WRC 2016)

Second, as part of the 2018 supplemental budget, the Legislature set the precedent of unsustainably diverting revenues from the GFS to the ELTA in order to avoid a constitutionally-required deposit to the BSA (WRC 2018a). Gov. Inslee proposes a similar diversion, which allows his budget proposal to balance. While a balanced budget is important for sustainability, so is the discipline of the constitutionally-required deposits to the budget stabilization account. A sustainable budget should balance without the need for such a maneuver.

Third, a capital gains tax would present other budget sustainability problems. If enacted by the Legislature, it would surely be challenged in court as an income tax—and that would take time. It is not assured the state would ever collect any capital gains revenues, least of all in the upcoming biennium. Additionally, capital gains taxes are highly volatile, and as the governor's budget documents note, fluctuations in capital gains revenues could be managed with "careful budgeting." This would require even more emphasis on increasing reserves, something neither the governor nor the Legislature has prioritized.

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