Washington Research Council

Policy Brief

January 4, 2019 PB 19-02

Washington's Budget Sustainability Requirements Work When Followed

Briefly

Washington's four-year balanced budget requirement and constitutionally-protected rainy day fund promote state budget sustainability. The requirement that budgets balance over four years helps to limit the use of budget gimmicks and to prevent unsustainable bow wave spending. Reserves improve sustainability by providing a cushion for emergencies and limiting major program cuts during economic downturns. Because the rainy day fund is protected in the constitution, deposits are mandated, and withdrawals are limited.

Still, the Legislature plans to withdraw $2.044 billion from the rainy day fund in 2017–19. On top of that, it diverted $711 million before it could be deposited in the fund in order to avoid the limits on withdrawals, setting a bad precedent that Gov. Inslee has already attempted to repeat. By making these withdrawals, Washington is less prepared for a recession, should one occur in the next biennium.

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.)

Near general fund–outlook (NGFO) revenues are forecast to increase by 9.2 percent, to $50.002 billion in 2019–21. Meanwhile, NGFO spending is projected to increase by about 14 percent in 2019–21, before even considering new spending on policy additions. Gov. Inslee's 2019–21 budget proposal would increase spending by 22.3 percent over 2017–19 and revenues by an additional 7.4 percent over the forecast (see our recent report, "Gov. Inslee Proposes a 22.3 Percent Spending Increase for 2019–21").

The Legislature has spent many sessions focused on complying with the state Supreme Court's McCleary decision on school funding. Now that McCleary is behind it, there is clearly pent-up demand for spending increases in areas of the budget outside of K–12 education. How much additional spending can the state afford, and will it be sustainable?

Washington has made important improvements to its budget practices in recent years that have promoted sustainability—when they are followed.

Four-Year Balanced Budget Requirement

In 2012, the Legislature passed a law that requires it to pass budgets that balance over two biennia (RCW 43.88.055). Since the 2013–15 biennium, the Legislature has been required to pass budgets that leave positive ending balances in the NGFO. The projected maintenance level of the budget then also must not exceed available resources for the ensuing biennium. To determine the impact in the second biennium, the Economic and Revenue Forecast Council (ERFC) prepares regular budget outlooks (RCW 82.33.060).

Maintenance level is the cost of continuing current programs and services, adjusted for caseload and inflation changes, and it includes actions required by law and assumptions for phased implementations.

Despite this being merely a statutory requirement, the Legislature has abided by it. Four years after enactment, the requirement appeared to be a sticking point in budget negotiations (TCH 2016).

Table 1: April 2018 NGFO Outlook (Dollars in Millions)

	2017-19	2019-21
Beginning Balance	1,149	1,240
Total Resources	45,673	50,286
Appropriations	44,433	50,198
Unrestricted Ending Balance	1,240	88
Budget Stabilization Account Ending Balance	1,139	1,692
Total Reserves	2,379	1,779

Note: As passed by the Legislature, the 2018 supplemental included a delay of professional learning days for teachers. Gov. Inslee vetoed this provision, but the outlook was not adjusted to restore the anticipated savings. The ERFC estimated that the veto would result in future costs of $106 million through 2019-21.

Gov. Inslee then proposed suspending it in 2017 (WRC 2017). In the end, though, the requirement has held.

Still, the Legislature routinely leaves little reserve in the second biennium. For example, the official April 2018 outlook, based on the 2018 supplemental budget as signed by the governor, showed an unrestricted ending balance of just $88 million in 2019–21.

The four-year balanced budget law applies only to the Legislature. The governor has long been required by state law to propose budgets that balance within existing resources for the biennium (RCW 43.88.030). (The governor may also propose a separate budget that uses new revenue sources.) Because the four-year balanced budget law does not apply to the governor, veto actions may result in budgets that do not balance over four years. Indeed, this happened with budgets enacted in 2015, 2016, and 2017.

Table 2: Unrestricted NGFO Ending Fund Balance in Second Biennium (Year of Enactment, Dollars in Millions)

	As Passed by Legislature	As Signed by Governor
2013	$386	$388
2014	$32	$20
2015	$47	($23)
2016	$9	($314)
2017	$42	($57)
2018	$103	$88

As we wrote in 2012, "by requiring lawmakers to consider the four-year perspective, the adopted reform forces consideration of the long-term effects of legislation" (WRC 2012). Thus, the law helps to limit the use of budget gimmicks and to prevent unsustainable bow wave spending (which occurs when a program is not fully implemented in the current biennium and inflates to full cost in a subsequent biennium). One example of a gimmick that occurred before the four-year balanced budget requirement was in place was a one-day delay in school district apportionment payments from June to July 2011. This shifted costs from 2009–11 to 2011–13 (LEAP 2011).

Budget Reserves

Reserves improve sustainability by providing a cushion for emergencies and limiting major program cuts during economic downturns. There are two components to total state reserves: the unrestricted NGFO ending balance and the budget stabilization account (BSA).

The unrestricted NGFO ending balance is simply the difference between resources and spending. Any surplus at the end of the year becomes the beginning balance for the next year. Under the four-year balanced budget law, this must be positive at the end of the current and second biennia.

The BSA is the state's rainy day fund. It was established by a 2007 constitutional amendment (Article VII, section 12). Withdrawals from the BSA require a three-fifths vote of the Legislature, unless employment growth is expected to be less than 1 percent or the governor declares a state of emergency. In those cases, only a simple majority is required to withdraw funds.

The state constitution also provides that when the BSA balance is more than 10 percent of general state revenues in a fiscal year, a simple majority of the Legislature may withdraw the amount over 10 percent. Funds withdrawn in this way must be deposited in the education construction fund (Article VII, section 12).

Under the constitution, 1 percent of general state revenues must be transferred

Table 3: Total Reserves (Dollars in Millions)

	2007-09	2009-11	2011-13	2013-15	2015-17	2017-19
Unrestricted NGFO Ending Fund Balance	193	(92)	156	1,011	785	1,633
BSA Ending Fund Balance	21	1	270	513	1,638	1,558
Total Reserves	**214**	**(91)**	**426**	**1,524**	**2,423**	**3,191**

The state constitution defines "general state revenues" and "extraordinary revenue growth":

- **General state revenues** are "all state money received in the treasury from each and every source, including moneys received from ad valorem taxes levied by the state and deposited in the general fund in each fiscal year, but not including:

  (1) Fees and other revenues derived from the ownership or operation of any undertaking, facility, or project;

  (2) Moneys received as gifts, grants, donations, aid, or assistance or otherwise from the United States or any department, bureau, or corporation thereof, or any person, firm, or corporation, public or private, when the terms and conditions of such gift, grant, donation, aid, or assistance require the application and disbursement of such moneys otherwise than for the general purposes of the state of Washington;

  (3) Moneys to be paid into and received from retirement system funds, and performance bonds and deposits;

  (4) Moneys to be paid into and received from trust funds and the several permanent and irreducible funds of the state and the moneys derived therefrom but excluding bond redemption funds;

  (5) Moneys received from taxes levied for specific purposes and required to be deposited for those purposes into specified funds or accounts other than the general fund; and

  (6) Proceeds received from the sale of bonds or other evidences of indebtedness" (Article VIII, section 1).

- **Extraordinary revenue growth (EORG)** is "the amount by which the growth in general state revenues for that fiscal biennium exceeds by one-third the average biennial percentage growth in general state revenues over the prior five fiscal biennia" (Article VII, section 12).

from the general fund–state (GFS) to the BSA each fiscal year. "General state revenues" include most state money for the general fund. The education legacy trust account, which is part of the NGFO, is a dedicated account and its funds are not included in general state revenues. (For the technical definition, see the box above.)

A second constitutional amendment approved in 2011 requires the transfer of three-quarters of any extraordinary revenue growth (EORG) to the BSA at the end of each biennium. EORG occurs when general state revenues exceed the average biennial percentage growth over the last five biennia by one-third. (See the box above for the technical definition.)

Table 4: Budget Stabilization Account (Dollars in Millions)

	2007-09	2009-11	2011-13	2013-15	2015-17	2017-19
Beginning Balance	303	21	1	270	513	1,638
Deposits	118	248	269	359	1,316	1,964
Withdrawals	**(400)**	**(268)**	0	**(115)**	**(191)**	**(2,044)***
Ending Fund Balance	**21**	**1**	**270**	**513**	**1,638**	**1,558**

* The withdrawals for 2017-19 do not include the diversion of $711 million.

The state has experienced extraordinary revenue growth in 2013–15 ($38 million), 2015–17 ($925 million), and likely in 2017–19 ($1.486 billion, as estimated in November 2018).

The 1 percent and EORG deposits to the BSA have been made by the Legislature, as required by the constitution. (In 2018, the Legislature maneuvered to keep some EORG out of the BSA in the 2017–19 biennium, as we describe below.)

The two BSA constitutional amendments are sensible budgeting practices. First, having a cushion in case of emergency is standard financial advice. Second, saving extraordinary revenues means that the state is setting aside money to sustain programs when revenue dips during economic downturns.

Use of the Budget Stabilization Account and Extraordinary Revenue Growth

Despite the restricted nature of the BSA, it is not impossible to tap. In fact, the state has made withdrawals from the BSA in each biennium of its existence except 2011–13. The withdrawals made in 2007–09 and 2009–11 were to sustain programs during the Great Recession—the quintessential rainy day. Additionally, the state has appropriated funds from the BSA to pay for emergency fire costs and disaster response in 2013–15 ($77.2 million), 2015–17 ($190.6 million), and 2017–19 ($41.5 million).

However, the state has also used EORG deposits to fund ongoing costs. Instead of saving the EORG the state has experienced during this long period of economic expansion, the Legislature has spent it. Still, in doing so, it followed the procedures laid out in the constitution—until last year.

In 2015, the Legislature passed a bill (with a supermajority vote) that directed the transfer of the entire EORG amount for 2013–15, 2015–17, and 2017–19 from the BSA back to the GFS. The legislation included upper limits on the amount that was allowed to be transferred (Chapter 2, Laws of 2015, 3rd Special Session). As a result, the full EORG deposit was transferred back to the GFS in 2013–15.

In 2017, the Legislature passed (with a supermajority vote) a bill that repealed the previously directed transfer back to the GFS for 2015–17 (Chapter 29, Laws of 2017, 3rd Special Session). Instead, the same legislation transferred $925.166 million from the BSA to the pension funding stabilization account during 2017–19. Thus, the Legislature used the 2015–17 EORG deposit to cover pension costs for public employees in lieu of the NGFO (half was used for 2017–19 and the other half is planned to be used for 2019–21). Additionally, for 2017–19, the legislation increased the ceiling on the amount of EORG that will be transferred out of the BSA (as originally directed in 2015), from $550 million to $1.078 billion.

In July 2017, the state estimated that the 2017–19 EORG deposit would be $898 million, so the $1.078 billion ceiling would have been high enough such that the entire deposit would be automatically transferred back to the GFS (ERFC 2017). However, a February 2018 outlook estimated the EORG deposit would instead be $1.609 billion, an increase of $711 million since July 2017 (LEAP 2018a). Transferring the amount of the deposit above the $1.078 billion ceiling would have required a new supermajority vote.

Many legislators wanted to use the BSA to fund a reduction in the state property tax, but they didn't have the votes of three-fifths of the Legislature to do so (WRC 2018b). Instead, legislation enacted without a supermajority (Chapter 295, Laws of 2018) re-directed $935 million of state property taxes from the GFS to the education legacy trust account. As a result, general state revenues were reduced by $935 million and the estimated EORG deposit was reduced by $711 million (LEAP 2018b). (This $711 million is not included in Table 4 on page 3.) At the time, it was estimated that the 2017–19 EORG deposit would thus be $924 million, which would automatically be transferred back to the GFS under the previous legislation (ERFC 2018a). The November 2018 revenue forecast subsequently increased the estimate for the 2017–19 EORG deposit to $1.486 billion (ERFC 2018b). Thus, $408 million of the EORG deposit will remain in the BSA (unless the Legislature enacts new legislation to transfer it in the 2019 session).

Reserve Level

Even with the diversion and withdrawals, the BSA is expected to end 2017–19 with $1.558 billion. That level is just $80 million lower than the BSA balance in 2015–17. But is it a large enough cushion?

One way to measure the adequacy of the reserve is found in the state constitution. As noted above, 10 percent of general state revenues is the threshold at which the Legislature is allowed to transfer money out of the fund without a supermajority vote. At the end of fiscal year 2017 (the end of the 2015–17 biennium), the BSA balance was 8.3 percent of general state revenues.

The November 2018 revenue forecast and budget outlook indicate that the BSA balance will exceed 10 percent of general state revenues in FY 2023, for the first time. If that holds, a simple ma-

Table 5: BSA Balance as a Percent of General State Revenues

2009	0.2%
2010	0.7%
2011	0.0%
2012	0.9%
2013	1.7%
2014	2.5%
2015	2.9%
2016	3.0%
2017	8.3%
2018	6.3%
2019	7.0%
2020	7.7%
2021	8.6%
2022	9.6%
2023	10.6%

jority would be able to withdraw $161 million from the BSA for the education construction fund in FY 2023. (That will depend on actual revenues and whether legislators refrain from making other withdrawals from the BSA.)

Another way to determine reserve adequacy is more nuanced. There is no single amount that acts as a rule-of-thumb across states. Instead, budget experts believe that a state's "optimal reserve size" is tied to its revenue volatility: "In general, states with greater revenue volatility need to save relatively more than do those with less fluctuation" (Murphy and Bailey 2018). As we noted in a recent policy brief, Washington's tax revenues are the 14th least volatile in the country (WRC 2018c).

Pew has analyzed states' reserve levels and volatility. It shows that Washington has below average volatility and above average total reserves (rainy day fund plus unrestricted ending balance). According to Pew, Washington and the other states in this category "might be relatively better off than others" (Murphy and Bailey 2018). However, Pew cautions, "their saving levels still may not be high enough to mitigate a severe recession" (Murphy and Bailey 2018). Additionally, the governor has proposed a 9 percent capital gains tax, which would make state revenues relatively more volatile (WRC 2019).

Table 6: November 2018 NGFO Outlook (Dollars in Millions)

	2017-19	2019-21	2021-23
Beginning Balance	1,149	1,633	689
Total Resources	46,350	51,442	54,825
Appropriations	44,717	50,753	54,603
Unrestricted Ending Balance	1,633	689	221
Budget Stabilization Account Ending Balance	1,558	2,149	2,831
Total Reserves	3,191	2,838	3,053

Outlook for 2019–21 and 2021–23

The November 2018 outlook is based on the November revenue forecast and the enacted 2017–19 budget (including the 2018 supplemental). It presents the preliminary maintenance level of that budget for 2019–21 and 2021–23 (the maintenance level amount will continue to be refined into the session). Since the February 2018 revenue forecast, revenues for 2017–19 and 2019–21 are up $1.735 billion. Given that increase, the new outlook is rosier than the one adopted in April.

As Table 1 on page 2 shows, at the time the 2018 supplemental budget was enacted, it barely balanced over four years. The November 2018 outlook indicates an unrestricted NGFO ending balance of $689 million in 2019–21 and $221 million in 2021–23 (see Table 6). (However, the indicated appropriations levels for 2019–21 and 2021–23 are not actual budgets, and they do not include any spending changes related to new policies. For example, Gov. Inslee has proposed new policies for 2019–21 that would increase spending by $3.557 billion.)

Still, if a recession occurs during the 2019–21 biennium, Washington would not be prepared, despite the extraordinary revenue growth we've seen in recent years. Although recessions are very difficult to predict, a December 2018 outlook from the National Association for Business Economics puts the risk of recession at 20 percent by the second half of 2019 and 30 percent by the end of 2020 (NABE 2018). If the current expansion extends into the 2019–21 biennium, it would be the longest of the post-World War II era.

Along with adopted revenue forecasts, the ERFC also presents optimistic and pessimistic alternative forecasts. The November 2018 pessimistic forecast for 2019–21 has a probability of 35 percent; it represents a reduction in estimated revenues of 5.8 percent.

Table 7 shows an estimate of what could happen to the outlook under such a scenario. Instead of having a positive ending fund balance in 2019–21, the unrestricted ending balance would be negative $2.186 billion. Reserves would not be large enough to cover the shortfall, which means that the state would have to make program cuts or increase taxes. Had the withdrawals and diversion from the BSA not occurred in 2017–19, there would be more than enough in the BSA to offset the recession level revenue losses.

Comment

Washington has made important budget process improvements over the past decade that promote budget sustainability. Although the Legislature has followed the letter of the laws, it hasn't always followed their spirit.

First, suggestions have been made that the four-year balanced budget requirement should be scrapped. To be sure, it is more difficult to balance a budget over four years than two, but the requirement provides a useful check against unsustainable bow wave spending.

Second, the Legislature has spent all the extraordinary revenue growth the state has experienced in the past two biennia. (Legislators may still end up saving a fraction of it this biennium thanks to increasingly rosy revenue forecasts.) Had the Legislature saved these funds, the state would be better prepared to weather a potential future downturn.

Third, the redirection of funds last year to avoid the BSA and a difficult supermajority vote set "a precedent that seriously weakens the constitutional provisions," as we wrote at the time (WRC 2018b). While the diversion (and withdrawals) may not have lowered reserves to dangerous levels this biennium, future diversions could have more detrimental effects. With the precedent set, Gov. Inslee's 2019–21 budget proposal would similarly direct some revenues to the ELTA to avoid an extraordinary growth deposit to the BSA (WRC 2019).

Washington is very fortunate to be experiencing strong revenue growth, but it won't last forever. And, despite extraordinary revenue growth, expected revenues are not high enough to fund Gov. Inslee's 2019–21 spending proposals. When enacting the 2019–21 budget, in addition to being cautious about increasing spending in light of the potential for an economic downturn, the 2019 Legislature should be cautious about changing provisions that help make the budget sustainable for the future.

Table 7: NGFO Outlook (Dollars in Millions)

	2017-19	Adopted 2019-21	Recession Scenario 2019-21
Beginning Balance	1,149	1,633	1,633
Total Resources	46,350	51,442	48,567
Appropriations	44,717	50,753	50,753
Unrestricted Ending Balance	1,633	689	**(2,186)**
Budget Stabilization Account Ending Balance	1,558	2,149	2,121
Total Reserves	3,191	2,838	**(66)**

Sources: ERFC, WRC estimates

References

Economic and Revenue Forecast Council (ERFC). 2017. "Outlook for Enacted 2017–19 Operating Budget." July 28.

——. 2018a. "Outlook for Enacted 2018 Supplemental Budget." April 25.

——. 2018b. "November 20, 2018 Budget Outlook." Nov. 20.

Legislative Evaluation & Accountability Program Committee (LEAP). 2011. "Legislative Budget Notes: 2011–13 Biennial Budget – 2011 Supplemental Budget." October.

——. 2018a. "2017–19 Omnibus Operating Budget – 2018 Supplemental: ESSB 6032 Senate Passed (Version SBC)." Washington Legislature. Feb. 23.

——. 2018b. "Legislative Budget Notes: 2017–19 Biennium – 2018 Supplemental."

Murphy, Mary and Steve Bailey. 2018. "State Revenue Volatility and Optimal Reserve Size Are Directly Linked." Pew. Nov. 14.

National Association for Business Economics (NABE). 2018. "NABE Outlook Survey – December 2018." December.

Tri-City Herald (TCH). 2016. "Our Voice: House Democrats need to budget by the rules." Editorial. March 20.

Washington Research Council (WRC). 2012. "Balancing the Operating Budget." PB 12–11. May 14.

——. 2017. "Gov. Inslee's 2017–19 Operating Budget Proposal Would Significantly Increase Spending and Taxes." SR 17–01. Jan. 17.

——. 2018a. "Legislature Has Used Rainy Day Fund Each Biennium Except 2011–13." PB 18–02. Jan. 12.

——. 2018b. "In the 2018 Supplemental, the School Salary Increase is Fully Funded, But the Rainy Day Fund is Shortchanged." PB 18–07. March 15.

——. 2018c. "Washington Revenue Review: Revenues Are Still Growing Strong, But for How Long?" PB 18–10. Dec. 7.

——. 2018d. "Washington Spending Review: Spending Up 44 Percent Since Pre-Recession Peak." PB 18–11. Dec. 12.

——. 2019. "Gov. Inslee Proposes a 22.3 Percent Spending Increase for 2019–21." PB 19–01. Jan. 2.