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King County's 2009 Budget: "Turn over some taxing authority and no one gets hurt!"

Briefly

Now that sales tax revenues are dipping and construction has slowed, King County is facing a deficit of $93 million in its status quo general fund budget.

Although the economic downturn deserves a share of the blame, the county's budget woes in large part stem from the evolution of county government along parallel tracks that have produced an entity that seems like several separate governments tied together.

The fiscal train wreck that has long been predicted for Washington's largest county may finally have come into view. The growing mismatch between the county's revenue authority and its service obligations to its unincorporated areas was masked for several years by a strong economy. But now that sales tax revenues are dipping and construction has slowed, the county is facing a deficit of $93 million in its status quo general fund budget.

County Executive Ron Sims released his budget proposal on October 13. While unincorporated area services, such as the Sheriff and parks system would take their share of the hit under the Sims proposal, countywide services such as courts, prosecutors and jails also share in the pain. County Council's budget committee approved a modified version of the Sims proposal on Friday, and the full council will vote on the plan today.

This brief reviews the fiscal problems faced by King County and largely shared by counties across Washington. Urban county governments have become enormously complex and this brief will not attempt to unravel the budget problems of King County's many tendrils. It will, however, look at the policy and political strategies being employed by the Executive, the Council and the separately-elected officials who have a hand in county finances.

The schizophrenia of county government

King County's budget woes in large part stem from the evolution of county government along parallel tracks that have produced an entity that seems like several separate governments tied together:

Division of the state. Counties had their origin as agents of the state, fulfilling state government functions at a convenient local level. Counties prosecute and judge cases under state law, assess property according to state standards, conduct elections for state and federal offices, record titles for real property and fulfill all manner of other essential functions that are the ultimate responsibility of state government. To fund these functions the county has authority to levy a property tax on all property in the county.

Regional service provider. Over the years King County has taken on other regional functions, most notably the transit and wastewater services formerly operated by the Municipality of Metropolitan Seattle (Metro). These services have their own tax and rate bases and continue to operate with fiscal independence.

Health and welfare delivery mechanism. The county is a major provider of public health and human services. The county owns Harborview Hospital (which is run by the University of Washington) and provides public health and mental health services throughout the county. These services are mostly funded by state and federal dollars plus service fees. Some county initiatives have been receiving county general fund support which is now imperiled.

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Contract service provider. The county provides services on contract to cities, which are funded by city taxes. The county operates jails where city misdemeanants are locked up, and the county Sheriff provides police service to several cities. Cities can turn over their minor offenses to the county's District Court system. Contracting for complex services allows jurisdictions to concentrate on the most important priority of their constituency: land use.

Local services to unincorporated areas. But while the county is working to provide these regional and contract services, it is also the provider of basic services in unincorporated areas. Rural areas historically did not need many services, and those that they did need they provided for themselves through special districts. Now, however, many formerly rural areas are urbanized and expect urban levels of service. Thus, volunteer fire and utility districts have been professionalized, while the county is expected to provide Sheriff response time similar to that found in cities and deal with a wide range of growth issues.

These multiple roles and responsibilities have made the county budget something of a mess. The budget lists 63 different funds, with the general fund constituting just 12 percent of the total. (The total budget is fuzzy, however, since the county charges all departments for internal services and employee benefits, thus leading to "double-budgeting:" an expenditure exists in both the departmental budget and in the internal services budget.)

Any one department can have revenues from multiple sources, making it difficult to track the impact of budget cuts. For example, the Sheriff's budget includes mostly revenue from the general fund, intended to cover services in unincorporated areas. But the Sheriff's budget also includes contract revenue from cities, which will not be affected by county budget problems, and contract revenue from the transit department which may or may not be affected.

It is the first and the last of the functions above that generate the most headaches for the county. The taxes collected in the unincorporated areas do not come close to covering the cost of providing services to those areas. This results in subsidies to the unincorporated areas from the cities in the county: property taxes paid by city residents that are supposed to cover countywide services end up paying for services for unincorporated areas. The 2009 King County proposed budget estimates that the unincorporated areas within the urban growth area receive a subsidy of about $20 million from taxes collected in cities.

Chart 1: The Current Expense Fund is Less than One-Quarter of the County Operating Budget

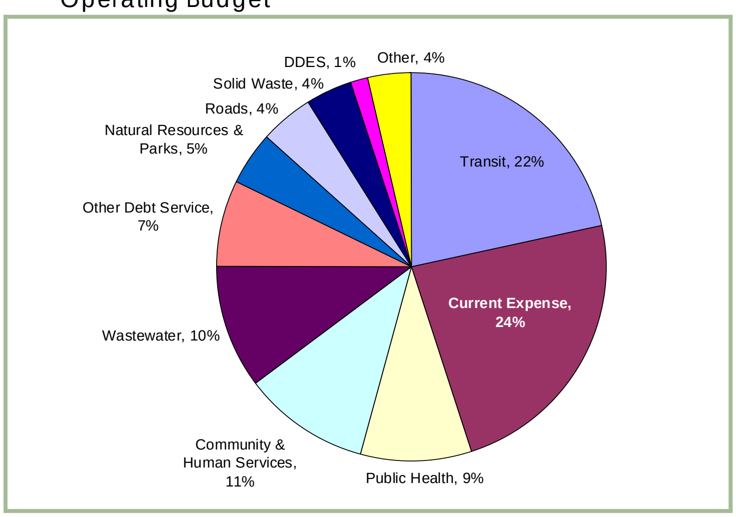


Chart 1 shows the major expenditures of the total county budget, and Chart 2 shows the breakout for the current expense (CX) fund, which corresponds to what most governments call the general fund. This chart eliminates the double count of internal services; therefore the percentages do not agree with those found on some county budget documents. This chart illustrates how large segments of county government are not dependent on the general fund tax sources that, as will be discussed next, are inadequate to the ambitions of the county. (The Sheriff, Public Health and Community Services receive both CX and non-CX funding. The "other" slice in the total budget pie includes funds for the Sheriff, and the "other" slice in the CX pie contains funds for Public Health and Community Services.)

County taxing authority: weak and getting weaker

Cities in Washington have a range of taxing authority that allows them to raise a good deal of money, should they choose, to fund an elaborate array of city services, and through aggressive "fiscal zoning," they have managed to expand the bases of these taxes. Counties do not have the same range of taxes and the bases of those taxes they do have are eroding.

Chart 2: Breakdown of General Fund Spending

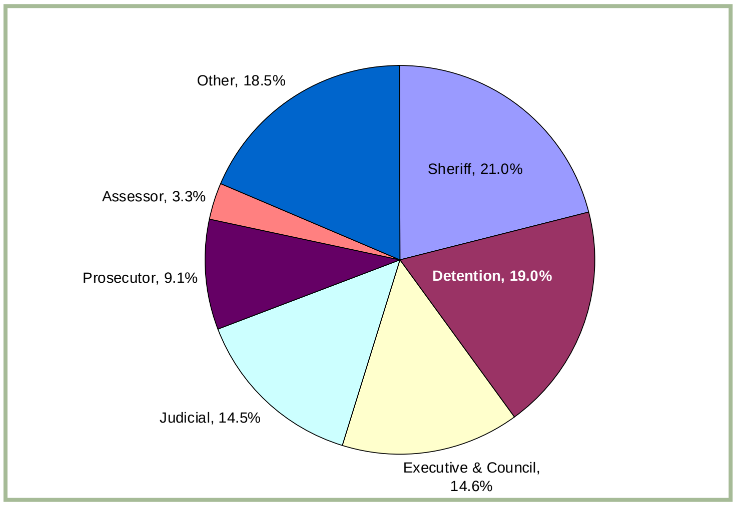
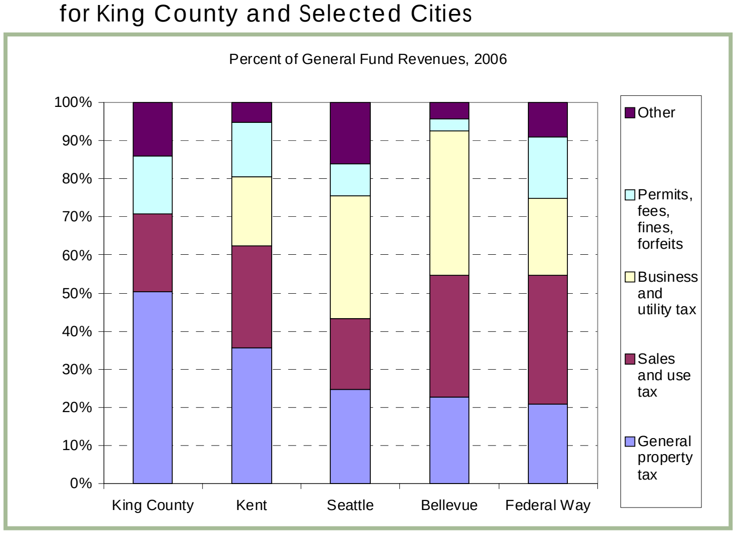


Chart 3 shows the use of various revenue sources for general fund purposes for King County and its four largest cities. The most notable difference is the lack of business and utility taxes available to King County. This leads the county to rely on the property tax for half of its general fund. (The Executive and Council are considering asking the Legislature for authority to impose a utility tax in unincorporated areas.)

But the county property tax levy, including that portion paid by unincorporated area residents, was always intended to fund the countywide services required by the state, such as courts, jails, elections and assessments. Residents of unincorporated areas pay an additional property tax, but that is dedicated entirely to roads, and they pay separately for fire protection through their local fire districts.

Unincorporated area residents do not, however, pay a general property tax to the county for other services. Cities all collect general property tax to pay for municipal services, but collections vary widely on a per capita basis. In 2008, Medina collected $742 per resident in property taxes, and Federal Way collected $106 per resident. The median per capita city property tax in 2008 was $237 in Issaquah. Unincorporated area residents paid a per capita road tax of $238, but, as noted, that tax goes entirely to pay for county roads, leaving none for general government. Unincorporated area residents also pay property tax to local fire districts.

Chart 3: General Fund Revenue Sources for King County and Selected Cities



The other large source of tax revenue for local governments is the sales tax. Under state law, local governments can charge up to 1 percent sales tax for general purposes. (Other local sales taxes are dedicated to transit, criminal justice and mental health). Counties receive the entire one percent collected on sales in unincorporated areas. For sales in cities, the city itself receives 0.85 percent and the county receives 0.15 percent on each sale.

Although the legal incidence of sales tax is on the consumer, the revenue from the tax go to the jurisdiction where the sale happens. Thus, jurisdictions try hard to lure retailers, employing "fiscal zoning" to encourage development that generates sales tax. Since cities can annex adjacent unincorporated areas, they can draw annexation boundaries to include lucrative retailing areas. Similarly the ten new cities formed in King County during the 1990s drew boundaries to capture retail districts.

And even if cities did not take action to lure retailers, they would likely end up in cities anyway. As the unincorporated areas are mostly on the

Chart 4: Per Capita Taxable Sales

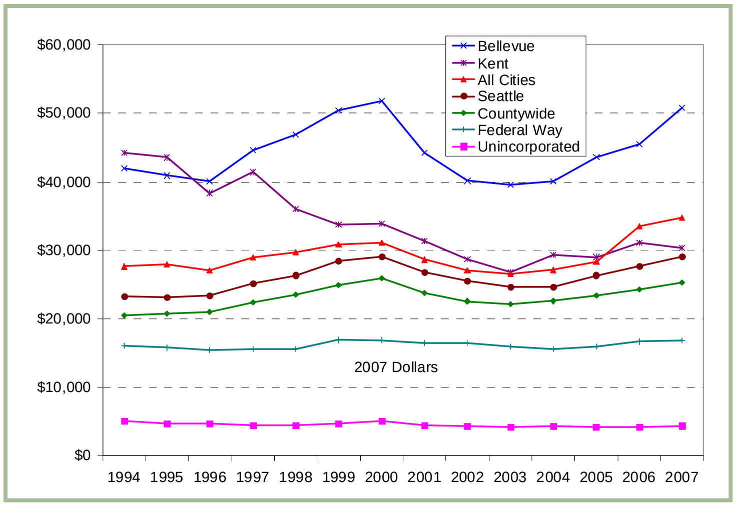


Chart 5: Per Capita Retail Trade Varies Widely Across Cities

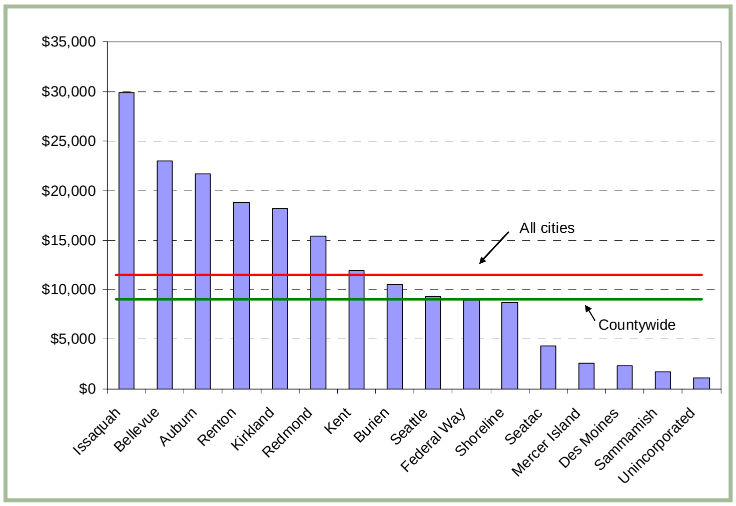
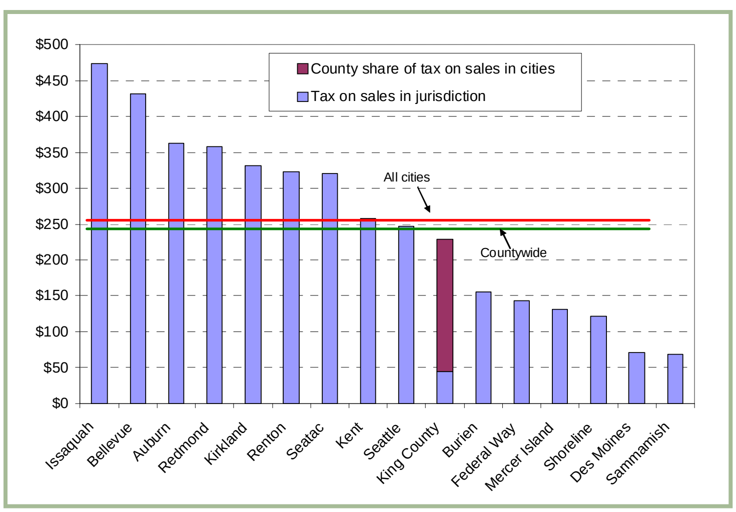


Chart 6: Per Capita Sales Tax Including the County's Countywide Tax



periphery of the urbanized area, retailers find the most logical trade areas are centered in cities. The retail centers left in unincorporated areas tend to be dominated by supermarkets, whose transactions are largely non-taxable.

Over time, the retail sales tax base of the unincorporated areas has been shrinking due to annexations and aggressive retail development in cities. For a number of years taxable construction has propped up sales tax collections in unincorporated areas, but unlike retailing, which is fairly stable, construction is highly cyclical.

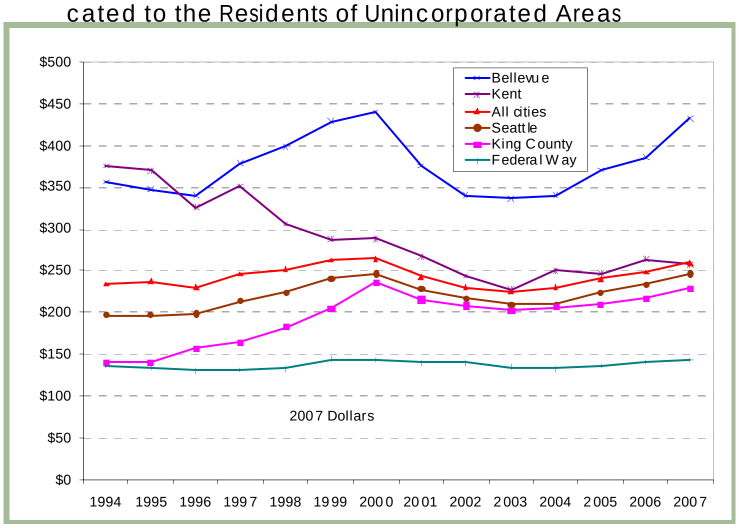
Chart 4 shows the trend in inflation-adjusted per capita taxable sales countywide, in unincorporated areas and in the county's four largest cities. Sales in unincorporated areas are quite low compared to cities, although not as cyclical.

Concentrating just on retail trade (sales in stores), we can see the real impact of location. Chart 5 shows per capita sales in retail stores (including car dealers) in 2007 for unincorporated areas and 15 cities. The unincorporated area has the lowest per capita sales of this group. The situation of the unincorporated areas is mirrored by the relationship between sales in Issaquah and Sammamish. The city of Sammamish has very little in the way of taxable retailing, with much of the retailing on the Sammamish Plateau in non-taxable food stores. Meanwhile, just down the hill, the city of Issaquah has a huge retailing base that serves many of the residents of Sammamish and soaks up their sales tax dollars.

One could argue, however, that the weakness of the sales tax base in unincorporated areas is almost entirely mitigated by the requirement that cities share their sales tax with the county. Chart 6 shows annual sales tax collections from all taxable sources for the same group of jurisdictions. The bar for the unincorporated areas has two pieces. The lower piece represents sales tax generated in the unincorporated areas themselves, and the upper piece represents the 0.15 percent tax generated in cities. The share of tax from sales in cities brings unincorporated areas close to the countywide and all-city average if one assumes that those moneys are intended to fund services in the unincorporated areas.

Ironically, it has been incorporations and annexations that have boosted the county's sales tax collections on a per capita basis. Chart shows the trend in inflation-adjusted per capita tax collections, with all of the county's tax allocated to the residents of the unincorporated area. In the early 1990s, unincorporated area sales tax collections were low, but grew steadily

Chart 7: Per Capita Sales Taxes, with All County Taxes Allocated to the Residents of Unincorporated Areas



during the 1990s, as the county shed population in the unincorporated areas. Calculated this way, , per capita sales tax collections by King County have been nearly equal to the city average for the past eight years.

Now, this line of reasoning raises a crucial question about sales taxes: is the county share of sales tax collected in cities intended to remedy the inequity in retailing locations, or is it meant as a further revenue source to fund countywide services? If it is the former, one could argue that the county has no business complaining about lost sales tax revenue since, as Chart 6 shows, the county now collects about the same per capita sales tax revenue as the average city. But if the answer is the latter, then the portion of county sales tax collections available for unincorporated area services would be just the tax collected in unincorporated areas which, as Charts 3 and 5 show, is very low. This question is not answered anywhere, and because countywide programs and unincorporated area services are all co-mingled in the general fund, there is no way to see how those revenues might be assigned.

A first step for the county in boosting its case for more revenue in Olympia would be to clarify its position on the purpose of the 0.15 percent sales tax collected in cities that ends up in the county's coffers.

2009 revenue trends

King County's tax base is especially vulnerable to a downturn in the economy for several reasons:

Property tax rolls growing more slowly. With the one-percent lid on increases in the property tax levy from existing property, the county's main source of growth in property taxes has been additions of new property value to the tax rolls. With construction slowing dramatically the county expects tax roll increases to fall from 3.4 percent in 2009 to 2.0 percent in 2010. In addition, debt service obligations, which come off the top of the property tax, are rising.

Sales tax on construction down. A major source of sales tax, especially in unincorporated areas, has been residential construction. With homebuilding down, that tax flow will drop.

Countywide sales slowdown. As seen in Chart 6, the county relies heavily on the sales tax share from cities, and with all sales throughout the county expected to slow, the county's share of sales tax will drop. This affects not only the general fund, but also transit operations and mental health services that rely on sales tax.

Low interest rates. The county maintains investments of reserve funds and earns interest on those funds. In the current climate of low interest rates, these earnings have been falling.

King County expects the amount of the countywide property tax levy going to the general fund, less debt service, to increase from $254 million in 2008 to $260 million in 2009. Sales taxes going to the general fund, including the special criminal justice tax, are expected to drop from $105 million budgeted in 2008 to $93 million budgeted for 2009. All tax sources going into the general fund are expected to fall by $7 million. Some of the tax shortfall will be made up through contract and fee increases. Total general fund revenue will fall from $658 million budgeted in 2008 to $639 million in 2009. It should be noted, however, that in 2008 the County booked $10 million in one-time revenue from the sale of the parking lot north of Qwest Field.

Table 1: The Rest of the Budget Fares Better than the General Fund

Dollars in Thousands

	General Fund			Non-general Fund		
	2008 Adopted	2009 Proposed	Change	2008 Adopted	2009 Proposed	Change
Taxes	388,743	381,655	-7,088	764,876	780,146	15,270
Licenses and permits	7,152	9,303	2,151	19,885	19,786	-99
Intergovernmental	66,605	77,655	11,050	264,479	282,581	18,102
Federal grants - direct	577	735	158	31,272	30,282	-990
Federal grants - indirect	7,971	8,534	563	104,696	104,084	-612
State grants	2,048	2,215	167	37,236	46,133	8,897
State entitlements	7,443	7,459	16	32,170	31,772	-398
Charges for services	109,733	117,895	8,162	928,455	976,985	48,530
Fines and forfeits	8,547	9,834	1,287	35	21	-14
Other	59,458	23,756	-35,702	1,006,459	983,321	-23,138
Total Revenue	**658,277**	**639,041**	**-19,236**	**3,189,563**	**3,255,111**	**65,548**

Source: 2009 King County Budget - Executive Proposed

Outside of the general fund things are not quite so bleak. Table 1 shows the change in revenues from major sources for the general fund and for all other non-general fund sources. The difference comes from the fact that taxes constitute 60 percent of general fund revenues and only 23 percent of non-general fund revenues. Massive county programs such as health and human services and wastewater treatment are largely funded by other governments or through fees and are mostly independent of fluctuations in tax collections.

The line for total taxes under non-general fund sources does mask two offsetting changes. First, sales taxes to fund transit operations are expected to fall from the $465 million budgeted in 2008 to $441 million in 2009. On the upside, the new 0.1 percent sales tax for mental health and drug dependency will add $48 million to the health and human services budget.

The anticipated 2009 budget gap

The County's public budget documents and presentations show a general fund deficit of $93.4 million. This figure has a lot of moving parts behind it, but roughly equates to an inherited 2008 deficit of $24 million, a drop in revenues of $19 million and a projected baseline expenditure increase (regular cost of living adjustments, inflation in material and service costs, etc) of around $40 million.

The Executive proposed closing this gap with four types of changes:

Permanent changes to programs. These permanent cuts to services, headcount and overhead are projected to yield $38.2 million in savings. For example, the Prosecuting Attorney will no longer handle small property crimes, leaving them to cities to prosecute as misdemeanors, and medical personnel at jails will change the way they monitor inmates with chronic health problems.

Overhead. A number of administrative functions of county government are consolidated into internal services funds that recover costs from operating budgets. These internal agencies are charged with finding administrative savings of $5.7 million.

Executive labor strategy. Most King County labor contracts provide for a 5.2 percent cost-of-living adjustment in 2009, plus merit increases of 2.4 percent. Non-represented employees have traditionally been given the same COLAs and merit increases. The Executive proposed that non-represented employees receive a 3.0 percent COLA and no merit increase for a $5.1 million saving. The Executive subsequently negotiated concessions from county labor unions under which non-essential employees will take 10 days unpaid furlough in 2009, saving an estimated $10.1 million.

Reserves. The county has previously set aside reserve funds in anticipation of revenue shortfalls and will call on those reserves to make up $15 million of the deficit.

Lifeboat. The program changes, efficiencies and salary caps will presumably not have a large impact on service delivery (which, of course, raises the question of why they have not been done before). Other programs that are considered discretionary or low priority have been put on the chopping block, or, in the friendlier term, placed in the "lifeboat." These programs, which total $21 million in expenditures, will be funded through reserves for six months while the county lobbies in Olympia for more revenue. If revenue is not forthcoming, the programs will be cut.

The lifeboat approach is both a good political strategy and a reminder of a central weakness of county government. It is good politics because the programs in it have strong constituencies that can be counted on for mobilization in Olympia. Programs that address domestic violence, juvenile justice and drug abuse are certain to bring attention to the county's budget problems. This is the old "Washington Monument Strategy," in which the National Park Service always threatened to close the Washington Monument to meet its target budget cuts.

It is worth noting that the Executive Summary of the proposed budget lists every single program headed for lifeboat status, even while glossing over three times as much budget savings in less sexy program reductions. It is also worth noting that the proposed budgets for the County Executive and the County Council place no programs, services or FTEs in the lifeboat.

The list of programs to be put in the lifeboat is a reminder of King County's continued habit of overreaching its revenue sources and spending money on worthy, but discretionary programs. Many of the lifeboat items represent general fund add-ons to human service programs that are otherwise funded with state and federal funds. But without sustainable funding, these become promises to vulnerable communities that the county cannot keep.

The image of a lifeboat is an odd one. A lifeboat is a refuge from a sinking ship, and the county's budget strategy represents exactly the opposite: the ship will stay afloat only if certain passengers are put in lifeboats that may, themselves sink. The reality is that the executive has rounded up a set of well-loved hostages that will be killed if money is not forthcoming. "Nice little program ya got here. Hate to see anything happen to it . . ." This is an unpleasant analogy, but a more accurate one.

Team players?

The King County charter specifies that the County Executive will propose an annual budget and the County Council will adopt it. Once that budget is adopted, all departments must adhere to it. This standard procedure must, however, contend with the fact that the County Executive directly controls only 54 percent of the general fund. The other 46 percent of the general fund is controlled by separately elected officials: Assessor, Prosecutor, Presiding Judges, Sheriff.

In building their 2009 budgets these elected officials were not as cooperative as the County Executive would have preferred, specifying cuts that were smaller than requested. The Executive's Proposed Budget particularly calls out the Sheriff's office for falling short of its required reductions of $10 million. Without specific guidance from the Sheriff, the Executive's budget included $3.1 million in unspecified program changes and efficiencies, and then put an unspecified $4.5 million in spending in the lifeboat (half of which would be funded in 2009). The Superior Court also fell short of its target and needed to find an additional $382,000 in savings.

The dynamic between the County Executive and the Sheriff, which has included a public tiff over the budget, is predictable. Although the Sheriff is elected countywide, her natural constituency is the unincorporated areas that rely on the Sheriff for their local police protection. An elected Sheriff, knowing that public safety is the most important issue over time for the majority of voters, has nothing to lose by bucking the Executive's requests.

The annexation problem

As noted above, the underlying structural problem for King County budgeting is the mismatch between tax base and service costs in the unincorporated areas. The solution to this, which is encouraged by the Growth Management Act, is to ensure that the remaining unincorporated areas within the urban growth area get annexed to an adjacent city (with the possible exception of Fairwood, there appear to be no more candidates for incorporation as new cities).

But the demographics and economics that make the remaining urban unincorporated areas expensive for the county will make them just as expensive for a city to serve. The urbanized unincorporated areas are mostly low density single family areas with some neighborhood business districts, but no large commercial tax base. Two of these areas – North Highline and Skyway – have low incomes and low property values.

For years, the county has been trying to talk cities into annexing these areas, but with limited success. A section of Lea Hill recently annexed to Auburn and a section of Benson Hill annexed to Kent, but several other large areas remain: East Federal Way (21,000 people), Soos Creek (24,600); Fairwood (27,700), North Highline (33,400), and Skyway (14,900). Two additional areas, Klahanie (11,000) and Finn Hill (33,800) have higher property values and might make attractive annexations.

Annexation is not only problematic for the city doing the annexing, it can also be a tough sell for unincorporated area residents. These residents do not pay utility taxes, and their unincorporated area road tax is just at the median for local property taxes. Some of these areas may not see their taxes increase with annexation, but there is often a perception that being part of a city means having higher taxes.

A third source of resistance to annexation comes from current residents of cities who believe they will have to subsidize the new territory. Seattle neighborhood groups, in particular, have long fought the annexation of North Highline, fearing that that area's poor infrastructure and public safety challenges will rob them of investment and services.

So far, the County has been reluctant to force the issue by cutting back essential services, especially the Sheriff, to lower the "urban subsidy" and create a noticeable contrast in service levels between unincorporated urban areas and their adjacent cities. The county's strategy to-date has been to dangle some one-time adjustment funds in front of cities to mitigate the short-term cost of taking on new residential areas. This has not worked, and those funds have now been rescinded.

As long as the county is required to use countywide tax dollars to fund local services to urbanized unincorporated areas it will face budget problems. But annexation of most of the remaining unincorporated areas inside the urban growth boundary remains politically challenging. The county has failed to make the case for annexation to the city governments, their constituents or unincorporated area residents themselves. One of the County Executive's ideas for addressing budget problems is to ask the state to intervene and be more forceful about promoting annexations.

Bailing out the lifeboats

The lifeboat strategy is predicated on a full-court-press in Olympia to get new revenue authority or more flexibility in existing revenue sources. The county may ask the Legislature to allow it to:

- Use the real estate excise tax for maintenance and operations, and not just capital projects.
- Make the current road levy more of a general local levy, available for Sheriff and parks budgets (it can do so now, but would need a vote in order to preserve some existing state road funding).
- Institute new county-wide taxes dedicated to regional services such as criminal justice and public health.
- Institute utility taxes in unincorporated areas.
- Set licensing and filing fees currently established under state law.

Before it imposes new taxes on unincorporated areas, the county will need to recognize that some urbanized unincorporated areas already have relatively high tax rates. The lack of commercial tax base in unincorporated areas means that local taxing jurisdictions can have high millage rates. For example, the average fire district millage rate in King County is \$1.13 per \$1,000 in valuation, adding \$450 to the tax bill of a \$400,000 house. Many outlying school districts also lack strong commercial tax bases and rely on residential real estate to fund their capital, maintenance and operations levies.

One revenue option that does not require a trip to Olympia is a "lid lift" on the regular county-wide property tax. The county currently has \$240 million in unused property tax capacity, which could be tapped with the approval of a simple majority of county voters.

A perpetual state of crisis

A timeline included in the Executive's 2009 Proposed Budget summary shows that the county has been in a constant state of budget crisis for many years. And revenue projections give little solace to those looking for future relief. Each year brings belt tightening and fears of disaster, followed by relative calm. Outside of county government there appears to be little concern: the county may have cried "wolf" one too many times.

And it can be difficult to take the county seriously when it continually threatens to cut Sheriff's Deputies and then decides to take on ferry service, combat global warming and end homelessness, all worthy goals but ones that lead to cognitive dissonance. These may be budgetary apples and oranges, but because they are all lumped together in one big budget the public does not perceive that. Rather than seeing a complex, multi-faceted government working within dozens of restricted funds, the public will see a government with its priorities out of whack.

The 2009 Executive Proposed budget does acknowledge that changes are needed. But of the $93 million gap, only $10 million – the lifeboat – comes from cuts to programs that the Executive believes will have a real impact on county services. If another $83 million in fixes can be found this year, a taxpayer might believe that there is plenty more to squeeze out next year.

The lifeboat strategy may provide enough political push to get the state to provide counties with new taxing authority or more flexibility on existing taxes. But $10 million in the context of a $4 billion budget may generate more of the typical reaction to yet another county budget crisis: a yawn.