WashACE

COMPETITIVENESS BRIEF

Washington Alliance for a Competitive Economy

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Building a Budget for Long-Term Stability

THE BOTTOM LINE

Washington State government faces a structural budget gap. To close this gap, lawmakers must focus first on expenditure control, combining the discipline of the Priorities of Government budget process with the fiscal constraints of a comprehensive tax and expenditure limitation. Substantial revenue increases can neither be justified nor implemented successfully at this time. In addition, the existing tax structure relies too much on business taxes; any increase in business costs risks dampening the pace of recovery. Household tax increases would doubtless trigger a swift and negative reaction from a skeptical public.

Although the recession has ended for now, Washington's budget problems continue to plague lawmakers. Even 7 percent revenue growth, reflecting the strengthening economic recovery, failed to keep pace with the 12 percent growth in general fund state spending for the coming biennium (WRC, 2005). And while the Legislature ultimately bridged the short-term fiscal gap, they did so without creating a sustainable budget.

Governor Christine Gregoire acknowledged as much when she released her budget plan last March. "It's not sustainable," she said. "Post-session I'd like us to be working together toward how we can really, ultimately have a structurally sound, sustainable budget" (Garber, 2005).

In working toward a sustainable budget, policymakers face difficult decisions with clear implications for our economy and state competitiveness. In 2002, commenting on an impending budget gap of more than $2 billion for the 2003-2005 biennium, the Washington Research Council described the persistent budget shortfalls as a "major competitiveness challenge" (WRC, 2002).

BUDGET SUSTAINABILITY

In 2003, Governor Gary Locke and the Legislature used the Priorities of Government (POG) process to resolve the short-term revenue crisis. Although successful, the reforms did not realize the POG's full potential to address the long-term structural instability caused by Washington's accelerating spending commitments.

By the time the 2005-2007 budget planning began, the estimated cost of maintaining current state services, including workload and compensation increases, exceeded projected revenues by about $1.5 billion. Eventually, lawmakers filled the gap with a combination of tax increases, program reductions, fund transfers, and reserve drawdowns. However, these patches won't solve the long-term problem. Even with a strong June revenue forecast and revisited inflation estimates, analysts project a shortfall of more than $600 million for the 2007-2009 biennium (Washington State OFM, 2005b).

Priorities of Government. In 2002, Governor Locke worked with Peter Hutchinson, a national consultant who pioneered the POG, to develop a budget focused on outcomes. The process concentrates on getting the best results within available resources, a departure from the "base plus" incrementalism that characterizes traditional government budgeting.

In their critique of traditional budgeting, Hutchinson and his colleague David Osborne wrote:

> The concept of the base is at the heart of the old system – and at the heart of its defects…The new game, which we call Budgeting for Outcomes, has no concept of 'base.' Last year's number is not an entitlement, and there is no argument about adding to or subtracting from it. Instead, the starting point is an agreed-upon price of government, and the objective is to buy results (Osborne & Hutchinson, 2004, p. 63-65).

In sum, outcome budgeting does away with the language of deficits, budget gaps, and shortfalls. The process begins by setting the "price of government" and tailoring spending to maximize return on the public investment.

Still, there is a political reality within which public spending has a steady trajectory. Taxpayers expect stability. Recipients of public services – and the people who deliver those services – rely on continuity. Students and teachers expect schools will remain open, educators will be paid, and capacity will expand to meet demand. People who rely on Medicaid expect continued benefits. Employers rely on dependable services, adequate infrastructure, and reasonable taxes and fees. While the POG encourages analysts to think creatively, the complexities and inertia of large institutions mitigate government's ability to make rapid or radical adjustments in public spending.

The current services budget, therefore, continues to set the stage for budget deliberations. And with analysts projecting deficits for the foreseeable future, it is clear that Washington faces an ongoing mismatch between available revenues and ongoing spending.

FACING FACTS

Across the country, continued increases in government expenditures combined with a reliance on slow-growing revenues and eroding tax bases have created unsustainable state budgets – a situation exacerbated by the recent recession. Washington has, in the short term, been able to mitigate the budget gap through a combination of budget cuts, program enrollment freezes, "sin" tax increases and reserve fund spending. However, the use of short-term "fixes" only delays the need for reform.

Emerging from the recession, it has become clear that the budget shortfalls are not a short-term problem. According to *The Fiscal Survey of the States*, a joint publication of the National Governors Association and the National Association of State Budget Officers, "In fiscal 2005, resurgent revenue growth was tempered by a backlog of expenditure demands, the after effects of the federal fiscal relief package and general spending increases in nearly all major program areas" (2005).

STRUCTURAL VS. CYCLICAL DEFICITS

Fiscal analysts distinguish between cyclical and structural deficits and agree that each type of deficit requires different policy responses.

A cyclical deficit may be attributed to short-term fluctuations in the economy. In 2001, for example, revenues dipped during the recession, forcing lawmakers to reduce or defer state spending. Cyclical deficits can be addressed by a combination of temporary and one-time measures: using the state's "rainy day" fund or cash reserves, postponing compensation increases, suspending planned program enhancements, and so on. When the economy recovers, normal spending patterns may resume. One virtue claimed for tax and expenditure limits has been that, by controlling spending and requiring reserves, they provide stability during periods of economic volatility.

Structural deficits stem from a persistent and ongoing mismatch between state revenues and expenditures. When the projected growth in long-term spending exceeds forecast revenues, the state faces a structural deficit that requires enduring policy changes. In this case, the state must change its tax structure to increase the long-term growth rate, alter the pattern of public spending to match more closely the revenue stream, or both.

Budget Shortfalls. State governments across the nation have emerged from the recession sharing a common fiscal situation and a common reluctance to make the structural adjustments required to create budget sustainability. Despite the relative mildness of the 2001 recession, states find themselves in worse shape than they were in following the recessions of the early 1980s and early 1990s (Sheffrin, 2004).

Steven Sheffrin cites three reasons for the "deterioration" of state budget positions between 1998 and 2002: the late-1990s tax cuts enacted by states, the expansion of Medicaid eligibility during a time where states began facing increases in the relative price of health care, and general spending increases by most state and local governments (2004, p. 209).

Similarly, a University of Tennessee study found that states aggravated their problems by cutting tax rates and reducing bases during the robust 1990s, "apparently believing that the existing short-run revenue conditions reflected the underlying long-run revenue environment" (Bruce, Fox & Tuttle, 2004, p. 24). As part of their analysis, the authors examined the performance of the two major revenue sources tapped by state governments, the income and sales taxes. While the income tax generally grows faster than the sales tax base over the long periods of time, how the tax is imposed matters a great deal, and there is considerable variation among the states.

According to the report, "neither the personal income tax nor the sales tax emerges as the universally more volatile tax" (Bruce, Fox & Tuttle, 2004, p. 3). Furthermore, "an adequate long-term growth rate is not necessarily sufficient to ensure that service delivery will be properly financed on an annual basis" (p. 3). With a clear understanding of their tax structures, states can "use careful resource planning, such as rainy day funds, to smooth expenditures during downturns" (p. 3).

Underscoring the role played by public policy, economists Brian Knight, Andrea Kusko, and Laura Rubin examined state responses to the fiscal crisis in 2003 and found that the "marked deterioration in state and local budgets over the past couple of years has partly reflected a dramatic shortfall in revenues" combined with states' and localities' inability to "rein in spending" (2003, p. 429). From their analysis, they concluded that "neither the cyclical weakness in the economy … nor the direct effects of capital gains realization account for very much of the deficit in 2002" (p. 435). Instead "The implication is that the current deficit is largely structural and thus, unlikely to be eliminated in the absence of significant budgetary actions by these governments" (p. 435).

WASHINGTON'S CHALLENGE

The national pattern played out in Washington as the Legislature expanded Medicaid and rolled back business tax hikes passed during the early 1990s. In addition, lawmakers weakened the fiscal discipline imposed by the Initiative 601 tax and the expenditure limit passed by the voters in 1993.

Compounding the problem, voters passed citizen initiatives limiting taxes and forcing new spending. In 1999, Initiative 695 repealed the motor vehicle excise tax. Although the state Supreme Court overturned the initiative, lawmakers swiftly abolished the tax. Additional revenue pressure came with the passage of Initiative 747 in 2001, which limited state and local property taxes.

Even as revenues were being capped, voters mandated increased spending through a pair of education initiatives in 2000. Initiative 728 diverted general fund property taxes to local schools; Initiative 732 required cost-of-living increases for teachers.

In addressing the deficits of 2003-2005 and 2005-2007, lawmakers focused primarily on temporary measures appropriate to cyclical deficits.

In their 2004 book, Osborne and Hutchinson wrote, "Washington's new budget process has been something akin to emergency triage, ultimately making do with the ready-made solutions that its own agencies could offer." They said that the state stopped short of implementing the full budgeting for outcomes framework. The next steps, they concluded, will require a fundamental and permanent transformation in budgeting (p. 83).

Locke used the process in preparing his recommendations for the 2005-2007 biennium and Gregoire has said she endorses the Priorities of Government method (though she would customize it). Yet, the POG had little clear, beneficial impact on this year's state budget, as the Legislature continued to chart its own budget course following traditional processes. Where Washington takes the POG next is unclear. But there's no question the process, used consistently, could help policymakers achieve the goal of long-term sustainability.

THE REVENUE DIMENSION

Because of Washington's unusual tax structure, revenue issues have been considered in detail by policymakers in recent years, most prominently in the work of the 2002 Washington State Tax Structure Study Committee (TSSC). The TSSC estimated that Washington's tax revenue elasticity (the percentage long-run change in revenue collected divided by the percentage long-run change in state income) is slightly less than 1.0, meaning that revenues are growing somewhat slower than the rate of income (2002, p. 26). In contrast, the expenditure elasticity (the percentage long-run change in government spending divided by the percentage long-run change in state income) is slightly greater than 1.0, indicating that the demand for government services is increasing at a rate faster than both income and revenue (2002, p. 26).

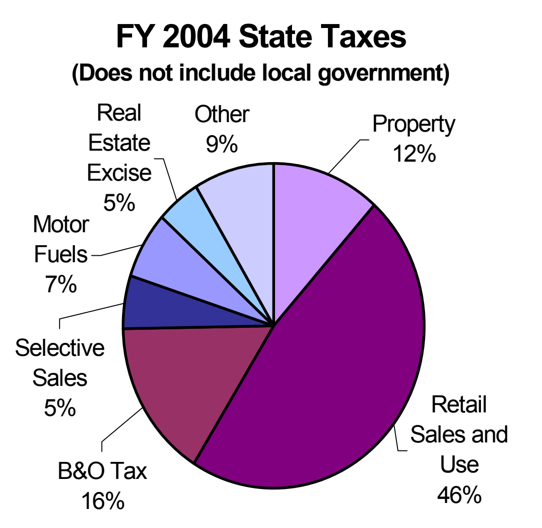
Evidence suggests that the low revenue elasticity is not due to recent fluctuations in the economy. In fact, the Rockefeller Institute of Government found that Washington's revenue sources were much more stable than other high-income states during the recent recession (Gais, Burke & Corso, 2003). While revenue levels dropped between 2001 and 2003 for thirty-one states, Washington experienced slight revenue increases (p. 9). This stronger performance can be ascribed to Washington's major broad-based taxes as well as its reliance on the less volatile sales tax. According to Fox (2003), in 2002, the corporate income tax and personal income tax revenues fell across the country by 11.7 percent and 10.2 percent respectively, while the sales tax fell only 0.9 percent. See Figure 1.

FIGURE 1. MAJOR WASHINGTON STATE TAXES

Retail Sales and Use Tax: The retail sales tax applies to the sale of tangible property. In addition, the tax is levied on a number of services including repair, construction, lodging, telephone services and landscape maintenance. Washington has one of the nation's highest sales tax rates. In 2004, the state rate of 6.5 percent was tied for fourth highest nationally (FTA).

Approximately 36 percent of the revenue generated by the sales and use taxes is derived from purchases made by businesses—largely through the purchase of intermediate goods and services (TSSC, 2002, p. 105).

Business and Occupation Tax: The State B&O tax is applied to the gross income of businesses, with no deductions made for labor, materials, taxes, or other costs of doing business. Washington is one of only five states that tax business services extensively and one of only four states that do so through a gross receipts tax (Cline, Mikesell, Neubig & Phillips, 2005, p. 10).



Property Tax**:** The property tax is primarily applied to real property, i.e. land and the structures permanently attached to it. However, the tax also covers certain types of personal property—including business machinery and equipment. Washington is one of nine states that impose a significant property tax at the state level (TSSC, 2002, p. 8).

Real Estate Excise Tax*:* The transfer of real property is taxed both on a state and local level through the Real Estate Excise Tax (REET). The state imposes a rate of 1.28 percent of the selling price. In addition, counties, cities and towns can impose addition taxes of up to 2.5 percent. According to the National Association of Realtors, only New Hampshire and Delaware impose a higher state REET rate. Washington is only one of twelve states that allow local governments to tax real estate transfers.

PRESSURES ON THE REVENUE SYSTEM

Although more stable than most income taxes, the proliferation of interstate sales and the shift from goods to services have diluted the productivity of the sales tax.

Internet and Interstate Sales. The growth of interstate sales (through electronic commerce, catalog sales and over the phone transactions) has contributed to the eroding tax base by allowing residents to more easily avoid state and local taxes. (Although remote sales are subject to the use tax, compliance and enforcement remain low.)

To reduce revenue losses, a variety of policies have been attempted by states including increasing consumer use tax compliance, enacting legislation aimed at broadening the definition of when a company has presence in a state and requiring agencies to do business only with companies that collect and remit sales taxes. Despite these efforts, revenue losses from across border sales continue to increase.

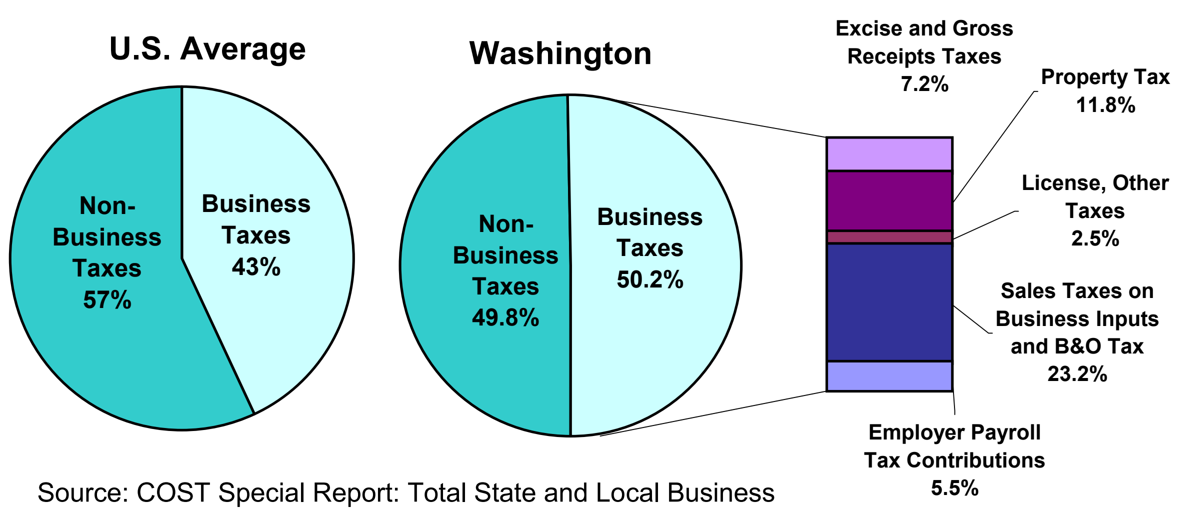
While all states are experiencing revenue reductions as a result of online shopping, Bruce and Fox found that the greatest reductions are in states relying more heavily upon the sales tax (2004, p. 6). Washington lost an estimated $488.2 to $508.7 million in state and local revenue in 2003 (p. 7). By 2008, the losses are projected to increase to between $692.3 and $1,082.7 million (p. 8).

Economic Restructuring. Exacerbating the weakness of the sales tax, consumption continues to shift from goods to services. According to the Bureau of Economic Analysis, service expenditures rose nationally from 45.7 percent of total consumption in 1974 to 59.1 percent by 2004 (BEA, 2005). Since most states levy sales taxes largely on tangible goods, the increased consumption of services has further reduced the growth of tax revenues.

In some respects, Washington is in a better position than many states. The Federation of Tax Administrators recently issued a report on states' incorporation of various services into their sales tax base; in 2004, Washington imposed 157 of the 168 service taxes surveyed (FTA, 2005a).

Still, while the average state experienced an 8.0 percentage point decrease in the sales tax base breadth, the percent of sales subject to the tax in Washington declined 15.9 percentage points between 1990 and 2003 (Mikesell, 2004; Mikesell, 2003). Even though the percent of sales subject to the sales tax in 2003 remained slightly greater in Washington than in most states (45.2 percent versus 43.3 percent nationally), Washington's high reliance on the sales tax causes a greater risk of future revenue instability.

FIGURE 2. STATE & LOCAL TAX COMPARISON, FY 2004



Source: COST Special Report: Total State and Local Business

Taxing Business-to-Business Services. While some economists support widening the sales tax base to improve and sustain the tax system, most oppose singling out businesses and professional services. Taxing "business-to-business" sales will increase tax pyramiding, complicate sales tax administration, add to the cost of doing business, and distort the allocation of resources by favoring businesses that have in-house services.

BUSINESS TAX RELIANCE

Washington, like most states, is faced with a limited number of revenue options. However, looking to businesses to fund additional government expenditures has serious economic implications.

Compared to both regional and global competitors, Washington raises an extraordinarily high share of state and local governmental revenue through business taxes. In FY 2004, the average state received 43 percent of tax revenue from businesses while Washington collected 50.1 percent - ranking 10th nationally (Cline, Neubig, Phillips & Fox, 2005, p. 8). Oregon's business tax reliance was 33.8 percent (ranking 49th) while Idaho's business tax burden was 38.8 percent (ranking 39th). See Figure 2.

FIGURE 3. STATE & LOCAL TAX BURDEN, FY 2005

	Tax Burden as a Percent of Income		Tax Burden Per Capita	
	Rank	Percent	Rank	Amount
United States	-	10.12%	-	$3,763
Alabama	46	8.69%	49	$2,656
Alaska	50	6.36%	50	$2,452
Arizona	21	10.17%	33	$3,184
Arkansas	11	10.52%	41	$2,993
California	20	10.27%	11	$4,078
Colorado	37	9.53%	19	$3,758
Connecticut	12	10.51%	1	$5,400
Delaware	48	8.04%	36	$3,128
Florida	44	9.25%	28	$3,271
Georgia	31	9.81%	26	$3,377
Hawaii	3	11.46%	9	$4,161
Idaho	27	9.97%	39	$3,014
Illinois	30	9.81%	15	$3,920
Indiana	18	10.28%	23	$3,503
Iowa	25	10.01%	24	$3,479
Kansas	15	10.37%	22	$3,629
Kentucky	19	10.28%	32	$3,199
Louisiana	16	10.36%	31	$3,200
Maine	1	12.97%	7	$4,390
Maryland	17	10.32%	5	$4,501
Massachusetts	32	9.79%	4	$4,608
Michigan	22	10.15%	21	$3,686
Minnesota	10	10.71%	6	$4,409
Mississippi	26	10.00%	48	$2,739
Missouri	41	9.42%	27	$3,282
Montana	39	9.46%	45	$2,878
Nebraska	8	10.89%	14	$3,984
Nevada	38	9.53%	25	$3,423
New Hampshire	49	7.37%	38	$3,040
New Jersey	14	10.39%	3	$4,971
New Mexico	29	9.89%	44	$2,882
New York	2	11.99%	2	$5,170
North Carolina	28	9.97%	30	$3,268
North Dakota	42	9.36%	34	$3,170
Ohio	7	11.03%	16	$3,906
Oklahoma	40	9.45%	46	$2,876
Oregon	36	9.59%	28	$3,271
Pennsylvania	35	9.71%	20	$3,747
Rhode Island	4	11.42%	8	$4,327
South Carolina	33	9.75%	43	$2,976
South Dakota	45	8.75%	42	$2,976
Tennessee	47	8.35%	47	$2,757
Texas	43	9.34%	35	$3,167
Utah	9	10.85%	37	$3,122
Vermont	6	11.11%	12	$4,005
Virginia	34	9.72%	17	$3,820
Washington	24	10.03%	13	$3,990
West Virginia	13	10.50%	40	$2,996
Wisconsin	5	11.38%	10	$4,141
Wyoming	23	10.10%	17	$3,802

Sources: Tax Foundation and Bureau of Economic Analysis

Washington also has one of the nation's highest effective tax rates for business (measured as the ratio of state and local business taxes to private-sector gross state product). In 2004, the US average effective tax rate for businesses was 4.7 percent while Washington had an effective tax rate of 5.7 percent, the eighth highest in the nation (Cline, Neubig, Phillips & Fox, 2005, p. 8).

To put this in context, consider that Washington businesses pay an extraordinary share of an overall state and local tax burden. Although timely official figures are not available from the federal government, the Tax Foundation estimates Washington's tax burden to be 10.0 percent of personal income, 24th highest in the nation, and the tax burden per capita to be $3,990, 13th highest (2005a, p. 13). See Figure 3.

According to the 2002 Tax Structure Study Committee (TSSC), "high business tax burdens reduce the economic vitality of the state, discourage firms from locating their operations here, and invite firms already located in Washington to consider other locations" (p. 52).

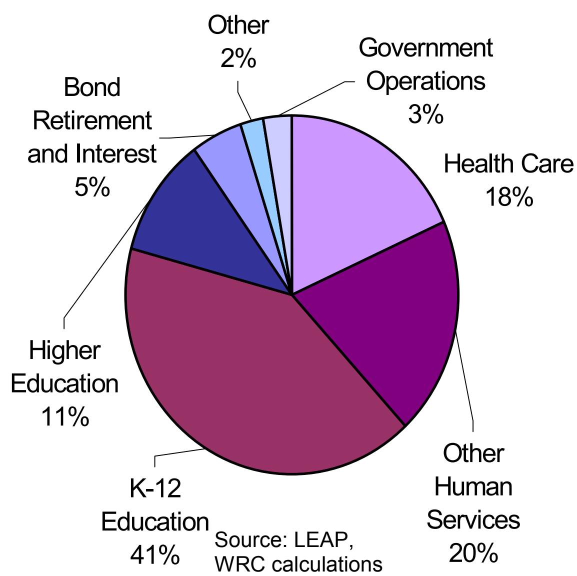
Washington's unusually high reliance on business taxes also limits policymakers' options in correcting structural deficits through tax increases and exacerbates the state's long-term revenue problem. Major structural reform, the accepted euphemism for an income tax, remains unpopular. The TSSC recommendations failed to generate any substantial political or public support, despite significant media attention. Therefore, in the short-term at least, lawmakers must turn their attention to expenditure control.

THE EXPENDITURE DIMENSION

Human service programs, especially Medicaid and education, claim most of the spending in Washington's general fund, replicating the pattern seen across the country in state budgets. Other areas of state spending exhibit growth as well, but for this discussion of the state's structural deficit, a health and education overview is sufficient. See Figure 4.

Health Care. In recent years, rising health care costs have exerted the greatest budget pressure. Health care spending for employee compensation, medical assistance, and the basic health plan (funded from the Health Services Account, a “near general fund” account) is expected to total $4.45 billion in 2005, with about 40 percent of the total coming from the state general fund. The $1.75 billion in general fund health care spending represents about 14.3 percent of all general fund spending. Beyond this, about $440 million will be spent on health care from the Health Services Account.

FIGURE 4. NEAR GENERAL FUND EXPENDITURE, 2005-07



Source: LEAP, WRC calculations

Combined health care spending from the HSA and general fund is forecast to grow by about 9.1 percent for the 2006 fiscal year and 7.4 percent in FY 2007, exceeding the growth rate for inflation, population, and state revenues. This mismatch creates ongoing problems for the HSA, which relies primarily on slow growing alcohol and tobacco taxes (increasing between one and two percent annually) to support rapidly rising health care expenditures.

Employer-paid health insurance for state employees increased 13.5 percent in FY 2006, with another 12.2 percent increase scheduled for FY 2007. Both increases were negotiated under the state’s collective bargaining agreement.

Medical assistance and Basic Health Plan (BHP) enrollment is estimated to increase by about 7.2 percent between FY 2005 and FY 2007, more than twice the growth rate of the state population. The cost of assistance per person for medical assistance is projected to grow by 7.5 percent in FY 2006 and 8.1 percent in FY 2007. BHP costs are estimated to grow even faster, 8.3 percent in FY 2006 and 9.1 percent in FY 2007 (WashACE, 2005).

While Washington has unusually generous health care policies – both for its employees and for the low-income populations served by the BHP and medical assistance – efforts to scale back costs have met with resistance. In 2003, lawmakers made two changes to the Children’s Medicaid Program: they required the Department of Social and Health Services to verify applicants’ declared income and they required recipients to re-verify their eligibility every six months, rather than annually. As policy changes go, these actions must be considered relatively mild; Eligibility standards were not changed and no qualified recipient was denied coverage. Yet, even these minor reforms sparked opposition and Governor Gregoire eliminated the six-month re-verification as one of her first acts on taking office in January 2005.

Education. Demographic trends drive education spending. The funding formulas governing K-12 spending peg off enrollment and growth in the 17-22 year-old population increases demand pressure on the state’s colleges and universities.

The Washington state constitution (Article IX, Section 1) says, “It is the paramount duty of the state to make ample provision for the education of all children residing within its borders.” What the framers intended by that pronouncement periodically gets sorted out in the courts, but the clear consequence has been that public school spending dominates the state budget (though escalating health care increasingly claims a larger share of new spending).

Since the middle of the Twentieth Century, there has been a predictable cyclicality to K-12 enrollment demand. First there was the baby boom, then the baby boom echo. Now, OFM predicts a “third population wave” beginning in the next five or six years, “with annual increases reaching 13,000 to 14,000 by 2015” (Lowe, 2005). This pulse of enrollment follows a period of relative stability from 1999 to present.

Although flagging public school enrollment pressure theoretically eases budget strain, lawmakers and education advocates typically use the “dividend” to increase per pupil spending. For example, Initiative 728 capitalized on a temporary state surplus to make a substantial increase in education spending, establishing a dedicated fund to channel property tax and lottery money to local schools for class size reduction. However, increased budget pressure ensues when the higher per pupil costs are compounded as enrollments begin to rise again.

As part of the budget fix in 2003, certain provisions of I-728 were temporarily suspended. This year, however, lawmakers created the Education Legacy Trust Account (ELTA) into which they channeled funds from increased tobacco taxes and a new estate tax to support K-12 and higher education. But projections by the nonpartisan Office of Program Research reveal that the ELTA will be, at best, a short-lived solution. The new taxes will yield $313 million in the 2005-2007 budget and $366 million for the 2007-2009 biennium. In the current budget, the $313 million paid for the I-728 class size reduction ($138 million), increased spending for the learning assistance program ($25 million), and 7,900 new higher education enrollment slots plus increased financial aid ($150 million). For 2007-2009, the I-728 commitment alone will claim $360 million, leaving just $6 million for the rest. That means the higher education enrollment slots will require additional funding or fall back to the general fund, increasing the size of the structural deficit.

Sustainable spending for higher education is becoming an increasingly important issue. As WashACE has reported in earlier competitiveness reports, industry demand for an educated workforce continues to rise, particularly but not exclusively in technology and R&D sectors. At the same time, demographically-driven enrollment pressures are mounting. The Office of Financial Management projects that, if the state were to maintain the existing participation rate, an additional 23,000 budgeted enrollments would be required by 2010 (2005c, p. 5).

CONCLUSION

While health care and education costs exert the greatest pressure on the state budget, they are not the only source of fiscal distress. Prison populations, pension obligations, public employee salaries, social services caseloads, and aging infrastructure all foreshadow future increases in public spending. Taken together, the demands of current services spending exceed available revenues for the foreseeable future.

These conditions meet the conventional definition of a structural deficit. Applying the label, however, suggests inevitability and implies an ongoing succession of tax increases and spending reductions. While, as Sheffrin (2004, p. 224) says, “failure to come to grips early with budget difficulties sharply increases the risks of truly severe fiscal problems,” what can be foreseen can often be avoided.

Washington's continued growth is far from assured and planning for an unpredictable future is essential in maintaining consistent growth. For instance, escalating global demand for fossil fuels, in addition to uncertainty in future supply, have generated growth in energy prices that will continue to an unknown degree. Already, energy expenditures have increased in Washington from 5.1 percent of GSP in 1999 to 6.6 percent in 2004 (Washington State CTED, 2005, sec 4 p. 12).

Threats such as this make it imperative to solve Washington's budget problems now. The structural deficit must be altered so the state can regain control of its fiscal situation. Several factors augur well for Washington policymakers.

- Though it must be nurtured by smart public policy decisions, the economic recovery here has taken hold.
- The state's experience with the Priorities and Price of Government budget process should enable the governor and legislature to break free of the current services model of incremental budget growth.
- The civil services reform of 2002 that established collective bargaining for public employees also made it possible for state government to expand its use of competitive sourcing for public service delivery.

Combining the discipline of the Priorities of Government budget process with the fiscal constraints of a comprehensive tax and expenditure limitation, lawmakers must focus first on expenditure control. Substantial revenue increases can neither be justified nor implemented successfully at this time. In addition, the existing tax structure relies too much on business taxes; any increase in business costs risks dampening the pace of recovery. Furthermore, household tax increases would doubtless trigger a swift and negative reaction from a skeptical public.

It would be naïve to suggest that controlling spending will be easy. Politically difficult decisions will have to be made. Some low-priority programs should be eliminated. State employees and enrollees in state programs may be asked to accept more cost-sharing and benefit reductions. Public employee jobs may be lost to more efficient providers through outsourcing. Cost containment cannot be achieved without adverse consequences for some populations.

Despite the challenges, Washington is in better shape than many states. The economic foundation and the management and budget tools are in place for addressing decisively the foreseeable budget challenge. While the transition may be difficult, the long-term benefits will strengthen state government, public services, and contribute to a healthy, stable business climate.

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