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Initiative 1033: Lid or Hammer?

Is Initiative 1033 a lid to protect taxpayers, as proclaimed by its proponents, or a sledge hammer crafted to dismantle state and local government?

The measure, which applies to all state, county, and city governments, stipulates that general fund revenue cannot rise faster than population growth plus inflation. Revenue collected in excess of the limit is put aside to lower the following year's property taxes. Any change to these restrictions requires voter approval.

Tax and spending lids are common features of state and local governments. Thirty states, including Washington, make use of them, according to the National Conference of State Legislatures. In 1993, state voters passed I-601, which imposed a population growth-inflation limit on state general fund expenditures. I-601 is still on the books, but the state legislature has greatly loosened the spending restrictions over time.

The popularity of I-1033 is not surprising. In a recession, tax relief, especially from property taxes, has great appeal. Moreover, I-1033 appears to be founded on a reasonable premise—state and local government budgets need only keep pace with a growing population and the rising cost of public goods and services.

Opponents to I-1033, on the other hand, portray the measure as a financial disaster. It would erode our ability to provide high-quality education, a safe place to live, adequate healthcare, and much needed infrastructure. Despite lowering taxes, the initiative would increasingly hinder our ability to compete in the world economy.

U.S. State and Local Taxes

Percent of Personal Income

	1970	1990	2008
Personal income	1.3	2.3	2.5
Corporate income	0.4	0.5	0.4
Sales	3.8	3.8	3.6
Property	4.4	3.3	3.4
Other	1.0	0.9	1.0
Total	10.9	10.7	10.9

Source: U.S. Bureau of Economic Analysis

At the heart of this debate is an age-old question—how much should we tax? This is a thorny issue, largely because it involves personal values. But there is a clear answer. Based on the historical record over the past forty years, state and local governments have taxed households and businesses an amount equal to 11 percent of personal income.

Between 1970 and 2008, U.S. state and local tax collections averaged 10.8 percent of personal income ($108 per $1,000 of income), according to the U.S. Bureau of Economic Analysis. The ratio was 10.9 percent in both 1970 and 2008. Economic cycles have caused only minor fluctuations in the ratio over time. It hit a low of 9.8 percent in the recession year of 1982 and a high of 11.6 percent in the boom year of 1972.

This does not mean that all states adhere to the 11 percent norm. The U.S. Bureau of the Census reported that in FY 2006, the latest year for which individual state data are available, the tax burden ranged from $91 per $1,000 of personal income in South Dakota to $166 in the bordering state of Wyoming.

Washington State and Local Taxes

Actual and Simulated

	FY 1996	FY 2006	Annual Percent Change
Taxes			
Actual (bils. $)	15.5	25.2	5.0
11 percent lid (bils. $)	15.5	26.0	5.3
I-1033 lid (bils. $)	15.5	21.5	3.3
Economic variables			
Personal income (bils. $)	134.3	236.3	5.8
Population (thous.)	5,525.4	6,307.6	1.3 [1.4]
U.S. consumption deflator (05=1.000)	0.829	1.016	2.1 [1.9]
Taxes per $1,000 of income			
Actual ($)	115	107	---
11 percent lid ($)	115	110	---
I-1033 lid ($)	115	91	---
Rank among states			
Actual	13	28	---
11 percent lid	13	23	---
I-1033 lid	13	47	---

Source: U.S. Bureau of Economic Analysis
U.S. Bureau of the Census
Washington Research Council

Note 1. Taxes reported by the U.S. Bureau of the Census include some taxes, such as motor fuel taxes, not included in general fund revenue.

Note 2. The I-1033 tax and spending growth limit in a given year is determined by population growth and inflation in the previous year. Thus, FY 1995-FY 2005 population growth and inflation determine FY 1996-FY 2006 tax and spending growth. FY 1995-FY 2005 growth rates are shown in brackets.

In FY 2006, Washington state and local tax revenue amounted to 10.7 percent of personal income, down from 11.5 percent ten years earlier. Washington ranked 28th in tax burden among the fifty states in FY 2006, compared to 13th in FY 1996. (Note that our estimates of tax burdens differ slightly from the Census estimates because of data revisions and the fact that we use fiscal-year personal income, not calendar-year personal income, to make the calculations.)

The details of how I-1033 would work have not been completely ironed out. But it is a straight-forward proposition, making it easy to analyze. Imagine that the initiative was implemented in FY 1996. To what extent would it have constrained the growth of state and local taxes? How would it have stacked up with the 11 percent lid, the collective choice of state and local governments?

Between FY 1996 and FY 2006, Washington state and local taxes increased at a 5.0 percent annual rate, climbing from $15.5 billion to $25.2 billion. Because tax revenue grew more slowly than personal income, which advanced at a 5.8 percent rate, the tax burden declined from $115 per $1,000 of income to $107, as previously noted.

Under the 11 percent lid—implying that future taxes would be limited to 11 percent of personal income—tax revenue would have risen at a 5.3 percent rate, reaching $26.0 billion in FY 2006. This amount is very close to the actual tax collections in that year, indicating that Washington state and local governments were generally operating in accordance with the national norm over the ten-year period.

If the I-1033 lid had been in effect, the fiscal picture for state and local governments would have looked radically different. Between FY 1996 and FY 2006, tax revenues would have grown at a 3.3 percent annual rate—the sum of the population growth rate (1.4 percent) and the inflation rate (1.9 percent) between FY 1995 and FY 2005 (see table note). As a consequence, total taxes would have amounted to $21.5 billion in FY 2006.

Washington's tax burden under I-1033 would have dropped to $91 per $1,000 of income, well below the norm. Washington would have ranked 47th in tax burden, sharing company with South Dakota, New Hampshire, Tennessee, Alabama, and Colorado.

Public finance experts would describe the tax system proposed by I-1033 as inadequate. Adequacy refers to the ability of taxes to keep up with the demand for public goods and services, which grows about as fast as personal income. Adequacy is not an abstract concept. It is a notion based on the empirical observation that people are willing to pay 11 percent of their personal income for the goods and services produced by state and local governments.

Why is the inadequacy of the I-1033 lid a problem? It would curb the growth of needed public goods and services. It would also unduly restrict government wages, driving out the public sector's best and brightest workers.

If schools, for example, attempted to keep class size constant—hiring new teachers when enrollments increased—they would be forced to limit teacher pay raises to the inflation rate. Because of productivity gains in the economy, wage rates typically increase about one percentage point faster than inflation. Thus, compared to workers in the private sector and teachers in other states, Washington teachers would experience falling wages.

If voters approve I-1033 in November, the limits would take effect in 2010. The base year would be 2009, which has been wracked by one of the state's worst recessions. Preliminary figures indicate that state and local tax revenue relative to personal income is currently running about 5 percent below normal, roughly $105 per $1,000 of income. Thus, I-1033 would start with tax revenues in a hole.

Over the next ten years, the state economy is projected to grow at a healthy pace—5.2 percent annually for personal income, 1.1 percent for population, and 2.2 percent for inflation, according to our forecast. The 11 percent lid would permit state and local taxes to expand at a 5.7 percent rate, reaching $50.2 billion in 2019.

I-1033 would restrict growth to 3.0 percent per year. As a consequence, tax revenue would increase to only $39.0 billion.

Bound by I-1033, tax collections would fall to $85 per $1,000 of personal income in 2019. This would most likely place Washington 50th—dead last—among states in terms of tax revenue to support state and local government. On a per capita basis, state and local operations in Washington— its programs, employees, and expenditures—would be one-fifth smaller than operations in other states.

Washington State and Local Taxes

Projected	2009	2019	Annual Percent Change
Taxes			
11 percent lid (bils. $)	28.9	50.2	5.7
I-1033 lid (bils. $)	28.9	39.0	3.0
Economic variables			
Personal income (bils. $)	275.4	456.3	5.2
Population (thous.)	6,627.8	7,372.1	1.1 [1.1]
U.S. consumption deflator (05=1.000)	1.090	1.354	2.2 [1.9]
Taxes per $1,000 of income			
11 percent lid ($)	105	110	---
I-1033 lid ($)	105	85	---

Source: The Puget Sound Economic Forecaster

The sum of money that I-1033 would divert from state and local governments would be staggering. In 2019, it would amount to $11.2 billion, according to our projections. Over the ten-year period, it would total approximately $40 billion.

It is hard to imagine that withholding that much money from the public sector would not have a crippling effect on schools and universities, police and fire departments, public health, roads and mass transit systems, and the myriad other services provided by state and local governments.

One last onerous feature of I-1033 is the selection of the U.S. consumption deflator as the binding inflation rate. A more appropriate deflator would be the U.S. state and local government implicit price deflator, since it reflects the costs of the goods and services—education, healthcare, infrastructure—provided by state and local governments. Even better would be a deflator adjusted to take into account how fast local prices were rising relative to national prices, as indicated by the respective consumer price indexes.

Between 1995 and 2009, the adjusted state and local inflation rate was 3.8 (=3.4+2.9-2.5) percent, nearly twice the 2.1 percent rate for U.S. consumer expenditures. Over the next ten years, it is projected to be 3.0 percent. Adopting this higher inflation rate would appreciably loosen the tax lid. By 2019, Washington state and local taxes would grow to $43.2 billion or $95 per $1,000 of personal income.

Price Deflators

Annual Percent Change

	1995-09	2009-19
U.S. consumption deflator (05=1.000)	2.1	2.2
U.S. state and local deflator (05=1.000)	3.4	3.0
U.S. consumer price index (82-84=1.000)	2.5	2.4
Seattle consumer price index (82-84=1.000)	2.9	2.4

Source: U.S. Bureau of Economic Analysis
U.S. Bureau of Labor Statistics
The Puget Sound Economic Forecaster

There is nothing inherently wrong with a limit on state and local taxes. Over the past four decades, state and local governments as a whole have been operating under an 11 percent lid. Washington has also implicitly adopted this restriction, sometimes rising above it and sometimes falling below it. The existence and longevity of this lid reflects the fact that the demand for public goods and services and our willingness to pay for them—like the demand for private goods and services and our willingness to pay for them—tends to increase proportionally with personal income.

I-1033 is a lid on state and local taxes, but its impact would be more like that of a sledge hammer. Rather than letting the public sector expand along with the rest of the economy, it would knock down Washington state and local government one brick at a time. In ten years, our ability to provide the quantity and quality of public goods and services required for a competitive economy and a high standard of living would be the lowest in the nation.

Is that what the people of Washington want?

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Dick Conway is solely responsible for the research and conclusions in this article. He has not been paid or sponsored by any person or entity.