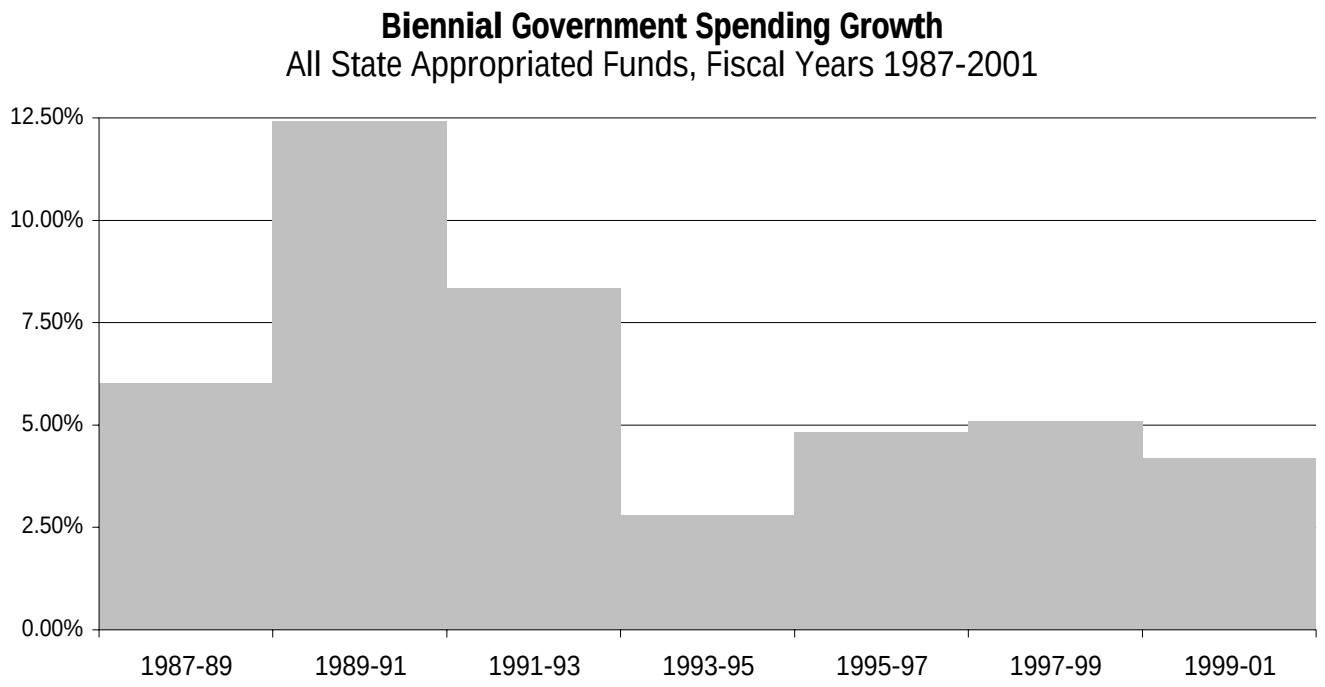
Changing the Rules of the Game:

Washington Fiscal Developments Before and After Initiative 601*

Institute for Public Policy and Management



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About the Study

The research project which resulted in this report was supported in part by a grant from the Ford Foundation State Fiscal Analysis Initiative.

The purpose of this report is to provide policymakers and the public with clear and objective information on recent fiscal developments in Washington state, with an emphasis on the role Initiative 601 has played in state budgetting and tax policy.

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1. Introduction

Initiative 601 (I-601) changed the rules of budgeting and tax policy in the 1990s. This study recounts Washington fiscal developments in the 1990s, using I-601 to help organize the story and numbers behind state fiscal policies in those years. I-601, passed by voters in November 1993, placed limits on state spending and restrictions on tax increases.

The study recounts Washington fiscal trends leading up to the passage of I-601. It then examines fiscal developments in the years since budgets became subject to the Initiative, beginning in Fiscal Year (FY) 1996, and discusses the outlook for the spending limit, revenues, and budgetary reserves. Three biennial budgets in the 1990s – 1995-97, 1997-99, and 1999-01 – have been written under the umbrella of I-601.

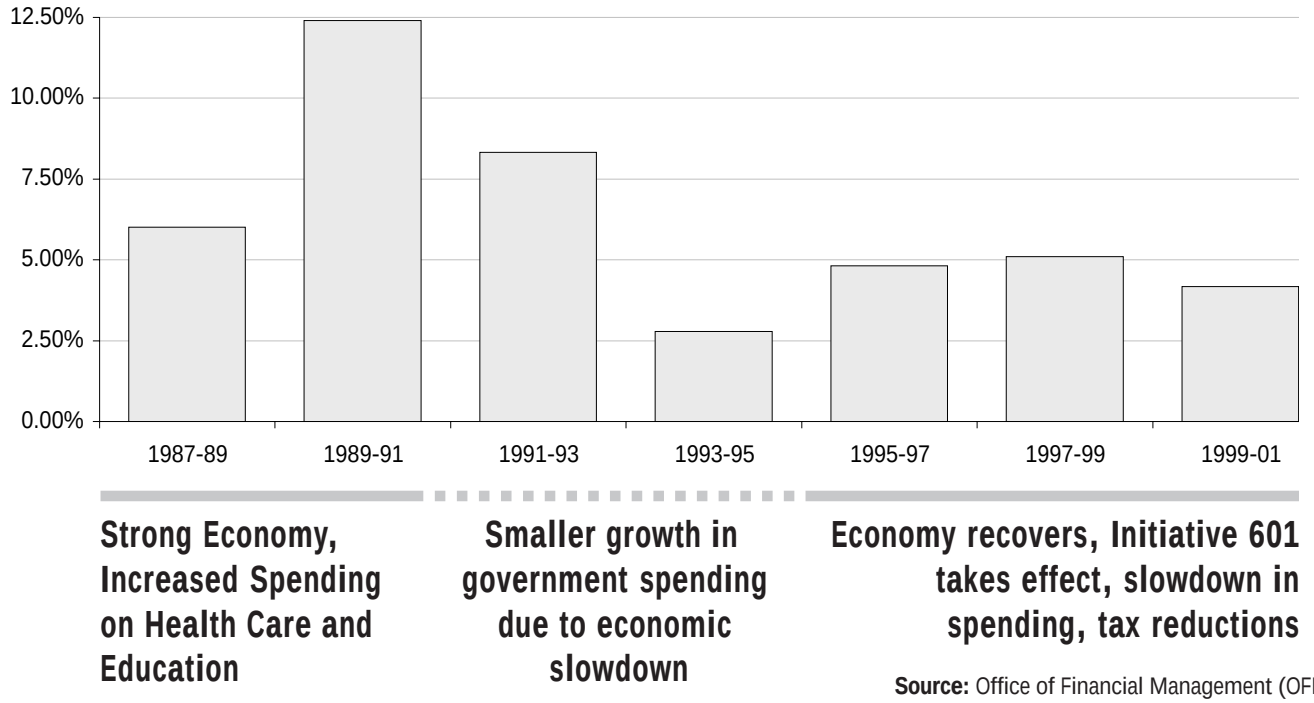
A major challenge in this type of analysis is to avoid attributing all major fiscal developments since I-601 took effect to the Initiative itself. Many other important contemporaneous factors affected state fiscal trends in the 1990s, including a national economic recession, ebbs and flows in aerospace employment, two changes in the Governorship, and a switch in the parties controlling both houses of the Legislature.

The three budgets subject to I-601 spending limitations in the 1990s were passed with Republicans controlling at least one house of the Legislature, while the three budgets adopted prior to I-601 were passed under Legislatures controlled by Democrats. Democrats held the Governorship during all six budget periods.

Untangling the impact of the Initiative from the effects of political and economic change is virtually impossible, especially since the three sets of developments were not entirely independent. While the study sometimes alludes

FIGURE 1

Real Growth in State General Fund Expenditures



Source: Office of Financial Management (OFM)

to interactions among the factors, its main purpose is to clarify and organize the complex fiscal events of the 1990s – not to allocate the causes of fiscal decisions among politics, economics, and the Initiative itself.

Another limitation of the study is that it confines itself, as it must, to "first order" effects on expenditures, taxes, reserves, and other fiscal indicators. This means that even when major fiscal decisions can be attributed to I-601, or to another factor, the ultimate outcomes of the decisions –- on the quality of education, the health of the state's residents, or the condition of the economy, for example — are not evaluated. As tempting as it may be to speculate on how I-601 may have affected education in the K-12 public school system, for example, the Initiative has not operated long enough to reach these kind of conclusions. Besides, agreeing on appropriate outcome measures for education requires a treatise in itself.

Over the past decade Washington state government finances have been shaped by several key economic, demographic, and political factors:

- An economic boom in the late 1980s provided the resources to increase discretionary state spending for health care, the expansion of handicapped, bilingual, and other special education programs, and the enhancement of training options in the state's welfare program.

- A national recession, followed by large layoffs in the aerospace industry, slowed the Washington economy in the mid 1990s, making it difficult to sustain spending patterns that began in the 1980s. This resulted in a combination of tax increases and slower spending growth in the 1993-95 Biennium.

- A resurgence of economic growth in the late 1990s, lower inflation, a voter-approved expenditure limit (Initiative 601), and changes in political control of the legislature resulted in relatively slow spending growth for the remainder of the decade. The period also included a series of large tax reductions enacted in the 1994 through 1999 legislative sessions.

Although changes in state fiscal policy over the last three biennia were shaped by a number of forces acting in concert, the passage and implementation of I-601 clearly affected the fiscal debate in state government and provided a reference point for tax policy and budget development.

2. Major Provisions of I-601

Initiative 601 was passed by voters in November 1993. It placed limits on growth in state General Fund expenditures and taxation.

There are five key provisions of I-601 affecting state government spending and taxes. The Initiative:

- Establishes annual limits on **General Fund** state expenditure growth based on a three year average of inflation and population growth, called "fiscal growth factors." The fiscal growth factors are ***lagged,*** i.e., based on the past. For example, the fiscal growth factor for FY 2000 is based on average inflation and population growth for fiscal years 1998, 1997, and 1996.

- Requires that the spending limit be adjusted for fund shifts – e.g., the spending limit is reduced when revenues or program costs are shifted from the General Fund to other funds.

- Requires that when actual expenditures fall below the spending limit, that future limits be based on the lower amount. This is called "re-basing."

- Establishes an Emergency Reserve Fund (a "rainy day account") consisting of revenues collected in excess of the spending limit.

- Requires a 2/3 majority of both houses of the Legislature to increase revenues.

It is important to add that although I-601 requires reductions to the General Fund spending limit when General Fund revenues or program costs are shifted to other funds, it does not directly restrict spending from other funds or formally restrict growth in capital or transportation budgets.

The current estimate of the expenditure limit for the 1999-01 Biennium is **$20.651 billion**. Actual **General Fund** expenditures for the prior biennium were $19.155 billion. Thus, allowable spending growth for the 1999-01 Biennium is currently 7.8 percent.

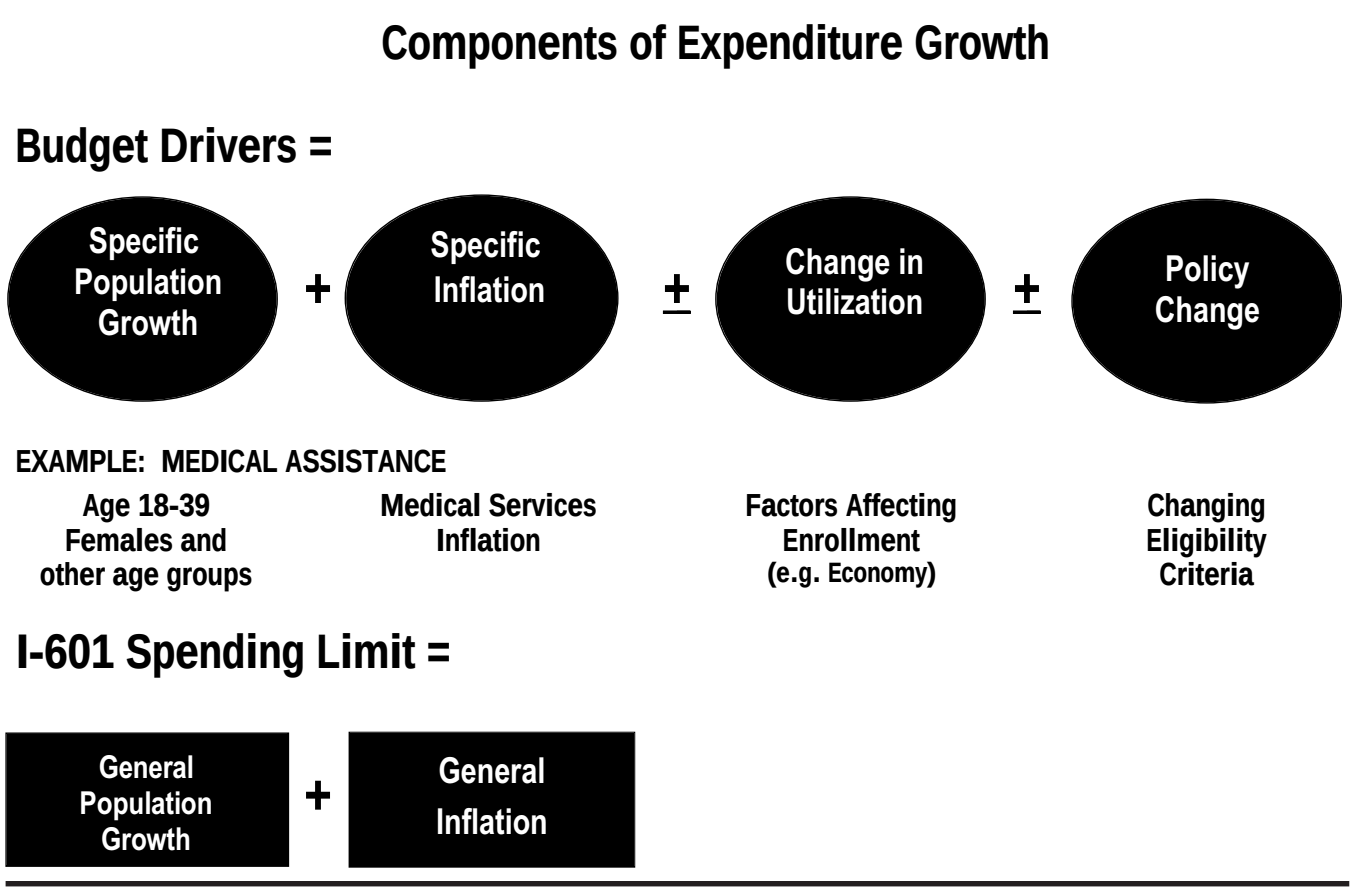
3. Implications of the I-601 Formula

The basic premise of I-601 is that state spending can and should be determined by growth in the number of people needing services (as represented by total population growth) and by changes in the cost of providing those services (as represented by general inflation). Inflation plus population growth comprise the I-601 "fiscal growth factor." Although this premise roughly reflects the realities of government budgeting, it misses some important details that could result in actual growth pressures being higher or lower than the I-601 fiscal growth factor.

Figure 2 compares the I-601 spending limit with the components of actual spending growth. There are four basic differences between the I-601 limit and actual budget pressures:

- I-601 limits growth on the "people" side of the equation to growth in total population. In reality, budgets are driven by growth in the "**specific populations"** served by state government, such as the school age 5-17 population. At various times, growth in the

FIGURE 2



Structural Difference Between Revenue Growth and I-601

Average Annual Growth 1997-2005 (assumes average economic growth)

The I-601 Calculation

- **Inflation** 2.3 %
- **Population Growth** 1.3 %
- **Real Per Capita Personal Income Growth (Productivity)** 1.5 %

PERSONAL INCOME GROWTH = 5.1%

→ **3.6%**

1 Point Difference

To forecast revenue, economists multiply personal income growth by a factor of 0.90, since revenue grows about 90% as fast as personal income

REVENUE GROWTH = 5.1 X 0.90 = 4.6%

populations typically served by government can be higher or lower than total population growth.

- I-601 limits growth on the "price" side of the equation to growth in the general price level of the economy, or general inflation. In reality, **"special inflation**," — inflationary pressures for specific government services, such as health care — can be higher or lower than general inflation. "Special inflation" is not entirely uncontrollable.

- The I-601 formula does not explicitly address **"policy changes"** affecting program costs. In order to increase access to the state's regular medical assistance program under I-601, for example, savings or productivity gains would have to be realized in the medical assistance budget or elsewhere in the state budget. Policy changes can, of course, also result in lower spending.

- The I-601 formula does not explicitly address changes in the **"utilization"** rates of programs and services. Due to economic conditions or factors affecting health, for example, enrollment demands in the medical assistance program can grow faster or slower than the populations typically served by the program.

Having just stated that they are imperfect reflections of real world budgeting, it is only fair to add that inflation and population growth, because they represent relatively uncontrollable pressures on spending, do capture and explain a large part of the variation in spending. They also provide a good baseline for budget construction, and a reality check on the rate of expenditure growth.

I-601 Compared with Economic and Revenue Growth

Another feature of the I-601 formula concerns the relationship between government spending and general economic growth. I-601 allows state government

spending to grow by the rate of inflation and population growth; whereas the state economy grows by these factors plus the effect of "productivity gains" in the economy.[1] As a result, a basic implication of I-601 is that over time, state government will shrink as a share of the state economy.

Since revenues grow at almost the same pace as the general economy, a related implication of the I-601 formula is that if the tax system is unchanged, growth in general revenues will also, over time, exceed growth in the spending limit. Under an assumption of "average economic growth," revenues are expected to grow about 1 per cent per year faster than the spending limit over the long term. Figure 3 depicts these relationships.

4. The Fiscal Context for Initiative 601: FY 1980 to FY 1995

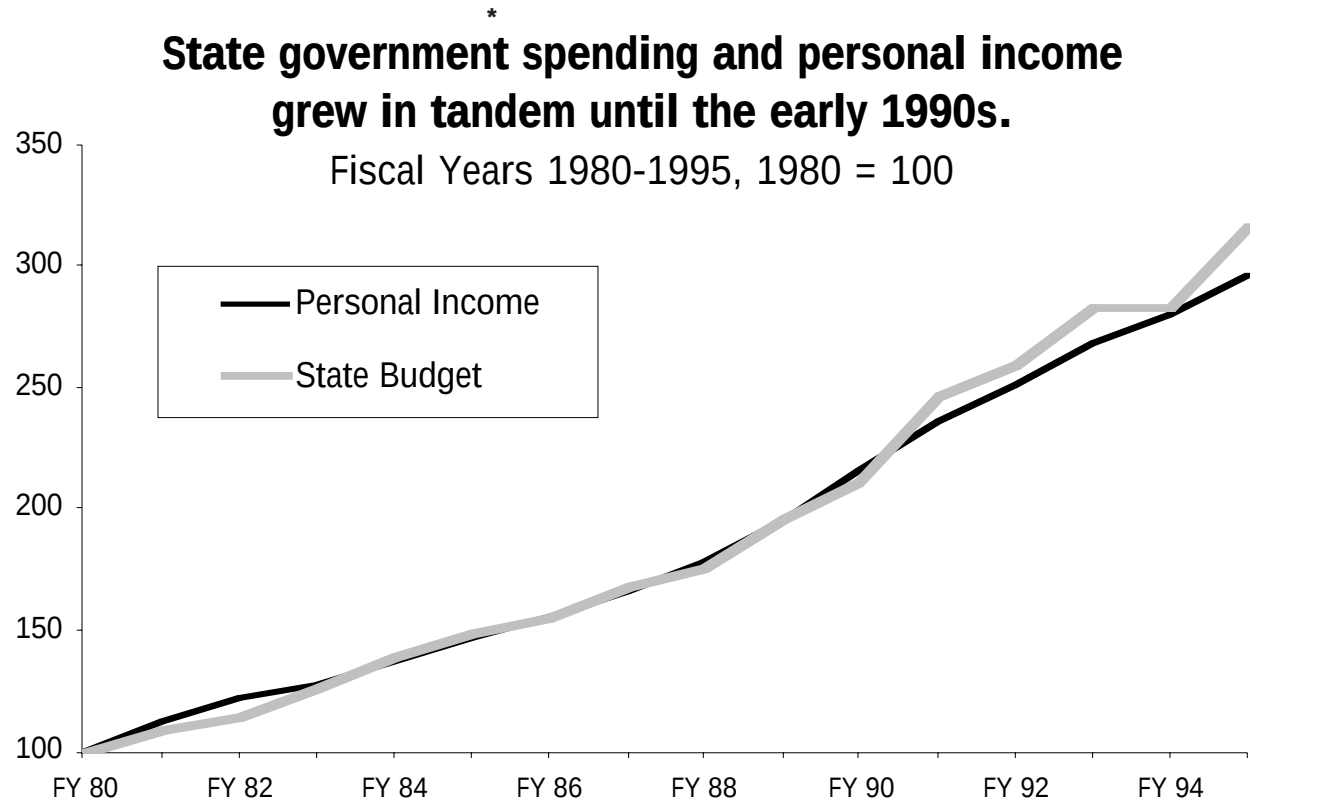
I-601 can be better understood in the context of the major fiscal developments of the 1980s and 1990s. In the fifteen year fiscal period before I-601 took effect:

- State spending (including the General Fund and all other state budgeted funds) grew at about the same rate as the state economy, until the last few years of the period. Overall, state government spending grew at a rate of 8.0 percent per year, slightly faster than personal income growth, which increased at a rate of 7.5 percent per year. See Figure 4.

- A very large tax increase at the outset and a much smaller one (in proportionate terms) in the latter years of the period bracketed a long stretch of relatively few and small changes to state revenues.

- Although spending during the FY 1980 to FY 1995 period grew only slightly faster than income, it exceeded inflation and population growth by a considerable margin; and some categories of the budget exceeded this benchmark by a very wide margin.

FIGURE 4



*** All state appropriated operating funds.**

Sources: OFM and US Bureau of Economic Analysis (BEA)

TABLE 1

Expenditure Growth Components, All State Funds, FY 1980-1995*

Factor	Annual Average Growth	Increase, FY 1980 – FY 1995 (Billions of Dollars)	Percent Share
Population Growth**	1.2	$1.289	18%
General Inflation	4.5	$3.111	43%
Policy/Utilization/Special Inflation	2.3	$2.849	39%
TOTAL	**8.0**	**$7.248**	**100.0%**

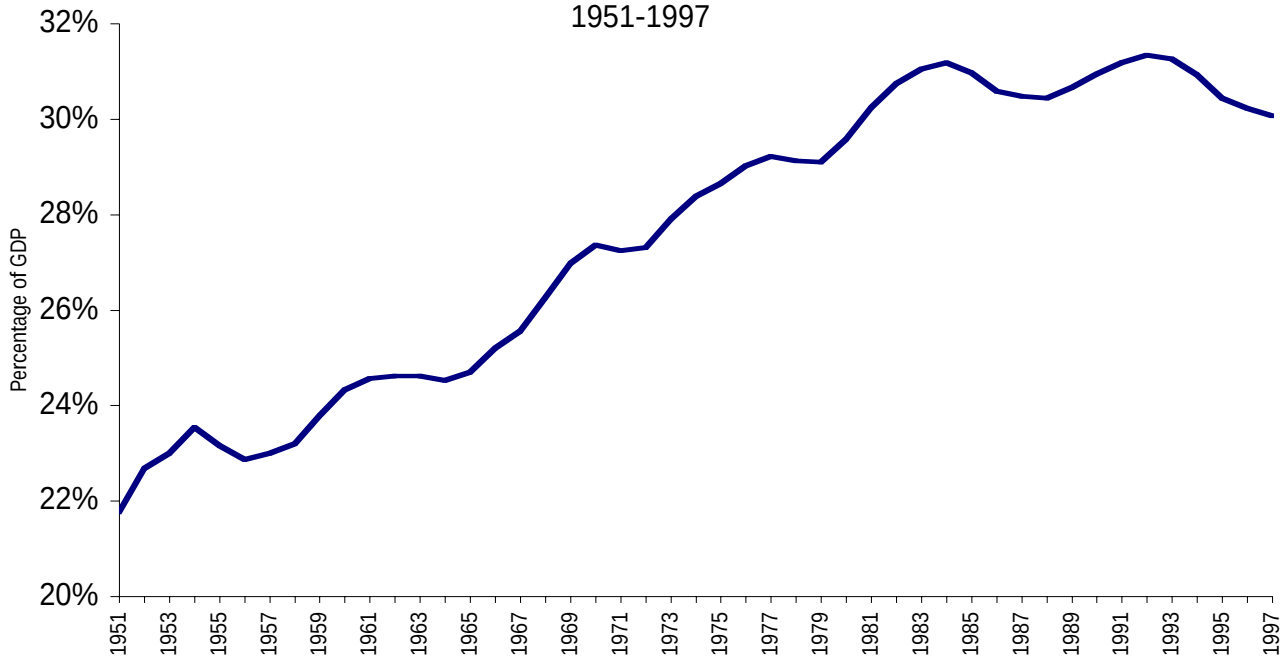
* The All State Funds budget includes the General Fund (about $20.6 billion) plus other appropriated state funds (about $4.5 billion).

**Based on growth rates of specific population age groups associated with major areas of the state budget (e.g., age 5-17 school age children).

FIGURE 5

The most dramatic changes in the size of government occurred between 1950 and 1980.

Total Federal, State, and Local Government spending as a percentage of GDP, FY 1951-1997



Sources: US Office of Management and Budget (OMB)

- Overall, about 60 percent of the annual average expenditure growth rate during these years can be accounted for in terms of relatively uncontrollable factors – inflation and population growth. As **Table 1** indicates, general inflation and population growth, together, can account for 5.7 percent per year growth, with **Policy, Utilization, and Special Inflation** accounting for 2.3 percent annual growth. The latter three factors are termed the **Residual.**[2] (The Residual is the difference between how fast a program would have grown had it increased solely on the

basis of population growth and inflation, and how much it actually grew. The Residual can, of course, be positive or negative).

- The levels of spending above general inflation and population growth established in the 1980s and early 1990s were not sustainable during the economic slow down that began in the 1993-95 Biennium.

At the state level, there was a relatively small change in the size of government between FY 1980 and FY 1995. Roughly the same picture emerges when state, local, and federal government spending across the fifty states are combined. After summing expenditures at all three levels of government (including "off-budget" federal expenditures), spending as a percent of Gross Domestic Product (GDP) rose from about 20 percent in the early 1950s to about 30 percent in the mid 1970s. It has hovered around 30 percent throughout the 1980s and 1990s. See **Figure 5.**

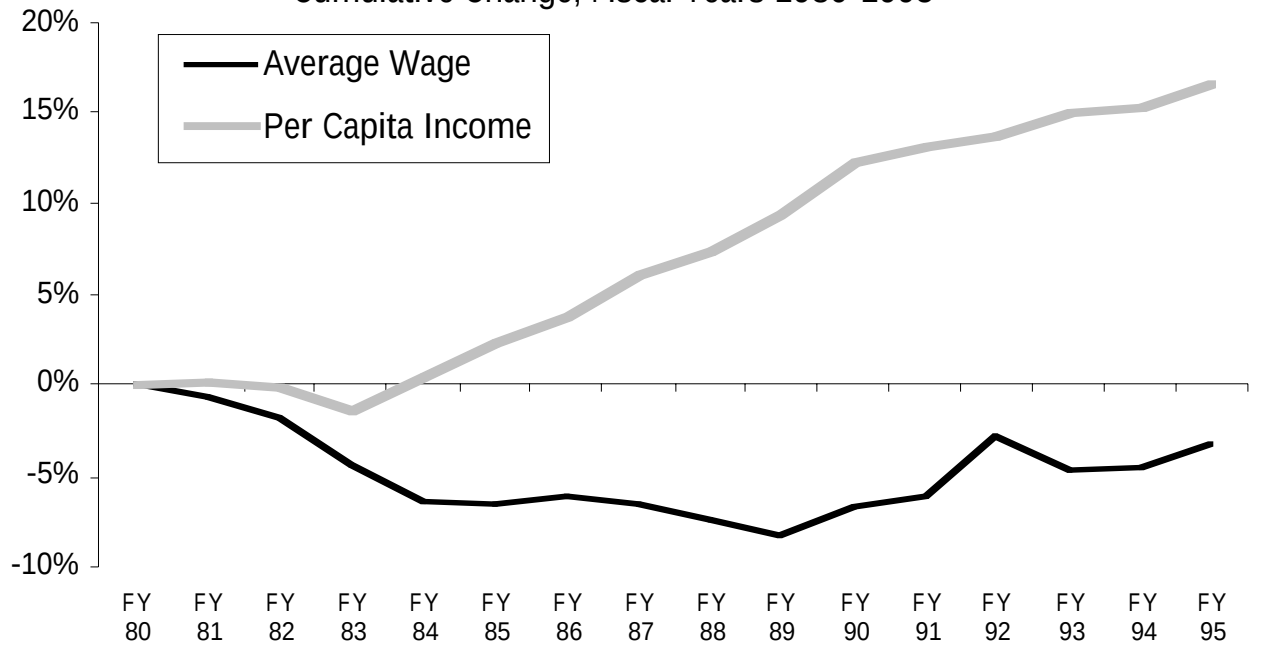
Although the most dramatic increases in total government spending occurred before the 1980s, the effects of larger government may not have been felt till much later. The 1980s were characterized by major economic restructuring, which resulted in a decline in real average wages and an increase in wage disparity. Real wage declines have been only partly reversed in the 1990s. (See **Figure 6**). Households dependent on wage income, and accustomed to steady improvements in living standards, may have experienced the relatively small increase in average tax burdens during the 1980s and early 1990s differently from those receiving the full benefits of rising personal income.

Factors shaping perceptions of growth in the size of government are complex. Perceptions are not only based on changes in taxes and spending. They are also shaped by laws and regulations affecting businesses and households. Although the General Fund tax increase passed in the 1993-95 Biennium was proportionately small compared with the one adopted more than a decade earlier, it highlighted

FIGURE 6

The decline in real average wages during the 1980s may have affected reactions to increased government spending

Cumulative Change, Fiscal Years 1980-1995



Source: BEA

the fact that spending patterns beginning in the mid 1980s were not sustainable during the economic slow-down in the 1993-95 Biennium.

Initiative 601 responded to these fiscal and economic developments by limiting expenditure growth in the General Fund to the sum of general inflation and population growth, restricting shifts of program costs to other funds, and making it more difficult to increase taxes. I-601 also established an Emergency Reserve Fund that was intended to provide sufficient revenues to maintain programs during economic downturns – i.e., to ensure that spending decisions are sustainable.

5. An Overview of How the Limit Has Worked

The expenditure limit provisions of I-601 first took effect in FY 1996 and helped shape the 1995-97 State Biennial Budget and ensuing budgets. **Table 2** summarizes the official expenditure limits, actual General Fund expenditures, and applicable fiscal growth factors since I-601 took effect.[3]

Actual expenditures have fallen significantly below the limit only once, in FY 1996. Altogether, budgets passed beginning with FY 1996 have spent $230 million below allowable spending under I-601. Because the "rebasing" provision of I-601 requires that future limits be based on actual spending, the decisions to spend below the limit, in turn, have lowered subsequent limits (thus far) by a total of $186 million. Thus, cumulatively, budgets passed under I-601 have spent about $416 million less than the maximum capacity granted under the I-601 formula.

As required by the Initiative, the spending limit has also been adjusted numerous times for transfers of money or program costs from the General Fund to other state and local accounts and for transfers of program costs between the state and federal government. The net effect of over eighty adjustments for fund shifts — money transfers and program cost shifts — has been to reduce total spending capacity, beginning with FY 1996, by $70 million. **See Table 3.**

TABLE 2

Comparison of Actual Expenditures to I-601 Spending Limits

Millions of Current Dollars

	I-601 Spending Limit	Actual Expenditures	Difference between Limit and Expenditures	Fiscal Growth Factors
FY 1996	8,757.3	8,619.0	138.3	5.13%
FY 1997	9,119.8	9,112.8	7.0	4.45%
FY 1998	9,336.4	9,329.6	6.8	4.05%
FY 1999	9,826.0	9,826.0	0	4.18%
FY 2000	10,169	10,158.0	11.0	3.32%
FY 2001	10,482	10,417.0	65.0	2.93%*

*** Preliminary estimate; subject to revision in November 1999.**

Source: OFM

TABLE 3

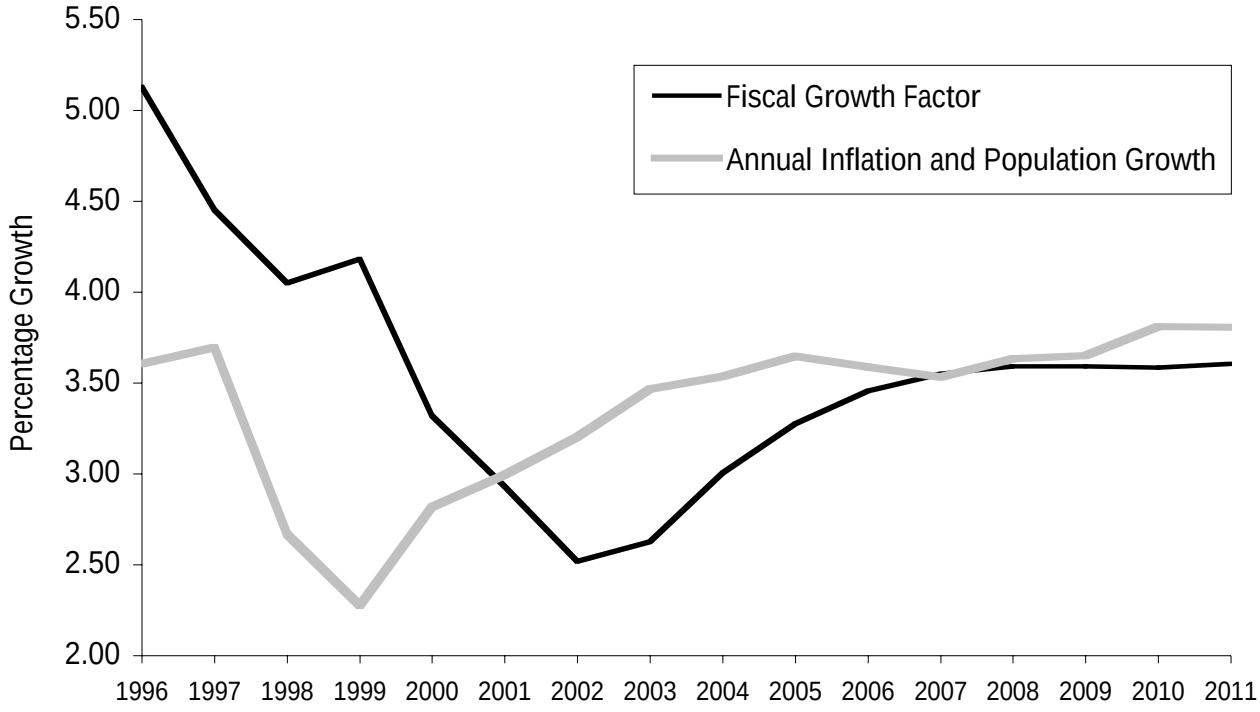
Effects of Re-Basing and Fund Shift Adjustments on the Initiative 601 Expenditure Limit

FY	Limit Without Rebasing	Adjustment For Rebasing	Net Effect of Adjustments For Fund Shifts	Official Limit	Actual Spending	Difference (Limit vs. Actual)
1996	8,753	0	4	8,757	8,619	(138)
1997	9,147	0	(27)	9,120	9,113	(7)
1998	9,518	(150)	(32)	9,336	9,330	(6)
1999	9,887	(7)	(53)	9,826	9,826	(0)
2000	10,159	(8)	18	10,169	10,158	(11)
2001	10,482	(21)	20	10,482	10,414	(68)
	TOTAL	**(186)**	**(70)**			**(230)**

Source: OFM

FIGURE 7

Because of lags in the I-601 formula, Fiscal Growth Factors differ from contemporary inflation and population growth.



Sources: Data Resouces, Inc., and OFM

Referendum 49, passed by voters in November 1998, transferred about $220 million in revenue (in terms of 1999-01 Biennium revenue) from the General Fund to criminal justice and transportation accounts. However, since the Referendum amended I-601 by exempting these transfers from the requirement to lower the spending limit, General Fund spending capacity was not affected.

Inherent in the computational structure of I-601 is a difference between the rate of spending growth allowed by I-601 (the "fiscal growth factor") and current inflation and population growth — the actual inflation and population growth experienced during a budget period.[4] For example, the fiscal growth factor for FY 2000 is based on the average of inflation and population growth for fiscal years 1996, 1997, and 1998.

Because of these lags, allowable spending growth has been higher, until now, than actual inflation and population pressures, which has made it easier to accommodate I-601 spending constraints. However, in practice, adjustments to the spending limit due to re-basing and fund shift adjustments have brought allowable growth close to contemporary inflation and population growth. Since FY 1995, General Fund expenditures have grown at a rate of 3.6 per cent a year, while current inflation and population growth have increased 3.0 percent per year.

After FY 2001, however, the relationship between the fiscal growth factors and current inflation and population growth is expected to reverse as inflation rises above the exceptionally low rates of recent years. If inflation rises next biennium, as predicted, it will be harder for I-601 to accommodate growth pressures. See Figure 7. The inflation forecasts used in this analysis are based on the U.S. portion of the official state economic forecast prepared by Data Resources Incorporated (DRI). DRI's inflation forecasts, however, have tended to overstate inflation in recent years.

6. Effects on Spending

In both nominal and inflation-adjusted terms, there was a significant slow-down in **General Fund** spending growth in the six fiscal years that have been subject to I-601, compared with the six prior fiscal years. (See **Figure 8**). However, a large part of the drop in spending growth was aided by lower inflation and a deceleration in total population growth. There was also slower growth in most of the age groups served by state government, especially in the age 5-17 school population, which drives almost half of the state budget.

The two periods under study not only differed in terms of being subject to I-601, they also differed in which parties controlled the Legislature. As mentioned at the outset, it is difficult to disentangle the effects of I-601 from political and other factors which, together with I-601, changed Washington's fiscal landscape in the mid 1990s.

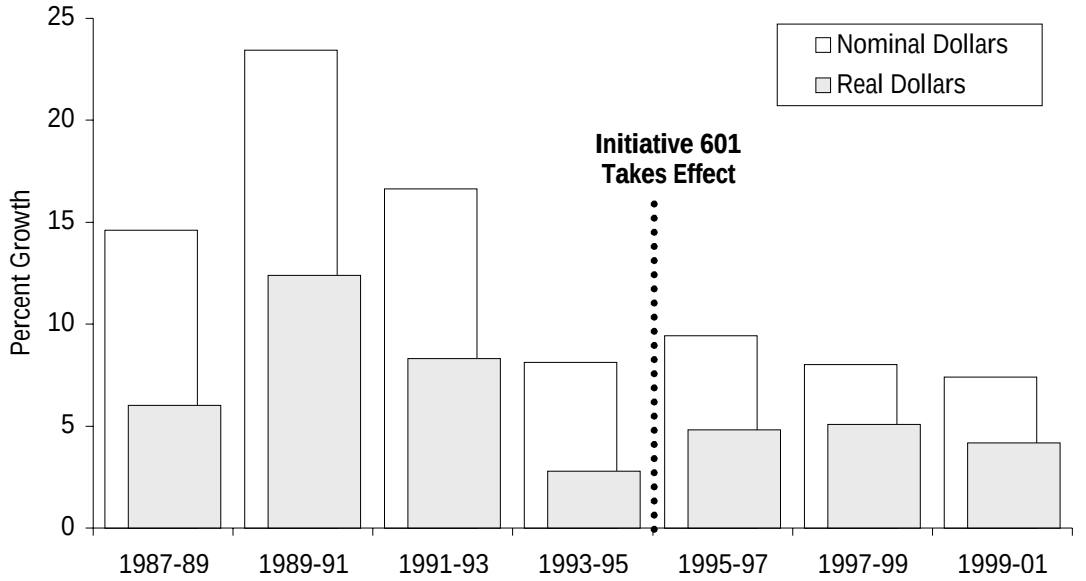
Spending Growth Before and After I-601

Between FY 1989 and FY 1995, before I-601 took effect, the **General Fund** budget grew at an annual rate of 7.5 percent. **General inflation and growth in specific populations** served by state government can account for 5.9 percent per year; leaving a **Residual** of 1.6 percent, which reflects **policy, utilization and special inflation**. See **Table 4.**

In the six fiscal years after I-601 took effect, beginning with FY 1996, overall annual expenditure growth was reduced to 3.6 percent per year, a decline of 3.9 points. However, most of this reduction — 2.9 percentage points out of a 3.9 point decline — can be explained by lower inflation and slower population growth. The remainder can be accounted for by a reduction in **Residual spending** – spending due to changes in policy, utilization of services, and special inflation. The annual growth rate of Residual spending was reduced by 1.0 percent per year under I-601, from 1.6 percent to 0.6 percent. See **Tables 4 and 5.**

FIGURE 8

In both nominal and real terms, growth in General Fund expenditures has slowed since Initiative 601 took effect.



Source: OFM

TABLE 4

Components of Expenditure Growth, General Fund-State, FY 1989-1995

Factor	Annual Average Growth	Increase, FY 1989 – FY 1995 (Billions of Dollars)	Percent Share
Population Growth*	2.4	$0.848	29%
General Inflation	3.5	$1.261	42%
Policy/Utilization/Special Inflation	1.6	$0.876	29%
TOTAL	**7.5**	**$2.985**	**100.0%**

* Based on growth rates of specific population age groups associated with major areas of the state budget (e.g., age 5-17 school age children).

Sources: OFM and IPPM

TABLE 5

Components of Expenditure Growth, General Fund-State, FY 1995-2001

Factor	Annual Average Growth	Increase, FY 1995 – FY 2001 (Billions of Dollars)	Percent Share
Population Growth*	1.4	$0.744	37%
General Inflation	1.6	$0.845	43%
Policy/Utilization/Special Inflation	0.6	$0.389	20%
TOTAL	**3.6**	**$1.978**	**100.0%**

* Based on growth rates of specific population age groups associated with major areas of the state budget (e.g., age 5-17 school age children).

Sources: OFM and IPPM

I-601 was supposed to slow spending growth to inflation plus population growth. Why did budgets after I-601 grow slightly faster than this standard? The small amount of General Fund spending growth above the "inflation plus population growth" line (0.6 percent) was made possible by lags in the fiscal growth factors used in the I-601 formula. Recall that the fiscal growth factors have been higher than contemporary inflation and population growth. The lags could have resulted in even higher Residual spending in the ***General Fund;*** however, additional spending was held down by three factors:

- Decisions by policy-makers to spend below the limit (especially in FY 1996);
- Re-basing the limit to actual (lower) expenditures, as required by the Initiative; and
- Reductions to the limit for money transfers and program cost shifts, as prescribed by the Initiative.

I-601 does not directly restrict growth in expenditures outside the General Fund. Slower growth in General Fund spending may have been accommodated by acceleration in the expenditure of dedicated funds, which are outside the General Fund. However, the provision of I-601 which requires that the General Fund limit be reduced whenever revenues or program costs are shifted to other funds, makes it difficult for this to happen.[5] Expenditures from these "other funds" have grown faster than General Fund spending since the 1993-95 Biennium, but their rate of growth has not accelerated since I-601 took effect.[6]

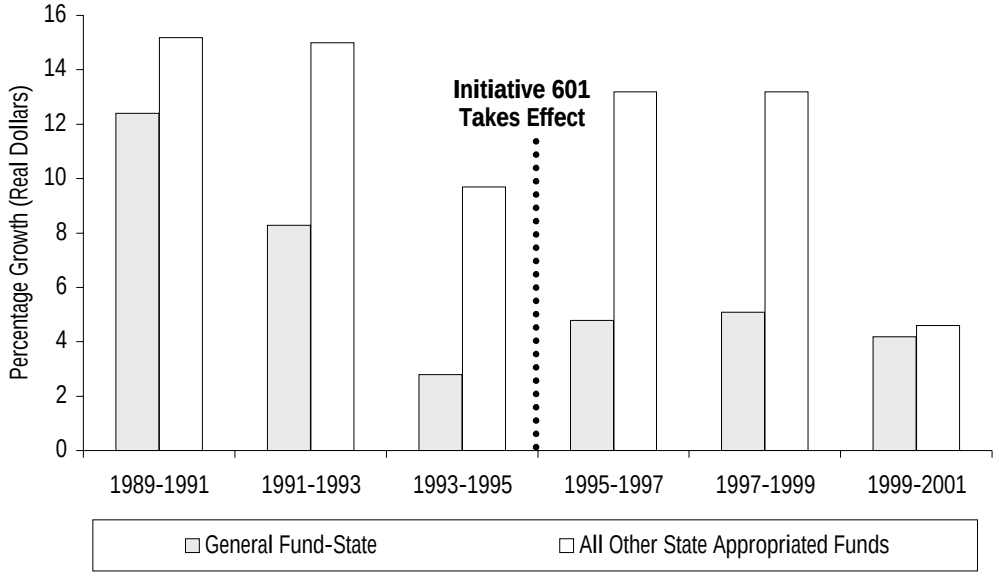
An analysis of spending trends in a more inclusive form of the state budget –- All State Appropriated Operating Funds (including the General Fund) – shows a similar pattern of decelerating expenditure growth and about a one percentage point per year difference in Residual spending before and after I-601.

What if pre-601 Spending Trends Had Continued?

In terms of its effect on spending, a basic question about I-601 is: "How large would the 1999-01 Biennial budget – the current budget — be without the constraints imposed by I-601?." Since changes in the control of at least one house of the state Legislature occurred at about the same time the I-601 spending limit took effect, answering this question also sheds some light on the effects of political change.

FIGURE 9

Expenditures from "Other Funds" have grown faster than the General Fund, both before and after Initiative 601.



Source: OFM

It is possible to gain some perspective on how I-601 has affected current spending by asking a related question: "How large would the 1999-01 budget have been if pre-601 "spending trends" had continued?" [7] Answering this question fairly requires that changes in the general inflation environment and population pressures be taken into account.

With the changes in general inflation and population growth taken into account, if pre 601 growth trends in policy, utilization, and special inflation had continued, **General Fund** appropriations would have been about **$1.4 billion** higher than actual appropriations in the 1999-01 Biennium. The comparable figure for a more inclusive budget that contains all state appropriated funds — the **All State Funds** budget — is about **$1.6 billion**.[8]

Table 6 breaks down the $1.4 billion difference in General Fund spending into nineteen major program areas. (The categories and the major agencies or programs included in each area are shown in the **Appendix**).

TABLE 6

1999-01 Budget Compared with Pre-1995 Spending Patterns

General Fund Appropriations and Hypothetical Budget based on Pre-1995 Policy/Utilization Drivers and Current Inflation and Population Growth (Millions of Current Dollars)

	Actual 1999-01	**Hypothetical 1999-01**	**Difference**
	General Fund Appropriations	Pre-1995 Residual Spending Patterns	Actual vs. Hypothetical
Children's and Juvenile Programs	$617.8	$530.0	$87.8
Corrections	980.4	1,069.5	(89.1)
Developmental Disabilities	529.4	595.8	(66.4)
Debt Service & Pension Funding	1,158.6	1,273.5	**(114.9)**
Economic Development	160.5	189.9	(29.4)
General Government	497.3	483.3	14.0
Higher Education – 2 Year	942.2	874.7	67.5
Higher Education – 4 Year	1,596.6	1,382.5	214.1
Health Care – General	1,663.1	2,026.6	**(363.5)**
Health Care – Social	562.8	410.8	152.0
K-12 Education – General	8,333.1	9,093.1	**(760.0)**
K-12 Education – Special	1,148.1	1,355.5	**(207.4)**
Long Term Care	952.7	929.6	23.1
Miscellaneous	32.2	2.7	29.5
Natural Resources	286.5	355.2	(68.7)
Social Services Administration	115.5	97.0	18.5
Transportation	44.8	6.0	38.8
Welfare	912.2	1,276.6	**(364.4)**
Workforce Training	41.9	29.1	12.8
Total	**$20,575.8**	**$21,981.4**	**$(1,405.3)**

In absolute terms, budgets have continued to grow each year under I-601. Thus, the differences highlighted in the table are not absolute reductions in expenditures. The differences result from a comparison of the actual 1999-01 General Fund budget with an imagined budget created using pre-601 Residual spending rates and contemporary inflation and population growth.

For the **General Fund** budget, actual 1999-01 appropriations were significantly smaller than what would have been expected based on pre-601 spending trends in four areas: Welfare, K-12 Education (both General and Special), Health Care (General), and Debt and Pension Funding. [9] Again, it is important to emphasize that these are not absolute reductions in spending, but less spending in relation to a hypothetical budget based on pre-601 spending trends.

The **$364 million** difference in the **Welfare** category reflects changes in policies affecting eligibility as well as new work incentives and work requirements for clients. This new approach to public assistance resulted in a large decline in caseloads – that is, spending growth due to policy and utilization fell dramatically.

The **$363 million** difference in Residual spending on **Health Care (General**) represents, in part, a drop in medical services inflation ("special inflation") and the effects of "managed care" practices. However, it also reflects the decision to fund expanded health care services for children and working families outside the General Fund – in the Health Services Account — using new revenues not subject to I-601. About $165 million derived from the states' legal settlement with tobacco manufacturers is being used to fund Health Services Account programs in the 1999-01 Biennium.

The **$115 million** difference in Residual spending in the combined **Debt Service and Pension Funding** category is primarily related to a reduction in appropriations needed to support employee benefits in the state employee retirement system. Lower appropriations were made possible by higher than expected earnings from pension fund investments. For the 1999-01 Biennium lower state agency contribution rates actually saved **$361 million** in General Fund costs.

The **$207 million** difference in Residual spending for **K-12 Education (Special)** is due mainly to a slow-down in enrollment growth in special ('handicapped") education programs. After explosive growth in the 1980s and early 1990s, and perceptions that many children were being categorized inappropriately, changes in funding formulas adopted in the 1993-95 Biennium resulted in a rapid deceleration of enrollment and expenditure growth in this area. This, again, is a clear example of a change in policy and utilization. The policy change was both a response to the economic slow down and a preparation for the constraints of I-601.

The largest absolute dollar difference in Residual spending — **$760 million** — occurred in **K-12 Education (General).** This difference appears related to both an overall slowdown in salary growth for state employees, including teachers and other K-12 staff, as well as a reduction in the level of state pension fund contributions required to maintain actuarially approved fund balances. Salaries and benefits represent about 80% of General Fund costs in K-12 Education. Even a very small slow down in per-teacher salary growth or required state pension contributions can have a very large impact on aggregate spending. The slowdown in salary growth for state employees also contributes to the differences in Residual spending in nearly all of the budget categories.

State employee salary growth has slowed down, but a gap between public and private sector salaries has also begun to emerge. Covering years for which comparable data are available, private sector wages (in real inflation adjusted terms) grew much more rapidly than state government wages between 1995 and 1999, a reversal of the trend from the 1980s. A large part of the rapid growth in private sector wages since FY 1995 is due to the inclusion of

Trends in Real Average Wages

Annual Average Growth	1982-1989	1989-1995	1995-1999
Private Sector	-1.22%	0.66%	5.34%
State Government (excluding K-12)	0.92%	0.01%	1.24%
K-12 Education	-0.88%	-0.46%	-0.50%

Source: OFM

income from exercised stock options in employee wage data. However, private sector wage growth has still been much stronger than wage growth in the public sector during this period, even when the data are adjusted for stock options.[10] See **Table 7.**

Although the I-601 formula does not directly limit growth in salaries, it makes it harder for public sector wages to grow faster than inflation. The I-601 formula holds overall growth in government spending below general economic growth. In the long run, in order for average wages in state government to keep pace with private sector wages (which have recently resumed rising in pace with the general economy), savings and efficiencies have to be achieved in other areas of the state budget. Some government services must either be reduced or provided more efficiently (e.g., fewer employees providing the same level of service) in order for average wages in state government to keep pace with private sector wages in the long run.

In two areas of the budget, Higher Education (Four Year) and Health Care (Social), actual 1999-01 appropriations were significantly larger than what would have been expected based on pre-601 spending trends.

In **four year Higher Education**, the large positive difference in Residual spending ($214 million) is due mainly to the fact that in the six years before I-601, spending in this area grew at a slightly slower pace than inflation and college age population growth. However, since FY 1995, expenditures for four year higher education have grown about two percent per year faster than inflation and population growth. (These data exclude tuition expenditures for the entire FY 1989 to FY 2001. period).

The positive difference in Residual spending for higher education is also based on special factors affecting their pension system. As a result, higher education budgets did not fully benefit from lower state pension contribution requirements.

The **In Health Care – Social** (which includes mainly Mental Health programs), the large increase in Residual spending is apparently due to changes in mandatory treatment requirements for sex offenders and other convicted criminals.

7. Effects on Taxes, Revenues, and Reserves

Beginning with the 1994 legislative session, a series of tax cuts, revenue transfers, and deposits into the I-601 rainy day account — the Emergency Reserve Fund — have removed $2.9 billion in revenue from the General Fund that might otherwise have been available for spending in the 1999-01 Biennium. Some of these revenues, however, were spent outside the General Fund.

As the accompanying pie chart (Figure 10) shows, nearly two thirds of this revenue (or about $1.8 billion) was returned in the form of tax cuts or exemptions; about 17 percent (or almost $500 million) was transferred to other accounts (where it is dedicated to transportation, criminal justice, health care, flood control, and other functions);[11] and about 20 percent (or nearly $600 million) was

TABLE 8

General Fund Tax Changes, 1993 through 1999 Legislative Sessions

	General Fund Taxes	1994	1995	1996	1997	1998	1999	2000	2001	TOTAL
1993 Session	B&O Rate Increase on Services	156.0	174.3	183.5	193.3	203.6	214.5	226.0	238.0	1,589
	Sales Tax on Personal Service	44.9	50.7	53.1	55.8	58.6	61.5	64.6	67.8	457
	Temporary B&O Surtax	50.3	56.0	58.1	60.3	0.0	0.0	0.0	0.0	225
	HMO/HCSC Premiums tax	32.3	66.9	41.6	0.0	0.0	0.0	0.0	0.0	141
	REET (conveyances)	10.0	11.0	11.6	12.1	12.7	13.4	14.0	14.7	100
	Public Utility Tax (repeal deduction)	9.3	9.9	10.4	10.9	11.5	12.0	12.6	13.3	90
	Repeal credit for Insur. Guarantee Assocs.	0.0	5.4	5.7	6.0	6.3	6.6	6.9	7.2	44
	Homes for the retarded (IMR tax)	(15.4)	(15.4)	(16.2)	(17.0)	(17.9)	(18.7)	(19.7)	(20.7)	(141)
	Other Reductions	(16.4)	(30.5)	(32.0)	(36.7)	(35.3)	(37.0)	(38.9)	(40.8)	(268)
1994 Session	Hi Tech tax incentives	0	(10)	(33)	(36)	(38)	(39)	(41)	(44)	(240)
	Distressed Area exemption	0	(12)	(17)	(18)	(18)	(19)	(20)	(21)	(126)
	Temporary B&O Surtax Reduction	0	(8)	(20)	(20)	(2)	0	0	0	(50)
	Small Business Tax Reduction	0	(18)	(20)	(20)	(21)	(22)	(23)	(24)	(149)
	Other Reductions	(0)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(20)
1995 Session	Manufacturing Tax Exemption	0	0	(67)	(82)	(86)	(90)	(95)	(99)	(519)
	One time Property Tax relief	0	0	(30)	(24)	0	0	0	0	(54)
	Misc. Sales Tax Exemptions	0	0	(6)	(7)	(7)	(7)	(8)	(8)	(43)
	Misc. B&O reductions	0	0	(7)	(8)	(8)	(9)	(9)	(10)	(50)
1996 Session	B&O Rate Decrease on Services (roll back)	0	0	(34)	(98)	(103)	(108)	(113)	(119)	(576)
	Repair and Replacement	0	0	0	(20)	(21)	(22)	(23)	(24)	(108)
	R&D Equipment	0	0	0	(12)	(13)	(14)	(14)	(15)	(69)
	Other Reductions	0	0	0	(11)	(12)	(12)	(13)	(13)	(61)
1997 Session	Property Tax Reduction (Ref. 47)	0	0	0	0	(59)	(136)	(189)	(238)	(621)
	Continue 4.7% cut (HB1417)				(32)	(26)				(59)
	B&O Rate Decrease on Services (roll back)	0	0	0	0	0	(94)	(115)	(124)	(333)
	Other Reductions	0	0	0	0	(12)	(21)	(22)	(23)	(77)
1998 Session	MVET tax cut only (Ref. 49)	0	0	0	0	0	0	(126)	(131)	(257)
	Other Reductions	0	0	0	0	0	(25)	(35)	(36)	(96)
1999 Session	Rural County Incentives							(8)	(12)	(20)
	Other Changes							1	(6)	(5)
1994-1999	**Annual Total**	(0)	(50)	(236)	(391)	(428)	(621)	(856)	(951)	(3,533)
	Biennial Total		**(51)**		**(626)**		**(1,050)**		**(1,807)**	
1993-1999	**Annual Total**	271	278	80	(106)	(189)	(369)	(590)	(671)	(1,297)
	Biennial Total		**549**		**(26)**		**(558)**		**(1,262)**	

Sources: OFM and Senate Ways and Means Committee

deposited in the 601 rainy day fund. Referendum 49, passed by voters in November 1998, was responsible for almost half of the revenue transfers and for 14 percent of tax cuts affecting 1999-01 General Fund revenue.

When tax increases passed in the 1993 legislative session, mainly affecting businesses, are taken into account, the net reduction affecting 1999-01 taxes is $1.3 billion (rather than $1.8 billion). **Table 8** documents all of the tax changes beginning with the 1993 legislative session.

Tax Reductions

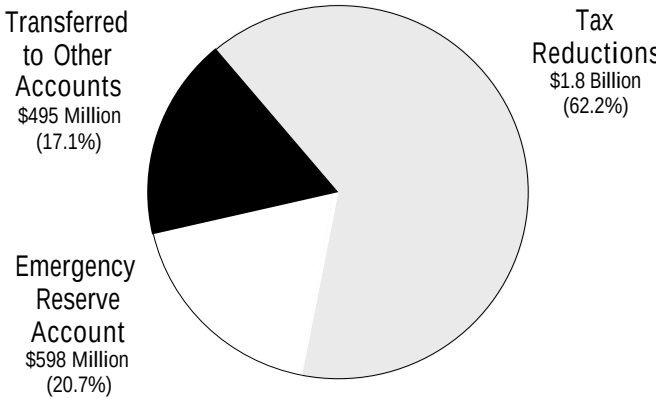
The series of tax reductions and revenue transfers passed beginning in 1994 had the effect of reducing General Fund revenues to approximately the level of the I-601 spending limit for each of the three biennial budget periods subject to I-601. Thus far, revenues, after tax changes, have exceeded the spending limit in only the 1997-99 Biennium. See **Figure 11.**

Since some of the business taxes raised in the 1993 legislative session were characterized as "temporary," to help state government through a period of slow economic growth, a portion of the $1.8 billion reduction in General Fund taxes would have likely taken place even without the

FIGURE 10

$2.9 billion of unspent General Fund revenues has been returned in the form of tax cuts, transferred to other accounts, or deposited in the rainy day fund

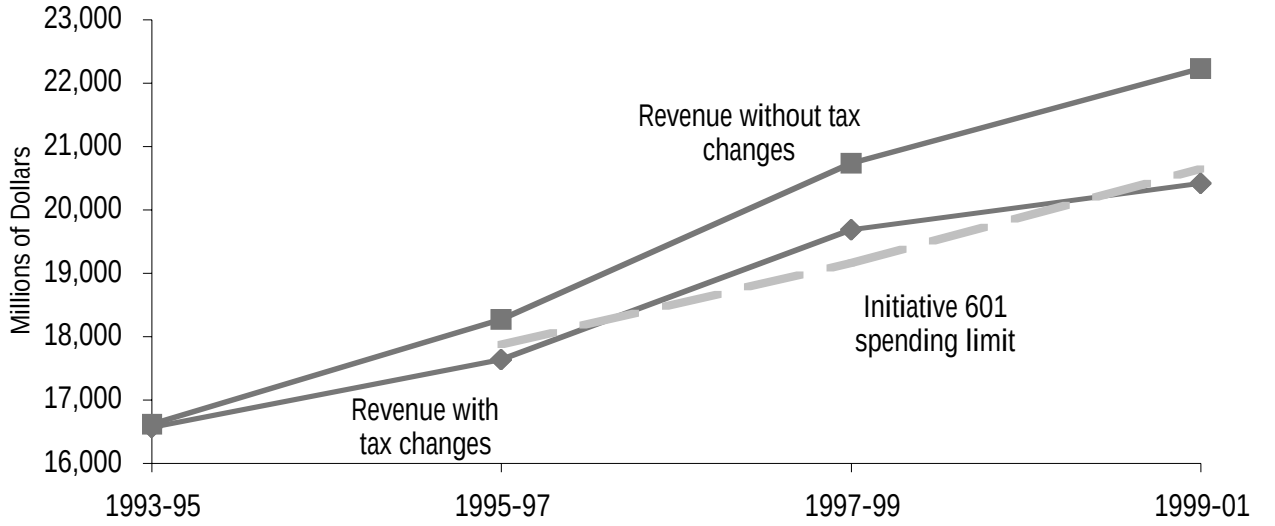
Expressed in terms of 1999-2001 Biennium Impact



Source: OFM

FIGURE 11

Tax reductions passed beginning in 1994 had the effect of reducing General Fund revenues to approximately the Initiative 601 spending limit



Source: OFM

surpluses made possible by I-601. Most of the Business and Occupations (B&O) tax increase on services passed in the 1993 session was rolled back in the 1996 and 1997 legislative sessions, reducing taxes in the 1999-01 Biennium by about $470 million.

As discussed earlier, a continuation of pre 601 spending trends would have added $1.4 billion to the 1999-01 Biennium General Fund budget. If tax cuts affecting the biennium totaled $1.8 billion, there would still have been room to roll back most of the 1993 B&O tax increase on services or to reduce state property tax growth by nearly the same amount as in Referendum 47.[12] However, both reductions would not have been possible under the higher spending scenario. Still, tax reductions beginning in 1994 have far exceeded the 1993 tax increases that were characterized as "temporary."

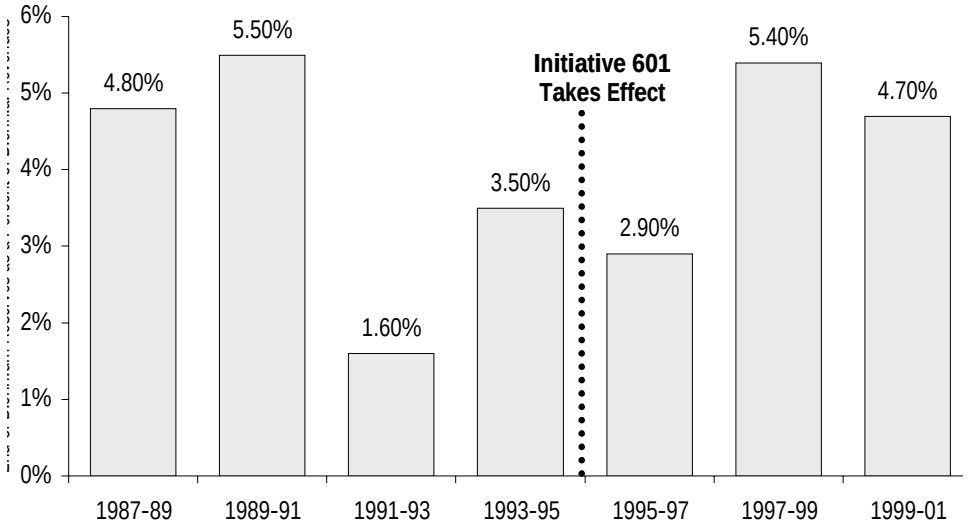
It is, of course, unclear whether I-601 is the main cause of the large tax reductions adopted since the Initiative took effect in FY 1995. Although adherence to the I-601 growth formula resulted in a large amount of revenue that could not be spent under the Initiative, I-601 itself does not require tax reductions, nor does it require the return of surplus revenue to taxpayers.
Although I-601 discourages tax increases by requiring a two-thirds legislative majority to raise revenues, provisions dealing with reserves appear to assume that unspent revenues will accumulate in an Emergency Reserve Fund. Under the terms of the Initiative, once revenues in the reserve are more than five percent of total biennial revenues, the excess would automatically spill over into a new fund to support education construction projects.

The series of tax reductions and revenue transfers beginning in FY 1994 have limited growth in the Emergency Reserve Fund. The amount currently in the fund ($600 million) is about $400 million below the five percent threshold for spill over into the education construction fund.

Compliance with I-601 yielded a large amount of unspent revenue. However, the policies adopted by Legislatures, Governors, and the public (through Referendum 47 and Referendum 49) beginning in 1994 – rather than the requirements of the Initiative itself – made the choice of how exactly to allocate unspent revenue between tax cuts and reserves. Indeed, because of tax cuts (and revenue transfers) the size of budgetary reserves at the conclusion of budget periods has not changed significantly since I-601 took effect.[13] (See **Figure 12**).

FIGURE 12

Because of tax cuts and revenue transfers, end of biennium General Fund reserve levels have not changed significantly under Initiative 601



Source: OFM

Distribution of Tax Increases and Cuts

In terms of initial incidence[14], about three-quarters of the taxes raised in the 1993 Legislative session fell directly on businesses, mainly in the form of an increase in the B&O tax on legal, management and other services provided by businesses to other businesses. Most of these B&O tax increases on services were eventually rolled back.

Again, in terms of initial incidence, almost 70 percent of the tax reductions adopted in the 1994 through 1999 Legislative sessions (including Referendum 47 and Referendum 49[15]), applied directly to business; the remaining 30 percent to households.

The picture changes somewhat when net tax changes, beginning with actions in the 1993 legislative session, are considered. From this perspective, about 55 percent of net tax reductions affected businesses (in terms of initial incidence), while 45 percent applied to households. Nearly all of the tax reductions directly affecting households were part of the property tax reductions passed by public vote in Referendum 47 and the Motor Vehicle Excise Tax (MVET) reductions adopted by voters in Referendum 49.

About two-thirds of the business cuts passed in the 1994 through 1999 legislative sessions were general tax reductions meant to reduce overall tax burden; the remaining one-third were targeted incentives, designed to spur investments and job creation.

Effect on Productivity of the Tax System

Because they affected two of the fastest growing revenue sources, the tax reductions passed since 1994 will reduce the long term "productivity" of the state's tax system. Productivity refers to how fast revenues grow relative to income growth. Revenue elasticity is a common measure of productivity. If revenues grow at the same rate as personal income, elasticity is said to be 1.0; if revenues grow 20 percent slower or 20 percent faster than income, elasticity is 0.8 and 1.2, respectively.

Voter approved Referendum 47 slowed growth in one of the fastest growing sources of General Fund revenue, the state property tax. Referendum 49 eliminated from the General Fund another rapidly growing revenue stream, the motor vehicle excise tax (MVET).

These decisions will likely make the General Fund tax system less productive in the future. Long term Elasticity is expected to decline from 0.99 (elasticity for the FY 1988 to FY 1998 period) to about 0.92, a reduction of .07. By the 2003-05 Biennium, an elasticity reduction of .07 would lower revenues by over $400 million compared with the tax structure in place before Referendums 47 and 49. The official state revenue forecast already reflects the changes in the composition of General Fund taxes

As mentioned earlier, revenues, in the long run are expected to grow about 1.0 percentage point per year faster than the I-601 spending limit. This was based on a 0.90 elasticity assumption. Total General Fund elasticity would have to fall to about 0.70 for this "structural surplus" under I-601 to disappear entirely.

8. Size of Government

An implicit feature of the I-601 formula is that state government will shrink as a share of the general economy. The size of state government, measured by expenditures as a share of total state personal income, has, indeed, been reduced since I-601 took effect.

State General Fund expenditures as a percent of total personal income has fallen from 6.8 percent in FY 1995 to 5.9 percent in FY 1999. When all state appropriated funds are considered, spending as a share of personal income falls from 8.1 percent in FY 1995 to 7.0 percent in FY 2001 — a decline of about 13 percent. See **Figure 13.**

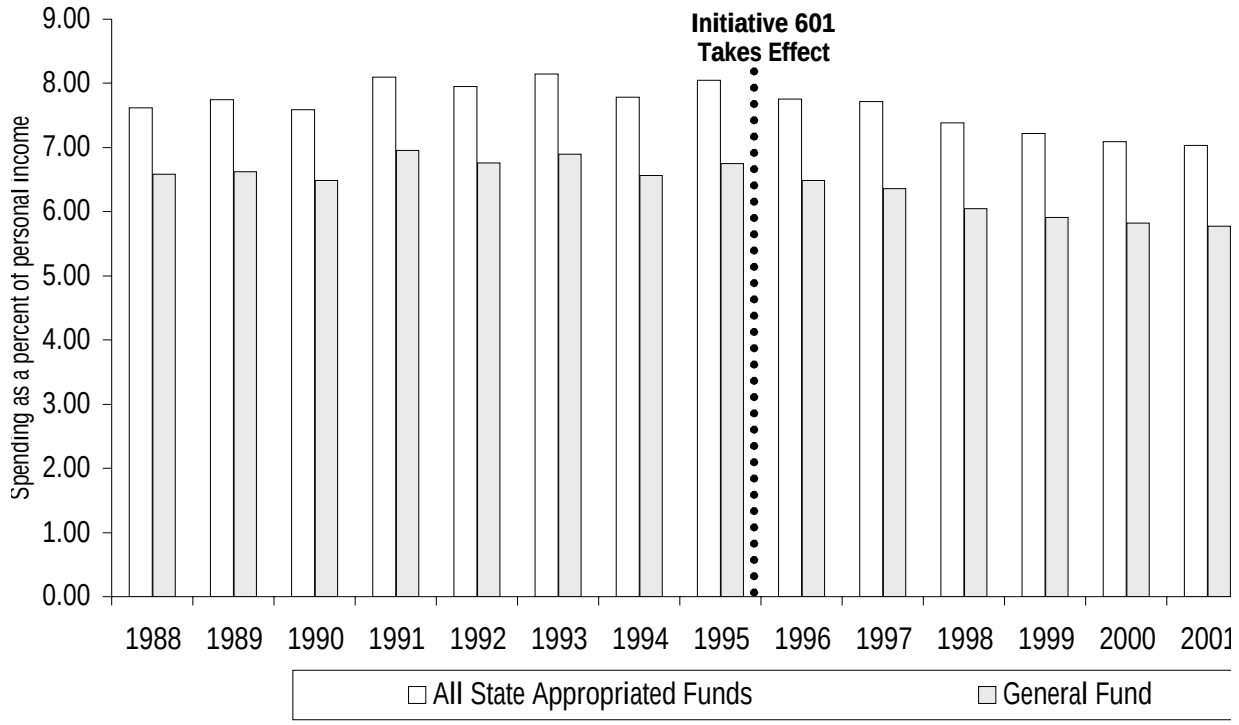
The level of public employment also is a useful measure of the size of government. According to the Bureau of the Census, between 1993 and 1998, Washington ranked 42nd among the 50 states in terms of growth of public (state and local government) employees, despite above average population growth. As of March 1998, Washington state was 38th in the country in state and local government employment, with 520 public employees per 10,000 of population. Data are not yet available to determine whether these rankings have changed based on recently adopted budgets.

Whether it is beneficial or harmful for state government to shrink as a share of the state economy depends on one's view of the "optimum size" of government. This involves balancing the need to fund "public goods" and address "market failures" against the efficiencies of allowing private individuals and businesses to make a larger share of society's spending decisions.

Whether or not it is good to reduce the size of government relative to the economy also hinges on whether the goods and services provided by

FIGURE 13

State spending as a percentage of total state personal income has declined since Initiative 601 took effect in Fiscal Year 1996.



Source: BEA and OFM

government are ones that people normally would buy more of if their incomes increased. If allowed to make the buying decisions individually, would citizens buy more education, fire protection, or general social services when their incomes increase, or would they choose to spend their money on other goods and services?

9. Fiscal Outlook

As intended by its supporters, I-601 has clearly imposed constraints on state government spending. The ability of state government to respond to demands on services under the I-601 formula in the future will depend on a number of factors, many of which are beyond the control of policy-makers.

The Limit and the 2001-03 Budget

The estimate for the 1999-01 Biennium spending limit, as updated in June 1999, is $20.651 billion.[16] (The limit will be adjusted again in November 1999). If actual spending in the Biennium ultimately equals the expenditure limit, the limit for the 2001-03 Biennium will be about $21.8 billion. On a fiscal year basis, this represents annual growth of about 2.5 percent per year. Contemporary inflation and population growth, on the other hand, is expected to average about 3.5 percent per cent per year. Until now, lags in the application of fiscal growth factors under the I-601 formula have allowed spending to grow faster than contemporary inflation and population growth. This is expected to change after FY 2001.

Consistent with this expectation, preliminary projections by the Office of Financial Management of the cost of maintaining current General Fund programs in the 2001-03 Biennium and providing cost of living adjustments (COLAs) for state employees and teachers exceed the projected $21.8 billion spending limit. COLAs, however, are not required by law.

Unless actual inflation next biennium is lower than forecasted levels, one of the challenges for the 2001-03 Biennial budget will be responding to expectations for COLAs within a spending limit based on exceptionally low inflation rates of the late 1990s. See **Figure 7**. Inflation forecasts by mainstream economists over the past several years, however, have been consistently above actual rates of inflation.

Although it appears I-601 can accommodate demographic pressures in the years ahead, inflationary and other cost pressures affecting about twelve percent of the budget spent on Health Care are likely to exceed the I-601 inflation factor. Reduced medical services inflation and the introduction of "managed care" practices helped slow down spending growth in Health Care during the FY 1995 to FY 1999 period. The 1999-01 Biennium budget, however, already reflects an increase in special inflation (as measured by the implicit price deflator for medical services) and the diminishing effect of managed care on growth in health care spending.

Revenues Above the Limit

Based on the September 1999 official state revenue forecast, revenue collected in the 1999-01 Biennium is expected to fall about $140 million below the spending limit. (This figure does not include monies held in reserve). Barring a significant economic slowdown or recession within the next several years, and without further tax cuts, General Fund revenues should again exceed the I-601 spending limit in the 2001-03 Biennium.

Assuming "average economic growth," revenues are expected to exceed the spending limit by about $250 million in the 2001-03 Biennium, and by nearly $1 billion in the 2003-05 Biennium.[17] However, state revenue growth is highly sensitive to economic conditions. Under a relatively mild recession scenario for the 2001-03 Biennium, revenue would fall as much as $500 million below the spending limit in FY 2003, and would not rise above the limit again until FY 2005.

Productivity in the General Economy

Whether the recent gains in productivity nationally signal a new era of strong economic growth, or just a temporary surge, has significant implications for how state government functions under I-601. The

size of productivity gains will determine the gap between the spending limit and revenues, the amounts flowing into reserves, and the capacity for future tax cuts. And, if private sector wages capture these productivity gains, the recent gap that has emerged between public and private sector wages could widen.

Stronger productivity in the private economy, however, would also improve economic growth and reduce pressure on government services. And, it would imply that some of the factors behind private sector productivity gains – such as investment in computer, internet, and telecommunications technology and emphasis on performance and quality – can also improve productivity in state government services.

Demographic Pressures

Primarily because of slow growth in the age 5-17 school population, overall demographic pressures on the General Fund are not likely to exceed the rate of general population growth. In both the medium term (FY 1999 to FY 2005) and longer term (FY 1999 to FY 2011), almost 60 percent of the General Fund budget — including K-12 Education, Children's and Juvenile programs, Corrections, and Welfare — will be subject to relatively slow population growth, below the rate of total population growth. A little under 20 percent of the budget, including Higher Education and Long Term Care, will face relatively strong population pressures – above the rate of general population growth. The populations associated with the remaining 25 percent of the budget are expected to grow at an approximately average rate. Population pressures, however, are not necessarily the same as caseload pressures. Policy and utilization factors can cause caseloads to rise faster or slower than the underlying populations.

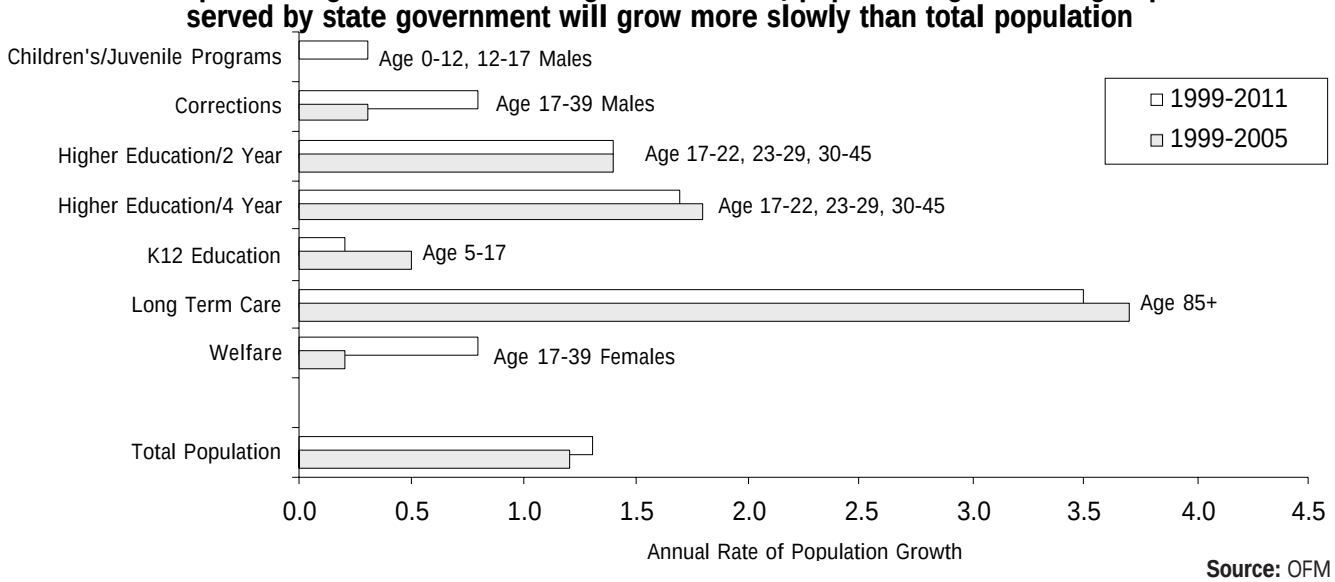
Savings and Balancers

The earlier comparison between actual appropriations in the 1999-01 Biennium and what the budget would have been if pre-601 spending trends continued, suggested that at least five factors have helped spending growth stay within the constraints of I-601:

- Welfare reform, which substantially reduced caseload growth in the state's public assistance programs.
- A reduction in medical services inflation and other cost savings in health care due to the introduction of managed care practices.

FIGURE 14

Except for Long Term Care and Higher Education, population growth for groups served by state government will grow more slowly than total population



Source: OFM

- A slowdown in salary growth for state employees (through at least the 1997-99 Biennium).

- Additional, unexpected revenues (the "tobacco settlement") which helped fund health care programs outside the General Fund.

- A favorable investment climate which (at least temporarily) reduced required public contributions to state pension funds.

The outlook for state finances depends heavily on whether these or similar factors which helped accommodate I-601 constraints can be maintained or replicated in the future, or whether new "balancers" or "savings" can be found.

It is also likely that some gains in state government productivity (not to be confused with productivity gains in the general economy) have acted as a budget balancer over the past several years, slowing down growth in spending without necessarily affecting services. Productivity gains will be a key factor in how the state handles budgetary challenges under I-601 in the future.

As in the case of private sector firms that provide services, state government has looked to technology to slow down growth in labor costs. Productivity gains have apparently been realized in the provision of fairly routine state services, such as tax collections, check distributions, and some public information activities.

However, there are limits to productivity gains in state government. Conventional measures of productivity imply higher ratios of students to teachers or children to caseworkers, an outcome that would likely be unacceptable to most parents of students and public officials.

Potential Impact of I-695

The state's capacity to budget under I-601 will also be affected by any new or unexpected budget pressures that arise, whether induced by legal or federal actions or by voter initiatives, as in Initiative 695.

I-695 would eliminate the state's Motor Vehicle Excise Tax (MVET) which presently supports numerous state and local non General Fund programs, including transportation, transit, criminal justice, and public health services. At the time of this writing, almost two weeks remain before the November 2nd election which will determine whether the Initiative passes.

The passage of I-695 would result in the loss of $1.1 billion in revenues during the current biennium and $1.7 billion in the 2001-03 Biennium. Although the General Fund is under no obligation to back fill any of these losses, local governments, transit authorities, and supporters of transportation projects will expect at least some relief from the state General Fund surpluses.

Current surpluses are ot two kinds — restricted and unrestricted reserves. Of the one billion total, about $600 million are revenues collected above the I-601 spending limit in the 1997-99 Biennium. By law, these revenues are placed in the Emergency Reserve Fund (the restricted reserve), which can only be spent with a two-thirds vote of the Legislature and only within the current spending limit. The remaining $400 million in unrestricted reserves are primarily revenues that were carried forward from the 1993-95 Biennium before I-601 was in effect and can be spent with a simple majority vote so long as total expenditures do not exceed the spending limit.

Even without restrictions on how much could be spent, it is unlikely that the General Fund will have the capacity to replace revenues lost from I-695 on a continuing basis. Under a scenario of average economic growth,[18] revenues collected above the I-601 spending limit would not be sufficient to replace revenue losses under I-695 in the foreseeable future. Annual surpluses are projected to fall below annual revenue losses for about a decade, until fiscal year FY 2009. Revenues are expected to be about $250 million above the I-601

spending limit in the 2001-03 Biennium, and about $1 billion higher than I-601 in the 2003-05 Biennium. Revenue losses from I-695 for these two budget periods are expected to be about $1.7 billion and $1.9 billion respectively.

Thus, if the Legislature were to rely on revenues above the spending limit to back fill losses under I-695, the shortfall would be about $1.4 billion in 2001-03 and $900 million in 2003-05. Barring larger annual surpluses, spending reductions of these amounts — below the I-601 spending limit — would have to be made in General Fund programs to replace revenues lost under I-695.

10. Tax and Expenditure Limitations: The Experience of Other States

Twenty seven states currently apply some form of tax or expenditure limitation (TEL) to state government, using a variety of methods to restrict public finances. In comparison, the provisions of Initiative 601 are relatively unique and strict, but some basic lessons can still be learned from the experience of other states. Most states, like Washington, limit expenditures, but five states constrain tax collections. Most state limitations are codified in statute, but one (Florida) took the form of a constitutional amendment, and others are tied to constitutional balanced budget provisions.

The First Wave – Late 1970s and Early 1980s

In 1978 California voters enacted **Proposition 13**, resulting in substantial property tax reductions and placing a supermajority approval requirement on any state tax increase. In the following years, a dozen other states experienced similar "taxpayer revolts," including Washington state, with passage of **Initiative 62** in 1979. Nearly all of these measures were driven by concerns about property tax levels, which were in turn driven by the economic dynamics of stagflation. Indeed, most analysts have found that high inflation in this period, coupled with economic dislocation, motivated this movement.[19]

Many of these tax limitations remain in force today, but none had the impact anticipated at the time of passage. The most stringent limits have been supplanted, and looser restrictions have remained on the books, but with little meaningful impact. In this regard, Washington's experience is typical: Initiative 62 placed a ceiling on tax collections tied to personal income, but provided no real constraint on state revenue policy. Use of lagged economic indicators captured high inflation in the late 1970s and early 1980s as price levels. Coupled with the 1981-83 recession, which severely reduced actual revenue collections in Washington, the gap between the revenue cap and actual revenues was large enough from the start to never be a factor in the budget process. Alaska's 1982 spending limit was similarly ineffective in tying spending to oil revenues.[20]

In other states, measures that placed significant limits on government were often bypassed. In California, for example, local government revenue restrictions were skirted as state government assumed a larger share of the cost of public services during the 1980s. It was not until the early 1990s when repeated budget shortfalls led the state to shift costs back tolocals, that Proposition 13 truly impacted local governments (with Orange County the most prominent example).[21] **Proposition 2 1/2**, approved by Massachusetts voters in 1980, brought about much the same result.[22]

The Second Wave -- Early 1990s

Inflation and recession brought a second movement of tax rollback and fiscal limitations in the early 1990s. **Measure 5**, approved by Oregon voters in 1990, limited growth in property taxes. Its main impact has been to increase income tax rates and shift responsibility for funding many programs from local government to the state.[23] The limit also requires tax refunds if actual revenue collections exceed the revenue forecast by more than 2 percent.

The Oregon measure, phased in over five years, inspired two other limits contemporary to Initiative 601. Colorado's 1992 Taxpayer's Bill of Rights, or TABOR amendment to the state constitution,

marked a renewed effort to limit revenue growth. Among the mechanisms employed were rebasing of the revenue cap formula to what was collected the previous year, with growth limited to inflation rather than income, coupled with an Oregon type tax refund that has occurred in each of the past four years. In 1993, a Florida constitutional amendment implemented constraints on taxation, tied to personal income, but with a similar rebasing provision.[24] Initiative 601 is at this time the only limitation to apply to expenditures, constrain growth below personal income (inflation and population), and employ a rebasing mechanism.

The 1990s brought some variation. Maryland officials, without any statutory or constitutional tax or expenditure limitation, have advocated "spending affordability." Rather than using a formula, a legislative committee considers the appropriate level of government expenditure for the coming budget year, with the long term objective of keeping government from growing any faster than the state economy as a whole. This expenditure ceiling is then transmitted to the governor, who must merely provide a written explanation for exceeding it. As a practical matter, however, the limit has rarely been exceeded, and the growth of government in Maryland has been reduced.

Longer Term Impact of Fiscal Limitations

Fiscal constraints enacted in the late 1970s and early 1980s have been the subject of considerable analysis. Most research has shown that this generation of tax and expenditure limitations has not effectively stopped growth in the size of government. State governments have proven remarkably inventive in finding ways around such limitations. Limitations intended to restrict growth in government spending growth in personal income have been circumvented through growth in non-constrained state funds, or through revenue and cost shifts to local governments.[25] While there is general agreement that fiscal constraints have not significantly slowed the growth in state government expenditures, to the extent such limits have had an impact, it has been in the first five years after adoption.[26]

With only limited data available, it is too early to assess Initiative 601 and its contemporaries. While it is equally clear that this second of generation of fiscal constraints, particularly in Washington and Colorado, provide the most stringent limitations adopted to date, they do not completely preclude limit circumvention. In Washington state, for example, increased spending in non-constrained budgets is outpacing spending in the constrained general fund, but it is unclear whether this marks a significant departure from pre-Initiative 601 spending trends.

Likewise, the use of tax expenditures — re-direction of general tax revenues to provide targeted tax relief and exemptions — have characterized many states with limitations.[27] Washington state adopted several targeted reductions along with large general tax reductions, reducing revenues to the approximate level of permissible spending. Colorado has adopted large tax reductions in the face of provisions that require a refund to taxpayers of excess revenues. It is not clear, however, that this represents a particular change from pre-constraint tax actions.

Appendix: Functional Area Categories

Program Area	Comment
Children's and Juvenile Programs	Includes DSHS Children's and Juvenile Rehabilitation programs.
Corrections	Corrections includes primarily prison inmate costs.
Developmental Disabilities	DSHS Division of Developmental Disabilities costs.
Debt Service and Pension Funding	Includes debt service on bonds issued to support capital projects and appropriations for LEOFF and 2 smaller retirement systems.
Economic Development	Includes CTED and Agriculture.
General Government	Includes, Legislature, Governor's office, Judicial functions, Office of Financial Management, Department of Revenue, General Administration and other agencies.
Higher Education – 2 Year System	Includes community and technical colleges.
Higher Education – 4 Year System	Includes mainly the 6 four-year colleges and the HECB.
Health Care – General	Includes medical assistance, BHP, and DOH costs.
Health Care – Social	Includes mental health, alcohol and substance abuse programs.
K-12 Education – General	K-12 Education – General (mostly general apportionment and levy equalization).
K-12 Education – Special	K-12 Education – Special (mostly handicapped and bilingual programs).
Long Term Care	Long Term Care includes state nursing home costs.
Natural Resources	Includes DNR, Ecology, Fish & Wildlife and other natural resource agencies.
Social Services Administration	Includes mostly DSHS administrative costs.
Transportation	Includes mainly Department of Transportation and State Patrol.
Public Assistance/Welfare	Includes DSHS Economic Services.
Workforce	Includes ESD, Vocational Rehabilitation L&I, and Workforce Training Board.

Endnotes

[1] Strictly speaking, the third component of growth is "real per capita income."

[2] In a sense the term "Residual" is misleading since, from the standpoint of budget writing, much more attention is devoted to the Residual than to the relatively uncontrollable factors of inflation and population change. The components of expenditure growth can, indeed, be arrayed by the degree of control which policy makers exert over each. Clearly, population growth and general inflation are much less subject to control than policy change, with utilization and special inflation somewhere in-between on this continuum.

The residual also includes the effects of productivity – how efficiently the service is being provided by the government. Unfortunately, productivity is the most difficult of all the residual factors to measure or document. As a consequence, the present study essentially passes on this issue, accepting the general view of public finance economists that productivity in the government sector has probably increase slowly in the 1980s and early 1990s, as did productivity in the service sector of the private economy. This implies that in general, it is reasonable to assume that the residual is comprised mainly of policy and utilization factors and special inflation. Because productivity gain has a negative effect on budget pressures, the failure to quantify productivity means that the effects of policy, utilization, and special inflation are probably slightly understated.

[3] Because the spending limit is adjusted for program cost shifts and money transfers and is re-based to actual spending, application of the fiscal growth factors alone will not result in the limits shown in the first column of Table 2.

[4] Recall, however, that even without the lag between the fiscal growth factors and actual budget pressures, the specific inflationary and population pressures affecting the budget are not necessarily the same as general inflation and total population growth.

[5] The spending limit does not need to be reduced when "new programs," ones that were never part of the General Fund base, are funded outside the General Fund.

[6] Appropriation data for the 1999-01 Biennium, however, still does not fully reflect the shift of $156 million in General Fund revenues to the Motor Vehicle Account under Referendum 49 to support transportation projects.

[7] Asking what spending would have been had pre 601 trends continued should not impart any special or normative status to these trends – i.e., there is no assumption that these trends "should have" continued, only that without an intervention, such as a voter approved initiative, the recent past in budgeting is generally a good predictor of the near future.

[8] The hypothetical budgets for 1990-01 use FY 1995 as the base, grow each area by current inflation and population pressures, and then add the Residual growth factors of the pre-601 period. The hypothetical budgets basically represent what spending would have been in the 1999-01 Biennium had the policy and other relatively discretionary elements of the pre-601 budgets been carried forward.

[9] This category includes debt service on capital projects and specific appropriations to Law Enforcement Officers and Fire Fighters (LEOFF) pension fund and to two other smaller employee retirement pension funds.

[10] Another data source – the U.S. Bureau of the Census – corroborates the slowdown in Washington public sector wage growth. Between 1993 and 1998, average wages for Washington state and local government employees rose 6.4 percent; however the U.S. average was 16.9 percent.

[11] Besides cutting motor vehicle excise taxes, Referendum 49 also shifted $156 million in General Fund revenues beginning in the 1999-01 Biennium from the General Fund to the Motor Vehicle Fund to pay for transportation projects. Another $66 million was transferred to local criminal justice funds, mostly to compensate these funds for revenues lost due to the reduction in the MVET.

[12] Referendum 47, approved by voters in November 1997, reduced allowable state total property tax growth from six percent to the rate of inflation.

[13] Counting both non-obligated General Fund revenues as well as monies deposited in the Emergency Reserve Fund or in the defunct Budget Stabilization Account, end-of-biennium reserves under I-601 have been 4.3 percent of biennial General Fund revenue, compared with 3.9 percent before I-601. (see Figure 12).

[14] The "initial incidence" of a tax obligation refers to the person that is legally responsible for paying the tax. Taxpayers, such as businesses, often pass on tax increases or reductions to consumers.

[15] Referendum 49, approved by voters in November 1998, reduced Motor Vehicle Excise taxes by $30 per vehicle and transferred remaining General fund MVET revenues to accounts supporting transportation projects and local criminal justice programs.

[16] This does not include adjustments for fund shifts that may be adopted in any supplemental budget passed in the year 2000 legislative session.

[17] These forecasts begin with the June 1999 official revenue forecast for the 1999-01 Biennium. Then, in collaboration with legislative fiscal analysts, OFM prepares a six-year outlook on state finances based on an assumption of "average economic growth." Other scenarios are also prepared. The "average economic growth" scenario assumes no recession, no slowdown, and no additional tax cuts over the next six years. Through FY 2001, the forecast is based on the official state revenue forecast issued by the Revenue Forecast Council in June 1999. This forecast predicts 3.7 percent revenue growth for the biennium, including the effects of Referendum 49 and other tax reductions adopted by the Legislature. (The growth rate would be 7.3 percent excluding the effect of tax reductions from the calculation). After 1999-01, the average growth scenario expects General Fund revenues to grow about 8.0 percent in the 2001-03 Biennium and about 9.3 percent each biennium thereafter.

[18] The "average economic" growth scenario is based on a long-term projection of personal income and inflation by Data Resources Incorporated (DRI), the national forecast firm which supplies the U.S. forecast assumptions for the official state economic forecast prepared by the Economic and Revenue Forecast Council. The average growth scenario also uses OFM's long-term population growth forecast which is based on economic trends of the past 30 years. The forecast of the I-601 spending limit is based on the same assumptions for inflation and population growth.

[19] Cf. Gloudemans, Robert J;. "Property tax limitation: an evaluation," *Assessors Journal* (Summer 1979) and Olmsby, James, *The Rollback Movement*, Monograph, Syracuse University (1981).

[20] Goldsmith, Scott; "Sustainable spending levels from Alaska state revenues*," Alaska Review of Social and Economic Conditions* (Fall 1983).

[21] *Proposition 13: Its Impact on California and Implications for State and Local Finances*, California Budget Project: Monograph (April 1997).

[22] Bradbury, K.L,, Case, K.E., and Mayer, C. J; "School quality and Massachusetts enrollments shifts in the context of tax limitations," *New England Economic Review* (July/August, 1998).

[23] Figlio, David N; "Short term effects of a 1990s era property tax limit: panel evidence from Oregon's Measure 5," *National Tax Journal* (March 1998).

[24] MacManus, Susan A; "Florida: Reinvention Derailed," in Gold, Steven D., Ed., *The fiscal crisis of the states*; Washington, D.C: Georgetown University Press (1995).

[25] Shadbegian, Ronald J; "Do tax and expenditure limitations affect the size and growth of state government?" *Contemporary Economic Policy* (January 1996).

[26] Elders, Harold W., "Exploring the Tax Revolt: An Analysis of the Effectiveness of State Tax and Expenditure Limitation Laws," *Public Finance Quarterly* (Winter 1992).

[27] Bails, Dale G; "The effectiveness of tax-expenditure limitations: a re-evaluation," *American Journal of Economics and Sociology* (April 1990).

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