New Tools for Building the Middle Class

Economic Opportunity Institute

Blueprint

It's Not Just the Recession: The Budget Crisis and Washington State's Structural Deficit

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Key Findings

The national economic downturn is a major factor in large deficits in the Washington state budget. However, the state's revenue problems will remain even when the economy is flourishing again, because our tax system is so out of step with the 21st century economy. At the root of Washington's long-term budget problem is the heavy reliance on a retail sales tax on goods, a part of our economy that is shrinking. Without restructuring the tax system, Washington residents will face the choice of either continually raising tax rates or having insufficient public revenues to fund the level and quality of public services they want and a healthy economy needs.

- Because personal income grows at the same rate as the economy, a tax on personal income would provide a critical revenue source that keeps pace with the economy.
- Extending the sales tax to the growing service sector would provide another source of revenue that keeps up with demand for public services.

Executive Summary

How fast should government and government spending grow? Do they need to grow at all?

These questions are an important part of the on-going debate over Washington state's budget and tax system. In order for state services to meet the demands created by a changing economy and growing population, *state revenues need to grow at the same rate as overall economic growth.*

Until the mid-1990s, Washington's state spending did grow along with the economy. Unfortunately, under Washington's antiquated tax system, public revenues grow more slowly than the general economy unless tax rates are continually raised. For decades the legislature did periodically raise tax rates in order to keep up with demand for improvements in public education, transportation, and other state services. However, in the 1990s a series of people's initiatives and legislative actions

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cut taxes. The economic boom of the 1990s generated sufficient public revenues to blunt the effects of those cuts at first. But the boom is over, and isn't likely to return for any sustained period.

The national economic downturn that began in 2001 has hit the Pacific Northwest particularly hard and has been a major factor in large deficits in the state budget. Almost every state in the country is faced with similar deficits in 2003. However, unlike most other states, Washington's financial problems will remain even when our economy is flourishing again, because our tax system is so out of step with the 21st century economy. Washington residents will face a continuing struggle to find sufficient public revenues to fund the level and quality of government services they want and need – unless we bite the bullet and reform our tax structure.

At the root of Washington's long-term budget problem is the heavy reliance on a retail sales tax on goods, a part of our economy that is shrinking. As the 2002 Washington Tax Structure Study Committee headed by William Gates, Sr. also concluded, Washington state needs to expand the tax base to fit the 21st century economy, particularly by:

1. extending the sales tax to areas of the economy that are growing, that is services; and
2. adding a new source of revenue to our overall system that can be expected to keep pace with general economic growth. Since personal income grows at the same rate as the economy, a personal income tax would best fill this need.[1]

These reforms would also improve Washington's tax system by making it fairer, distributing tax paying responsibilities more equitably among state residents.[2]◆

Is Government Growing?

Measured against the state's economy, government spending and jobs have both been declining in recent years. Historically, demands for public services and growth in government spending have closely followed growth in the overall economy and in personal income, both in Washington state and nationally.[3] Figure 1 shows Washington state spending from all sources and the state economy (gross state product) growing at similar rates, with a tail-off in the growth of state spending in the late 1990s after the adoption of spending limits and tax reductions. Personal income in the state grew at the same pace as the economy over this period.[4]

The growth in government jobs has also followed fairly closely the growth in jobs in Washington's overall economy over the past 50 years, increasing a little faster than general job growth early in the period and a little more slowly since the late 1970s. Meanwhile, manufacturing employment in the state has shrunk steadily from over a quarter of non-agricultural jobs in 1950 to 13% in 2001, while the percentage of service jobs has more than doubled.

In comparison to these major shifts, government employment has remained a fairly stable component of the state's workforce. Nevertheless, the long-term trend toward smaller government is obvious. Government workers make up a smaller percentage of the state's workforce today than at any time since 1950.[5]◆

Figure 1. Percentage Growth in Washington State Spending and the State Economy

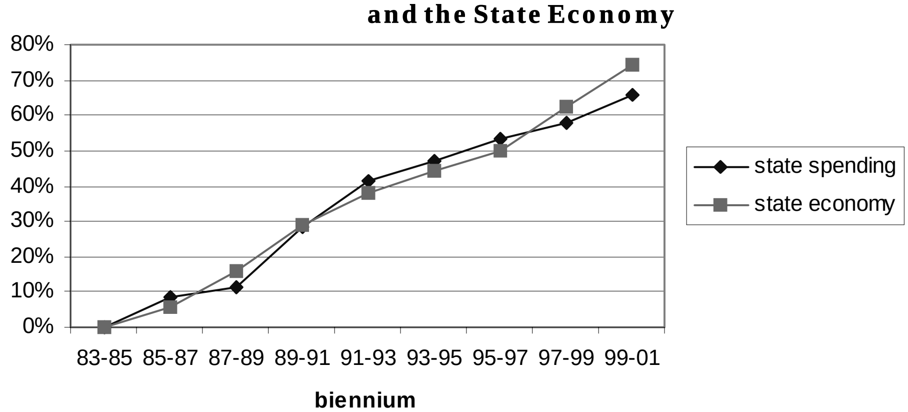
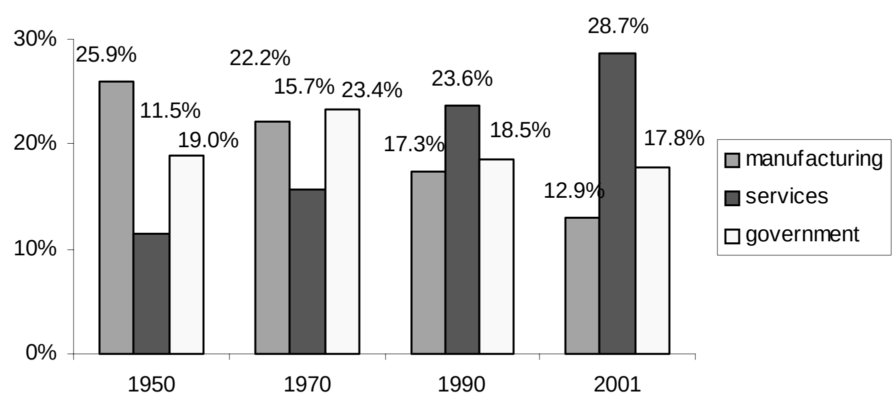


Figure 2. Non-Agricultural Workers by Selected Industry in Washington, 1950-2001*



*"Government" includes federal, state, local government, and school district workers.
Source: Employment Security Department

Who are government workers?

- 58% are in local government; 51% of those are in K-12 education
- 28% are in state government; 54% of those are in higher education
- 13% are in federal government

How Fast Does State Spending Need to Grow?

Initiative 601, passed by Washington state voters in 1993, established state spending limits based on population growth and inflation over a three-year average.[6] While at first glance this may seem like a reasonable limit, over time it will further shrink state government and not allow services to keep pace with public needs. In fact, state spending needs to grow at the same rate as the overall economy and personal income. Even President Bush, who has often advocated smaller government, noted in his 2003 State of the Union address that government spending should grow "about as much as the average family's income is expected to grow. And that is a good benchmark for us."

Population growth and inflation are certainly two major factors that push up government spending, but the 601 limit fails to account for other important drivers of demand for state services:

1. The economy and personal income grow at a faster pace than population growth plus inflation, creating more demand for state services.
2. Particular populations requiring state services, for example school-aged children and seniors, increase at higher rates.
3. The cost of some services, such as medical care, rise faster than inflation.
4. Policy changes, such as shifting responsibilities from the federal government to the states or increasing homeland security, require new expenditures.

Pressures from economic growth

The economy and personal incomes grow faster than population growth and inflation because of productivity growth. Increased productivity means that fewer workers can produce more goods; therefore workers can also earn more. Over the past 30 years, personal income in Washington state increased at an average annual rate of 8.8%, while inflation averaged 5% annually. At the national level, between 1970 and 2000 average wages (which does not include all income) increased by 6% annually. These growth rates slowed over the decade of the 1990s, with personal incomes rising on average 6.1% annually, average wages rising 4.5%, and inflation averaging only 2.7%.[7] The difference in these rates of growth is small in any single year, but over time, the differences add up.

Of course some state services are also provided more efficiently over time with productivity and technological improvements, but other state services require new or higher levels of spending as the economy grows and standards rise. Rising personal incomes alone lead to more demands on government. As their incomes go up, people spend more and come to expect a higher standard of living. They also expect more from their government, including higher quality schools, better-equipped hospitals, nicer parks, and more technologically sophisticated libraries.[8]

K-12 education, which consumes 43.5% of the state General Fund, provides a good example of why state spending needs to increase along with economic growth. What if the number of teachers grows only with population growth or, more appropriately, with growth in the school-age population, and teacher salaries increase only at the rate of inflation? Our schools would not be able to meet the rising standards demanded by a more complex and technological economy. They would not be able to provide smaller classes in the primary years or to teach higher levels of math, science, and computer literacy to a greater percentage of high school students. In addition, with salaries in the private sector rising faster than inflation, over time teachers would lose substantial ground compared to individuals in other occupations, making it harder to attract and retain good teachers and to meet rising expectations of student achievement.

At the same time, our state's businesses are demanding more workers with post-high school training and education. As a result, more state residents need access to our technical and community colleges and universities. Between 1970 and 2000, the percentage of 17 to 22-year-olds enrolled in public institutions of higher education in Washington increased by 22%.[9]

Demands on the transportation infrastructure and other state services also increase as the economy grows and becomes more complex. Between 1980 and 2000, while Washington's population increased by 43% and employment increased by 58%, vehicle miles driven on our state roadways increased by 88%.[10] Not only are new residents putting more pressure on our state's roads, but everyone is driving more. Over the past thirty years, far more women have entered the workforce and the number of two-earner households has substantially increased.[11] As a result, there are more commuters today. At the same time, as our cities have grown average commute distances have lengthened. And as incomes rise, families have more vehicles and individuals drive more for other purposes as well.[12]

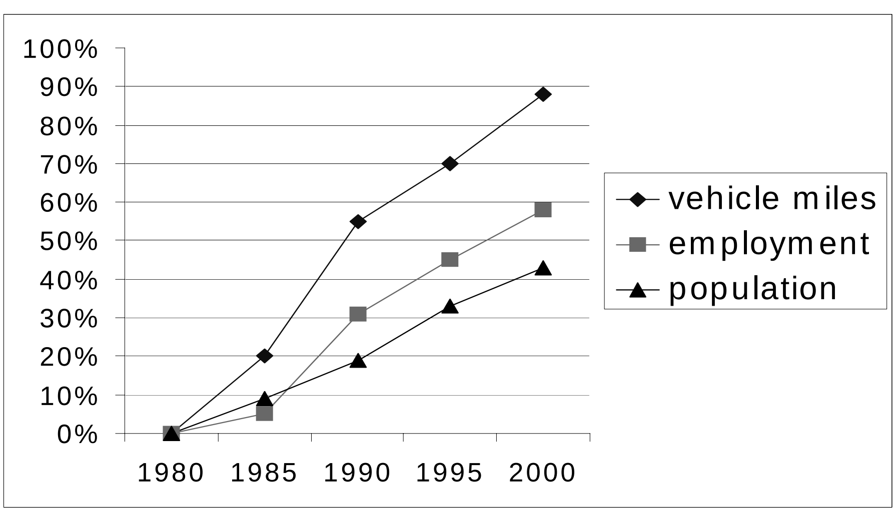
Pressures from specific population and cost increases

General population growth also fails to account for particular demands for state services brought about by either natural population shifts or policy changes. In addition, some specific costs increase faster than inflation. For example:

- **K-12 education -** Between 1985 and 1998, the number of 5 to 17-year-olds increased sharply as the baby boom echo reached school age. The rate of increase in school kids is expected to slow over the next decade.[14] However, heightened pressures on the public school system may continue, as the progress towards higher standards, smaller class sizes, and popular programs like all-day kindergarten leads more parents to choose public over private schools.

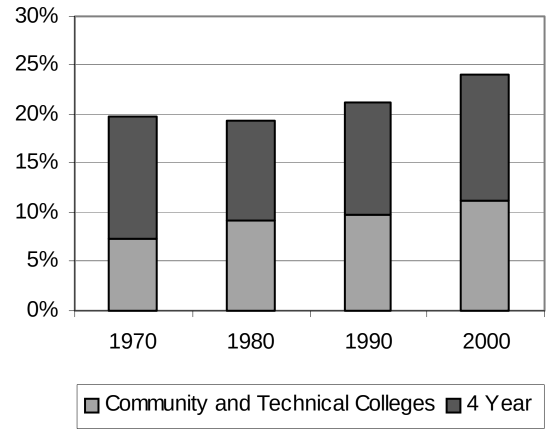
How Fast Does State Spending Need to Grow?
cont'd

Figure 3. Extra Cost Drivers in Transportation: Percentage Increase in Population, Employment, and Vehicle Miles in Washington, 1980-2000[13]



How Fast Does State Spending Need to Grow?
cont'd

Figure 4. Extra Cost Drivers in Higher Education: Percentage of 17-22-Year-Olds in Public Higher Education in Washington



Source: OFM, Washington State Data Book

In Seattle, the state's largest school district, the percentage of 5-year-olds entering public kindergarten increased from 57.3% in 1996 to 63.8% in 2002.[15]

- **Higher education -** Since 1995, the prime college-age population has been rising steeply and will continue to increase faster than general population growth through about 2010.[16] At the same time, a greater percentage of young people are continuing their education beyond high school (Figure 4), and more displaced workers are trying to return to technical and community colleges to upgrade and modernize their job skills.

- **Senior services -** The percentage of seniors in the population is steadily increasing and will continue to through the 21st century, placing ever greater demands on such state supported services as home care, long-term care, and Medicaid.[17]

- **Prisons –** Tough-on-crime policies adopted in the late 1980s caused the prison population to double between 1988 and 2000.[18]

- **Healthcare spending** – Public policy changes, declines in employer-provided coverage, and skyrocketing costs have all driven up state spending on health care.

  Since the mid-1980s, both the state and federal governments have sought to expand health insurance coverage to greater numbers, including children, pregnant women, and low-income working adults. Meanwhile, private employers cut back substantially on health insurance coverage.

  The percentage of workers in firms with more than 100 employees with employer-provided health plans fell from 97% in 1979 to 76% in 1997, and employers also began requiring workers to contribute substantially more to the cost.[19]

  Because of these policy and employer decisions, while Washington's overall population grew by 41% between 1981 and 2001, the number of state residents receiving public medical assistance increased by 168%.[20] In addition, during the 1990s healthcare costs increased at an average rate of 7% annually, or over twice the rate of inflation, driving up the costs of public healthcare programs for children and low-income, disabled, and senior residents, as well as the costs of providing medical insurance to state employees.[21]

Over time, different population shifts, inflationary trends, economic changes, and social pressures affect different state programs and different parts of the state budget. Growth in the overall economy encompasses these various changes for the most part, and therefore is a good general yardstick for how fast state spending actually needs to grow over the long run.◆

Washington's Tax System Has Fallen Behind

The structural deficit

Washington state's current tax structure was adopted in the 1930s. The three major sources of revenue for the state General Fund are a retail sales tax on goods, a Business & Occupation (B&O) tax on gross business receipts, and a tax on real property.[22] A recent analysis by the Office of Financial Management shows that Washington's tax system has failed to produce public revenue at a rate to match economic growth. As a result, the state has been forced to raise rates on existing taxes or add new taxes in order to keep up with demand for services.[23]

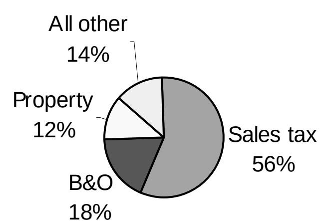
The Office of Financial Management estimates that without constantly raising rates or expanding the tax base, future state revenue will only grow at about 85% of the rate that personal income and the overall economy are expected to grow. This "structural deficit," or the gap between state revenues and demand for state expenditures, will persist after the economy rebounds from the recession. The gap will grow each year, becoming an ever greater problem.

The structural deficit in Washington's tax system is due in part to recent tax cutting initiatives and legislatively enacted tax cuts. However, a more important factor is the state's heavy reliance on retail sales tax.

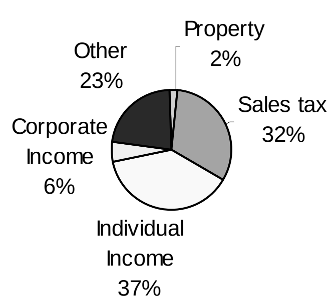
In Washington, sales taxes accounted for 56% of General Fund revenues in the 2001-03 biennium. In contrast, among all states in the nation, sales taxes accounted for 32% of state revenues on average, and personal income taxes contributed 37%.[24] Washington is one of only seven states without a personal income tax.

Figure 5. Revenue Sources for Washington State and Average for All States, 2001[27]

Washington State General Fund



Average for All States



Washington's Tax System Has Fallen Behind cont'd

Washington's tax structure is also unusual in applying a gross receipts tax on businesses rather than a corporate income tax, and in remitting a significant share of property tax collections from local governments to the state to more equitably finance public schools.[25]

The structural deficit that Washington faces mirrors those in many other states that rely heavily on sales taxes, but Washington's problem is more severe because sales taxes represent such a large share of total revenues. A national analysis ranked Washington state 49th in the nation when comparing the growth in tax revenue to the growth in personal income between 1999 and 2000.[26]

Why the sales tax isn't keeping up with economic growth

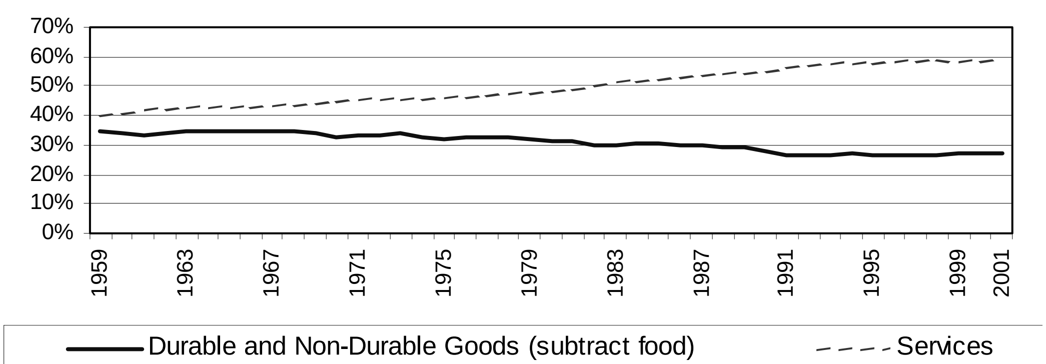
When Washington adopted the retail sales tax in 1935, it applied only to goods. Services such as those provided by lawyers, accountants, and barbers were excluded from the sales tax. This exclusion was not a problem initially because at the time services accounted for a relatively small portion of the economy. Our economy has changed considerably since 1935, however. Since 1960, services have increased from 40% of personal expenditures to nearly 60%. Over the same time period, our traditional sales tax base (durable and non-durable goods, minus food) has decreased from 35% to 27% of personal expenditures.[28]

The implication for Washington's tax system has been a slow growing sales tax base that constantly requires an increase in rates to keep pace with the faster growing needs for public goods and services. Washington's retail sales tax started at a rate of 2% and has been raised eight times to the current rate of 6.5%.[29] Local governments also have the authority to collect sales tax, so in most parts of the state consumers pay over 8% tax on their purchases.

Internet and other remote sales, such as through catalogs, have also begun to cut into sales tax collections. Typically, state sales taxes are collected on in-state purchases by merchants and then remitted to the state government. In the case of purchases made over the Internet, the United States Supreme Court has ruled that state and local governments cannot require Internet merchants to collect sales taxes on purchases unless the merchant has a physical presence within the state's borders.

In theory, Internet purchases are subject to the state use tax, which requires taxes to be paid on goods that are purchased in another state for use in Washington, but in practice the use tax is nearly impossible to enforce on individuals. As a result, consumers and some businesses that purchase goods over the Internet

Figure 6. Traditional Sales Tax Base vs. Services as a Share of Personal Consumption



Source: Personal Consumption Expenditures - Bureau of Economic Analysis can easily evade local sales taxes. The General Accounting Office in 2000 estimated that by 2003 Internet and other remote sales would result in states loosing between 1% and 8% of sales tax revenues.[30] Economists Donald Bruce and William Fox estimate that by the year 2006 Washington state could be losing $762 million in sales tax revenue as a result of growth in electronic commerce.[31]

The retail sales tax is an important component of a stable tax system, but Washington's over-reliance on sales tax, exemption of services, and high rates are causing problems. In addition to the structural deficit, the sales tax as it is now collected contributes to making Washington's overall tax system highly regressive, with low and middle-income residents paying a disproportionate share of state taxes.[32] It also leads to evasion, with consumers going to other states to purchase goods or buying over the Internet. Without acting to expand the current tax base, Washingtonians will face long-term loss of needed state services or increasingly higher rates on existing taxes.

Tax Cutting Initiatives and Legislative Tax Reductions

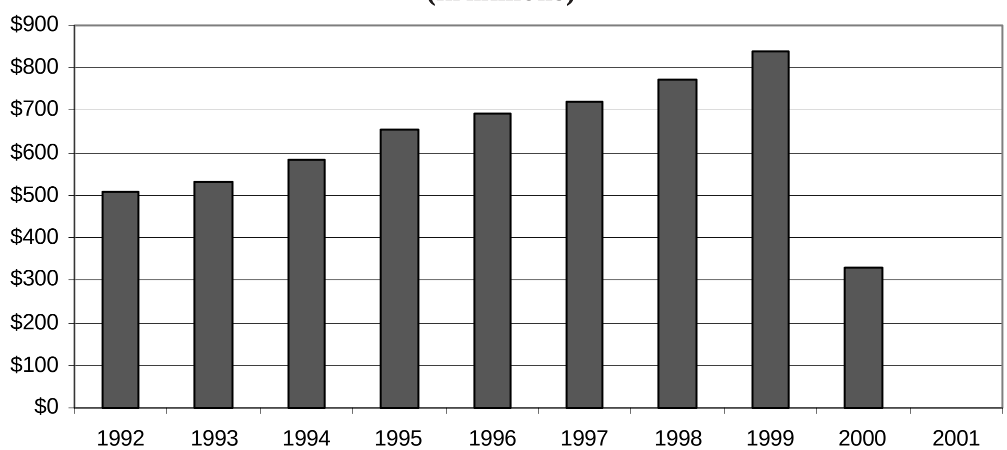
Even with the structural deficit, Washington state revenues increased steadily as the economy boomed in the mid-1990s. However, Initiative 601, passed by the voters in 1993, limited how much the state could spend, and surpluses began to build. Both the Legislature and the people responded by passing tax reductions. The long-term result of these tax reductions is a tax base that is further constricted and less able to produce adequate revenue to fund needed state services.

Tax Preferences - Between 1993 and 1999, the state adopted 101 new tax credits, deductions, or exemptions, costing the state $829 million and local governments $160 million in the 1999-01 biennium. Washington state now has over 430 tax preferences on the books, worth over $46 billion per biennium to state and local governments. These preferences include the sales tax exemption on food, tax breaks designed to protect struggling industries or lure business investment, and exemptions required by federal law. While many may be necessary or meet laudable public goals, tax breaks are rarely evaluated for effectiveness and almost never repealed.[33] And a tax preference for one industry or group reduces revenues for public services that would support and encourage all.

Motor Vehicle Excise Tax – The state began levying taxes on the assessed value of motor vehicles in 1937. In

Washington's Tax System Has Fallen Behind
cont'd

Figure 7. Motor Vehicle Excise Tax Revenues, 1992-2001 (in millions)



Source: Washington Department of Revenue

Washington's Tax System Has Fallen Behind
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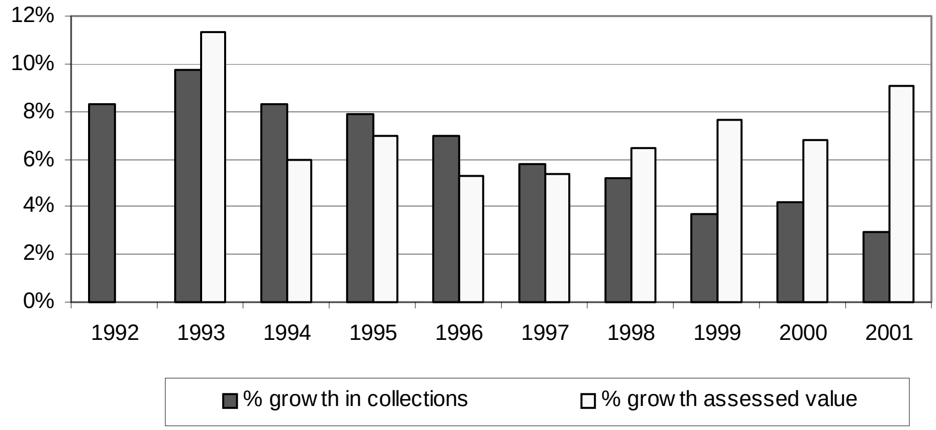
Figure 8. Growth in State Property Tax Collections vs. Growth in Total Assessed Values



1999 the Motor Vehicle Excise Tax (MVET) was levied at an annual rate of 2.2% of vehicle value. During the 1990's MVET revenues grew at a faster pace than general economic growth, compensating in part for the declining growth in the retail sales tax. However, in the late 1990s two ballot initiatives ended the MVET as a taxing source. In 1998 voters passed Referendum 49, which lowered MVET rates and diverted a portion of MVET revenue out of the state General Fund and into the state Transportation Fund. In 1999 voters passed Initiative 695, which led to the repeal of the MVET. The ballot measure was initially ruled unconstitutional, but was ultimately implemented by the Legislature in 2000. This removed a robust source of revenue from the tax base.

Property Taxes - The state portion of the property tax accounts for 25% of all property taxes paid in Washington. The other 75% of property tax revenue goes to local governments, supporting police, fire, library, and other services. Despite a rapid increase in the assessed value of real property in Washington, growth in state property tax revenues declined during the 1990s due to voter enacted initiatives. Referendum 47 passed in 1997 limited the annual growth in the property tax portions of state and local government budgets to the lesser of 6% or the rate of inflation. In November 2001, voters enacted Initiative 747, which further capped growth in total property tax collections at an annual rate of 1%. As long as this lid remains in place, property tax collections will grow much more slowly than the state's economy.[34]◆

A Partial Solution to Washington's Structural Deficit

Ensuring that public services are funded at a level that keeps pace with a changing and growing economy requires dealing with the realities of a shrinking tax base. The best long-term solutions include the implementation of a state income tax and the extension of the retail sales tax to services. Both of these options would expand the tax base to better reflect the reality of the modern economy. As a result, rates on existing taxes would not need to be raised in future years in order to maintain basic public services, and might even be lowered. In addition, by spreading taxes more evenly across the various parts of the economy, our tax system would become fairer.

A state income tax?

Income taxes are highly versatile. No matter how our economy shifts and changes in the future, personal income will most likely continue to grow at the same rate as the overall economy, so revenues from an income tax will, over the long run, keep pace with demand for public services. An income tax would also partially counter the regressivity of Washington's tax system. Now, low and middle-income families pay much higher percentages of their income for state and local taxes than do the wealthiest state residents. An income tax would assure that the wealthiest also pay their fair share for our roads, court system, fire departments, schools, hospitals, and other public services. And adding this new source to our tax base would prevent continuing increases in the regressive sales tax.

Implementing an income tax, however, will require a multi-year effort. Although Washington voters overwhelmingly approved a graduated state income tax in 1932, a state Supreme Court ruling barred the state from implementing the tax. Adopting an income tax in most forms in this state would therefore likely require either a constitutional amendment or a review by the state Supreme Court.[35]

Washington voters have also voted down income tax measures seven times between 1935 and 1973 by wide margins.[36] Thirty years have passed since the last defeat of an income tax at the polls, and recent public opinion polls suggest that voter sentiment could now be different. However, the high level of organization and recent successes of anti-tax advocates make most political leaders leery of raising the subject.

Sales tax on services

Ending sales tax exemptions on services is a key component of long-term structural reform. It could also be done immediately by the Legislature. This is, therefore, a better option than a state income tax for dealing with immediate budget deficits and preventing cuts to important services in the 2003-05 biennium.

A handful of services have been added to the Washington sales tax base over the years, including services performed on tangible personal property (such as car repair), construction services, and more recently tanning parlors and dating services. Most services remain exempt, however, including medical services, financial services, professional and business services such as lawyers and accountants, and many consumer services.

Most states have found it easiest to add consumer services to their sales tax base and have gradually begun to do so.[37] The Washington Tax Structure Study Committee also recommended extending the sales tax to consumer services as an incremental step towards longer term system reform.[38]

Ending the sales tax exemption on consumer services would strengthen

A Partial Solution to Washington's Structural Deficit
cont'd

Washington's tax system in several ways, including:

- Expanding the tax base to a growing area of the economy.
- Making the system more fair. For example, now someone renting a movie, buying tax preparation software, or buying hair dye at the drug store pays sales tax, while someone going to a movie theater, having taxes professionally prepared, or going to a beauty salon does not.
- Making the system more stable. Revenues will always go up and down with the economy, but the broader the base, the less volatile the system.
- Generating additional revenues for local governments as well as the state, helping overcome the long-term losses local governments face as a result of initiatives to limit the property tax.
- Reducing the B&O tax rate on those businesses newly collecting sales tax. (Revenue estimates include this reduction.)

Applying sales taxes to other services would have similar advantages, but also more potential problems. Medical services represent a fast-growing sector of the economy and might be attractive to tax for that reason, but the exemption of medical services has many of the same social and policy advantages as exempting food and prescription drugs. Sales taxes on business, professional, and financial services could favor large businesses with in-house services over smaller firms that contract for services and lead to "pyramiding," that is, the same service being taxed multiple times before a product reaches the final consumer.[40] However, these issues and others might be mitigated with careful implementation, and the revenues generated from a sales tax on business and professional services would be sufficient to allow an overall reduction in the sales tax rate.[41]

The time to act is now

In 2003, Washington state and local governments are making serious cuts in public education, health care for our state's most vulnerable residents, and other important services. Because of the struggling national economy, every state is facing budget shortfalls. The economy will rebound from the recession, although most economists believe that recovery will be slow. State revenues will gradually increase again as the economy picks up. However, without a reformed and expanded tax

Estimates of New Revenue from Ending the Sales Tax Exemption on Consumer Services, 2003-05 biennium (in millions)[39]

Extending Retail Sales Tax to Consumer Services	State Revenue	Local Revenue
Barber/beautician services	$49.1	$15
Cable TV	$55.1	$16
Motion pictures, theaters, bands & orchestras	$28.7	$8.3
Amusement & recreation, professional sports	$74.8	$21.7
Veterinary	$35	$10.2
Misc. personal services	$12.4	$3.6
Tax prep. services	$2.8	$0.8
Total	**$255.9**	**$73.6**

base Washington's structural deficit will remain and get worse with time. State revenues will not grow nearly as quickly as the overall economy and personal incomes. As a result, there will not be enough public money to fund the kind of education system, transportation infrastructure, and social services that Washington residents want and need.

In order to have the resources and the services to keep our people, our businesses, and our communities healthy, government revenues need to grow at the same pace as the economy. Adopting either an income tax or a sales tax on services by itself would improve Washington's tax structure. Adopting both would provide Washington residents with a more fair and stable system, capable of supporting the public services that are essential to building and maintaining a high quality of life for the people of our state. The time has come to reform Washington's outdated tax structure.◆◆

Endnotes

[1] The Committee also proposed a major restructuring of business taxes and regular review of tax preferences. Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Nov. 2002, chap. 4, http://dor.wa.gov/content/WAtaxstudy/Chapter_4.pdf.

[2] Washington's tax structure has been ranked the most regressive in the country, with the lowest income residents paying 17.6% of their income in state and local taxes, middle income residents paying 11.2%, and the highest income paying 3.3%. The Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2002*, January, 2003, http://www.ctj.org/itep/whopays.htm. Somewhat different percentages but a similar pattern are reported by the Tax Structure Study Committee, Final Report, Chap. 9, p. 97-102, http://dor.wa.gov/content/WAtaxstudy/Chapter_9.pdf.

[3] Washington Office of Financial Management, "Adequacy of State Revenues Presentation to the Washington State Tax Structure Committee", Feb. 8, 2002, http://www.ofm.wa.gov/fiscal/adequacy/ofm20020208.pdf; Elizabeth McNichol and Kevin Carey, "Did States Overspend During the 1990s?" Oct. 15, 2002, Center on Budget and Policy Priorities, pp. 3-5, www.cbpp.org.

[4] Growth in state spending and personal income can be found in, Office of Financial Management, *2001 Washington State Data Book*, Table GT17, http://www.ofm.wa.gov/databook/index.htm. Gross state product is compiled by the U.S. Bureau of Economic Analyses, http://www.bea.gov/bea/regional/gsp/action.cfm. The figures were adjusted for inflation, using the Consumer Price Index figures from the 2003 Annual Report of the Social Security Trustees, Table V.B1, www.ssa.gov.

[5] Data on workers by industry in Washington since 1950 were provided by the Employment Security Department. Federal spending also shrank steadily as a percentage of gross domestic product (GDP) during the 1990s, from over 22% of GDP through most of the 1980s and early 1990s to about 18.5% from 1999 to 2001. Congressional Budget Office, Historic Budget Data, Table 6, http://www.cbo.gov/showdoc.cfm?index=1821&sequence=0#table6.

[6] The three year average under I-601 is lagged by two years, so the fiscal growth factor for fiscal year 2003 is based on population and inflation in 1999, 2000, and 2001. The inflation measure used is the "Implicit Price Deflator for Personal Consumption" estimated by the federal Department of Commerce. When actual expenditures fall below the allowed amount, the base on which the future limit is calculated lowers. For more on I-601, see Irv Lefberg, "Changing the Rules of the Game: Washington Fiscal Developments Before and After Initiative 601," Institute for Public Policy & Management, November 1999, www.ofm.wa.gov.

[7] Average annual personal income growth from OFM, "Adequacy of State Revenues." For inflation (Consumer Price Index) and average wages, see *The 2003 Annual Report* of the Social Security Trustees, p. 93, www.ssa.gov.
[8] McNichol and Carey, "Did States Overspend During the 1990s?" p. 4.
[9] OFM, *2001 Washington State Data Book*, Tables ET121 and ET191.
[10] Washington State Department of Transportation, "Key Facts 2002," p. 2, http://www.wsdot.wa.gov/keyfacts/key_facts.pdf; WSDOT, "2001 Annual Traffic Report," 9/26/2002, p. xxxix, http://www.wsdot.wa.gov/mapsdata/tdo/annualtrafficreport.htm.
[11] U.S. Census Bureau, "Record Share of New Mothers in Labor Force," October 24, 2000, www.census.gov/Press-Release/www/2000/cb00-175.html.
[12] *Seattle Post Intelligencer*, "Commuters driving farther, Census shows," March 6, 2003; *Seattle Times*, "Buried in traffic? There's more cars on the road," January 1, 1999.
[13] WSDOT, "Key Facts 2002," p. 2, http://www.wsdot.wa.gov/keyfacts/key_facts.pdf.
[14] OFM, "Adequacy of State Revenues."
[15] *The Seattle Times*, "Public Schools Seeing More Kindergartners," May 1, 2003. The increase in public school attendance began before the onset of recession.
[16] OFM, "Adequacy of State Revenues."
[17] See U.S. Census Bureau, "Census Bureau Predicts 65+ Population To Double In Eight States By 2020," May 20, 1996, http://www.census.gov/Press-Release/cb96-80.html.
[18] OFM, "Adequacy of State Revenues."
[19] Lawrence Mishel, et al, *The State of Working America, 2002/2003*, Economic Policy Institute, 2003, p. 247.
[20] OFM, "Adequacy of State Revenues."
[21] Kaiser Family Foundation, "Trends and Indicators in the Changing Health Care Market, 2002," May 2002, http://www.kff.org/.
[22] In the 2001-2003 biennium, Washington General Fund revenue received 56% from sales and use tax, 18.3% from B&O tax, and 12.4% from the state share of the property tax. Other sources of income include real estate excise tax, estate tax, lottery profits, and other sources. The general fund supports K-12 and higher education, the legal system, social and health services, and other governmental functions. There are separate transportation and capital budgets which receive additional sources of funding, including the gasoline tax and federal monies.
[23] OFM compared growth in the tax base to growth in personal income. OFM, "Adequacy of State Revenues."
[24] Tax Policy Center, http://www.taxpolicycenter.org/taxfacts/state/source_general.cfm.
[25] 25% of property tax collections in Washington go to the state to fund public schools, but Washington residents pay about average rates for property tax, with Washington ranking 23rd among all states in property tax rates in 2000. See Table, Appendix C-26 of the Tax Structure Study final report, http://dor.wa.gov/content/WAtaxstudy/Appendix_C.pdf.
[26] Tax Foundation See http://www.taxfoundation.org/taxgrowth.html.
[27] Washington budget figures from the 2001-03 state budget. "Other" includes real estate excise tax, lottery proceeds, licenses and fees, estate tax, and other sources. Average for all states from Tax Policy Center, http://www.taxpolicycenter.org/taxfacts/state/source_general.cfm.
[28] Bureau of Economic Analysis, Department of Commerce, Personal Consumption Expenditures, http://www.bea.doc.gov/.
[29] Jason Smith, "A Concise History of Washington's Tax Structure," August 2002, Economic Opportunity Institute, http://www.eoionline.org/WATaxHistory.pdf.
[30] General Accounting Office, "Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain," June, 2000, http:??frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.21&filename=g600165.pdf&directory=/diskb/wais/data/gao; Forrester Research http://www.forrester.com/home/0,6092,1-0,FF.html.

[31] Donald Bruce and William F. Fox, *State and Local Tax Revenue Losses from E-Commerce: Updated Estimates*, Center for Business and Economic Research, The University of Tennessee, September, 2001, http://cber.bus.utk.edu/ecomm/ecom0901.pdf. Washington is one of several states seeking to adopt a streamlined sales tax agreement in an effort to capture sales tax on internet sales. See Senate Bill 5783 and House Bill 1863 and related analyses. http://www.leg.wa.gov/pub/billinfo/2003-04/Senate/5775-5799/5783_sbr.pdf.
[32] Washington's tax structure has been ranked the most regressive in the country. See, The Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2002*, January, 2003, http://www.ctj.org/itep/whopays.htm; Tax Structure Study Committee, Final Report, Chap. 9, p. 97-102, http://dor.wa.gov/content/WAtaxstudy/Chapter_9.pdf.
[33] Washington Department of Revenue, *Tax Exemptions 2000*, http://dor.wa.gov/docs/reports/2000/Tax_Exemptions_2000/contents.htm. See also, "Tax Incentives: Review or Remove," Economic Opportunity Institute, March 2003, http://www.eoionline.org/Taxes/TaxIncentives-ReviewOrRemove.pdf.
[34] See Steve Idemoto, "Potential Impacts of Proposed Initiative 747," Economic Opportunity Institute, August 2001, http://www.eoionline.org/TaxPolicy2001.pdf.
[35] The Court ruled in 1932 that income was property and therefore must be taxed uniformly under Washington's constitution. The constitution also imposes a 1% levy limit on taxes on property and limits exemptions to $3,000. Therefore any tax that exempted more than $3,000, exceeded 1%, or imposed varying rates would risk being declared unconstitutional. However, some legal scholars argue that the Court would now be unlikely to view income as property. See Hugh D. Spitzer, "A Washington State Income Tax – Again?" *University of Puget Sound Law Review*, vol. 16, no. 2, 1993.
[36] See Smith, "A Concise History of Washington's Tax Structure," http://eoionline.org/WATaxHistory.pdf.
[37] Michael Mazerov, "Expanding State Sales Taxation of Services: Options and Issues," March 24, 2003, Center on Budget and Policy Priorities, http://www.cbpp.org/3-24-03sfp.htm.
[38] Tax Structure Study, Final Report, http://dor.wa.gov/content/WAtaxstudy/Intro&Summary.pdf.
[39] Washington State Department of Revenue estimates, March 2003.
[40] Mazerov, "Expanding State Sales Taxation of Services."
[41] A sales tax on business and professional services could raise around $2 billion for the biennium, and financial services would raise about $1.4 billion according to October 2002 DOR estimates. Actual collections would be lower if adjusted to reduce pyramiding.