

# Washington's Structural Deficit



## Without tax reform, pain will outlast recession

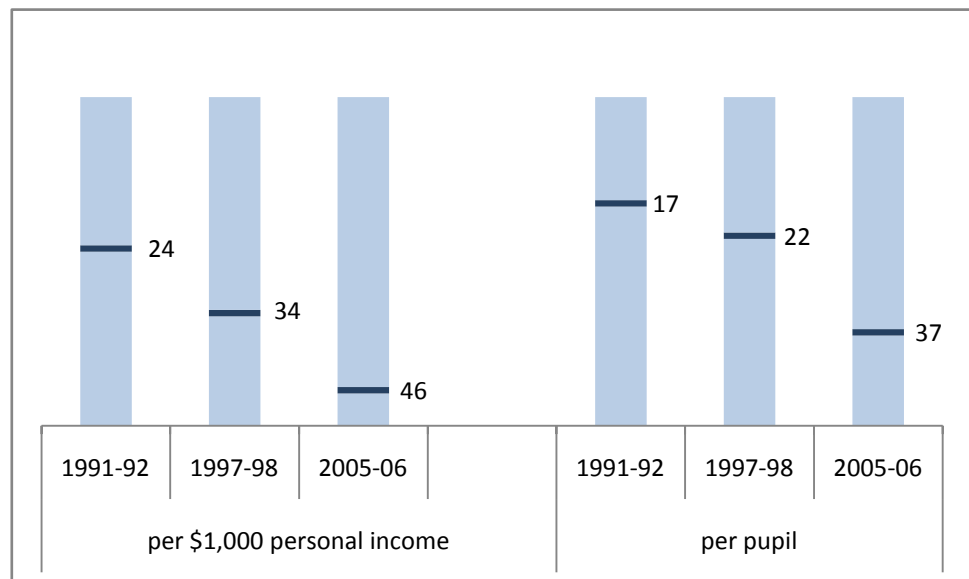
BY MARILYN WATKINS, PH.D.

The worldwide recession has struck a major blow to state and local government budgets, including Washington's. But Washington's budget woes will outlast the recession because the state also has a **structural deficit**. Without raising rates or adding new taxes, revenues to support public services grow more slowly than the economy as a whole. As a result, our state is losing the ability to provide the kind of education system and infrastructure that residents and businesses need to thrive in the modern economy.

Many states with more flexible sources of revenue for public investments are keeping up better than Washington. For example, in the critical area of public education, Washington's rank among the states has fallen from 17<sup>th</sup> in 1991-92 to 37<sup>th</sup> in 2005-06 in total per pupil spending, and from 24<sup>th</sup> to 46<sup>th</sup> K-12 spending per \$1,000 of personal income.<sup>1</sup>

### WASHINGTON'S RANK AMONG THE STATES IN K-12 SPENDING

1991-2006



Source: U.S. Census, Annual Survey of Local Government Finance

## What's behind the structural deficit?

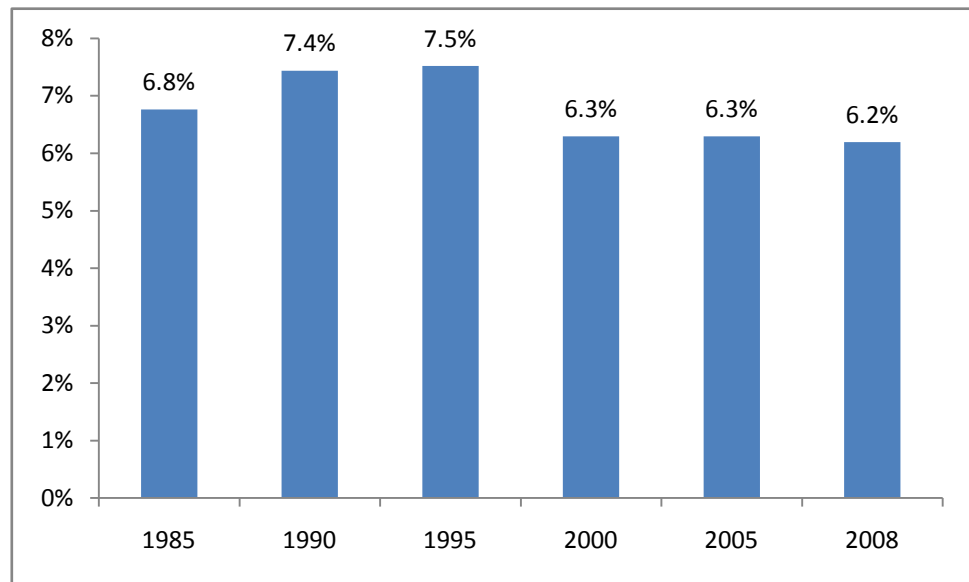
OUR TAX BASE HAS SHRUNK, WHILE THE QUALITY OF PUBLIC SYSTEMS NECESSARY TO PROMOTE OPPORTUNITY AND PROSPERITY HAS INCREASED.

Our tax system hasn't kept pace with the dramatic changes in our economy. Washington adopted its current revenue structure in 1935, establishing taxes on the most important parts of the economy at that time. Land was still a primary basis of wealth then, and consumers bought more goods than services. It was possible for a single breadwinner to support a family without even a high school education. In the mid-20<sup>th</sup> century, 12% of jobs in the state were in agriculture and one quarter in manufacturing.

Today, investment wealth is more important than land and consumers spend more on services. Agriculture provides only 3% of jobs and manufacturing one tenth – and many of those jobs require high level skills in math, science, and computers. Rapidly rising health care costs and transportation modernization also demand new state investments.

As a result of these changes, our tax base has shrunk relative to the whole economy, while the quantity and quality of public systems necessary to promote economic opportunity and prosperity have increased.

**PERCENTAGE OF PERSONAL INCOME COLLECTED AS PUBLIC REVENUE**  
ALL WASHINGTON STATE TAXES, 1985-2008



Sources: U.S. Bureau of Economic Analysis, Washington Department of Revenue.

# Why do public investments need to grow?

## The rate of economic growth

We have a higher standard of living today – at least in material goods – than did our grandparents. We also need and expect more from our government. Over time, the economy and personal incomes have grown faster than simply the rate of inflation and population growth. This is because of technological improvements and productivity increases. Workers can produce more goods and services with each hour of work today than 10, 50, or 100 years ago.

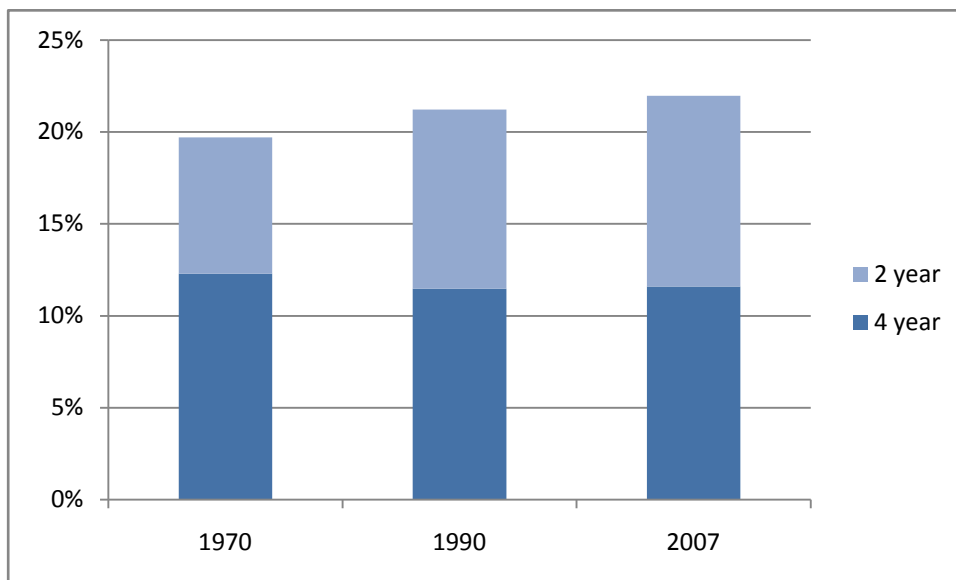
The rate of personal income growth is a better measure of the need for state services than inflation and population growth, because it better reflects changing standards as well as added pressures from specific budget drivers.

**THE RATE OF PERSONAL INCOME GROWTH IS A BETTER MEASURE OF THE NEED FOR STATE SERVICES THAN INFLATION AND POPULATION GROWTH.**

## Changing public needs and standards

Decades ago the state’s obligation to educate all children did not extend much beyond being sure they could read, write, and do basic arithmetic. Today we expect almost all state residents to have high school diplomas and many to pursue higher education. Consequently, as our state population has grown, not only are there more traditionally college-age people, but a higher percentage of them are enrolling in public institutions of higher learning. If the state is to ensure that all children have the foundation to meet those higher standards, it needs to expand provision of preschool, full-day kindergarten, and small class sizes in the elementary years.

**PERCENTAGE OF 17-22 YEAR OLDS ENROLLED IN PUBLIC HIGHER EDUCATION, WASHINGTON STATE, 1970-2007**

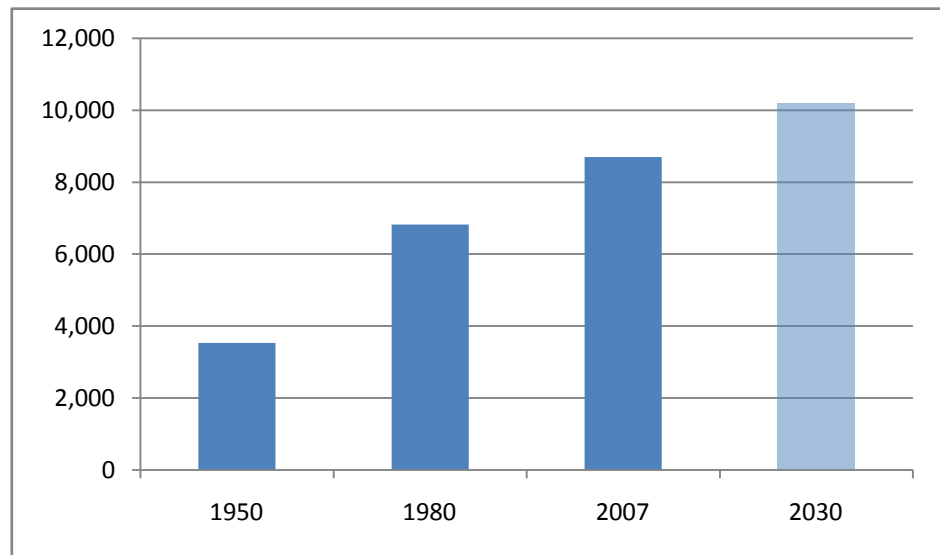


Source: Washington Office of Financial Management, State Data Book 2007

In the past fifteen years, we've come to expect our schools and libraries to be equipped not just with books, but with computers and high speed internet. We've also set higher standards for roadways and other infrastructure for accident prevention, noise reduction, and earthquake safety. And Washington residents drive more miles than they used to, with two-career families, suburban sprawl, and increasing affluence. That puts more wear and tear on the road system.<sup>2</sup>

### PER CAPITA VEHICLE MILES TRAVELED, WASHINGTON STATE

1950-2007, FORECAST TO 2030



Source: Washington State Department of Transportation

THE NUMBER OF SENIORS OVER AGE 85 IS EXPECTED TO INCREASE MORE THAN TWICE AS FAST AS THE GENERAL POPULATION.

In the corrections system, harsher drug sentencing implemented during the 1990s has resulted in a near doubling of the percentage of the state's population that is incarcerated.<sup>3</sup>

### Populations needing services

Some segments of the population grow faster than others. The number of seniors over age 85 is expected to increase more than twice as fast as the general population, raising the need for long term care services. The traditional college-age population is now growing a little faster than overall growth. The K-12 age population, which swelled in the last decade with the baby boom echo, is now growing more slowly, but is expected to take off again in the next decade.<sup>4</sup> The demographics of students enrolled in public schools are also changing, with more kids needing special education and English as a second language, or from low-income families.<sup>5</sup>

### Differing rates of cost increase

Inflation measures combine a large array of goods and services, but some costs rise much faster than the average rate and have a much bigger impact on public budgets. The percentage of the Washington state budget devoted to

health care – including public health, teacher and other public employee benefits, and subsidized programs such as Medicaid and the Basic Health Plan – rose from 21.7% in 2000 to 28.5% in 2007.<sup>6</sup> Spikes in fuel costs can devastate public budgets, particularly schools which must transport students and heat buildings.

## Keeping public service competitive with the private sector

Over time, average wages rise faster than inflation. Between 1991 and 2007, the average annual wage for all workers in Washington increased by 89%, from \$23,700 to \$44,700.<sup>7</sup> If the average wage had merely gone up at the rate of inflation, it would have been \$36,000 in 2007.<sup>8</sup> When the salaries of teachers and other public servants rise only at the rate of inflation – or even more slowly – public occupations can't compete with the private sector.

## Components of the shrinking tax base

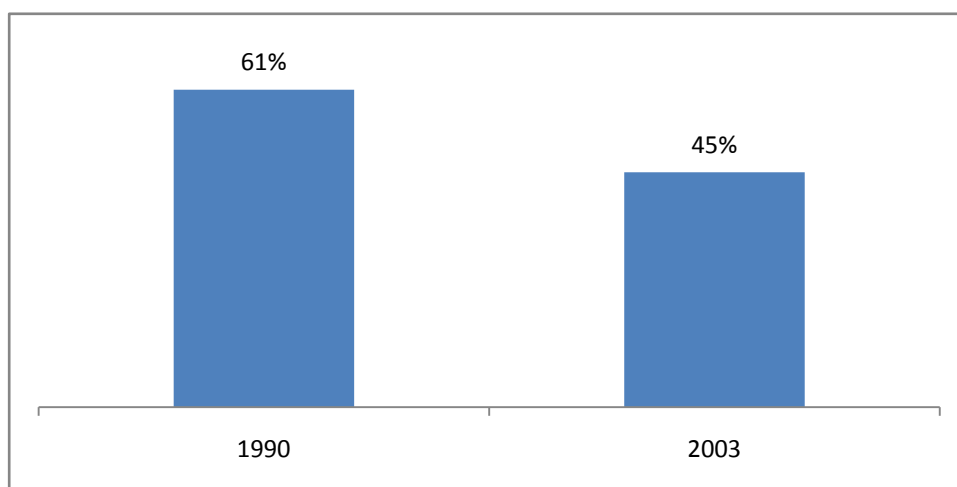
### Sales Tax

Sales tax is the backbone of Washington's public revenue system, but it doesn't apply to the parts of our economy that are growing most quickly. In fiscal year 2008, the sales tax contributed 49% of all state tax revenues and 56% of general fund revenues.<sup>9</sup> The state collects 6.5% on the sale of most goods and on construction and repair services. Cities, counties, and other local districts collect additional sales tax, making the top rate in the state 9.5% in King County as of April 1, 2009. For decades, consumers have been gradually shifting their spending from goods subject to sales tax to services with no sales tax – such as beauty salons, veterinarians, accountants, attorneys, and health care. From 1990 to 2003 alone, the percentage of sales subject to sales tax in Washington fell from 61% to 45%, according to an Indiana University study of sales taxes across the country.<sup>10</sup>

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### PERCENTAGE OF SALES SUBJECT TO SALES TAX

WASHINGTON STATE, 1990, 2003



Source: John L. Mikesell, cited in Center on Budget and Policy Priorities, "Faulty Foundations."

## Tax Breaks

Since the early 1990s, Washington's legislature has passed new tax breaks at an accelerating rate. Many of these are "business incentives," lowering rates for particular types of companies or exempting them from certain taxes altogether. These may seem justified individually, but unlike public services, tax exemptions are not reevaluated every budget cycle against other options for public investment and the state bottom line. From 1994 to 2008, the legislature passed 185 tax breaks that together drain \$2.5 billion from the roughly \$32 billion 2009-11 biennial state budget. Some of these eliminated sales tax on certain business equipment or construction, accelerating the decline in sales subject to sales tax described above. Tax breaks passed just since 2004 contribute nearly \$1 billion to the current shortfall in state revenues.<sup>11</sup>

## Tax Limiting Initiatives

Washington's voters have both cut taxes and limited the legislature's ability to raise and spend revenues. Except for new construction and voter approved levies, the growth of **property tax** revenues is now limited to 1% annually – less than the rate of inflation in most years.<sup>12</sup> Since about three fourths of property tax revenues finance city, county, school and other local districts, this restriction is a particular hardship for them. **Initiative 695** passed in 1999 eliminated the state motor vehicle excise tax, which in that year yielded the state nearly \$900 million.<sup>13</sup> **Initiative 601** limited growth in state spending to an inflation plus population growth factor from 1995 to 2007, when the growth factor was changed to the average growth in state personal income over the previous ten years. I-601 also required a super majority vote of the legislature to raise taxes, made even more restrictive by **I-960** which passed in 2007.<sup>14</sup>

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## Conclusions

Washington's public revenue structure is out of sync with the modern economy. The tax base is concentrated on an ever shrinking portion of the economy. Even when our state recovers from the current recession, we will find ourselves without sufficient funds to build education and infrastructure systems that meet global standards.

If Washington is to provide the public foundations that will allow all state residents and businesses to thrive in the modern economy, we need to restructure and expand our tax base. A more functional tax structure would rely less heavily on sales and gross receipts business taxes, and tap into growing personal incomes and the receipts from the vast store of intangible wealth held by state residents.<sup>15</sup> Such a system would be more fair to individuals and businesses. It would also help build a sustainable economy in which everyone can thrive.

## Endnotes

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- <sup>1</sup> U.S. Census Bureau, Public Elementary-Secondary Education Finances, <http://www.census.gov/govs/www/school.html>.
- <sup>2</sup> The rate of growth has flattened since 1990, but the Washington State Department of Transportation forecasts 17% growth in miles per capita between 2007 and 2030. Washington State Department of Transportation, "Vehicle Miles Traveled," viewed April 20, 2009, [www.dot.wa.gov](http://www.dot.wa.gov), and WSDOT Financial Planning & Economic Analysis Office, "Forecast of Fuel, Vehicles, and Related Data Through 2025," February 2008, <http://www.ofm.wa.gov/budget/info/Feb08transpovol1.pdf>.
- <sup>3</sup> Washington Office of Financial Management, Washington Trends, Prison Inmate Population, December 2008, [www.ofm.wa.gov](http://www.ofm.wa.gov).
- <sup>4</sup> Washington Office of Financial Management, Washington Trends, Projected Change in Budget Driver Populations, December 2008, [www.ofm.wa.gov](http://www.ofm.wa.gov).
- <sup>5</sup> League of Education Voters Foundation, K-12 Education, viewed April 21, 2009, [http://levfoundation.org/issues/k12\\_education](http://levfoundation.org/issues/k12_education).
- <sup>6</sup> Washington Blue Ribbon Commission on Health Care Team, Background Information, June 22, 2006, <http://www.leg.wa.gov/>.
- <sup>7</sup> Washington Employment Security Department, Average Annual Wage, [www.workforceexplorer.com](http://www.workforceexplorer.com).
- <sup>8</sup> U.S. Bureau of Labor Statistics, Inflation Calculator, <http://data.bls.gov/cgi-bin/cpicalc.pl>.
- <sup>9</sup> Washington Department of Revenue, Tax Statistics, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>10</sup> John L. Mikesell, "State Retail Sales Tax Burdens, Reliance, and Breadth," *State Tax Notes*, July 12, 2004, as cited in Iris Lav, et al, "Faulty Foundations: State Structural Budget Problems and how to Fix Them," 2005, Center on Budget and Policy Priorities, [www.cbpp.org](http://www.cbpp.org).
- <sup>11</sup> See Marilyn P. Watkins, "Everybody Else Gets One: An analysis of tax breaks in Washington," April 2008, Economic Opportunity Institute, [www.eoionline.org](http://www.eoionline.org); and Department of Revenue, *Tax Exemptions 2008*, January 2008, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>12</sup> Department of Revenue, *Tax Reference Manual 2007*, p 155, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>13</sup> Department of Revenue, Tax Statistics, Washington State Tax Collections, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>14</sup> Washington State Expenditure Limit Committee, "Chronology of I-601 Amendments," <http://www.elc.wa.gov/sub/chronology.pdf>; Washington Office of Financial Management, "Initiative 601: Experience and Context," PowerPoint presented to the House Finance Committee, February 2005.
- <sup>15</sup> See Marilyn P. Watkins, "Fairer Taxes for Washington," April 2008, Economic Opportunity Institute, [www.eoionline.org](http://www.eoionline.org).

## About Us

The Economic Opportunity Institute (EOI) is a nonpartisan, non-profit public policy organization founded in 1998 and based in Seattle, Washington. Our mission is to forge realistic public policies that promote long-term economic security and opportunity for Washington's middle-class and low-income workers and families, ensuring the benefits of prosperity are broadly available to all those who contribute to it. We utilize research, education and advocacy to shape public debate and advance new policy ideas that support high-quality education, modern work-life standards, retirement security, and shared investments in our common future.

## Contact Us

Economic Opportunity Institute  
1900 N. Northlake Way Suite 237  
Seattle, WA 98103

P: 206-633-6580  
F: 206-633-6665  
[info@eoionline.org](mailto:info@eoionline.org)  
[www.eoionline.org](http://www.eoionline.org)