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Time Will TEL: Voters to Decide the Fate of Initiative 1033

Briefly

Initiative 1033, which will be on the statewide ballot in November, would establish limits on the annual growth in revenue deposited in state, county and city general funds. Revenues above the limit would be rebated through property tax reductions.

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Overview

Initiative 1033 will be the sole statewide initiative on the November ballot this year. The measure's stated intent is "to protect taxpayers by reducing our state's obscene and unsustainable property tax burden by controlling the growth of government to an affordable level."

Which governments does the I-1033 cover? The initiative applies to the major taxing districts in the state: state government itself, counties and cities. It does not apply to other local jurisdictions such as school districts, ports, fire districts, library districts, and so on.

What does I-1033 do? The initiative places an annual limit on the amount of revenue from "taxes, fees, and other governmental charges" that can be deposited to each covered jurisdiction's general fund. General-fund designated revenues above the limit are to be deposited in the jurisdiction's "Lower [State, City or County, as appropriate] Property Taxes Account" rather than the general fund. The money deposited in the lower property taxes account is then rebated to taxpayers through a reduction in the following year's property tax levy.

How is the limit determined? For any calendar year, the rate of growth in deposits to a jurisdiction's general fund could be no greater than the sum of the jurisdiction's rate of population growth and the national rate of consumer price inflation, the same growth factor used in the Initiative 601 state general fund spending limit adopted by the voters here in 1993. The population growth rate to be used in this calculation is to be based on the annual population estimates prepared by demographers in the state office of financial management. The inflation rate to be used is the annual increase in the implicit price deflator for personal consumption expenditures, as calculated by the U.S. Department of Commerce's Bureau of Economic Analysis.

When would the limit become effective? General fund revenue would first be limited in calendar year 2010. The first rebates of surplus revenues would occur through the 2011 property tax levies, which are to be certified to county treasurers by November 30, 2011 for collection in 2012.

TELs

The revenue limit that would be imposed by I-1033 is a type of TEL (tax and expenditure limitation), which will complement Washington's existing spending TEL, Initiative 601.

The National Conference of State Legislature's reports that 30 states, including Washington, have some sort of TEL. Specifics vary considerably from state to state. Key dimensions of variation include: whether spending or revenue is limited, the rate at which the limit grows, the scope of state and local funds covered by the limit, and whether the limit is statutory or constitutional.

The most common type of TEL is an expenditure limit that ties the growth in spending to an index such as personal income or the sum of population growth and inflation. Eighteen states have such a limit. Another four states limit appropriations to a percentage (ranging from 95 percent to 99 percent) of forecast revenues. In four states the TEL takes the form of a limit on revenue, with the excess refunded to taxpayers. For three of these states, the limit is tied to personal income; for the fourth state, the limit is tied to wage and salary income. Three states have hybrid limits.

In 16 of the 30 states, the TEL is (at least in part) in the state constitution.

Many TELS are accompanied by provisions that make it more difficult for legislators to raise taxes, such as requirements that tax increases receive supermajority votes in the legislature or that increases be referred to a vote of the people. Initiative 601 imposed supermajority and public vote requirements, subsequently reenacted in Initiative 960 adopted by the voters in 2007.

I-601 originally limited the growth in spending from the state general fund to the sum of the rate of state population growth and inflation, averaged over three years. The initiative also required that tax increases receive two-thirds majorities in the legislature and be referred to a vote of the people when the revenue increase would allow spending to exceed the limit. In the same election, voters turned down a second TEL initiative, I-602, that would have capped the total revenue from a broad range of sources to approximately 9.3 percent of state personal income.

Approval of I-601 was in part a reaction to actions by the 1993 Legislature that raised $1.2 billion in new revenue to fund unsustainable spending commitments made in the 1991 and 1992 sessions. These tax increases capped a long period of rising tax burdens in the state.

In FY 1980, Washington ranked 28th highest among the states in state and local tax collections per $1,000 of personal income ($108.75) and 19th highest in state and local tax collections per capita ($981). By FY 1995, the last year before the I-601 spending cap became effective, Washington's ranking had risen to 11th highest in tax collections per $1,000 of personal income ($123.00) and 10th highest in tax collections per capita ($2,728).

By FY 2006 (the most recent year for which state and local tax data are available from the Census Bureau), Washington ranked 28th in taxes per $1,000 of personal income ($111.99) and 18th in taxes per capita ($3,948).

The 2000 and 2005 Legislatures each passed a bill that substantially weakened the I-601 limit. (After two years, lawmakers may amend initiatives by a simple majority. Washington does not permit constitutional amendment by popular

Limits on Regular Property Taxes

While I-1033 would impose broad limits on general fund revenue growth, revenues from property taxes are already subject to several specific limitations.

Washington's constitution limits "the aggregate of all tax levies upon real and personal property" to "one percent of the true and fair value of that property in money," except in cases where the taxes have been explicitly approved by voters for a limited period of time. With only a few exceptions, taxes levied within the one-percent levy limit are termed regular levies, while those outside of the one-percent limit are excess or special levies.

Tax rates are generally stated in terms of dollars per $1000 of value. The one-percent limit thus limits regular property taxes to $10 per $1000. Of the $10 limit, state statute reserves $3.60 for the state, $3.60 for cities, $1.80 for counties and $2.25 for county road districts, which build and maintain roads outside of city limits.

Since the 1970s, regular property taxes have also been subject to revenue growth limits. These limits were substantially tightened in November 2001 when voters approved Initiative 747.

The Initiative 747 growth limit caps the annual growth in a district's regular property tax revenue at the lesser of 1 percent or the rate of inflation, plus an increment equal to the percentage by which new construction has increased the districts property tax base (i.e. the assessed value of property within the district).

The I-747 limit has reduced the property tax burden in the state. In FY 2000, Washington ranked 16th highest among the states in per capita property tax collections and 18th highest in collections per $1,000 of personal income. By 2006, Washington's property tax rankings had dropped to 25th per capita and 29th per $1,000 of personal income.

For more information on property taxes, see the WRC publication, *A Citizen's Guide to Property Taxes*:

http://www.researchcouncil.org/publications_container/Citizens%20Guide%20Jan%202008%20Final.pdf initiative.) The 2000 bill, HB 3169, established the “two way street” loophole that allowed legislators to manipulate the limit by shifting program costs and tax revenue back and forth between the general fund and other state accounts (WRC 2001; WashACE 2005).

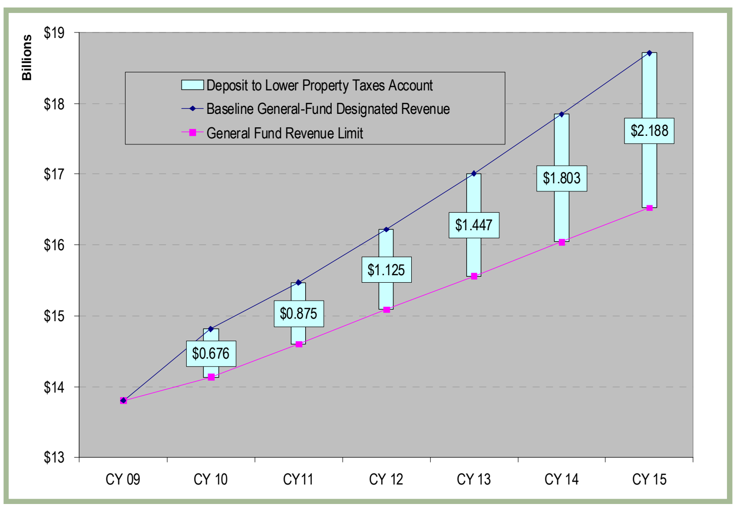
The 2005 bill, SB 6078, changed the allowed rate of growth in spending from a three-year average of inflation plus population growth to a ten-year average of personal income growth (WashACE 2005).

Over the last thirty years, state personal income growth has exceeded the sum of inflation and population growth by an average of 2 percent per year (6.2 percent per year versus 4.2 percent).

Fiscal Impact

The Office of Financial Management (OFM) estimates that in its first six years of operation, the I-1033 limit will divert $8.1 billion from the state general fund, $3.0 billion from city general funds and $0.9 billion from county general funds. Charts 1 and 2 illustrate the workings of the limit for the state, based on the OFM estimates.

Chart 1: General Fund State Revenues Under I-1033



The upper line on Chart 1 represents OFM’s forecast path of general-fund designated revenues (net of the constitutionally required transfer to the budget stabilization account), while the lower curve represents the forecast path of the I-1033 limit. Baseline general-fund designated revenues are expected to grow from $13.8 billion in 2009 to $18.7 billion in 2015. The limit grows more slowly, reaching $16.5 billion in 2015. The excess designated revenues over the limit, which must be deposited in the lower state property taxes account, begins at $676 million in 2010 and grows to $2.2 billion by 2015.

Chart 2: Impacts on the State General Fund by Year

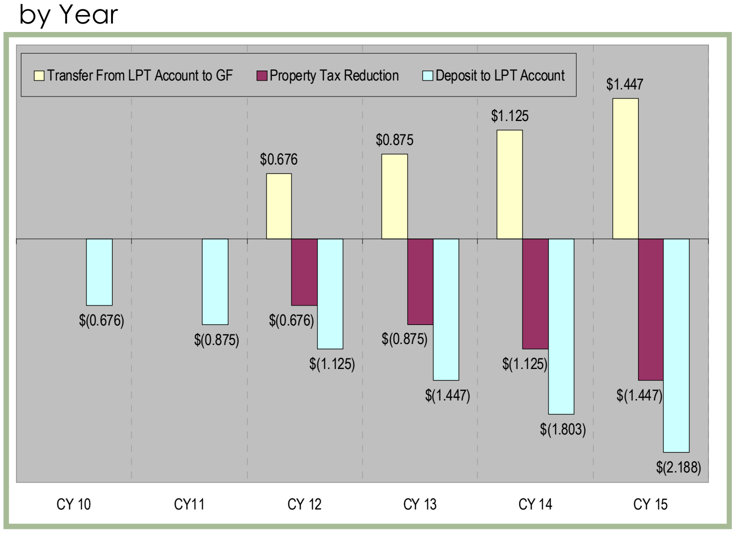


Chart 2 shows the specific impacts of the limit on the general fund by year. In 2010 and 2011 the only impacts are the diversions of deposits from the general fund to the lower state property taxes account, which reduce the flow of funds into the general fund by $676 million in 2010 and $875 million in 2012. Things are a bit more complicated in 2012, the first year for which I-1033 results in a property tax reduction. There are now three separate impacts: (1) a $676 million property tax reduction, equal to the 2010 deposit to the lower state property tax account, (2) a $676 million transfer from the lower state property tax account to backfill the tax reduction, and (3) a $1,125 million diversion of 2012 general-fund designated revenue in excess of the limit to the lower state property taxes account. The property tax reduction and the transfer from the lower state property tax account offset each other, so that the net impact is just the $1,125 million shown as the third impact.

The CY 2010 diversion will reduce general fund revenue for the 2009–11 biennium by $676 million, while the CY 2011 and 2012 diversions will reduce revenue for the 2011–13 biennium by a total of $2.0 billion.

Impact on the 2009–11 state budget.

Based on the March 2009 revenue forecast, the budget for the 2009–11 biennium enacted during the 2009 legislative session had a projected ending balance in the general fund of $488.8 million. The June revenue forecast reduced 2007–09 revenues by $183.8 million and 2009–11 revenues by $502.2 million, resulting in a projected 2009–11 ending balance of negative $195 million. The $676 million I-1033 diversion would increase that shortfall to negative $871 million.

Impact on the 2011-13 state budget.

Even without passage of I-1033, the budget outlook for 2011–13 is grim. While the 2009 legislature did make substantial real cuts in spending, it also relied heavily on onetime money to balance the 2009–11 budget. Incorporating the June forecast, general fund spending for the biennium exceeds revenues by $1.4 billion. In addition, $2.5 billion in federal stimulus funds are being used to sustain programs that would normally be funded through the general fund. For 2011–13 these programs will shift back to the general fund.

Using OFM's revenue growth assumptions, general fund revenues are expected to grow by $3.5 billion from 2009–11 to 2011–13.

We have yet to see projections of "maintenance-level" cost increases for 2011–13. Looking backwards, the maintenance level increase for the 2007-09 biennium was $1.4 billion, while the maintenance level increase for 2009-11 was $2.1 billion.

With a $1.4 billion maintenance level increase, the budget gap for 2011–13 would be $1.8 billion; with a $2.1 billion maintenance level increase the gap would be $2.5 billion. I-1033 would expand these gaps to $3.8 billion and $4.5 billion, respectively.

Issues

What's covered

Issues of interpretation frequently arise with respect to initiatives, which are not subject to the degree of vetting before they go to voters that bills typically receive before they come up for final vote in the Legislature. I-1033 is no exception.

I-1033's sponsors recently filed a lawsuit disputing the OFM interpretation of the scope of general fund revenue sources subject to the initiative's cap. The relevant language from the initiative reads:

> "general fund revenue" means the aggregate of revenue from taxes, fees, and other governmental charges received by [state/county/city] government that are deposited in [the general fund].

The initiative explicitly excludes federal monies from the limit for the state, but includes no such explicit exclusion for cities and counties.

In preparing the fiscal analysis of the impact on the state, OFM analysts assumed that revenue from sales; income from property, contributions and grants; grant and loan repayments; indirect and prior cost recoveries; unclaimed property; charges for publications and documents; and interest and investment earnings would not be subject to the limit. In preparing the analyses of impacts on cities and counties, the analysts excluded federal and state direct and indirect grants; state shared taxes or revenues; charges for contracted services performed by counties or cities; charges for enterprise activities or charges that are not governmental in nature; inter-fund and inter-department charges; and interest and investment earnings.

Initiative sponsors believe that all of these revenues should be covered by the limit, and fear that the OFM interpretation, by virtue of its inclusion in the voter's pamphlet, will become part of the "legislative record" of the initiative.

While the amount of money in dispute in the case of the state general fund is small, $30 million or 0.2 percent of general fund revenue, the amounts in question for cities and counties are significant. We estimate that the excluded categories were 17 percent of general fund revenues for counties in 2007 ($333 million) and 10 percent of general fund revenues for cities ($334).

Including federal and state grants, and charges for contracted services may be problematic. Federal bureaucrats will have little incentive to award grants to Washington cities and counties if they know the granted funds will simply flow out as property tax cuts. Similarly, if state legislators know that when they reduce grants, cities and counties will automatically recoup the loss through higher property taxes, they have little incentive not to reduce them. Including charges for contracted services under the limit may discourage intergovernmental contracting, which is an important tool for lowering the cost of providing government services.

OFM's analysts did count the movement of funds from the lower property tax accounts as revenue subject to the limit. One could argue, however, that these funds are outside of the limit because the initiative calls for this money to be transferred to (rather than deposited in) the general fund. Exclusion of transfers from the limit would mean smaller property tax cuts and allow somewhat greater growth of general fund spending.

Can local voters opt out?

The initiative contains this language with respect to voter approval for revenue to grow at a rate faster than the sum of inflation and population growth:

> "The growth rate of [state government/each county government's/each city government's] general fund revenue, not including new voter-approved revenue, must be limited to inflation and population growth."
>
> "For the purposes of this section, "new voter-approved revenue" is defined as the increase in revenue approved by the [state's/county's/city's] voters at an election after the effective date of this act."

While the authors of the initiative may have imagined that these votes would take the form of a levy lid lift, where voters were asked to approve an additional increment of property tax, an alternative interpretation might conclude that the language allows city or county voters to opt out of the I-1033 limit completely.

How bad is the "rebase"?

Some have expressed a concern that in economic downturns revenue would fall below the limit and that this lower revenue amount would become the base from which future limits would be calculated. For the state, at least, a mild recession would not automatically lead to such a rebasing. Why this might be so can be seen in Chart 1. The growth trend in revenue is about 1.8 percent per year more than the growth trend in the revenue limit. For this reason, the gap between the actual revenue and the limit widens considerably each year. By calendar year 2012, projected state revenue is actually greater than the projected limit for 2014. Were there no growth in revenue between 2012 and 2014, revenue in the latter year would nevertheless exceed the limit.

As a practical matter, however, there will be pressure on jurisdictions to rebase. In our example of no revenue growth from 2012 to 2014, taxing districts would be faced with a choice in 2015 and 2016: Should they set property tax rates to collect the full amount allowed by I-747, which would be perceived by property owners as a tax hike, or should they avoid the perceived tax increase by raising less revenue than allowed by I-1033. The latter option would, then, reset the limit at a lower level.

What about local rainy day funds?

For the state, I-1033 takes into account the constitutionally established rainy day fund and excludes from the limit monies transferred between the rainy day account and the general fund.

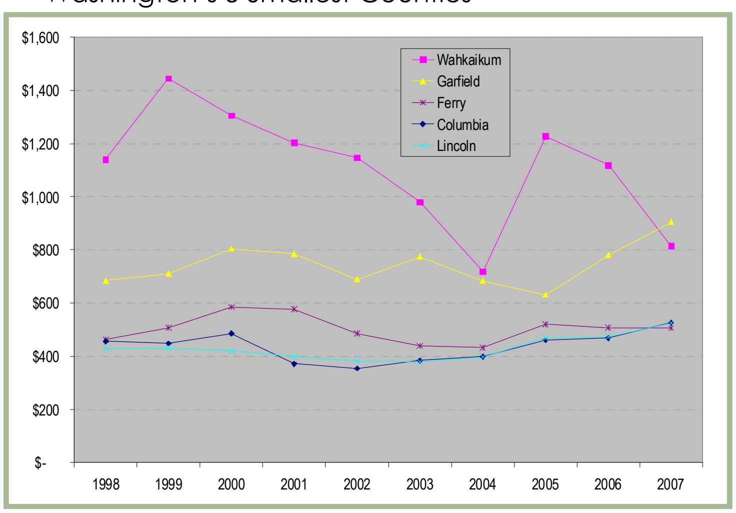
> 'General fund revenue' does not include the funds required to be transferred into the fund created under Article 7, Section 12 of the state constitution and does not include funds transferred from that fund.

For cities and counties there is no analogous provisions exempting transfers to and from rainy day funds from the limit.

Special burden for small counties and cities?

I-1033 may provide special challenges for smaller cities and counties. The revenue streams of small cities and counties are inherently less diversified than those of their larger brethren. As a result, they can be subject to larger year-to-year fluctuations. A well-managed small city or county will deal with this variability in the revenue stream by building up reserves in the good years and drawing down reserves in the lean years.

Chart 3: Inflation Adjusted, Per Capita General Fund Revenues in Washington's 5 Smallest Counties



The variability of small county revenue streams is evident on Chart 3, which shows per capita general fund revenue for Washington's 5 least populated counties, Garfield, Wahkiakum, Columbia, Ferry and Lincoln, inflation adjusted to 2008 dollars, for the years 1998 to 2007. The inflation adjustment was made using the implicit price deflator for personal consumption expenditures, which is the inflation index specified by I-1033. Of the 45 annual changes shown on the chart, 25 are positive, 18 are negative and 1 is zero. The average positive change is 14.4 percent; the average negative change is -9.2 percent.

Discussion

Passage of Initiative 1033 would reduce revenues available to state, city and county budgets in the coming years. Revenues in excess of the limit would be returned to property taxpayers as relief in the following year, beginning in 2012. Also, the pattern of property tax relief may well be lumpy.

The state's recent experience with I-601 may be instructive. In its early years, the initiative successfully kept a lid on state spending. Over time, lawmakers repeatedly amended the initiative. Some analysts argue that the ability to amend voter-approved initiatives gives lawmakers the flexibility necessary to adapt to changing fiscal conditions. Others argue that the statutory initiatives here, unlike the constitutional measures in other states, make it too easy for legislators to circumvent the will of the voters. Typically, legislators have been reluctant to overturn or make substantial amendments in initiatives in the years immediately after passage.

The effects of I-1033 on cities and counties will likely vary considerably. Some communities have substantial population growth, while others have plateaued or even fallen into decline. Economic conditions, property valuation, taxing authorities, and demand for public services are far from uniform across local governments in our state.

Initiative backers say there's a simple remedy to a too-tight limit: Ask the voters to loosen the restraints. Opponents, on the other hand, object to ballot-box budgeting, which can frustrate long-range planning, delay decision-making, and add another layer of election costs to tight budgets. That philosophical debate has been ongoing since well before the 1993 vote to adopt I-601 and is unlikely to end this year with I-1033.

However I-1033 plays out over time, the immediate effect will be to hold revenue growth below current projections for the state's major governments during the anticipated economic recovery, while providing uneven property tax relief beginning in three years.

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