Washington Research Council

Policy Brief

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How Should the State Spend Its Substantial Surplus?

Briefly

When the 2021–23 operating budget was enacted, it left an unrestricted ending balance for funds subject to the outlook (NGFO) of $83 million in 2023–25. With ever improving revenue forecasts and new, lower spending assumptions, we estimate that the unrestricted NGFO ending balance is now $8.649 billion. Additionally, the budget stabilization account (BSA, or the rainy day fund) ending balance is estimated to be $1.207 billion in 2023–25 and the new shadow reserve account holds $1 billion.

Heading into session, the surplus as a percentage of revenues is the highest it has been going back at least 20 years. Our estimated surplus of $8.649 billion for 2023–25 is 13.5% of revenues. The next highest surplus was 5.5% in Nov. 2005.

There are several ways the state could use its surplus while maintaining budget sustainability. In doing so, legislators should follow these general principles:

- *Restore reserves so that the state is ready for the next downturn.*
- *Do not use one-time funds for ongoing projects. (For example, the state could fund culvert fixes.)*
- *Focus on sustainably funding programs and projects that are already planned. (For example, the state could improve funding of state retirement systems, dedicate sales tax collections from vehicle purchases to transportation accounts, or better plan for the cost of the state's new child care program.)*
- *Consider whether the current level of taxation is higher than necessary to support state spending. (For example, the state could reduce unemployment insurance taxes, add a property tax homestead exemption, reduce the sales tax, or repeal the capital gains tax.)*

There will be many claims on the surplus during the legislative session, but caution is warranted. Although revenues are expected to continue to increase, lawmakers should not create spending bow waves that can't be sustained in the future.

The state is awash in money. Each revenue forecast since June 2020 has increased estimated revenues through 2023–25. By March 2021, the state no longer faced a pandemic-related revenue shortfall. At the same time, Washington allocated about $17 billion in federal relief dollars while also draining the budget stabilization account and increasing state spending.

When the 2021–23 operating budget was enacted earlier this year, it left an unrestricted ending balance for funds subject to the outlook (NGFO) of $83 million in 2023–25. With ever improving revenue forecasts and new, lower spending assumptions, we estimate that the unrestricted NGFO ending balance is now $8.649 billion.

Estimated Balance Sheet

Revenue. The Nov. 2021 revenue forecast estimates that NGFO revenues through 2023–25 will be $7.356 billion higher than the Legislature expected when the 2021 session ended. Revenues increased by 15.3% from 2017–19 to 2019–21 and they are expected to increase by another 13.4% in 2021–23 and 6.3% in 2023–25.

By statute, the budget must balance over two biennia using either the official revenue forecast or an alternative forecast that assumes 4.5% annual revenue growth in the second biennium. For the 2021–23 budget, the Legislature opted to use the forecast (which was estimated to grow by less than 4.5% in the second biennium) to help them avoid overspending (WRC 2021b). Our balance sheet below follows suit.

Spending. The Nov. 2021 caseload forecast reduced expected caseloads in state programs—particularly public school enrollments—compared to the forecast on which the budget was based. When caseloads drop, currently authorized programs don't cost as much. According to the Office of Financial Management (OFM), the Nov. 2021 caseload forecast is expected to reduce spending by $646 million in 2021–23.

Table 1: Estimated NGFO Balance Sheet (Dollars in Millions)

	2019-21	*2021-23*	*2023-25*
Beginning Balance	1,981	4,160	6,056
Revenue			
Nov. 2021 Revenue Forecast	53,132	60,238	64,047
4.5% Growth Assumption			737
Use Forecast Instead of 4.5% Growth			(737)
Total Revenue	*53,132*	*60,238*	*64,047*
Other Resource Changes			
Transfer to Budget Stabilization Account	(507)	(574)	(607)
Other Enacted Fund Transfers	960	50	7
ACFR/Prior Period Adjustments	190	41	41
Total Other Resource Changes	*644*	*(483)*	*(559)*
Total Resources	*55,756*	*63,915*	*69,544*
Spending			
Enacted Appropriations	52,562	59,067	
Maintenance Level			61,181
Nov. 2021 Caseload Forecast		(646)	
Actual/Assumed Reversions	(966)	(562)	(286)
Total Spending	*51,596*	*57,859*	*60,895*
Unrestricted Ending Fund Balance	4,160	6,056	8,649
Budget Stabilization Account Balance	1,618	20	595
Transfers from GFS and Interest Earnings	549	575	611
Appropriations from BSA	(364)		
Transfer from BSA	(1,820)		
Return of 2020 Appropriations	25		
Reversions	13		
Projected BSA Ending Fund Balance	20	595	1,207
Total Reserves	*4,180*	*6,651*	*9,855*

Sources: ERFC, OFM, WRC estimates

Additionally, reversions (appropriations that are not ultimately spent) were quite high in 2019–21 and are expected to be higher than normal in 2021–23. First, higher reversions were expected for both biennia related to K–3 class size reductions. Second, Gov. Inslee took several actions last year to lower state spending (including staff furloughs and hiring freezes) and federal relief dollars have been used in place of state funds.

Reserves. We estimate that the unrestricted NGFO ending balance will be $4.160 billion for 2019–21, $6.056 billion for 2021–23, and $8.649 billion for 2023–25. The budget stabilization account (BSA, or the rainy day fund) ending balance is estimated to be $20 million for 2019–21, $595 million for 2021–23, and $1.207 billion for 2023–25.

Further, the state created a new

Table 2: Unrestricted NGFO Ending Balance as a Percent of Revenues (Current Biennium, by ERFC Revenue Forecast)

Nov. 2002	1.74%
Nov. 2003	2.38%
Nov. 2004	2.77%
Nov. 2005	5.52%
Nov. 2006	4.17%
Nov. 2007	3.19%
Nov. 2008	-1.44%
Nov. 2009	-4.10%
Nov. 2010	-3.20%
Nov. 2011	-5.45%
Nov. 2012	0.35%
Nov. 2013	1.14%
Nov. 2014	2.11%
Nov. 2015	1.95%
Nov. 2016	2.46%
Nov. 2017	3.61%
Nov. 2018	4.28%
Nov. 2019	2.62%
Nov. 2020	-0.31%
Nov. 2021	9.43%

reserve account last year, which was funded via a transfer from the BSA. The Washington rescue plan transition account holds $1 billion. These reserves are not included in the balance sheet.

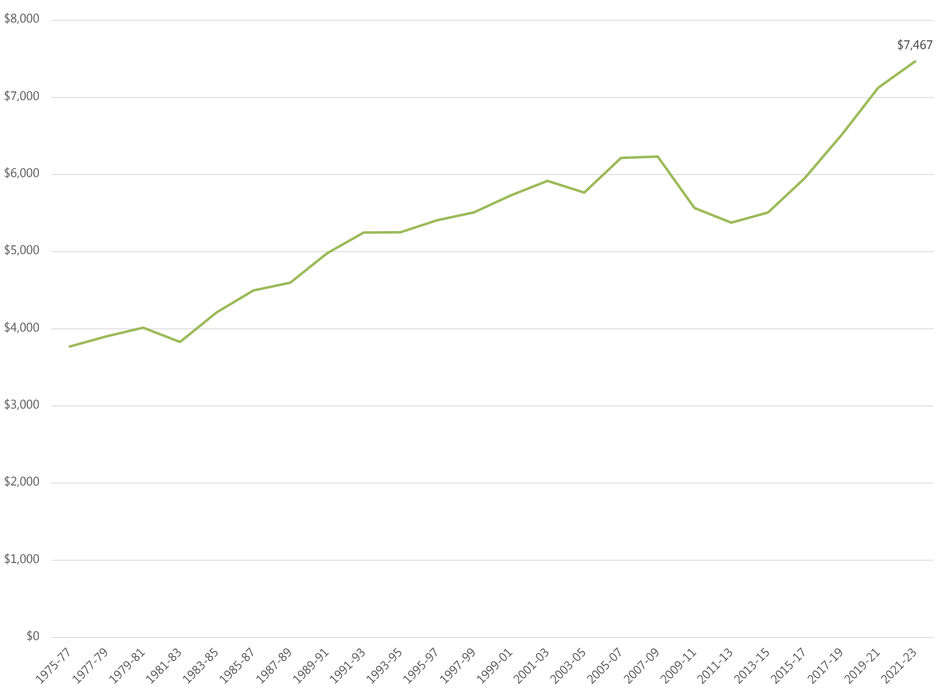
Washington's Estimated Surplus is Extraordinary

The state is in uncharted territory here. The surplus heading into session is the highest it has been going back at least 20 years.

The state has only produced four-year outlooks since 2012. But the revenue forecast has always included a balance sheet for the current biennium. The balance sheet in the November forecast estimates that the unrestricted ending balance for 2021–23 is $5.422 billion. This is lower than in our estimated balance sheet because the Economic and Revenue Forecast Council (ERFC) did not include the impact of the caseload forecast. Even that lower amount is the highest surplus in a November forecast going back to at least 2002. The ERFC's Nov. 2021 surplus is 9.43% of revenues. The next highest surplus was 5.52% in Nov. 2005 (see Table 2). Our estimated surplus of $6.056 billion for 2021–23 is 10.1% of revenues, and our estimated surplus of $8.649 billion for 2023–25 is 13.5% of revenues.

Notably, reduced state spending is not driving the surplus. Indeed, even including the higher-than-normal reversions for 2019–21 and 2021–23, NGFO spending increased by 15.5% in 2019–21 and 13.4% in 2021–23. (Those significant increases follow NGFO spending growth of 13.6% in 2015–17 and 17.0% in 2017–19.) NGFO per capita spending has also continued to increase (as shown in the chart). On top of the increased state spending, the state has allocated about $17 billion in federal relief and still has $1.273 billion of its share of the fairly flexible coronavirus state fiscal recovery fund (CSFRF).

Chart: Per Capita NGFO Spending (Adjusted for Inflation and Including Estimated Reversions)



Principles For Using the Surplus

During the Great Recession, the state reduced spending. In the years following, spending was restored (and then some). Much of the post-Great Recession spending increases were for public schools, in response to the state Supreme Court's decision in the McCleary case. However, spending unrelated to public schools has recovered as well. With the 2021–23 budget, real (adjusted for inflation) per capita K–12 spending was 45.6% above 2007–09 (the pre-Great Recession peak) and real per capita spending on all other programs was 7.1% above 2007–09.

Because spending didn't decline in response to the pandemic recession, there are no policy cuts to restore. But there are several ways the state could use its surplus while maintaining budget sustainability. In doing so, legislators should follow these general principles:

- Restore reserves so that the state is ready for the next downturn.
- Do not use one-time funds for ongoing projects.
- Focus on sustainably funding programs and projects that are already planned.
- Consider whether the current level of taxation is higher than necessary to support state spending.

Below are some ideas for ways the Legislature could sustainably use the surplus.

Restore Reserves. The Legislature swept the BSA in 2021. It spent some of the money, but $1 billion was merely transferred to a shadow reserve account. That $1 billion should be restored to the BSA, and, on top of that, the state should make a larger deposit to the BSA in order to protect more funds for a truly rainy day.

Additionally, in 2020, the Legislature deliberately left a high unrestricted balance given the uncertainty at the beginning of the pandemic. In 2021, as noted above, they chose to adopt a budget that balanced within actual revenues (instead of assuming 4.5% annual growth). It could be prudent to leave a higher-than-normal unrestricted ending balance again next year.

One-Time Investments. The state could direct funding to infrastructure projects. One example would be culverts. The state must address a federal court order that it fix fish passage barriers under state highways by 2030. The Department of Transportation estimates that this will cost about $3.8 billion overall (WSDOT 2020). Including the 2021–23 transportation budget and previous spending, the state currently plans to spend $1.740 billion on these projects through 2029–31 (including $400.0 million from the CSFRF). That's about $2 billion less than the total cost estimate. The state could fully fund these projects with its surplus. (However, the new federal infrastructure bill includes funding for culvert projects. It's not clear yet how much of that will flow to Washington, but federal dollars for this purpose should certainly be used before state dollars.)

Set Aside or Rework Funding for Spending that is Already Planned. The state has a number of existing, long-term obligations that are not fully funded.

First, the state could improve funding of state retirement systems. According to the Office of the State Actuary (OSA), most of the state's retirement plans are in good shape, but the Public Employees' Retirement System (PERS) Plan 1 and Teachers' Retirement System (TRS) Plan 1 have funded ratios of just 69% and 71%, respectively (OSA 2021a). The unfunded actuarial accrued liabilities in PERS Plan 1 and TRS Plan 1 are expected to be paid off in 2025 and 2024, respectively (OSA 2021b). In the 2021–23 operating budget, the Legislature appropriated $800 million from the general fund–state (GFS) to pay off the TRS 1 unfunded liability in 2023. The state could do the same thing for the PERS 1 liability.

Additionally, the OSA has recommended that the state reduce the investment rate of return assumption for state retirement plans from 7.5% to 7.0%. This would cost the state money in the short run because higher contributions would be required, but it would more accurately reflect foreseeable investment returns. OSA estimates that the lower assumption would increase GFS spending by $395 million in 2023–25 (OSA 2021c).

Second, unlike the NGFO, state transportation revenues declined from 2019 to 2020 (by 10.6%). The 2021–23 transportation budget appropriated $600.0 million from the CSFRF to backfill lost transportation revenues. But that federal money is a one-time fix to the immediate problem presented by the pandemic, not a long-term solution to address ongoing transportation needs. Several proposals have been made in recent years to dedicate sales tax collections from vehicle purchases to transportation accounts, rather than the GFS. An example is HB 2323, introduced in 2020. The fiscal note for HB 2323 estimated that sales tax collections on vehicle sales would be about $1.175 billion in FY 2021. A bill has already been pre-filed for the 2022 session that would make this change (HB 1604).

Third, the state could better plan for the cost of the state's new child care program, which is expected to bow wave twice. The Legislature used one-time federal relief programs to start the program in 2021–23. Those costs will have to be covered by state funds in 2023–25. Then, in 2025–27 (beyond the four-year outlook), the overall cost of the program is expected to balloon. Meanwhile, the budget anticipates that the new capital gains tax will fund some of these child care costs, but with a pending court challenge and potential ballot initiative, those dollars may never materialize. While this sort of bow wave beyond the four-year outlook is the kind of unsustainable spending we encourage lawmakers to avoid, the state could set aside some current funding to ensure it can pay for this program over the long term.

Tax Relief. Operating budget revenues are currently coming in substantially higher than obligations. This suggests that taxes could be cut, while maintaining a sustainable budget. There are many ways this could be done. Relief could be temporary or permanent, targeted or broad.

One option would be to reduce unemployment insurance (UI) taxes by shoring up the UI trust account. The trust fund balance as of Dec. 31, 2019 was $4.778 billion. At the end of CY 2021, it is estimated to be $1.791 billion (UIAC 2021). As we discussed in a policy brief this year, employer UI taxes automatically increase when the trust fund balance is insufficient to cover seven months of benefits and when benefits paid exceed revenues received (WRC 2021a). Legislation adopted in 2021 (ESSB 5061 and ESSB 5478) reduced UI taxes, but average UI tax rates are still expected to increase to 1.45% in CY 2022 (up from 1.08% in CY 2019). The Legislature could use surplus funds to increase the trust fund and (via legislation) reduce the tax rates further.

More broadly, the state could provide a homestead exemption for the state property tax or cut the sales tax. In 2021, SB 5463 would have exempted $250,000 of the assessed value of a principal residence from the state property tax. (Such a policy would require a constitutional amendment.) The fiscal note estimated it would reduce state revenues by $2.402 billion in 2023–25. Meanwhile, the Department of Revenue estimates that an increase to the state sales tax of 0.1% would increase state revenues by $305 million in 2021–23, implying that a reduction of 0.1% would reduce revenues by about $300 million (DOR 2021).

Finally, the state could consider repealing the capital gains tax. The June 2021 official budget outlook assumes that the capital gains tax will increase NGFO revenues by $415 million in 2021–23 and $840 million in 2023–25. The Nov. 2021 revenue forecast reduced the estimate of revenues from the tax to incorporate more behavioral effects, and it is being challenged in court. Given the uncertainty of the capital gains tax's future and the fact that its revenues are not needed to balance the budget, the state could preemptively repeal the tax.

Note that the CSFRF may not be used to directly or *indirectly* offset tax cuts. This provision of the American Rescue Plan Act is being challenged in court by several states; in November, a federal judge blocked Treasury from enforcing the provision (Chandler 2021). But even if the provision ultimately stands, we do not expect it to preclude Washington from offering at least some tax relief.

Treasury's interim final rule for the CSFRF lays out the process for determining whether a state has used its share of the CSFRF to indirectly offset tax cuts (if it has, the state must repay the federal funds). If actual tax revenue after a tax cut is greater than state tax collections in FY 2019 (adjusted for inflation), Treasury would not consider the state to have used the CSFRF to offset a tax cut. The calculation is based on tax revenues, as defined by the U.S. Census Bureau. (In 2019, NGFO revenues were about 85% of state tax revenues.) For illustration purposes, using NGFO revenues as a proxy for state tax revenues, the state could potentially cut taxes by about $4 billion in FY 2022 and not have to pay back any CSFRF money.

Comment

Washington's estimated unrestricted surplus of $8.649 billion, both in absolute terms and as a percentage of revenue, is higher than it's been in at least 20 years. On top of that, the state has $2.207 billion in reserves and still has federal relief funds to spend. There will be many claims on this money during the session, but caution is warranted. Although revenues are expected to continue to increase, lawmakers should not create spending bow waves that can't be sustained in the future.

Given the current economic uncertainty, the surplus should not be used to begin new obligations and one-time funds should not be used for ongoing projects. Instead, the state should restore reserves, focus on sustainably funding programs that are already planned, and consider whether the current tax burden is higher than necessary to support state spending.

NGFO

Under the four-year balanced budget requirement, a positive ending balance is required in both the current and following biennium for "funds subject to the outlook." This is a synthetic "account" that rolls up the general fund–state (the state's primary budget account) with the education legacy trust account, the opportunity pathways account, and the workforce education investment account. It is also called the near general fund–outlook, or NGFO.

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