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Research Council

Policy
Brief

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Referendum 49, Again: Tax Relief and Transportation

Referendum 49 was placed on the ballot by the 1998 legislature and will be decided by the voters November 3. With the release of the new state revenue forecast September 17 and the subsequent discussion of its implications for the next biennial state budget, we wanted to update our June 19 **Policy Brief** *to reflect current information.*

Our evaluation of the fundamental fiscal effects of Referendum 49 remains unchanged: the proposal represents a viable first step toward addressing the state's transportation problems.

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If adopted by the voters, R-49 will increase funding for highway and road construction by redirecting motor vehicle excise tax (MVET) revenues from the General Fund to the Motor Vehicle Fund to support a $1.9 billion bond issue to be retired over twenty-five years. With other revenues, the money is intended to pay for a five-year, $2.4 billion, transportation program.

Briefly

Ref. 49 will deliver general tax relief to owners of cars and trucks, provide an immediate source of revenue to begin a $2.4 billion five-year construction program, and modestly increase support to local government. If the referendum passes, the combination of reserves and income to the general fund will allow the legislature to spend to the I-601 expenditure limit in the foreseeable future without jeopardizing the state's fiscal health or denying necessary revenue to important state programs.

Boiled down to its essence, the measure comprises four features: a reduction in the MVET, the transfer of MVET revenues from the General Fund to transportation funds, assistance to local governments, and a one-time amendment to Initiative 601 to permit the transfer without lowering the spending limit. As this will remove revenue from the state general fund, the first important evaluation of the referendum must address its impact on the state budget.

Setting the Budget Context

Before the latest forecast, criticism of the referendum centered on its impact on the state general fund. The September economic forecast should allay concern. As we said in June, there is no cause for alarm. Sufficient reserves remain after accounting for the referendum's tax reductions and transfers for the legislature to spend to the limit without jeopardizing the state's fiscal health or threatening current spending programs.

General Fund-State Balance Sheet
(Dollars in Millions)

	1997-99	1999-01	2001-03
RESOURCES			
Beginning Balance	**$513**	**$583**	**$282**
Revenue Forecast *	**$19,509**	**$20,669**	**$22,603**
Referendum 49	***($34)***	***($469)***	***($518)***
State Route 16 tax deferral	$0	($7)	($7)
Adjusted Revenue Forecast	**$19,475**	**$20,193**	**$22,077**
Fish and Wildlife (loan and repayment)	($4)	$4	$0
Total Resources	**$19,984**	**$20,780**	**$22,360**
CURRENT APPROPRIATION AND EXPENDITURE LIMIT			
Current Appropriation Level	**$19,084**	**----**	**----**
Initiative 601 Expenditure Limit**	**$19,158**	**$20,498**	**$21,985**
RESERVES			
Unrestricted Ending Balance	$583	$282	$249
Emergency Reserve Fund	$333	$359	$484
Total Ending Reserves	**$916**	**$641**	**$733**

* Assumes passage of Referendum 49. Assumes official September 1998 revenue forecast for 1997-1999 and 1999-2001, and "average" growth of 4.7%/4.7% in 2001-2003.

** Preliminary estimate of the I-601 limit for the 1999-2001 biennium, reflecting expected changes in 601 fiscal growth factor and Federal Matching Assistance Percentage. Projection of limit for 2001-2003.

Source: Legislative Fiscal Committees

FIGURE 1

Consider the accompanying balance sheet (Figure 1), projecting through the 2001-2003 biennium. Several items on the balance sheet again deserve special attention. First, because I-601 requires that revenues above the spending limit be placed in the emergency reserve account (ER), the account is increased for 2001-2003. Second, in the 1999-2001 biennium, with passage of R-49, revenues fall about $305 million below authorized spending under the limit. When the unrestricted beginning balance of $583 million is added to revenues, total resources available for spending are $20,780 million, allowing the legislature to spend to the limit and still maintain reserves of $641 million, or about 6.2 percent of annual spending. This calculation is virtually unchanged since the June forecast.

The reason is significant. The working estimate of the Initiative 601 spending limit has been revised downward, reflecting in large measure the effect of lower inflation figures. With the September forecast, the June budget estimates were adjusted in four key respects:

1) 1997-1999 revenues are increased by $80 million,

2) 1999-2001 revenues are reduced by $195 million,

3) the I-601 spending limit for 1999-2001 dropped $89 million, and

4) about $16 million in interest earnings has been added to the ER for 1997-1999 and $26 million for 1999-2001.

As a result, 1997-1999 total reserves increased $96 million to $916 million and 1999-2001 total reserves increase by $16 million to $641 million.

The level of reserves is adequate. The Washington Research Council, along with many other budget analysts, has in recent years suggested a target reserve of about 5 percent of *annual* (not *biennial*) spending, which would be about $500-525 million, below the amount left in reserves assuming passage of the referendum.

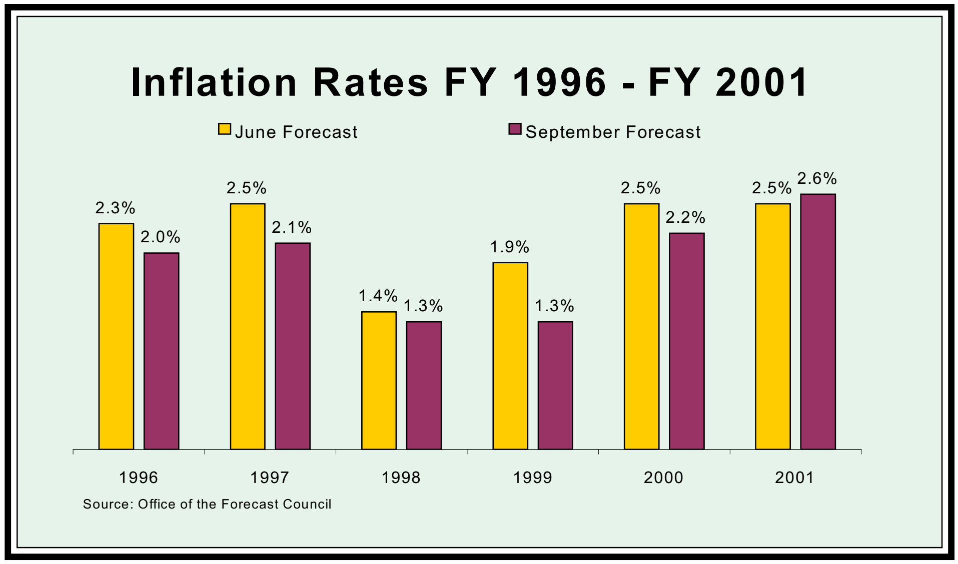

FIGURE 2

In evaluating these changes, it is important to consider the role played by inflation. Inflation affects not just the Initiative 601 formula,[1] but estimates of economic growth as well. In September, the estimates of inflation were sharply reduced, as shown in Figure 2.

The Washington Research Council applied the current estimates of inflation to the June forecast. The lower inflation rate results in revenue losses of $68 million in 1999, $96 million in 2000, and $88 million in 2001. In other words, lower inflation may account for as much as $184 million of the $195 million revenue reduction reported for 1999-2001. The corresponding reduction in the Initiative 601 limit (primarily, but not solely, a function of revised inflation figures) mitigates much of the budget impact of the revenue loss. The addition of interest income to the emergency reserve account takes care of the balance.

While the forecast contains important cautions about the Asian financial crisis, aerospace employment, etc., the overall fiscal condition of the state – in real terms, adjusted for inflation – remains essentially as it was last June. Forecasts are not precise, they're predictions not prescriptions, and a range of probabilities is also offered. For the next 34 months (i.e., through the 1999-2001 biennium), the optimistic forecast shows an additional $911 million in GFS revenue and has been assigned a probability of 15 percent. The pessimistic forecast would result in $1,595 million less, and has been assigned a probability of 35 percent. The baseline forecast, shown in Figure 1 and the forecast on which budgets are properly based, is assigned a probability of 50 percent. Viewed another way, there is a 65 percent probability of revenues coming in at or above the baseline. That's down from 70 percent in June, when the Office of the Forecast Council assigned a probability of 55 percent to the baseline forecast and 30 percent to the pessimistic.

While creative individuals can easily concoct worst case scenarios arguing against any reduction in reserves, past experience provides reasonable assurance that the 6 percent reserve available, assuming passage of R-49, will be adequate. It is neither prudent nor possible to reserve fully against a threat of a recession.

Identifying the GFS Impact

The Office of Financial Management (OFM) in late April published a useful analysis of the fiscal impacts of the referendum. The publication continues to stand as the best overview of the GFS impacts of the referendum and no update

[1] Initiative 601 calculates changes in the general fund limit based on the "fiscal growth factor," defined as "the average of the sum of inflation and population change for each of the prior three fiscal years."

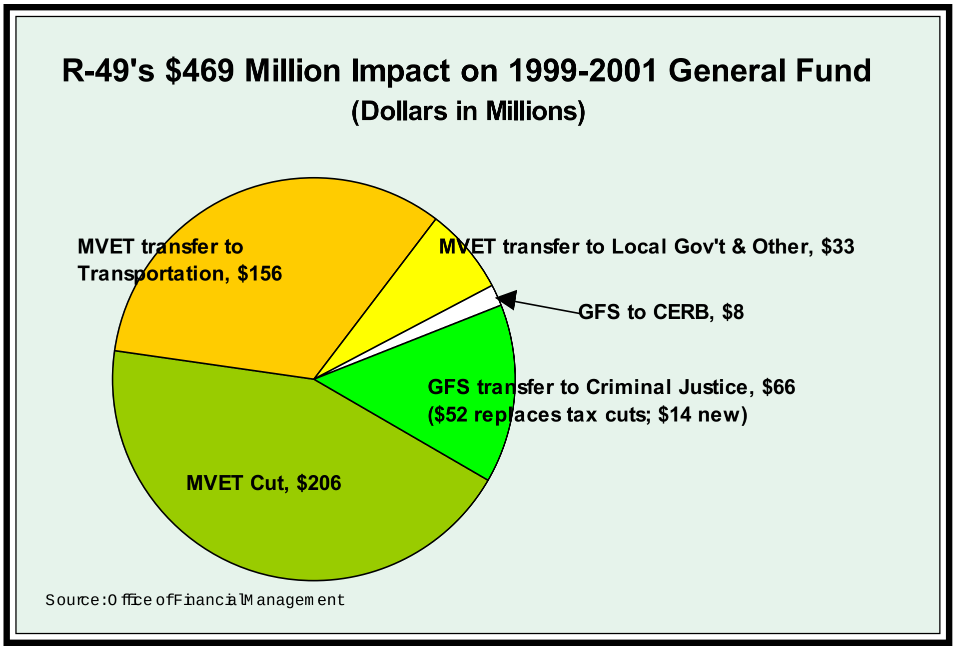

FIGURE 3

is planned. As the balance sheet showed, the 1999-2001 loss to the GFS is estimated to be $469 million. The distribution is shown in the pie chart (Figure 3).

The MVET cut accounts for $206 million, just under 45 percent of the lost GFS revenue. The transfer of MVET money to the Motor Vehicle Fund reduces the General Fund by about $156 million (one-third of the lost revenue); and the aid to local governments accounts for the balance, $107 million (including $52 million which replaces money lost through the MVET cut).

$30 MVET Credit; Change in Depreciation Schedule

The MVET is based on the manufacturer's suggested retail price of a vehicle and is levied in lieu of a personal property tax. Tax relief under the referendum comes in two ways: First, a credit of up to $30 is authorized against the MVET on vehicles, effective with July 1999 car tab renewals. Second, the depreciation schedule on which the MVET is based is changed to begin depreciation in the second year of service.

Currently, Washington's MVET burden ranks among nation's highest. A study published by the National Conference of State Legislatures (NCSL) in January 1998 found that most states levy a sales tax based on purchase price. Many then add an annual "car tax" - a "value-based" tax (like our MVET), a weight-based tax, a registration fee, or some combination. Nineteen states levy no such tax. An analysis of the NCSL data by State Budget & Tax News pegged Washington's car tax burden at seventh. (Virginia, which had the highest car tax, recently cut the tax dramatically.)

The referendum also changes the MVET depreciation schedule. Currently, Washington assesses vehicles at full value for their first two years of service. The initiative drops the assessed value to 95 percent in the second year and 89 percent in the third year. The balance of the schedule remains unchanged.

The $30 credit is expected to reduce biennial revenues by $241 million in 1999-2001; the depreciation change, by about $17 million. Of the $258 million tax savings, remember, $206 million would have gone to the state General Fund and $52 million to local criminal justice programs.

MVET Shift from GFS to Motor Vehicle Fund

The shift of General Fund MVET revenue to the Motor Vehicle Fund provides the means to increase transportation funding for road and highway construction without raising the gas tax. The General Fund impact of this transfer in the 1999-2001 biennium is $156 million.

The MVET pays for local criminal justice programs, ferry operations, public health programs, transportation and transit services. As well, about 22 percent of the MVET is deposited in the state General Fund without earmarks. R-49 transfers this share of the tax (about $156 million in 1999-2001) to the Transportation Fund, providing most of the funding for a $2.4 billion spending package. Of the $2.4 billion, $1.9 billion is associated with the bond sale authorized by the referendum.

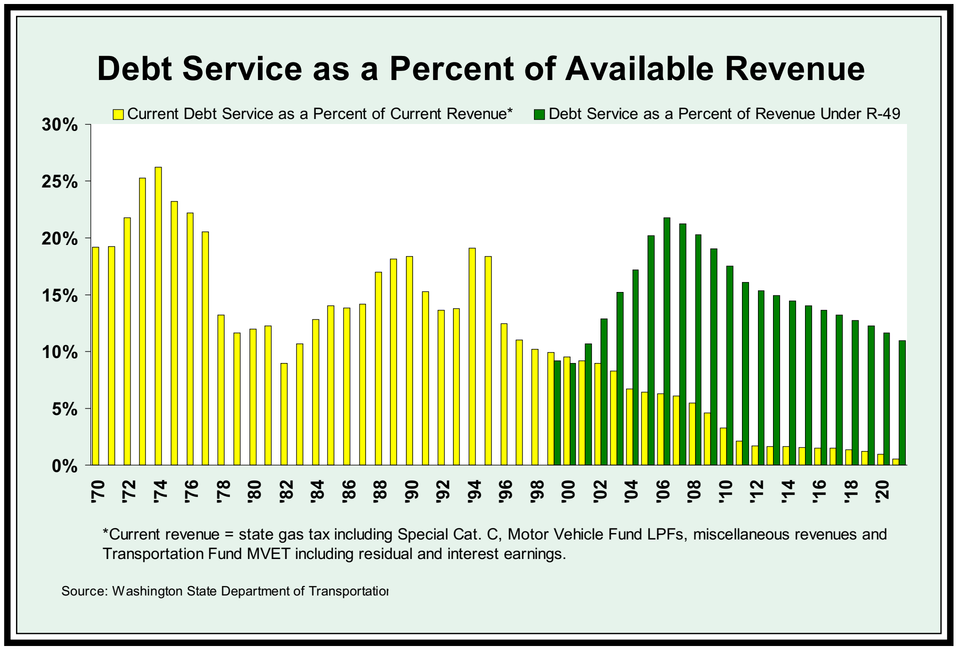

FIGURE 4

Sale of the bonds will, of course, increase the state's indebtedness, a point on which there has been some confusion. As Figure 4 shows, debt service payments for transportation purposes (outside the GFS) have fluctuated over time. The table clearly depicts the steady decline since 1994 in current debt service as a share of current revenues. Under R-49 debt service as a share of revenues rises to a high of 21.6 percent in 2006, never reaching the levels experienced in the Seventies.

The bonds issued under R-49 will be repaid from the motor vehicle fund and do not affect the GFS debt limit. The revenue reduction does result in a slightly lower GFS debt limit, as would any tax reduction, because the state's statutory debt limit is 7 percent of a three-year average of general state revenues. If R-49 were to pass, the state could issue about $910 million in new bonds in the coming biennium; if it fails, the capacity would be about $175 million higher. With revenues having grown faster than the I-601 limit (that is, than general fund expenditures), bonding capacity under the debt limit has increased correspondingly. A consideration more relevant for lawmakers than the loss of capacity under R-49 will be controlling GFS debt service payments, which compete directly with other general fund state spending programs.

A January 1998 report from the Congressional Budget Office (CBO), *Innovative Financing of Highways: An Analysis of Proposals*, reviews state transportation patterns. CBO writes, "Most of the innovative measures currently under consideration entail debt financing," many of them involving tolls. According to CBO, this trend stems from the inability of traditional revenue sources to keep pace with highway demand. Among the user fees they identify as common revenue sources are motor vehicle registration fees, i.e., the MVET. Innovative financing, they say, "can augment traditional sources of funding … and enable state and local government to proceed with major projects sooner than they might otherwise."

The MVET transfer will cover most of the bond issue. Additional revenues for debt service, as well as for the balance of the $2.4 billion plan, will come from stemming fuel tax evasion, shifting some programs from the Transportation Fund to the General Fund, and obtaining greater efficiencies in the Department of Transportation.

Support for Local Governments

While amounting to a relatively small share of the funding authorized by R-49, the local government portion received considerable attention in legislative debate. The result represents a potpourri of activities receiving formula distributions. Local criminal justice programs, according to OFM estimates, will receive a net increase of $14.2 million in the coming biennium. The $52 million in MVET funds lost to the programs will be replaced with a $66.2 million transfer from the GFS. As well, about $68 million in current MVET funding will continue. The referendum also calls for using $13.4 million in Violence Reduction and Drug Enforcement (VRDE) funds to pay for local criminal justice programs. According to the OFM report, most VRDE money already supports local programs, so this rule change would not increase local funding.

While the criminal justice programs were directly affected by changes in MVET distribution, the other local government assistance provided for by R-49 has no such clear connection. Included in the referendum is a $20.7 million transfer to a new Distressed County Assistance Account, about $8 million in additional funding for the Community Economic Revitalization Board (CERB), and $8 million for cities with small sales tax bases.

Amending and Affirming Initiative 601

To avoid a reduction in the Initiative 601 limit, R-49 asks for a one-time amendment to assure that "other programs funded from the General Fund are not adversely impacted" by the transfers. Voters are then asked to reenact and reaffirm the limit.

Because Initiative 601 limits expenditures only from the General Fund, it creates an incentive to shift funds to unlimited, non-General Fund accounts. To discourage such transfers, I-601 states:

> "If the cost of any state program or function is shifted from the state General Fund on or after January 1, 1993, to another source of funding, or if moneys are transferred from the state General Fund to another fund or account, the office of financial management shall lower the state expenditure limit to reflect the shift."

Without the exemption provided in R-49, the MVET transfer would result in a lower expenditure limit and further tighten budget constraints on the General Fund.

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