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BRIEFLY

In the supplemental budget proposed last week, Gov. Gary Locke signals his intent to boost education spending, mitigate I-695 revenue losses for local government transit, public health and safety programs, and provide modest property tax relief.

His budget also tests the I-601 spending limit in several areas: an ongoing property tax credit for local schools, a one-time sales tax credit for public transit, and program transfers from local government to the general fund to increase allowable spending under the limit.

The proposed budget would reduce reserves by more than $600 million.

With this opening from the executive, fiscal issues are certain to dominate the 2000 legislative session.

108 S. Washington St., Suite 406

Seattle WA 98104-3408

PH 206-467-7088

FX 206-467-6957

www.researchcouncil.org

Spending Up in Governor's 1999-2001 Supplemental Budget — Is I-601 Down?

Governor Gary Locke's proposed supplemental general fund-state (GFS) budget boosts state spending by nearly $500 million for the remainder of the biennium, through a combination of tax credits and direct appropriations. Most of the new spending promotes smaller class sizes in elementary schools and aid to local governments to mitigate Initiative 695 revenue losses.

To accommodate his spending hikes, the governor skirts I-601 limits with "tax credits" designed to channel money to specific programs before it reaches the state general fund. In other words, the money is "spent" without being appropriated, so the I-601 limit doesn't apply.

This mechanism supports the centerpiece of the governor's program, a $70 million shift to local schools through a "Learning Improvement Property Tax Credit." The money in the supplemental budget for this program is the first installment in a long-term plan to reduce the student-teacher ratio in the lower grades. The $70 million reflects just a single year's funding.

Acceptance of this tax credit plan would to a great extent vitiate the spending controls established by Initiative 601. While the mechanism has been used before, most prominently in stadium funding, nothing of this magnitude has even been broached.

While the details of the proposal are not clear, the core seems to be this: The state would allow school boards to increase local levies and credit the new taxes against the state portion of the property tax levy, causing state funds to flow directly to the local districts. As budget documents state, the credit is "tax neutral," that is, the increase in the local levy is offset fully by the state property tax, which does not increase.

The effect, however, is not benign: a long-term increase in state spending would be committed outside the appropriations process, and the general fund would fail to reflect the state's entire commitment to education.

Tax Credits Diminish General Fund

More than a billion dollars in new K-12 spending is expected to flow from the credit over the next five years — money that will not be available for tax relief or for other purposes in the appropriations process. It is as if the legislature were to create a new dedicated fund, supported by an earmarked property tax. Since this dedicated fund supports programs already receiving 46 percent of GFS appropriations, the I-601 limit's effectiveness as a control on state spending is largely nullified.

Since I-601 was adopted, general fund revenue flows have grown more rapidly than the limit, creating ongoing surpluses that have been used to provide tax relief. With this proposal, surpluses will grow more slowly as property tax revenues formerly a part of the general fund will flow directly to local school districts via the credit.

The tax credit card is also played in the supplemental budget to provide funds to local transit districts. The governor proposes $100 million in one time "Local Option Sales Tax (LOST) Credits" for transit districts to soften the 695 revenue losses.

The supplemental budget moreover contains direct appropriations to offset I-695 losses for local governments — $123 million in local government assistance and $100 million in transit assistance — as well as $64 million to replace funds lost to state programs. The transit assistance and $51 million of the local government aid is billed as "one-time" funding, with an additional $72 million tagged as ongoing assistance for public health and public safety programs.

Spending Limit Lifted for Local Aid

Here, again, there are I-601 spending limit ramifications. According to the governor, these appropriations to local governments permit the state to increase the I-601 spending limit by $223 million for the 1999-01 biennium. (An additional $35.8 million upward adjustment is made to reflect federal funding shifts.) But because $151 million of the funding is temporary assistance, the limit would be lowered by that amount in 2002.

Although additional details may emerge during the legislative session to add weight to the governor's interpretation, the raising and lowering of the I-601 limit for this purpose is far from straightforward. Initiative 601 did provide for an increase in the limit. Specifically: "If by order of any court, or legislative enactment, the costs of a federal or local government program are transferred to or from the state, the otherwise applicable state expenditure limit shall be increased or decreased, as the case may be, by the dollar amount of the costs of the program." (RCW 43.135.060)

Initiative 695, however, did not transfer costs; it eliminated funding. The decision to pick up those costs, even temporarily, is a separate matter for the legislature. There may be grounds for increasing the spending cap as funding responsibilities shift, but not for transitional revenue sharing.

1,000 New Teachers

In other new spending, the governor targets $85 million for K-12 schools, most of it to add 1,000 new elementary teachers — deemed a major step toward achieving the governor's goal of reducing class sizes. Higher education would pick up an additional $16 million (about a third of that amount because more students qualified for "Promise Scholarships than originally estimated – these scholarships pay for the equivalent of two years of community college for qualified Washington high school students). He also boosts spending for domestic violence prevention, pipeline safety, long-term care, and a variety of other public safety programs. He increases WorkFirst job training and childcare programs and provides additional funding for air quality and salmon recovery.

The budget projects $157 million in savings, largely from pension changes, declining welfare caseloads and lower-than-expected public school enrollments. (Pension investments have been so good that the governor proposes pension enhancements while realizing savings in the general fund.)

All told, direct GFS appropriations climb by $312 million (after being offset by the savings mentioned above) and tax credits to support additional spending by local governments and public schools add $170 million, for $482 million. Of that total, approximately $387 million, or 80 percent, replaces funds lost as a result of I-695. Most of the proposed I-695 mitigation is one-time assistance, including all of the transit assistance and the majority of the public safety funding. About 90 percent of the public health losses as a result of I-695 would be replaced on an ongoing basis.

Long Term GF-State Balance Sheet
(Dollars in Millions)

	Gov. Supp. 1999-2001
RESOURCES	
Unrestricted Beginning Reserves	529.2
Revenue Forecast	20,727.5
Learning Improvement Property Tax Credit	(70.0)
Local Option Sales Tax Credit - Transit (I-695 mitigation)	(100.0)
Senior Citizen Property Tax Credit	(13.8)
Permanent 6.2 Percent Property Tax Cut	(45.9)
Other Revenue Reductions	(4.3)
Current Revenue Totals	20,493.5
Total Unrestricted Resources	**21,022.7**
APPROPRIATIONS	
Total 1999-01 Biennial Appropriation	20,572.8
Local Government Assistance (I-695 mitigation)	123.0
Transit Assistance (I-695 mitigation)	100.0
Other Revisions	89.0
Total Proposed Budget	20,884.8
Baseline 601 Spending Limit	***20,651.0***
Governor's Projected 601 Spending Limit	**20,909.8**
RESERVES	
Unrestricted Ending Balance	137.9
Reserve for One-time Local Property Tax Credit for School Capital	(95.0)
Adjusted Unrestricted Reserve	42.9
Emergency Reserve Account	532.0
Total Ending Reserves	574.9

Source: Office of Financial Management

Property Tax Relief Proposed

In addition, the governor offers two approaches to property tax relief. First, he makes a permanent 6.2 percent cut in the state property tax rate and exempts low income seniors from the state property tax altogether. Second, with his Learning Improvement Tax Credit he couples a proposal to split the benefits of economic growth between education and property tax relief through a mechanism called the “prosperity dividend.”

The property tax proposals will be the subject of a later *Policy Brief*.

Discussion

The proposed supplemental introduces several elements certain to draw fire in the 2000 legislative session. Already, it is properly dubbed a political budget, but there’s nothing new or inappropriate about that. The budget is the governor's (and, for that matter, the legislature's) primary policy document and as such represents the political philosophy of its drafter(s).

The governor's proposal, however, departs from past practice substantially in four areas.

First, it constitutes an unprecedented challenge to the I-601 spending limit. Although the governor says the limit is preserved in the supplemental, there can be no question that the Learning Improvement Tax Credit substantially erodes the effectiveness of the I-601 limitation.

As well, the transit assistance and local government assistance require a liberal construction of I-601 to pass muster. There will be tension between legislative forces holding to a strict interpretation of the limit and those wishing to boost spending for education and I-695 mitigation. (Of course, individual legislators will on occasion feel the same tension as their priorities clash.)

Second, surpluses are dropped to a level the governor used to consider unacceptable. A $575 million surplus is about half the level championed by fiscally conservative proponents of I-601, and represents the lowest level considered prudent by the Washington Research Council. If the economy weakens and if the state faces another major tax cut initiative, the reserve will provide little cushion. Also, most of the reserves are in the Emergency Reserve Account, which can be tapped only under extraordinary conditions.

Third, supplemental budgets are typically adjustments to the biennial budget. By introducing a major new policy initiative in his supplemental, the governor appears to be making a strong political statement that he's adhering to his avowed education first agenda, while postponing the serious work on transportation forced on the legislature by passage of I-695. Waiting until 2001 may not be good enough.

Fourth, the property tax relief provided in this budget is unlikely to deter momentum for more significant property tax relief in the future. A 6.2 percent reduction in the state rate amounts to about 1.5 percent of an average property tax bill, barely noticeable when coupled with the various increases in assessed valuation and local taxes experienced by most property owners. To the extent lawmakers wish to provide more tax relief, expenditure reductions will be required.

With passage of I-695, fiscal policy issues were certain to dominate the legislative session. By introducing a bold, even audacious, supplemental budget last week, the governor assures spirited debate in the new year.