

Adequacy of State Revenues

February 8, 2002

**Presentation by
Office of Financial Management**



Questions Posed by the Committee on Adequacy of State Revenues

- Do tax revenues keep up with, fall short of, or exceed change in personal income?
- Do tax revenues keep up with, fall short of, or exceed the same level of services given changes in caseload levels (including school enrollment), infrastructure needs, and governmental administration needs?
- How do changes in demand for services compare to changes in personal income?
- Do tax revenues provide adequate funding for infrastructure needs such as transportation?



Basic Question

Over the long run, is the state's tax structure and revenue stream adequate to meet demands?



Outline of Discussion

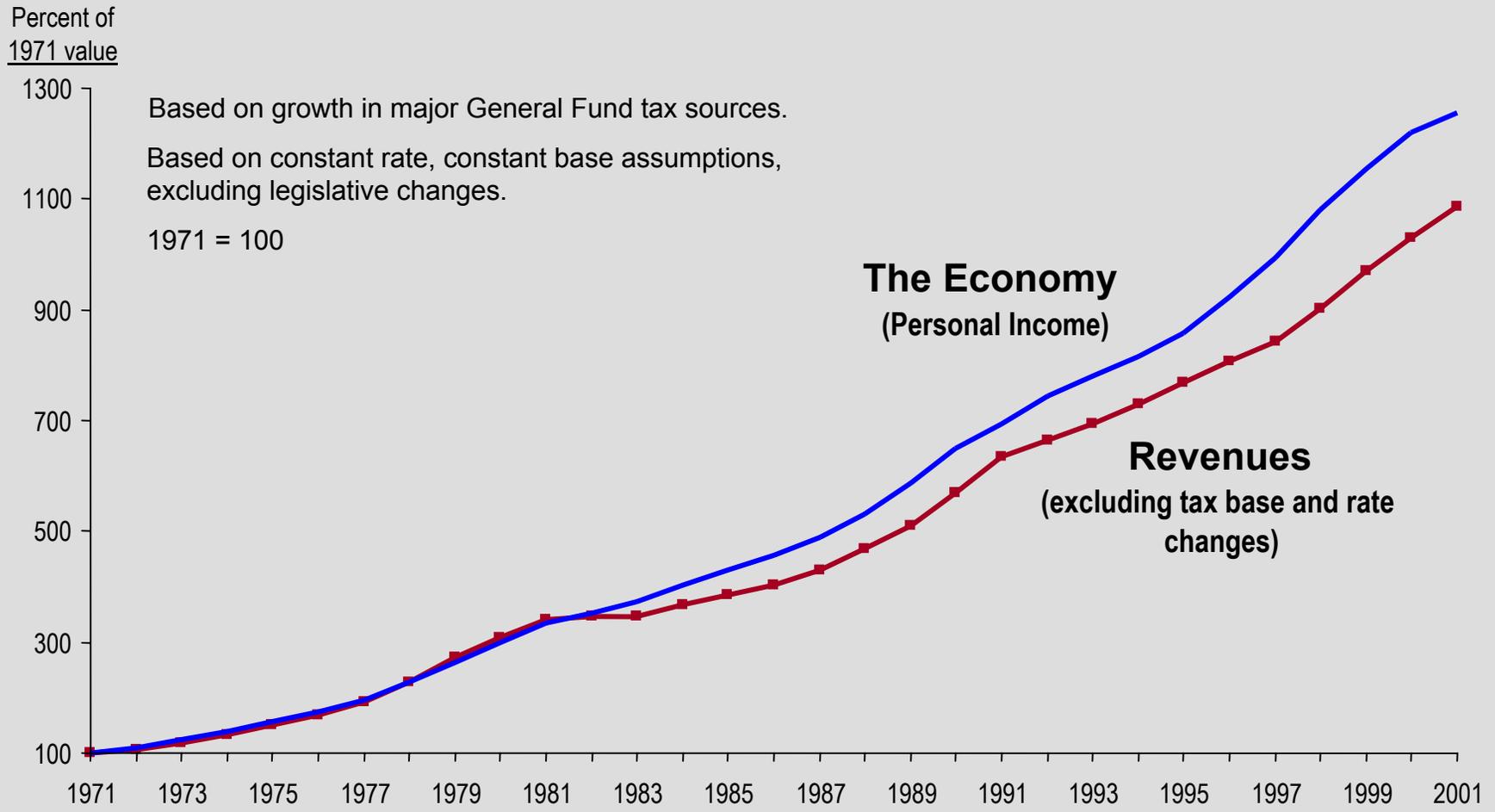
- **Overview of Revenue, Spending, and Personal Income Growth Trends**
- **Spending Pressures, Demographics, and Inflation**
- **Medium-Term Outlook: Spending and Revenue
Context
Assumptions**
- **Implications for the Longer Term**



Overview of Revenue, Spending, and Personal Income Growth



Excluding tax base and rate changes, over the past 30 years General Fund revenues have grown more slowly than the economy (personal income).



Revenue elasticity is declining slowly and is expected to fall to between 0.85 and 0.90 over the next decade.

	Average Annual Personal Income Growth	Average Annual Revenue Growth*	Elasticity
Past 30 years	8.8%	8.3%	0.94
Past 20 years	6.9%	6.0%	0.87
Past 10 years	6.1%	5.5%	0.91
Forecast	5.9%	5.0%	0.85

*Excluding tax base and rate changes.

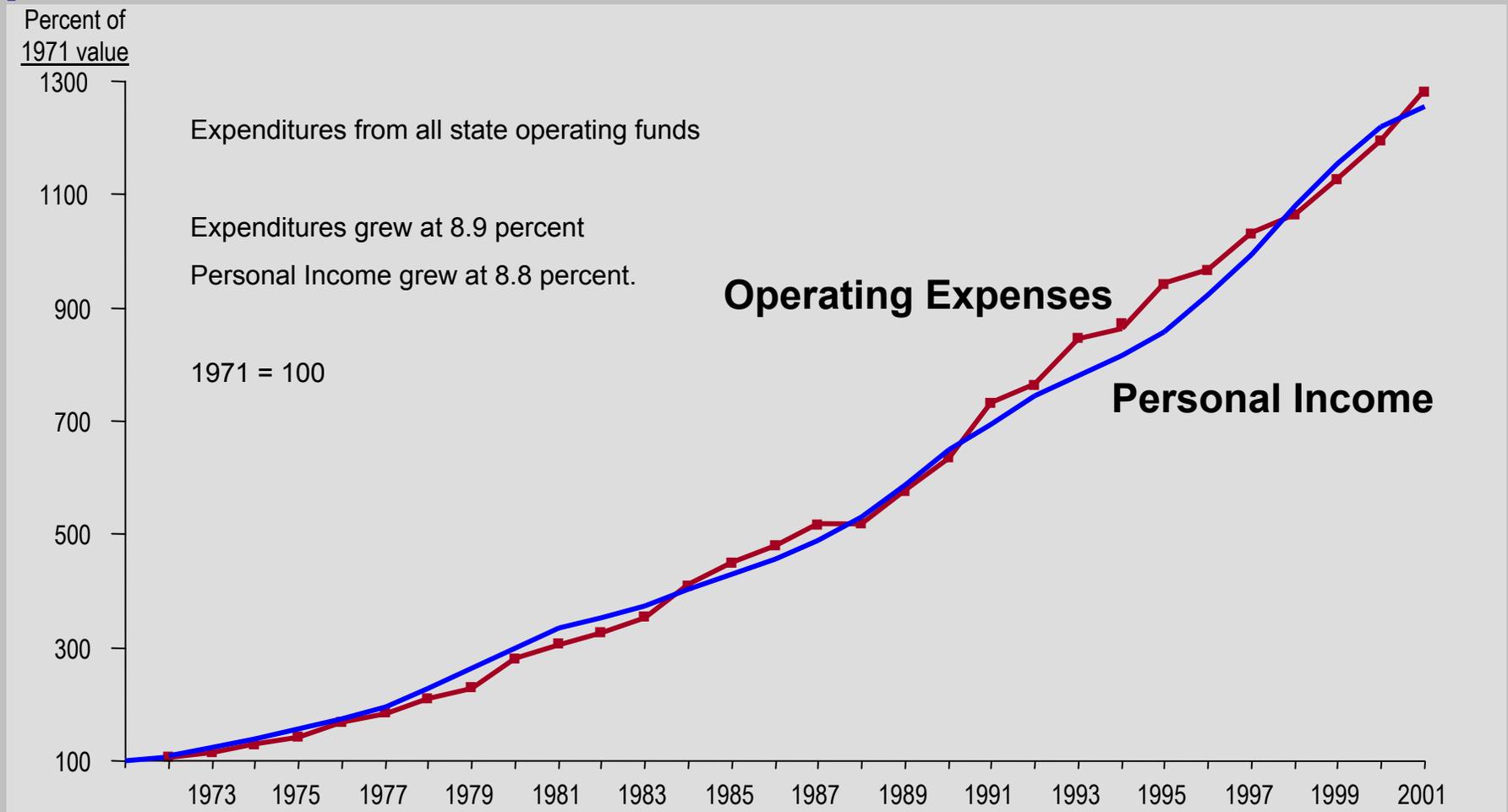


Why is elasticity expected to decline?

- **Referendum 47 and Initiative 747 slowed down General Fund property tax growth.**
- **Referendum 49 eliminated General Fund Motor Vehicle Excise Tax (MVET) – a relatively fast-growing revenue.**
- **Consumers continue to spend higher proportions of income on services rather than taxable retail items.**
- **Internet sales could further slow state sales tax collections.**



Over the past 30 years, operating expenditures from all state funds have grown at about the same pace as personal income.



Summary

- **Over the past 30 years, actual expenditures have grown at about the same rate as the economy (as indicated by personal income).**
- **Since revenues (without tax changes) tend to grow more slowly than personal income, taxes and fees were raised periodically to keep pace.**



Spending Pressures, Demographics, and Inflation



Basic Tools and Concepts

Budget Drivers



Personal Income



Revenue

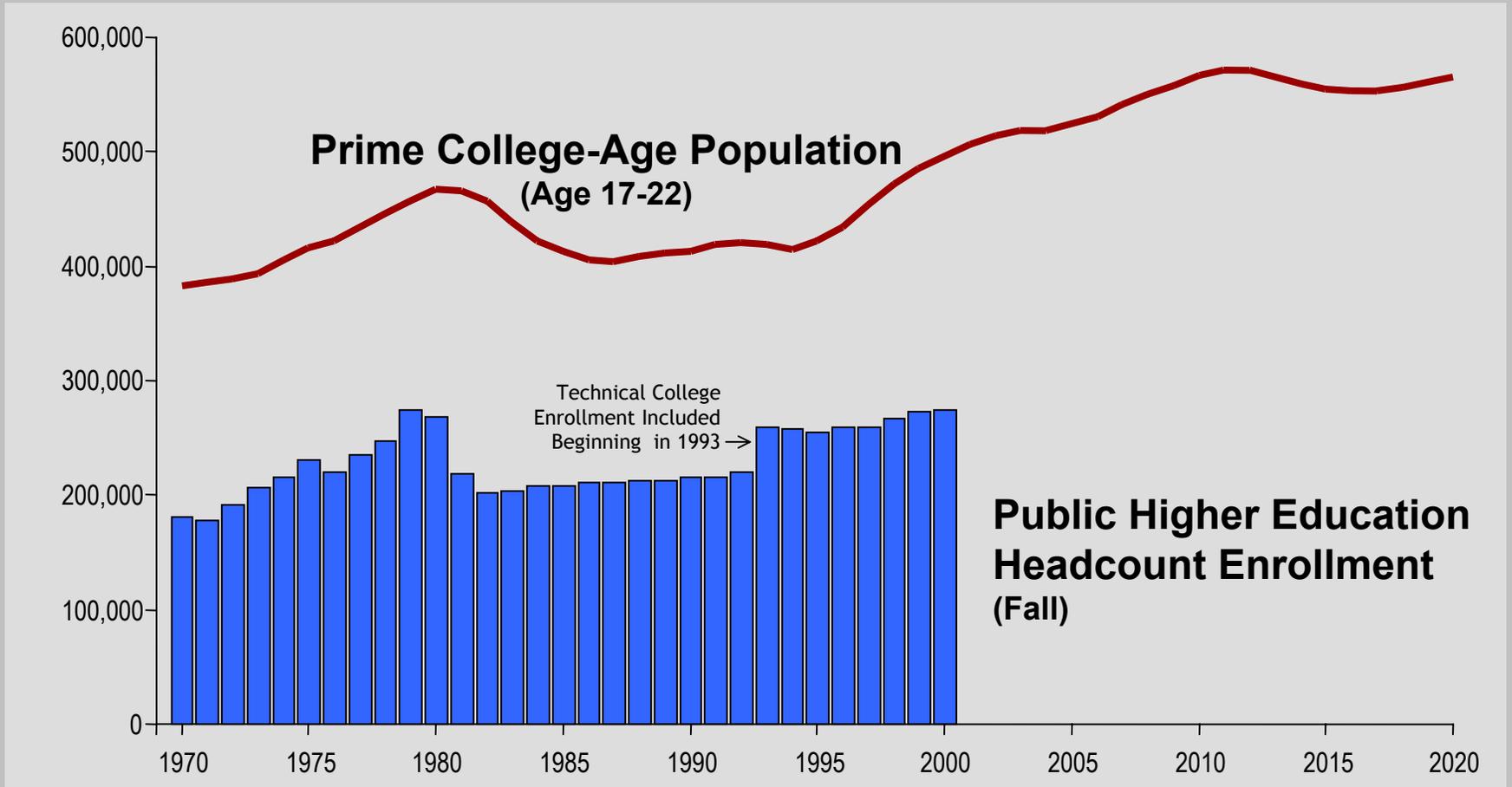


Budget pressures and personal income growth diverge...

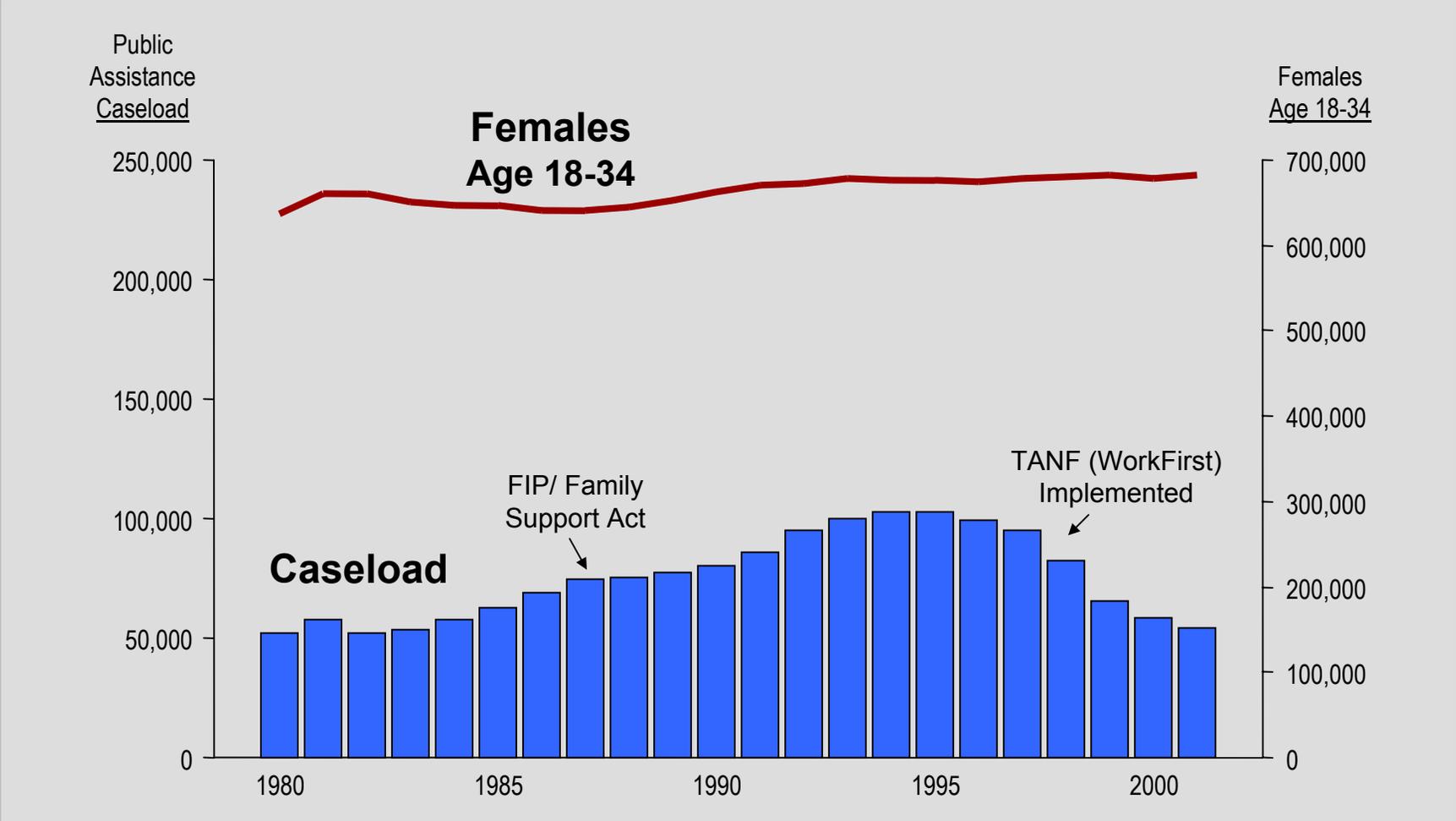
- when **specific population budget drivers**, like the age 5-17 school population, grow much faster or slower than general population growth
- when **specific inflation budget drivers**, like “health care inflation,” grow much faster or slower than general inflation
- when **utilization rates** for government services change – e.g., change in the percent of women in child-bearing years on public assistance rolls
- when **policy changes** increase or reduce government services



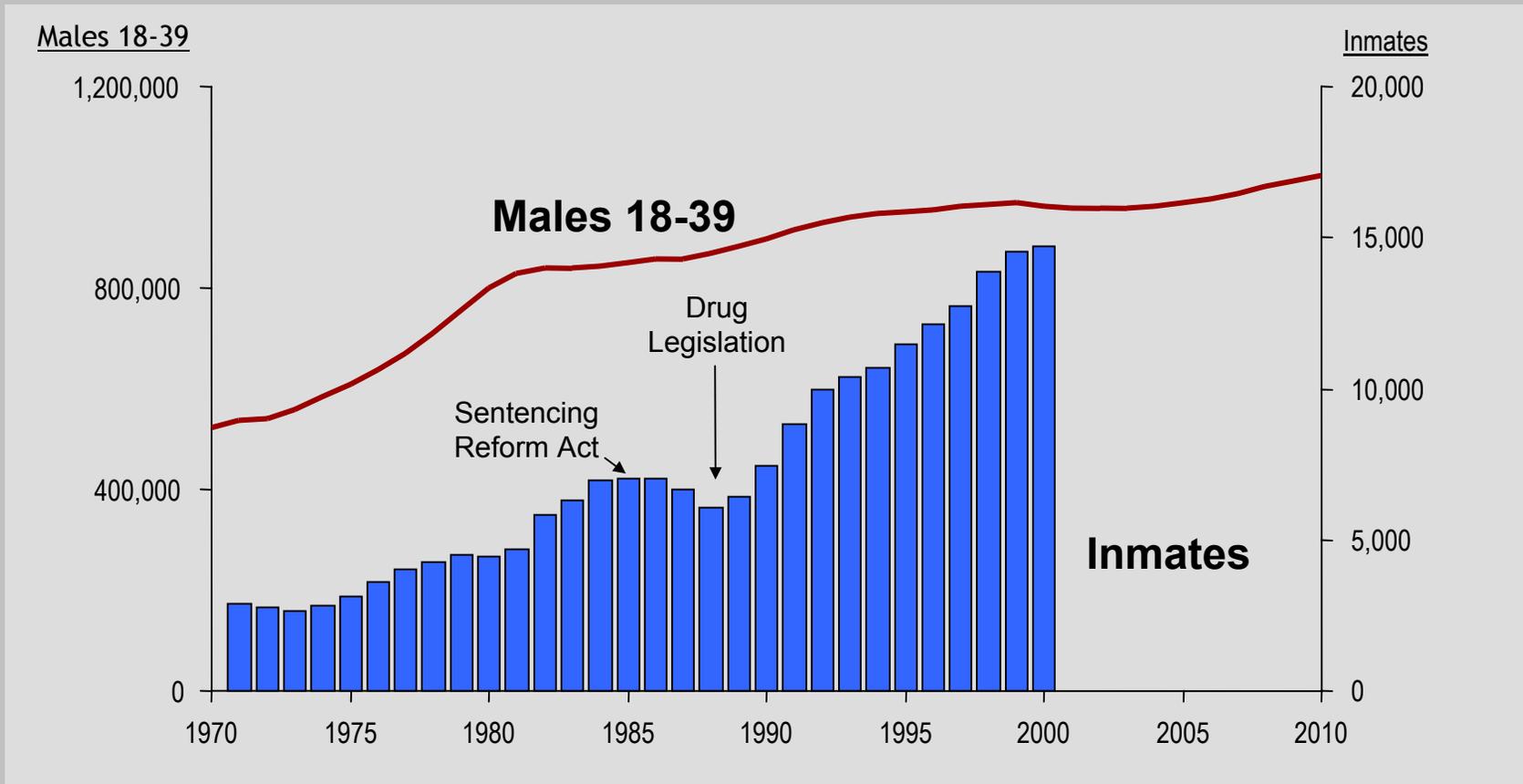
Enrollments in higher education have tracked well with demographics. Demographic pressures in higher education are now strong.



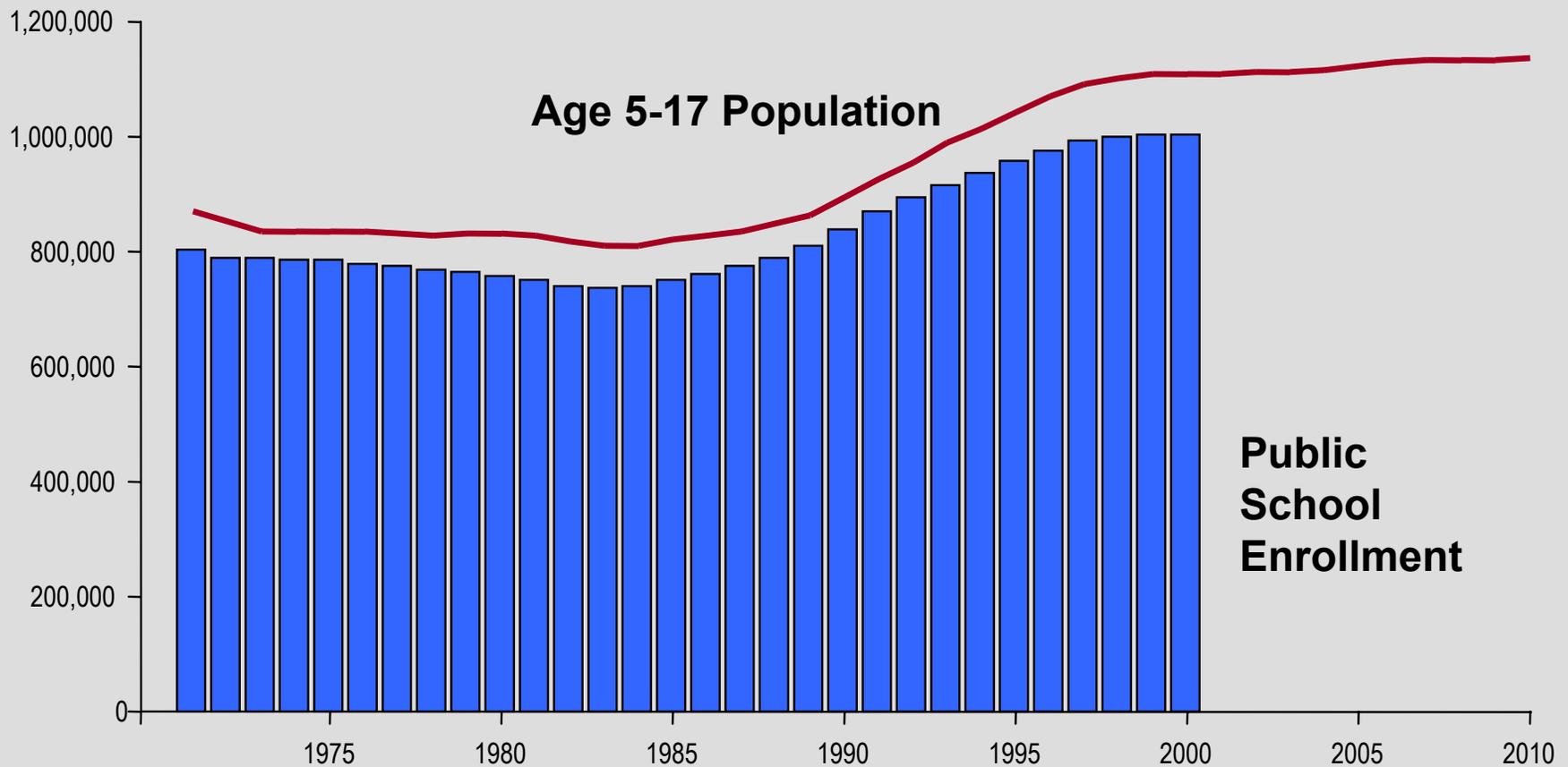
Policy choices can offset demographic pressures.



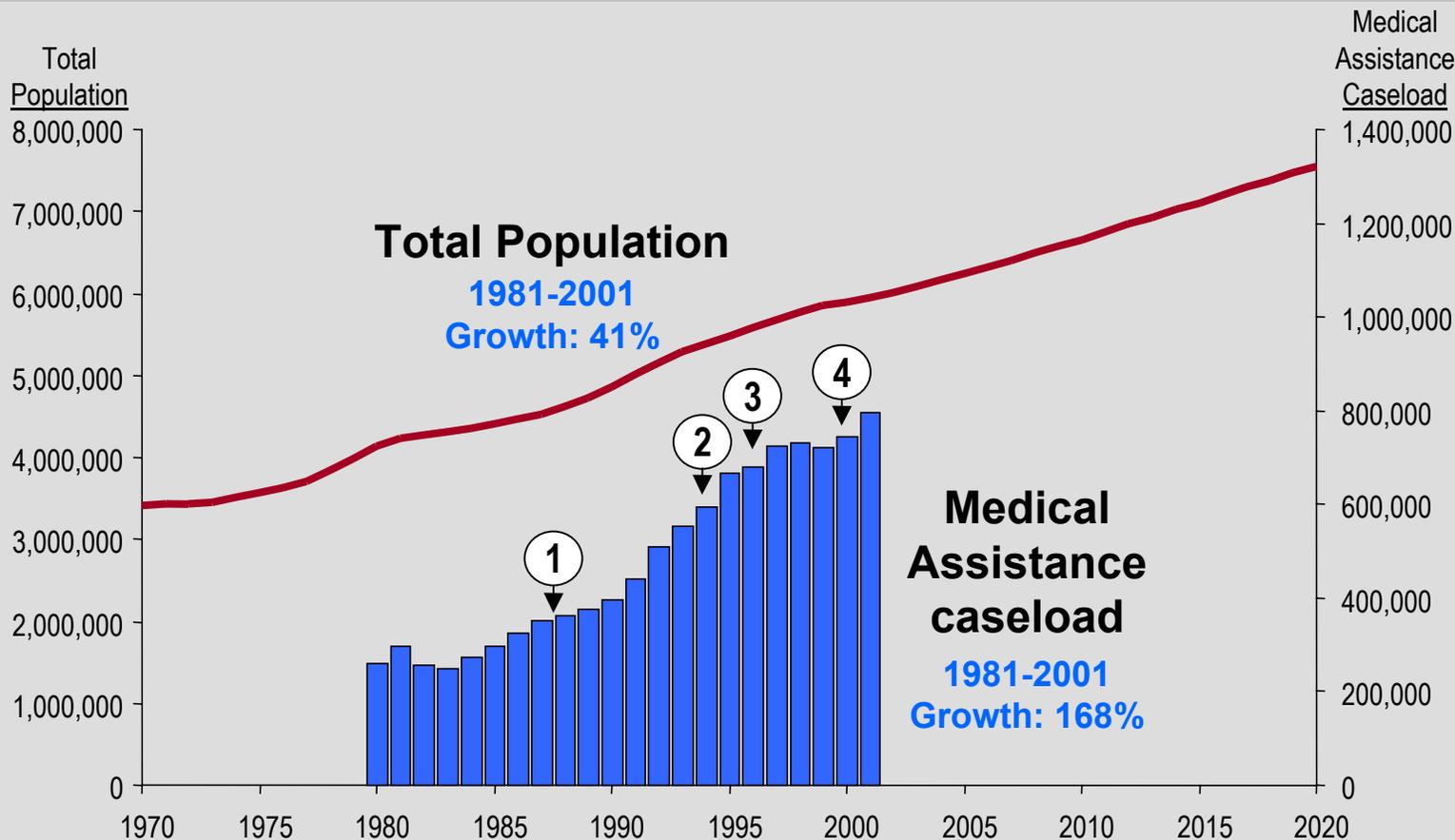
From 1970 through 1988 the prison population tracked the population fairly closely. The Sentencing Reform Act reduced the prison population. Emphasis on drug crimes increased the prison population.



Demography is a major factor in K-12 enrollment. In the medium term demographic pressures in K-12 will be very low.



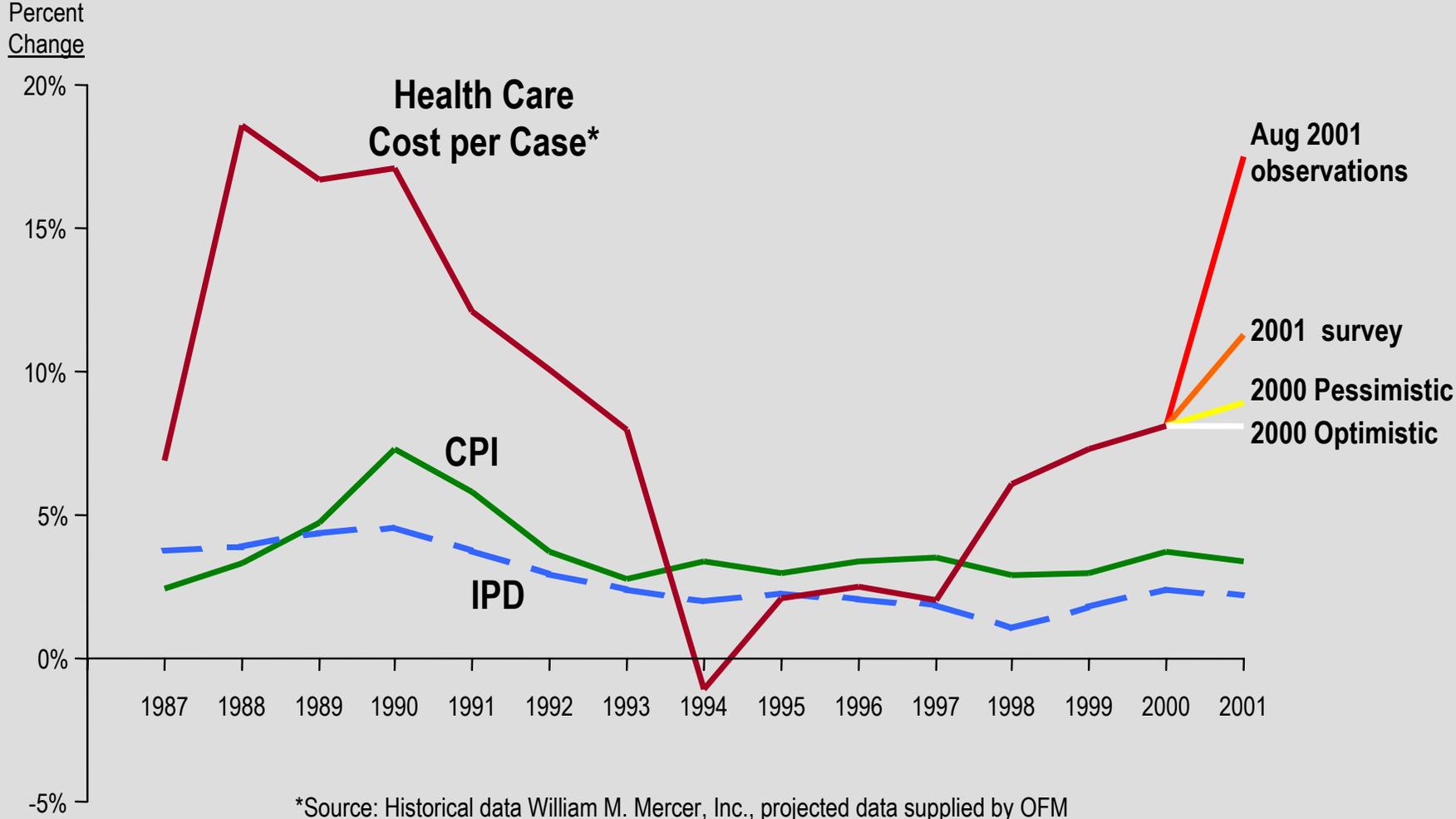
Policy factors have been a driver of Medical Assistance caseloads.



- ① July 1988: First Steps expansion for children and pregnant women.
- ② July 1994: Expansion to 200% federal poverty level (FPL) for children.
- ③ August 1996-August 1997: unintentional drop in AFDC/TANF related component as a result of Welfare Reform.
- ④ August 1999: TANF redetermination and reinstatement.



Health care costs are surging again.

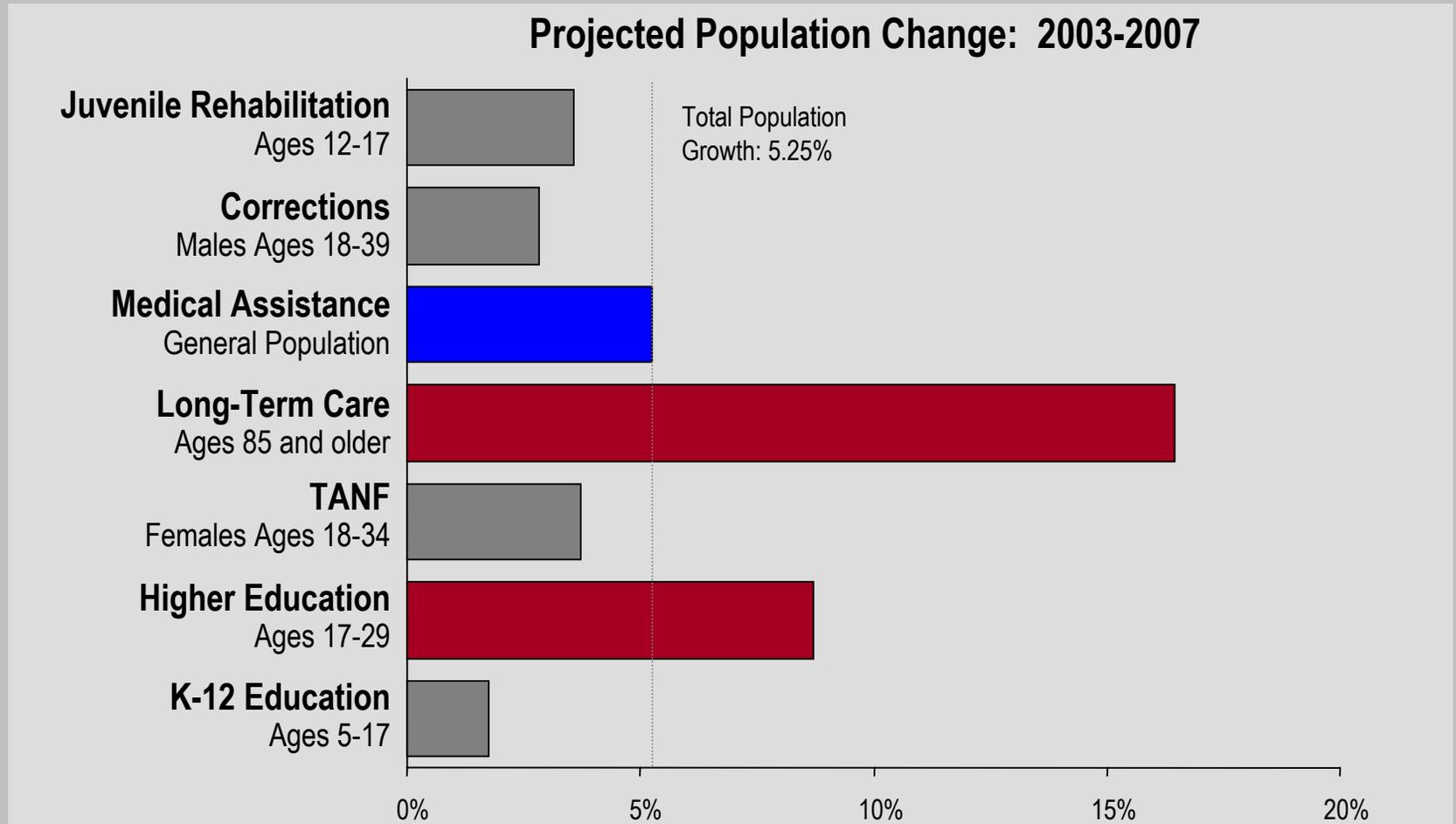


Underlying Pressures Increasing Costs per Case in Health Care

- **Traditional inflation: prices are up for same services and procedures**
- **New procedures, tests, and technology**
- **New drugs are driving up costs**
- **Advertising driving the demand for new drugs**
- **Ageing population**



Altogether, medium-term population pressures are high in Long-Term Care and Higher Education, but low for other major state government programs.



Context for Medium-Term Outlook

**Spending, Revenue, and Reserves
Beginning with the 2002 Supplemental
Budget**



Historical Context

- **\$700 million in tax increases in 1993-95**
- **Passage of I-601. Limit took effect in the 1995-97 Biennium**
- **Expenditure growth cut in half since 1991-93 Biennium**
- **Legislatively adopted tax cuts and voter-approved tax and spending initiatives reduce revenue by \$2.8 billion in current biennium**
- **\$900 million reduction in 2001-03 revenue forecast since September**
- **Projected \$700 million deficit after all reserves are spent**
- **Governor's proposed Supplemental Budget rebalances budget, resulting in \$300 million projected reserve**



The reserve was never allowed to get very big.

<u>Date(s) of Action</u>	<u>Cumulative Impact 1995-2003</u>
1994-97 B&O tax reductions	\$1.2 billion
1994-96 High tech and manufacturing tax reductions	\$1.0 billion
1997 Referendum 47 property tax reductions	\$600 million
1998 Referendum 49 General Fund license tab tax reduction	\$300 million
1995-00 Forty other specific tax reductions	\$600 million
1999 Initiative 695 – local revenue losses backfilled by state	\$200 million
2000 Initiative 732 – mandatory teacher COLA	\$344 million
2000 Initiative 728 – diversion to school districts	\$ 470 million
Cumulative Total	\$4.7 billion

In 2001-03, these actions have reduced revenue available to the General Fund by \$2.8 billion.



Budget Driver and Revenue Assumptions for the Medium-Term Fiscal Outlook



Revenue and Resource Assumptions

FY 2004 – FY 2007

- **Official Forecast Council economic and revenue forecast for 2001-03 Biennium**
- **5.8% per year personal income growth after 01-03 (slightly less than past decade)**
- **5.0% per year underlying revenue growth after 01-03 (0.5% less than past decade)**
- **Based on 0.85 elasticity, compared with 0.91 over past decade**
- **\$450 million additional federal revenues (ProShare)**
- **\$2.3 billion diversion to Student Achievement Fund through 05-07 under Initiative 728**



Spending Assumptions FY 2004 – FY 2007

(Builds on Governor's 2001-03 Supplemental Budget)

	<u>Scenario 1</u>	<u>Scenario 2</u>
Employee COLAs: Seattle CPI – 2.3%	X	X
Caseload growth – based on official caseload forecasts where available OR growth in associated population group	X	X
General inflation (goods and services): IPD – 2.2%	X	X
Higher education maintains its 01-03 participation rate.	X	X
No other policy adds are included.	X	X
Annual growth in health care costs	IPD (2.2%)	12%*

*Down from 15% in 01-03



Scenario 1: All programs grow based on caseload/specific population growth and general inflation. Revenue grows at 85% of personal income growth.

			PROJECTION			
			2004	2005	2006	2007
	2002	2003				
Total Revenues & Resources	\$10,736	\$11,121	\$11,530	\$11,764	\$12,180	\$12,756
Total Expenditures	\$11,316	\$11,214	\$11,530	\$11,890	\$12,307	\$12,748
	DIFFERENCE		(\$0)	(\$126)	(\$127)	\$8
RESERVES						
Unrestricted Balance	\$18	\$0	\$0	\$0	\$0	\$8
Emergency Reserve*	\$412	\$303	\$267	\$106	(\$56)	(\$91)
	TOTAL RESERVES/DEFICIT*		\$267	\$106	(\$56)	(\$83)

*Includes statutorily required transfers to other funds.

Result: Revenue almost keeps pace with budget pressures.



Scenario 2: Same as Scenario 1 except health care annual cost per case growth is 12%.

			PROJECTION			
	2002	2003	2004	2005	2006	2007
Total Revenues & Resources	\$10,736	\$11,121	\$11,530	\$11,764	\$12,180	\$12,756
Total Expenditures	\$11,316	\$11,214	\$11,748	\$12,354	\$13,057	\$13,826
DIFFERENCE	(\$581)	(\$93)	(\$219)	(\$590)	(\$877)	(\$1,070)
RESERVES						
Unrestricted Balance	\$18	\$0	\$0	\$0	\$0	\$0
Emergency Reserve*	\$412	\$303	\$49	(\$576)	(\$1,488)	(\$2,593)
TOTAL RESERVES/DEFICIT*	\$431	\$303	\$49	(\$576)	(\$1,488)	(\$2,593)

*Includes statutorily required transfers to other funds.

Result: Revenue does not keep pace with budget pressures.



Summary

- Over the past 30 years, actual expenditures have grown at about the same rate as the economy (as indicated by personal income).
- Since revenues (without tax changes) tend to grow more slowly than personal income, taxes and fees were raised periodically to keep pace.
- Reserves have not been allowed to grow very large during good economic times. They were quickly depleted due to increased spending or tax cuts.
- In the future, General Fund revenue would roughly keep pace with spending pressures – **provided all caseloads and costs per case increase by population growth and general inflation.**
- However, health care “inflation,” together with the future effects of tax cuts and spending initiatives, contributes to large projected structural deficits.

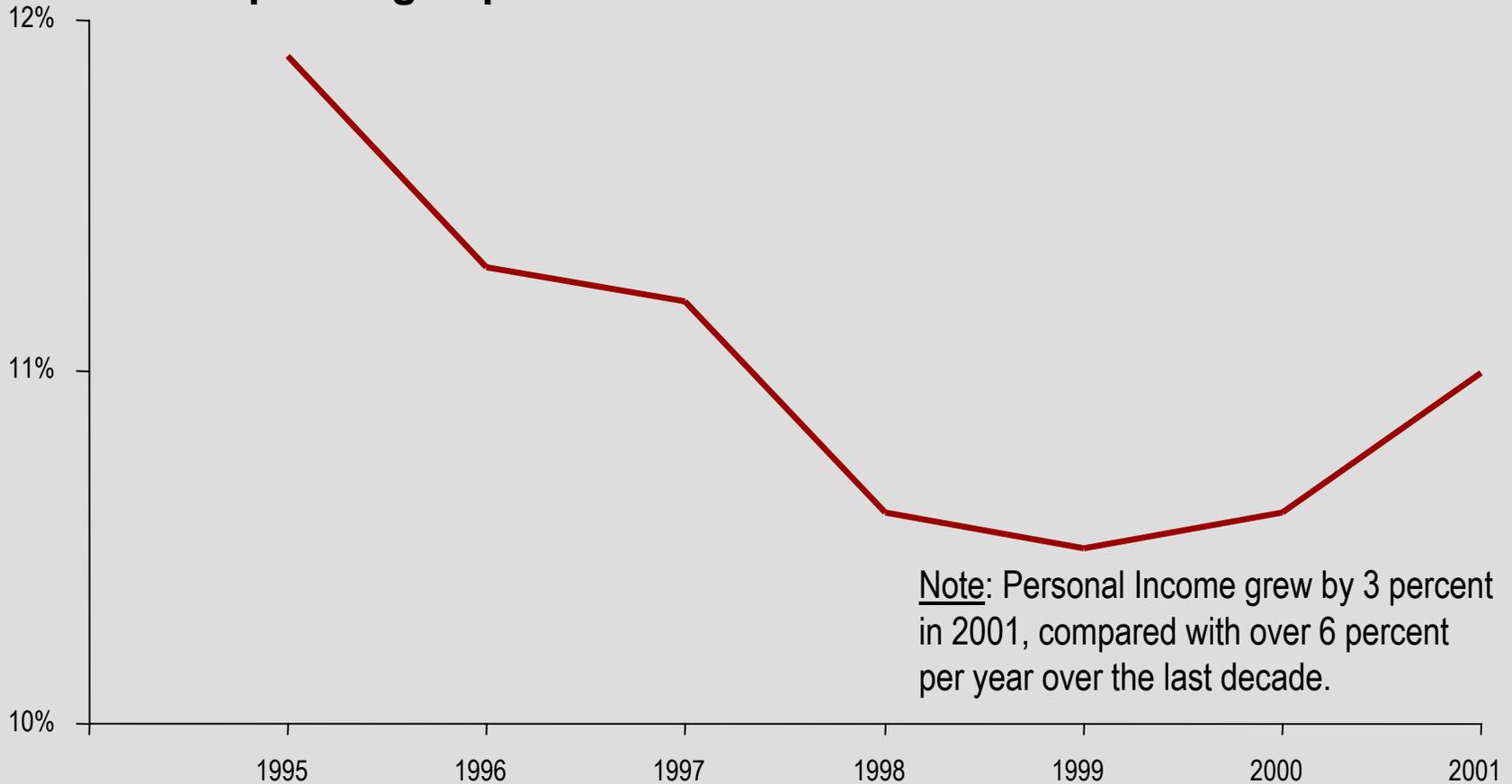


Implications for the Longer Term



Recently, state operating expenditures have become a smaller share of the state economy.

Operating Expenditures as Percent of Personal Income



Can government spending continue to grow more slowly than personal income?



Some implications of government spending growing more slowly than personal income

- It will be hard for spending on education, health care, and safety (comprising 80% of current budget), to keep pace with citizen demands.
- It will be hard for salaries and benefits to keep pace with those in the private sector. Private sector salaries grow faster than inflation, capturing the productivity gains in the economy.

On the other hand,

- **Productivity gains and less spending on the rest of government** (20% of budget) could help make room for a portion of the growth pressures in compensation, education, health care, and public safety..



