

Gov. Inslee's 2017–19 Operating Budget Proposal Would Significantly Increase Spending and Taxes

NGFS+

In recent years, legislative fiscal committee staffs have based budget presentations on the near general fund–state (NGFS), a synthetic “account” that rolls up the general fund–state (the state’s primary budget account) with the education legacy trust account, because they believed that the NGFS better reflected the entire budget situation. They are now using a broader rollup, the NGFS+.

In 2010 the legislature established the opportunity pathways account, and dedicated proceeds from the lottery to this account with the stipulation that the funds be spent for education. The NGFS+ combines the NGFS and the opportunity pathways account.

In 2012 legislation was enacted requiring four-year balanced operating budgets. A positive ending balance is required in the current biennium on an NGFS+ basis. Additionally, projected resources must be sufficient to cover projected maintenance level expenditures in the second biennium.

Briefly

- Economic growth means that NGFS+ revenues for 2017–19 are expected to increase by \$2.579 billion over 2015–17.
- Gov. Inslee proposes increasing revenues by another \$4.369 billion.
- The B&O tax rate on services would be increased from 1.5 to 2.5 percent (\$2.276 billion).
- A carbon tax would be imposed (\$1.069 billion).
- A capital gains tax would be imposed (\$821.0 million).
- Five tax exemptions would be repealed (\$308.3 million).
- The proposal would transfer \$118.4 million to the general fund from other funds.
- It would also transfer \$252.6 million from the public works assistance account.
- \$407 million would be transferred from the rainy day fund.
- Maintenance level spending is \$3.481 billion higher than 2015–17 appropriations.
- The proposal would increase spending by \$4.762 billion on top of that.
- Gov. Inslee would respond to the McCleary decision by spending \$2.746 billion on K–12 salaries and training.
- Resident undergraduate tuition would be frozen at SY 2016–17 levels.
- Children’s Administration and the Department of Early Learning would be transferred to a new agency, the Department of Children, Youth and Families.
- Community mental health and substance use disorder programs would be transferred from DSHS to HCA.
- Collective bargaining agreements with public employees would be funded.
- The four-year balanced budget requirement would be suspended.

The Economic and Revenue Forecast Council expects near general fund–state plus opportunity pathways (NGFS+) revenues to increase by \$2.579 billion in the 2017–19 biennium, to \$41.284 billion, as a result of economic growth. That is a substantial increase, but the Legislature is also under pressure to increase K–12 spending to comply with the McCleary decision.

In this environment, Gov. Inslee has proposed an operating budget for 2017–19 that would increase NGFS+ spending by \$8.242 billion over 2015–17. He has also proposed a tax package that would increase NGFS+ revenues by \$4.369 billion.

These proposals represent Gov. Inslee’s preferred budget. But, under state law,

the governor must present a budget that balances with existing revenues—this is called the “book 1” budget. The book 1 budget would increase NGFS+ spending by \$4.638 billion over 2015–17. This brief focuses on Gov. Inslee’s preferred, or “book 2,” budget, but it briefly discusses the book 1 proposal at the end.

Unless otherwise noted, the sources for this report are the budget documents on

the website of the Office of Financial Management (OFM) and fiscal.wa.gov.

Balance Sheet

Revenues. Gov. Inslee’s book 2 proposal would increase revenues by a net of \$4.369 billion over the November 2016 revenue forecast. That includes increasing the business and occupation (B&O) tax rate on services, imposing taxes on carbon and capital gains, and repealing several tax exemptions.

Other Resource Changes. The proposal would transfer \$407 million from the Budget Stabilization Account (BSA) to the general fund–state (GFS), negating the constitutionally-required transfer of 1 percent of general state revenues to the BSA for the biennium (Article VII, Section 12). It would also transfer \$118.4 million to the GFS from other funds, including \$91.9 million from the carbon pollution reduction account, \$12.0 million from the treasurer’s service account, and \$6.5 million from the performance audit of government account. Lastly, the proposal would transfer \$252.6 million from the public works assistance account (PWAA) to the education legacy trust account (part of NGFS+). (The enacted 2015–17 budget stated that it was the Legislature’s intent to use \$73.0 million from the PWAA in 2017–19 for basic education. The enacted 2016 supplemental added \$154.4 million to that figure, but Gov. Inslee vetoed that provision of the supplemental, in part because “there is a clear need for future public infrastructure improvement throughout the state” (Inslee 2016a).)

Spending. NGFS+ maintenance level spending (the cost of continuing current services) is \$41.934 billion for 2017–19, an increase of \$3.481 billion over 2015–17. On top of that, Gov. Inslee proposes making policy level (costs associated with new legislation) increases of \$4.762 billion.

Reserves. The proposal would leave an unrestricted ending fund balance of \$384 million in 2017–19 and total re-

Table 1: NGFS+ Balance Sheet (Millions of Dollars)

	2015-17	2017-19
Beginning Balance	1,011	646
Revenue		
November 2016 Revenue Forecast	38,705	41,284
Governor's Proposal		
Increase B&O Tax Rate on Services		2,276
Carbon Tax		1,069
Capital Gains Tax		821
Repeal Tax Exemptions		308
Revenue Reductions		(122)
Budget Driven and Other Revenue		16
<i>Total Revenue</i>	<i>38,705</i>	<i>45,653</i>
Other Resource Changes		
Transfer to Budget Stabilization Acct.	(380)	(405)
Transfer to BSA (Extraordinary Revenue Growth)	(680)	
Transfer from BSA (Extraordinary Revenue Growth)	75	
Other Enacted Fund Transfers	207	114
Actual/assumed prior period & CAFR adjustments	69	41
Governor's Proposal		
Transfers from Budget Stabilization Acct.		407
Additional 1 Percent BSA Transfer		(2)
Transfer from PWAA		253
Other Fund Balance Transfers		118
<i>Total Other Resource Changes</i>	<i>(709)</i>	<i>526</i>
<i>Total Resources</i>	<i>39,007</i>	<i>46,825</i>
Spending		
2015-17 Appropriations	38,454	
Governor's Proposal		
Actual/Assumed Reversions	(227)	(255)
2016 Supplemental	133	
2017-19 Maintenance Level		41,934
Policy Changes		4,762
<i>Total Spending</i>	<i>38,360</i>	<i>46,440</i>
Unrestricted Ending Fund Balance	646	385
Budget Stabilization Account Balance	513	1,340
Transfers from GFS and Interest Earnings	1,067	423
Use of BSA for Fire Response	(165)	
Estimated Increased Transfer to BSA		
Transfer to the GFS	(75)	(407)
Projected BSA Ending Fund Balance	1,340	1,356
<i>Total Reserves</i>	<i>1,987</i>	<i>1,741</i>

Note: Totals may not add due to rounding.

serves (including the BSA, or rainy day fund) of \$1.740 billion. As noted above, \$407 million would be transferred from the BSA to the GFS.

Revenue Details

B&O Tax Rate on Services. The proposal would increase the B&O tax rate on services from 1.5 to 2.5 percent, effective July 1, 2017. This would increase revenues by \$2.276 billion in 2017–19 and by \$2.609 billion in 2019–21.

Carbon Tax. The proposal would impose a tax on carbon emissions. It would be “levied on the first possession, meaning that it would be imposed on any company that generates or imports electricity, natural gas or petroleum” (Inslee 2016b). Emissions would be taxed \$25 per ton, effective May 1, 2018. The tax rate would increase by 3.5 percent plus inflation every year thereafter. The proposal would increase total revenues by \$1.904 billion in 2017–19 and by \$4.065 billion in 2019–21. Of those total revenues, \$1.069 billion in 2017–19 and \$2.459 billion in 2019–21 would go to the NGFS+ and would be used for education. The remainder would be split among programs related to clean energy and transportation, waters and forests, job growth and competitiveness, and affected communities.

Capital Gains Tax. The proposal would impose a 7.9 percent tax on capital gains above \$25,000 for individuals and \$50,000 for joint filers (SB 5111). Capital gains from the sale of any residential dwelling (single family residence, residential condominium unit, residential cooperative unit, or floating home), retirement accounts, assets sold due to eminent domain, certain livestock sales, certain agricultural land sales, certain timber sales, and sales of certain personal property used in business would be exempt from the tax. Additionally, a B&O tax deduction would be created to avoid double taxing. The first returns would be due in April 2019, and the proposal would increase revenues by \$821.0 million in 2017–19 and by \$1.848 billion in 2019–21. Recognizing that revenues from

capital gains taxes are volatile, Gov. Inslee would create a “school investment reserve fund.” If more than \$900 million is collected from the tax in a year, the amount over \$900 million would go to the reserve fund.

Tax Exemptions. The proposal would repeal five tax exemptions to increase NGFS+ revenues by \$308.3 million in 2017–19:

- Applying the sales tax to vehicle trade-ins valued over \$10,000 would increase revenues by \$90.8 million.
- Applying the real estate excise tax to certain foreclosure sales would increase revenues by \$59.4 million.
- Applying the sales tax to bottled water would increase revenues by \$57.1 million.
- Applying the use tax to extracted fuel (except hog fuel) would increase revenues by \$51.8 million.
- Changing the nonresident sales tax exemption to a refund program would increase revenues by \$49.2 million.

Revenue Reductions. On July 1, 2017, for service businesses, the proposal would increase the B&O tax filing threshold to \$100,000 and the small business B&O credit to \$125 per month (from \$70 a month). On July 1, 2018, for all businesses, the proposal would increase the B&O registration and tax filing thresholds to \$100,000 and the small business B&O credit to \$125 per month (from \$35 a month). Together, these changes would reduce revenues by \$91.9 million in 2017–19 and by \$151.0 million in 2019–21. Additionally, high technology research and development tax incentives would reduce revenues by \$30.2 million in 2017–19. According to OFM, these include a B&O tax credit of up to \$500,000 and a sales and use tax deferral of up to \$1 million per project per company.

Spending Details

The 2017–19 NGFS+ maintenance level is \$3.481 billion higher than 2015–17

Of the proposal's NGFS+ policy changes, 71.7 percent would occur in public schools.

appropriations. The governor's proposed book 2 policy level changes would increase spending by another \$4.762 billion. Unless otherwise noted, the NGFS+ spending amounts discussed below are proposed policy changes.

Public Schools. Of the proposal's NGFS+ policy changes, 71.7 percent (\$3.414 billion) would occur in public schools. This focus is in keeping with the need for the Legislature to respond to the Supreme Court's McCleary decision this session. The key remaining issue is that some amount of basic education-related K–12 salaries is currently being funded by local levies when it should instead be funded by the state. The Legislature has not yet come to an agreement as to how much.

Gov. Inslee believes that addressing the McCleary decision will require increasing NGFS+ spending by \$2.413 billion to fund K–12 employee salaries and by \$332.9 million for educator training. (This salary increase is on top of the Initiative 732 cost-of-living adjustment for teachers that is part of maintenance level and costs \$380.0 million.)

The governor would create a new salary allocation model that would pay teachers for 10 months of regular work plus 30 hours of professional learning in school

year 2017–18 and 80 hours of professional learning in SY 2018–19. The current state allocation for beginning teachers is \$35,700; that would increase to \$44,976 in SY 2017–18 and \$54,587 in SY 2018–19. According to the proposed budget bill, the professional learning would "include training related to closing achievement gaps, increasing cultural competency and supporting students' social and emotional learning."

Additionally, as a policy brief released by the governor's office states, "the governor believes the state must do more than just comply with the court's order" (Inslee 2016c). Thus, the proposal would increase spending for school nurses, psychologists, guidance counselors, and family engagement coordinators by \$325.2 million. It would also increase funding for health benefits for school staff by \$139.1 million. (The state benefit rate for teachers is currently \$780 per month—that would increase to \$835.96 per month in SY 2017–18.) Gov. Inslee would spend \$56.3 million on teacher and principal mentoring and \$49.6 million to enhance the learning assistance program (which provides extra services for underperforming students).

Higher Education. Spending for the state need grant (SNG) would be increased by

Table2: NGFS+ and All Funds Appropriations (Thousands of Dollars)

	2017-19 Biennium					
	2015-17 Biennium		Maintenance Level		Governor's Proposal	
	NGFS+	All Funds	NGFS+	All Funds	NGFS+	All Funds
Legislative	156,347	176,454	175,353	197,538	176,305	198,490
Judicial	269,241	340,990	283,549	319,192	324,252	386,285
Governmental Operations	509,927	3,891,226	539,181	3,876,410	576,936	4,062,948
DSHS	6,405,389	14,184,650	7,111,296	15,336,502	6,257,825	13,047,450
Health Care Authority	4,016,072	16,553,505	4,448,058	17,569,678	5,489,621	20,965,972
Other Human Services	2,091,361	4,645,866	2,192,194	4,748,848	2,935,373	6,073,311
Natural Resources	287,107	1,748,041	309,709	1,780,931	329,381	1,868,152
Transportation	83,338	201,704	85,639	193,528	97,915	214,677
Public Schools	18,197,434	20,110,525	20,086,431	22,020,272	23,500,314	25,436,362
Higher Education	3,557,824	13,902,354	3,665,028	14,057,937	4,062,458	14,652,280
Other Education	349,134	747,193	373,473	769,185	253,753	498,580
Other Appropriations	<u>2,529,840</u>	<u>2,896,345</u>	<u>2,663,701</u>	<u>2,858,145</u>	<u>2,691,114</u>	<u>2,887,200</u>
Total	38,453,014	79,398,853	41,933,612	83,728,166	46,695,247	90,291,707

\$30.1 million to maintain current service levels and accommodate an increase in College Bound students (who have priority for the SNG). An additional \$116.3 million would be spent to reduce the number of students who are eligible for the SNG but do not currently receive it due to lack of funding.

As part of the 2015–17 budget process in 2015, the Legislature reduced resident undergraduate tuition at the public colleges and universities. 2ESSB 5954 specified that beginning in SY 2017–18, tuition may not grow by more than the average growth in Washington’s median hourly wage for the previous 14 years. Gov. Inslee proposes holding resident undergraduate tuition for 2017–19 at SY 2016–17 levels, and his budget would provide \$56.4 million to the institutions to backfill the lost revenue.

The University of Washington would get \$10.0 million to continue and expand the Washington, Wyoming, Alaska, Montana, Idaho (WWAMI) medical program in Spokane. Washington State University would get \$10.0 million in support of its new medical school.

Other Education. In the Department of Early Learning, the proposal would spend \$27.8 million to expand the early childhood education and assistance program (ECEAP) by 2,708 new slots. It would spend \$13.8 million to increase ECEAP rates, and it would spend \$13.6 million to increase the reimbursement rate for child care centers (and change the rate methodology). Additionally, the proposal would spend \$10.6 million for a time and attendance tracking system to help identify payment errors and fraud.

Under Gov. Inslee’s proposal, the Department of Early Learning would be transferred to a new Department of Children, Youth and Families (described below under “other human services”), as of the beginning of fiscal year 2019 (the second year of the biennium). This would reduce spending in this budget area by \$197.9 million.

Department of Social and Health Services (DSHS). The proposal would transfer Children’s Administration (the state’s public child welfare agency) from DSHS to the new Department of Children, Youth and Families in 2019, thereby reducing DSHS spending by \$379.8 million.

Also, in 2014, the Legislature passed 2SSB 6312, requiring the state to fully integrate physical and behavioral health care for Medicaid clients by Jan. 1, 2020. To that end, the governor’s budget would transfer community mental health and substance use disorder programs from DSHS to the Health Care Authority and the Department of Health. Thus, DSHS spending would be reduced by \$956.0 million.

Mental health funding would increase by \$52.7 million, as 137 new staff would be hired to comply with a series of immediate jeopardy notices from the federal Centers for Medicare and Medicaid Services regarding the state psychiatric hospitals. The proposal would spend \$63.1 million for 356 community placement beds for patients discharged from state psychiatric hospitals.

Spending would increase by \$22.6 million to increase the rate paid to supported living providers by \$1.00 an hour, by \$77.3 million to fund an agreement with individual providers of in-home care that would increase their wages and benefits, and by \$41.4 million for in-home care providers employed by private agencies (corresponding with the individual providers agreement).

Health Care Authority (HCA). As noted above, community mental health and substance use disorder programs would be transferred to HCA from DSHS. This would increase HCA spending by \$954.3 million.

In the Healthier Washington project, integration of physical and behavioral care has been delayed. Because assumed savings will not be realized, the governor’s proposal would increase spending by \$61.0 million. The proposal would in-

The governor's budget assumes a suspension of the four-year balanced budget requirement.

crease spending by \$41.1 million to treat about 6,000 additional Medicaid patients who have Hepatitis C, as required by a federal court order.

Other Human Services. As noted above, the governor would create a new agency: the Department of Children, Youth and Families. For FY 2019, appropriations for the department would be \$577.7 million (the amounts transferred from the Department of Early Learning and Children's Administration). The new agency would house children's services that are currently handled by several different agencies. Additionally, in the Department of Health, \$20.0 million would be appropriated to be distributed to local jurisdictions to improve their communicable disease response.

Special Appropriations. Debt service on new bonds proposed in the capital budget would be \$39.6 million. The home security fund account, which is used to fund homelessness programs, would be appropriated \$20.0 million from the NGFS+.

Additionally, legislation in 2008 set up the local public safety enhancement account (RCW 41.26.800), from which funds are contributed to the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 2 and distributed to local governments for public safety purposes. Transfers must be made to the account from the general fund—state every odd-numbered year, if general state revenues in the previous biennium increased by more than 5 percent. The enacted 2013–15 and 2015–17 operating budgets suspended the scheduled 2013 and 2015 transfers of \$10.0 million and \$20.0 million, respectively. Gov. Inslee's budget proposal would suspend the scheduled 2017 transfer of \$50.0 million.

Employee Compensation. The governor's proposal would fund the collective bargaining agreements reached with state employees. The agreements would increase spending by \$500 million. Another \$232 million would be spent to extend the increases to non-represented em-

ployees. These amounts are accounted for throughout the budget areas. Under the agreements, most employees would get 2 percent raises effective July 1, 2017; July 1, 2018; and Jan. 1, 2019. (Some workers' wages would increase by more than this.) Starting wages would be at least \$12 an hour, and the state would continue to pay an average of 85 percent of employee health care premiums.

Other

As noted above, Gov. Inslee's proposal would address the McCleary decision. In conjunction with his budget proposal, the governor announced that the new state funding would allow school districts to reduce property taxes by a total of \$250 million a year. State funding would increase for every district and property taxes would be cut in 119 districts (of 295).

Also, despite the new taxes proposed, the governor's budget assumes a suspension of the four-year balanced budget requirement (RCW 43.88.055).

Book 1

Although the governor's book 1 budget won't even have the governor as a proponent, it is still instructive to consider. Within existing revenues, the option would increase spending by \$4.638 billion over 2015–17. Of that, \$1.157 billion would be policy changes. Tellingly, only \$117.8 million of the policy increases would be for non-compensation items. Above maintenance level, the governor would fund the collective bargaining agreements and very little else—not even McCleary-related teacher salary increases.

Comment

Prospects for the governor's tax package are uncertain. A recent Elway Research poll found that 56 percent of respondents support "funding education first and financing the rest of government with what's left over—even if that means cutting programs" (Brunner 2017). To be sure, that's easy to say when you aren't

faced with deciding which specific programs will be cut, and it may indicate a lack of understanding about the magnitude of the problem. Still, it lends credence to the approach outlined by Kris Johnson of the Association of Washington Business:

Rather than immediately resorting to new taxes, lawmakers should go into the legislative session with the premise that it's possible to fund education and balance the budget without implementing the biggest tax increase in state history.

They've already proved they can do it. Lawmakers have added \$4.5 billion in education funding since 2013 without a major tax increase. (Johnson 2017)

Indeed, it seems unlikely that the substantial tax increases in Gov. Inslee's proposal will advance in the Legislature. Many of them have been proposed before and rejected by either the Legislature or the voters. (For example, voters rejected a carbon tax just two months ago.) Also, the state Senate has approved a rule for the 2017 session requiring that any tax increase be approved by two-thirds of that body, unless it has a referendum clause (SR 8602, Rule 64). That said, it's possible that this will be the year for some of these tax ideas, given the pressure to increase education funding

and finally comply with the McCleary decision.

Whether or not new taxes are in the offing, the Legislators should refrain from suspending the four-year balanced budget requirement. Effective since 2013, the budget requirement continues to have detractors (and it was a point of contention during the 2016 supplemental budget negotiations). But by forcing the Legislature to take a longer view when considering appropriations, it is an important check on budget writers.

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