Washington Research Council
# Policy Brief
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# Legislature Adopts New Taxes to Increase 2019–21 Spending by 18.3 Percent

**Briefly**

*Appropriations for 2019–21 from funds subject to the outlook and the new workforce education investment account total $52.852 billion (pending gubernatorial action), an 18.3 percent increase over 2017–19. That includes $2.367 billion of spending on new policy. Major new spending items include funding the collective bargaining agreements with state employees and school employee health benefits, as well as increasing spending for higher education institutions and financial aid.*

*State revenues from existing resources are enough to fund the maintenance level (the cost of continuing current services). To pay for the new policy spending, the Legislature passed several new tax increases. These include business and occupation tax increases on certain businesses in the service and other activities category and on certain financial institutions and graduating the real estate excise tax rate. Notably, the Legislature did not adopt a capital gains tax.*

*The high level of spending in the maintenance level budget and the likelihood of an economic downturn should have moderated the Legislature's appetite and led to an increased focus on sustainable budgeting and building reserves. Yet the Legislature increased taxes by more than a billion dollars and much of the new revenue is directed to accounts that are not subject to constitutionally-required transfers to the rainy day fund. The result is a budget that may not be sustainable.*

The Legislature passed three bills that make operating appropriations for 2019–21. Together, they appropriate $52.852 billion from funds subject to the outlook and the new workforce education investment account. The Legislature also passed several bills that increase taxes, including increasing business and occupation (B&O) taxes on certain service businesses and financial institutions and making the real estate excise tax graduated.

The budget deal was made public the day before the end of the legislative session. A flurry of tax and other bills were passed on April 28, the last day of session. Consequently, the balance sheet released by the Legislature on April 27 does not capture the effects of all the revenue and spending changes that were ultimately passed. Further, fiscal notes for these bills are not all yet final, and Gov. Inslee has yet to act on the budget and tax bills. The balance sheet on page 2 is roughly based on the outlook released by the Legislature on April 27, adjusted to account for new information. But it is not a final accounting of the 2019–21 budget.

This policy brief provides an overview of the budget as passed by the Legislature; upcoming policy briefs will offer more details on the revenue and spending changes.

### NGFO Plus WEIA

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 both the current and following biennium on an NGFO basis.)

In 2019, the Legislature created the workforce education investment account (WEIA) to fund higher education programs. As these programs would typically be funded through the NGFO, it is appropriate for budget transparency purposes to roll up the WEIA with the NGFO (though the WEIA is not included in the four-year balanced budget requirement).

### Revenues and Other Resources

When the Legislature adopted the 2018 supplemental to the 2017–19 budget last year, the Economic and Revenue Forecast Council (ERFC) estimated that 2017–19 revenues would be $44.990 billion. In March of this year, the ERFC estimated that revenues will be $50.555 billion in 2019–21 (a $5.6 billion increase). Despite the substantial increase in expected revenues, the Legislature acted this session to increase taxes by a net of about $1.1 billion. (This figure includes $115.9 million that is included in the March revenue forecast, and it includes revenues going to all funds. The net revenue increase that goes to the NGFO is about $366 million.)

Table: NGFO Balance Sheet (Dollars in Millions)

| | *2017-19* | *2019-21* |
|---|---|---|
| Beginning Balance | 1,149 | 1,920 |
| Revenue | | |
| March 2019 Revenue Forecast | 46,106 | 50,555 |
| **Passed Legislature** | | |
| **Graduated REET** | | **244** |
| **Financial Institutions B&O Tax** | | **133** |
| **Int'l Investment Management B&O/Sales Tax** | | **59** |
| **Sales Tax Refund for Nonresidents** | | **54** |
| **Budget Driven and Other Revenue** | **(2)** | **(143)** |
| *Total Revenue* | *46,104* | *50,902* |
| Other Resource Changes | | |
| Transfer to Budget Stabilization Account | (440) | (497) |
| Transfer to BSA (Extraordinary Revenue Growth) | (1,696) | |
| Transfer from BSA (Extraordinary Revenue Growth) | 1,078 | |
| Other Enacted Fund Transfers | 162 | |
| Prior Period & CAFR Adjustments | 85 | 41 |
| **Passed Legislature** | | |
| **Transfer from BSA (Extraordinary Revenue Growth)** | **58** | |
| **Fund Transfers** | **73** | **209** |
| *Total Other Resource Changes* | *(680)* | *(247)* |
| *Total Resources* | *46,573* | *52,575* |
| Spending | | |
| 2017-19 Appropriations | 44,661 | |
| **Passed Legislature** | | |
| **Actual/Assumed Reversions** | **(195)** | **(356)** |
| **Maintenance Level Changes** | **87** | |
| **2019-21 Maintenance Level** | | **50,485** |
| **Policy Changes** | **100** | **1,992** |
| *Total Spending* | *44,653* | *52,121* |
| Unrestricted Ending Fund Balance | 1,920 | 454 |
| Budget Stabilization Account Balance | 1,638 | 1,670 |
| Transfers from GFS and Interest Earnings | 2,177 | 610 |
| Transfer to the GFS | (1,078) | |
| Transfer to the Pension Stabilization Account | (925) | |
| Appropriations from the BSA | (41) | |
| **Passed Legislature** | | |
| **Transfer to GFS (Extraordinary Revenue Growth)** | **(58)** | |
| **Appropriations from the BSA** | **(42)** | |
| Projected BSA Ending Fund Balance | 1,670 | 2,280 |
| *Total Reserves* | *3,590* | *2,734* |

Notes: • Details may not sum due to rounding.
• Based on the outlook produced by Legislative staff for the budget conference report prior to final passage, except this balance sheet includes the effects of ESHB 2163 (extraordinary revenue growth transfer) and updated estimates of revenue legislation.

*Workforce Education Investment Surcharge*. ESHB 2158 imposes a surcharge of 20 percent on top of current B&O taxes for businesses in certain sectors in the service and other activities category (e.g. doctors, lawyers, and accountants). The surcharge would be higher for certain advanced computing businesses: 33.3 percent for affiliated groups with worldwide gross revenue of between $25 billion and $100 billion a year and 66.7 percent for affiliated groups with worldwide gross revenue of more than $100 billion. Affiliated groups will have to pay combined advanced computing surcharges of at least $4 million but not more than $7 million a year.

A partial fiscal note estimates that the bill will increase revenues by $380.0 million in 2019–21 and $565.7 million in 2021–23. All revenues will be deposited in the new workforce education investment account (WEIA) and may only be used for higher education purposes. (For 2019–21 only, the revenues may also be used for K–12 career connected learning programs.) This account will not be subject to the four-year balanced budget requirement (so it does not appear in the balance sheet), and it won't be subject to constitutionally-required transfers to the budget stabilization account (BSA, or rainy day fund). Still, the account is substantially similar to accounts in the NGFO, as we discuss below.

*Real Estate Excise Tax*. Under current law, the real estate excise tax (REET) rate is a flat 1.28 percent of the sales price of real property. ESSB 5998 graduates the rate to reduce the tax for some taxpayers and increase it for others. The rate will be 1.1 percent on the portion of the selling price that is $500,000 or less; 1.28 percent on the portion that is between $500,000 and $1.5 million; 2.75 percent on the portion between $1.5 million and $3.0 million; and 3.0 percent on the portion that is more than $3.0 million. (The 1.28 percent flat rate will still apply to sales of timberland and agricultural land.) The bill is expected to increase NGFO revenues by $243.5 million in

2019–21 and $354.8 million in 2021–23. The bill will also increase the portion of REET revenues that are dedicated to the education legacy trust account, thereby avoiding contributions to the BSA.

*Additional Tax on Financial Institutions*. Financial institutions are currently subject to a 1.5 percent B&O tax rate. SHB 2167 imposes an additional tax of 1.2 percent for financial institutions with annual net income of at least $1.0 billion. (Financial institutions are also subject to the Workforce Education Investment surcharge, so their B&O rate increases from 1.5 percent to 3.0 percent.) It is estimated that this will increase NGFO revenues by $133.2 million in 2019–21 and $205.6 million in 2021–23. The text of this bill was first made public on April 26, and it was passed that day by the House and April 28 by the Senate. There is some concern that its treatment of out-of-state banks may violate the interstate commerce clause of the U.S. Constitution.

*Other Revenue Legislation*. Of the other tax bills, the two with the largest NGFO revenue impacts to the state are ESB 6016, which increases revenues by $59.4 million in 2019–21 by narrowing the preferential B&O tax rate for international investment management services, and ESSB 5997, which increases revenues by $53.8 million in 2019–21 from changing the sales tax exemption for nonresidents to a refund program.

*Other Resources*. The budget transfers $209.0 million from other funds to the NGFO in 2019–21. These include $160.0 million from the public works assistance account, $28.0 million from the disaster response account, and $16.0 million from the treasurer's service account.

### Spending

The operating budget bill (ESHB 1109) for 2019–21 appropriates $52.419 billion from the NGFO. Separately, the Legislature passed ESHB 2163, which appropriates $58.4 million from the NGFO, and E2SHB 2158, which appropriates $374.7 million from the new workforce education investment account (WEIA). The WEIA funds education programs that would normally be funded from the NGFO; for the sake of budget transparency, the spending numbers in this brief are in terms of the NGFO plus the WEIA (though because the WEIA is not subject to the four-year balanced budget requirement, official presentations of the outlook will exclude the account). Thus, the combined impact of the three bills is to appropriate $52.852 billion, an 18.3 percent increase over enacted 2017–19 appropriations. The maintenance level (the cost of continuing current services) for 2019–21 is $50.485 billion. New policy adds a net of $2.367 billion.

*Public Schools*. The budget increases appropriations by $328.7 million for school employee health benefits, $155.2 million for special education, and $61.6 million for local effort assistance. Additionally, pursuant to ESHB 2163, $58.4 million is appropriated for hold-harmless payments to school districts.

*Higher Education*. Most of the funding from the WEIA is appropriated for higher education. Funding for the State Need Grant (and its replacement under E2SHB 2158, the Washington College Grant) is increased by $177.3 million. The Legislature also appropriated $65.5 million for foundational support for the higher education institutions and $60.8 million for salary increases for nurse educators and other high-demand faculty at community and technical colleges.

*Compensation*. The budget funds collective bargaining agreements with state and higher education employees and extends them to non-represented employees. Employee compensation is increased by $460.8 million. Additionally, the budget appropriates $186.2 million to fund collective bargaining agreements with individual providers of in-home care (and provide parity for agency providers), adult family homes, family child care centers, and language access providers.

*Other*. The budget appropriates $73.9 million related to the settlement in

Trueblood et al v. Washington State Department of Social and Health Services, $66.2 million for state hospital operations, and $44.1 million for homelessness programs. It also adds $40.5 million for debt service on new capital projects. Some major savings in the budget include $101.8 million from program integrity activity recoveries from managed care plans and $22.5 million from a reduction in overtime costs, professional service contracts, travel, goods and services, and capital outlays across state agencies with more than 100 employees.

*Reversions*. Because agencies do not always spend all their appropriations, outlooks assume some level of reversions (appropriations not spent) each biennium. The standard estimate is 0.5 percent of general fund appropriations. The Legislature is assuming a higher amount of reversions in 2019–21 than usual due to new requirements for the use of K–3 class size reduction funding. Beginning in FY 2020, K–3 class size funding will only be provided to districts based on their actual class sizes (RCW 28A.150.260). Not all districts have yet lowered their K–3 class sizes to the funded level, so it is estimated that some of the funding will not ultimately go out to districts.

### Reserves and Outlook

The Legislature is not making any transfers or appropriations from the BSA in 2019–21, but it passed SHB 2159, which appropriates $42.3 million from the BSA for fire suppression costs in 2017–19. It also passed ESHB 2163, which transfers $58.4 million of extraordinary revenue growth from the BSA to the general fund in 2017–19. (As noted above, the bill uses these funds to make hold-harmless payments to school districts in 2019–21.)

As passed by the Legislature, the budget balances over four years. It leaves a relatively low estimated unrestricted NGFO ending balance of about $454 million in 2019–21 and $117 million in 2021–23. Including the BSA balance, total reserves are estimated to be about $2.734 billion in 2019–21 and $3.103 billion in 2021–23.

### 2019 Supplemental

In addition to the 2019–21 biennial budget, the Legislature passed a 2019 supplemental to the 2017–19 budget.

*Resources*. In the March forecast, estimated revenues for 2017–19 increased to $46.106 billion (up $1.116 billion since the February 2018 forecast). Aside from that, there are no net NGFO revenue changes, but ESHB 2140 shifts $84.7 million of state property tax revenues from the general fund–state to the education legacy trust account in FY 2019, effectively diverting about $64 million from the BSA.

Additionally, the supplemental transfers $38.0 million from the state toxics control account and $35.0 million from the local toxics control account to the general fund–state.

*Spending*. The supplemental increases NGFO appropriations by $186.7 million (other legislation increases appropriations by another $150,000). That includes $44.3 million for state hospital operations, $12.5 million for emergency fire suppression costs (in addition to the $42.3 million from the BSA mentioned above), and $905,000 for measles outbreak response.

### Comment

The NGFO plus WEIA appropriations level for 2019–21 is 18.3 percent higher than enacted 2017–19 appropriations. This is the largest biennial increase in at least 25 years. The 2019–21 maintenance level itself represents a 13.0 percent increase over 2017–19 appropriations. This substantial increase in the cost of continuing current services is due in large part to the state spending increases related to the McCleary decision on school funding. Although the state was found to be compliant with the law last year (in the second year of 2017–19), 2019–21 is the first biennium in which the McCleary response is fully funded in both years. Additional significant spending increases for 2019–21 were directed at school employee health benefits and collective bargaining agreements with state employees.

Despite the strong economy, the Legislature increased several taxes in order to fund $2.386 billion in new policy. In the end, legislators avoided imposing a capital gains tax, but some of the taxes they raised will increase the volatility of our tax structure or could be unconstitutional.

Additionally, increased use of the BSA in 2017–19 and the direction of substantial revenues to funds that aren't subject to BSA transfer is concerning. For example, none of the B&O tax increase for workforce education and just $23.0 million of the estimated revenues from the graduated REET count toward the constitutionally-required transfers to the BSA.

Given the high level of spending, the overall volatility of the increased taxes, and the calculated avoidance of transfers to the BSA, the sustainability of this budget is questionable. If the newly-passed revenue increases don't pan out or the economy falters, planned reserves may not be adequate to avoid spending cuts, additional tax increases, or some combination of the two.

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