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Abstract

The budget and taxes dominated Washington's 2010 legislative agenda. The Democrat-led legislature had to close a $2.8 billion shortfall for the 2009-2011 biennium. Unable to resolve debate on a mixture of program cuts and revenue enhancements, the legislature concluded its 60-day regular session without a budget and tax package. At the end of a 30-day special session, the legislature enacted a budget that filled the gap through a combination of new taxes, the cancelation of some tax incentives, spending cuts, and federal aid.

Keywords: Washington State budget, fiscal policy, state taxes, state budget cuts

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Washington State 2010 Supplemental Budget Bottom Line: New Taxes

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The two major issues that dominated the 2010 legislative agenda in Washington were the budget and taxes. In January, the Democrat-led legislature was faced with no small task, namely, closing a $2.8 billion shortfall for the 2009-2011 biennium. Unable to resolve debate on a mixture of program cuts and revenue enhancements, the legislature concluded its 60-day regular session without a budget and tax package and entered into a 30-day special session. By the end of the extended session, which concluded in the early morning hours on April 13, the legislature enacted a budget that filled the gap through a combination of new taxes, the cancelation of some tax incentives, spending cuts, and the use of federal aid. This combination of elements includes $757 million in revenue from new taxes, $840 million in cuts for already-existing programs, utilization of at least $618 million in federal funds, the movement of nearly $600 million from other accounts and reserves, and the termination of some tax incentives (Camden 2010a).

There was mixed sentiment among Democrats about the tax increases and the budget in general, especially because they were keenly aware of the potential political fallout in the Fall 2010 congressional midterm elections. Meanwhile, Republicans characterized the budget, particularly the tax increases, as "flat-out wrong" and "irresponsible" (Camden 2010a). Republicans also labeled the budget "unsustainable" because many of the tax hikes are only temporary (some phase out mid-2013). The call for a budget that oriented toward the long-term was among the many critiques of the newly enacted budget. The tax package was quite divisive, both across and within parties; all of the Senate Republicans voted against it as well as six Democrats.

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Despite the adverse sentiments aired by many solons, legislators in leadership argued that the new budget utilized the best available options given the economic climate. Senate Majority Leader Lisa Brown (D-Spokane) explained, for instance, that increasing taxes was necessary to generate much needed revenue for the state to pay for the "critical public structures that unite us together as communities." She explained "[t]his is a balanced budget. To do it without any revenues would be beyond our values" (La Corte 2010b).

One third of the new tax revenues are "menu-based" tax increases affecting individual consumers and various types of businesses to generate additional revenue for the state – a projected $258 million (La Corte and Woodward 2010). Washingtonians will notice an increased sales tax on a number of convenience items, including bottled water, soda, gum, and nonmicro brew beer. These tax hikes were scheduled to go into effect in June of 2010 and are temporary, slated to end in mid-2013. It is important to note in this regard is that those who do not have ready access to clean, drinkable water will be eligible for rebates on bottled water sales taxes, and patients who have been prescribed bottled water for medical purposes are also eligible for the sales tax rebates (Nicholas 2010).

Cigarette smokers, a frequent target of the Washington state legislature's desire to use "sin taxes," will feel an increased burden as well. The cigarette tax was scheduled to increase by $1.00 per pack and go into effect May 1, 2010. This statute will drive the cost of a pack of cigarettes to about $8.00, and may motivate some smokers to purchase cigarettes in bordering states where they are less heavily taxed. Some Spokane residents indicate they are likely to go to Idaho, about 30 miles away, where a pack of cigarettes is less than $5.00 (Associated Press, *Seattle PI* 2010). This tax, like the other convenience item taxes, is scheduled to end in mid-2013 (*Q13 Fox News* 2010).

The state relies heavily on these convenience item taxes—to date, cigarette taxes go directly to health care, the state general fund, programs to stop youth violence, and education programs (Washington State Liquor Control Board 2010). Please see Table 1 below for an overview of each product and the corresponding expected tax revenue for each.

In addition to higher sales taxes on convenience items, the legislature enacted a temporary increase on some professional services—in particular, those of lawyers, accountants, and real estate agents. Hospitals and research firms are exempt, and the increase will last through fiscal year 2013 and is expected to generate $242 million in revenue. The state also adopted an "economic nexus" framework with respect to on-line sales in the state expected to produce $85 million by collecting business and occupation (B&O) taxes for out-of-state businesses that conduct at least $250,000 in in-state sales. The budget also cracks down on tax avoidance (including increased authority for the Department of Revenue to penalize busi-

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Table 1. Expected Revenue by Product and Tax Change, WA 2010-2013

Product	Tax Change	Expected Revenue
Candy and Gum	Now subject to the state's 6.5 percent sales tax	$31 million
Bottled Water	Now subject to the state's 6.5percent sales tax	$33 million
Soda (12 oz. can)	Increase of 2 cents	$34 million
Beer (6-pack)	Increase of 28 cents	$59 million
Cigarettes (per pack)	Increase of $1.00	$101 million

Source: Washington State Budget and Policy Center, 2010.

nesses for tax avoidance), reduces some B&O tax exemptions, and holds former executives and chief financial officers of companies that have been terminated, or are insolvent, liable for uncollected taxes—among other things of a similar nature (Nicholas 2010).

Overall, the tax increases will be used to maintain multiple social programs already in operation throughout the state, including (Camden 2010a):

- All-day kindergarten
- Gifted program and levy equalization for public schools
- State need grants for college students
- Maintenance of the current levels of Basic Health and the Apple Health care program for children from low income families and temporary assistance for needy families
- Maintenance of the current levels of foster care payments and preservation of nursing home payments
- Restoration of certain nursing home funds

The protection of these social programs is largely in line with the governor's "Book Two" recommendations released in January. In addition to the protection of these social programs, the legislature enacted several measures that will extend a sales tax deferral program for select manufacturers located in rural counties with high unemployment rates. Additionally, the legislature provided $1.2 million in funding to continue the Working Families Tax Rebate program established for working families with children, based on the federal Earned Income Tax Credit. Measures such as these cost the state approximately $12.3 million in the current biennium and were prioritized as necessary (Murkami 2010).

Tax Structure in Washington State

Washington has a rather regressive tax structure that makes sales taxes more important for revenue generation than is the case in most other states. Unlike most states, Washington does not impose an income tax; state and local governments instead rely on property and excise taxes as their principal sources of revenue. This means that the state does not collect taxes on the net income received by individuals, households, or business entities. Consequently, the only options legislators have when considering new sources of revenue — at least from taxes — are property-related and excise-related. Forty-five states impose a corporate net income tax, and 43 states levy a personal income tax. Washington, Nevada, South Dakota, and Wyoming are the only states that do not impose income taxes. See Figure 1 below for an overview of tax revenue by tax category for Washington (Washington State Department of Revenue 2002).

Through the 1920s, the tax system in Washington was structured around an agriculturally-based economy. Land was the primary asset, and as a result a sales tax was deemed too unpredictable and unreliable from year to year to yield the necessary funds for state needs (Washington State Department of Revenue 2002). Given this set of premises the state and its local governments imposed property taxes to finance schools, roads, court operations, law enforcement, etc. As Washington became increasingly urbanized by the 1930s, the citizens and the state's economy required better government services. This need for enhanced government services placed a large stress on the rural economy as property taxes were increased to support the needed enhancements. This heavy reliance on the property tax led to a statewide movement aimed at reduced property taxes and the establishment of taxes and fees on other state assets that better suited a commercial and business-based economy. By 1935, the tax system was changed so that property taxes were primarily based on residential and commercial real estate, a B&O tax was created based on business receipts, and a sales tax was put into place to generate revenue from consumer purchases. This is essentially the tax structure still in existence in the state, one that continues to feature no income taxes (Washington State Department of Revenue 2002).

With the recently enacted temporary increases in sales taxes, some long-time observers of the state's politics argue that the current tax structure is outdated and in need of serious reform once again. One point of criticism of the existing system is that Washingtonians who earn the least amount of money are taxed the most via excise and property taxes, and consequently pay a larger proportion of taxes in relation to their yearly income compared to higher income-earners (Franklin 2010; Washington State Department of Revenue 2010). Though there was some talk of imposing an income tax on the state's highest earners in this last legislative session,

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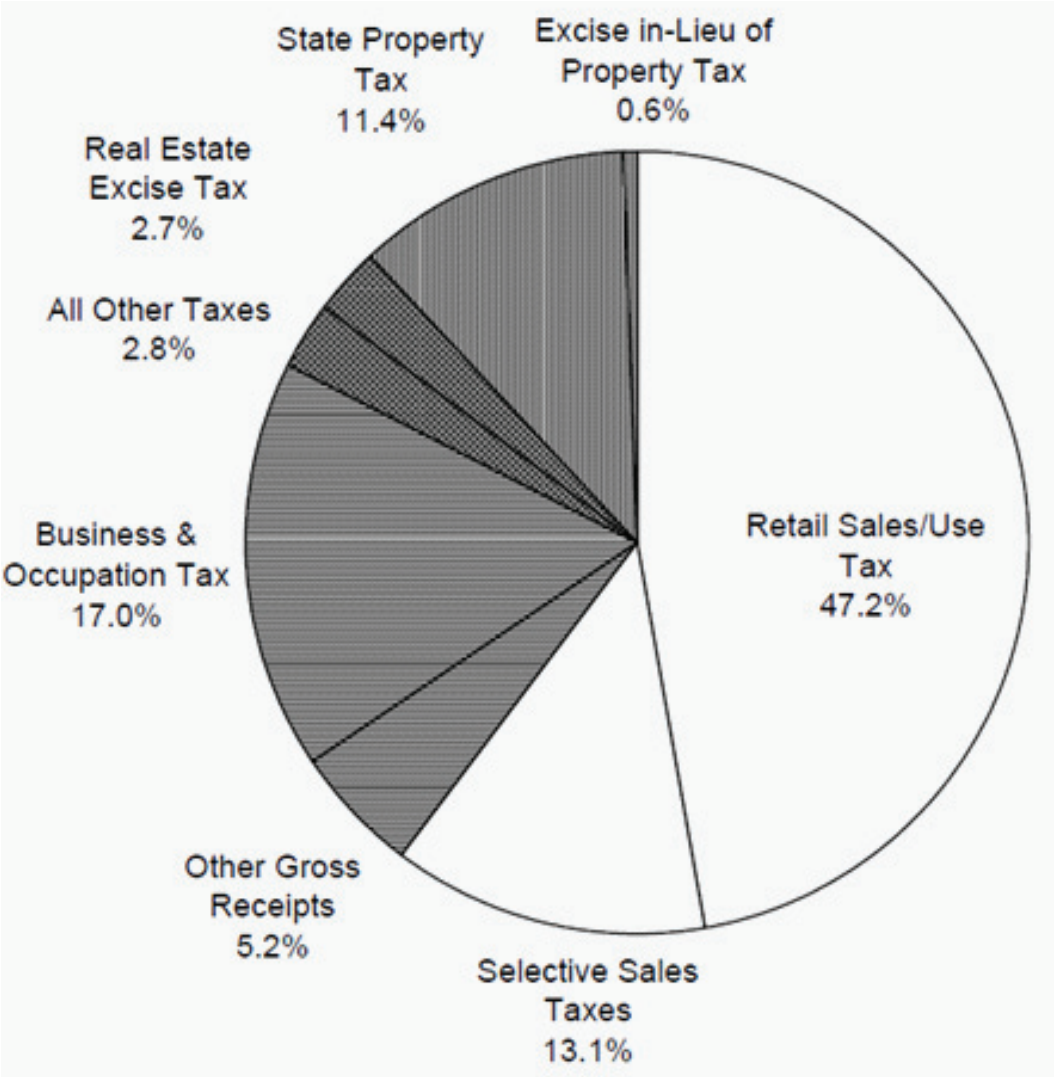
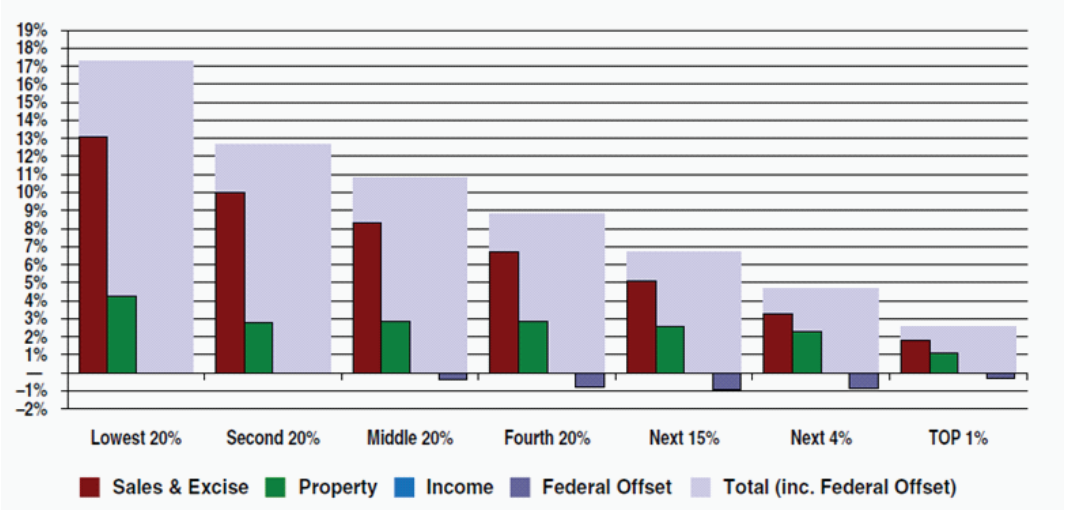
Figure 1. Percent Revenue per Tax Category, Washington State, 2009



Source: Washington State Department of Revenue.

this issue was not given much credence (La Corte and Woodward 2010). The idea is being promoted outside of the legislature by Bill Gates Sr. and his associates who will seek to qualify an initiative for a statewide ballot on taxing families making over $200,000 per annum.

Figure 2. State and Local Taxes in 2007: Shares on Family Income for Nonelderly Families



Source: Institution on Taxation and Economic Policy.

Tax Increases: Initiative 960

Although Washington does not have an income tax and the legislature can increase sales taxes, the state also has an often-used initiative process, one that many different groups have utilized to influence state government actions (WA State Secretary of State). Highly relevant to this discussion of tax increases is Initiative 960, passed by Washington voters in 2007. Co-sponsored by Tim Eyman, a very well-known conservative political activist and the most active initiative promoter in the state, the initiative requires that any tax increases legislated must be passed by a "supermajority" (two-thirds vote) in both chambers of the state legislature.

The state constitution stipulates that the legislature cannot amend or suspend an initiative during its first two years on the books; however, after the two-year period expires the legislature is free to alter, suspend or nullify an initiative of the people. In this legislative session, the governor and legislature did take such action—in mid-February, the legislature (Senate Bill 6130) amended the initiative to temporarily suspend the two-thirds vote threshold of Initiative 960, and the governor signed off on the action at the end of February. As a consequence the legislature was able to increase taxes to fund the state programs mentioned above. Governor Gregoire explained, "I hope, I expect, the people of the state of Washington will understand we're in unprecedented times" (La Corte 2010a).

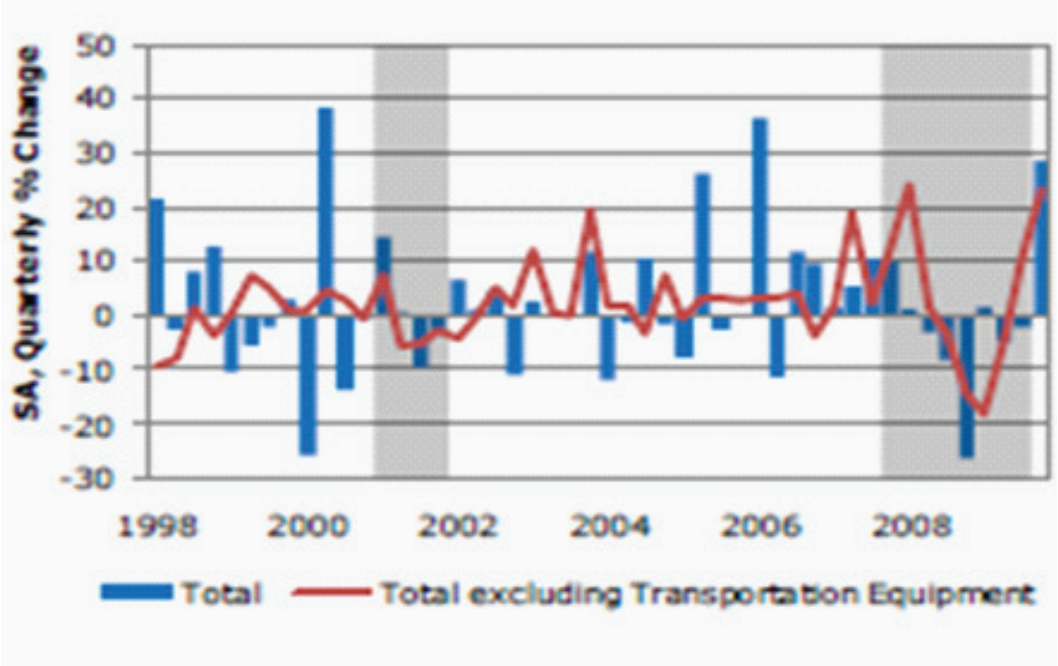
The tax increases ultimately emerging after the special session came to a close were quite controversial; the budget bill passed by a narrow margin in the Democrat-dominated chamber, 25-21. Many would argue that the legislators who voted for the tax increases will face electoral uncertainty in the Fall. However, Initiative 960 passed by a narrow margin in 2007—51% to 49% (WA State Secretary of State), which indicates that the increased taxes may not result in much electoral punishment, though this is not entirely certain. In November, all of the state House representatives and half of the state Senators were up for re-election. In the meantime, the notorious Tim Eyman filed eight tax limitation initiatives on April 13 and is beginning to collect signatures in an attempt to get them added to the November ballot (Brunner 2010). Among these measures is Initiative 1053, a statute that would reinstate the two-thirds requirement for increasing taxes. The mid-term elections should certainly be watched closely, both for the initiatives that make it to the ballot and for any changes the electorate votes through.

Revenue Forecast, February 2010

Most Republicans argue that the 2010 supplemental budget is much too oriented toward the short-term rather than the long-term welfare of the Evergreen State. They feel that the key question to be considered is this—what is the most likely long-term economic outlook for the state of Washington? The Washington State Economic and Revenue Forecast Council serves to "promote state government financial stability by producing an accurate forecast of economic activity and General Fund revenue," which the legislature and governor then use as the basis of the state budget documents they prepare. Consequently, the Forecast Council is required to prepare quarterly reports throughout the year. The latest report, released in February 2010, provides an overall positive outlook and characterizes the state as being in a slow recovery.

Although Washington is still experiencing economic challenges, the economy is beginning to stabilize, and it is expected to recover somewhat more quickly than the national economy. Washington is among the most trade-dependent states, and in line with the global recovery the state's exports have rebounded well in the first months of 2010 (see Figure 3 below). Also, job losses in aerospace and software—the state's two largest industries—were limited and are largely over at this point. In fact, Boeing is still in high demand, continuing to produce and fill orders, and Microsoft's profits are up 34.5 percent with the recent launch of Windows 7 (Schonfeld 2010). However, the amount of credit issued to small businesses, which is among the primary means of new job creation, remains low. Improvement here could result in increased employment statewide (Washington State Economic and Revenue Forecast Council 2010).

Figure 3. Washington State Exports



Sources: WISER Trade; Data through 2009-Q4; Washington State Economic and Revenue Council 2010.

Governor Gregoire imposed a hiring freeze in August 2008, which caused the state's workforce to decrease by more than 1,400 workers. The following January, the state replaced the freeze with a cap on the number of positions at each state agency and the state's workforce is expected to decrease by another 2,600 positions under the cap (Garber 2010). The state report from the Economic and Revenue Council compares the job losses between 2007 and 2009 and another recession in the 1981 and 1982 period, both challenging times for the state. (See Figure 4 below.) Though the job losses matched those in the early 1980s, the current recession has proven worse.

The number of monthly claims for unemployment insurance has declined and is now at its lowest level since September 2008 (these claims peaked in September 2009). The housing industry is also improving, with the number of permits increasing approximately 65 percent after reaching a historic low in April 2008. The number of permits is at its highest level in 15 months as of April 2010. However, the overall strength of the housing market remains relatively low. Consumer confidence remains low and an excess supply of housing exists statewide and in most locations (Washington State Economic and Revenue Council 2010).

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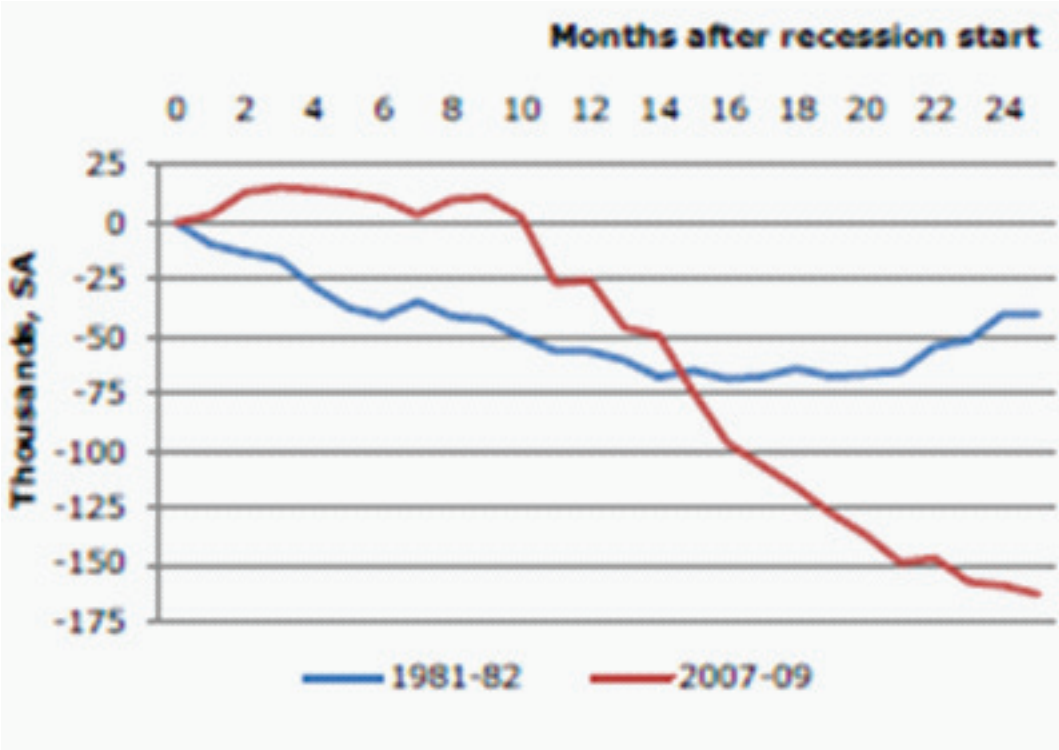
Figure 4. Washington Cumulative Job Losses in 1981-82 and 2007-09 Recessions



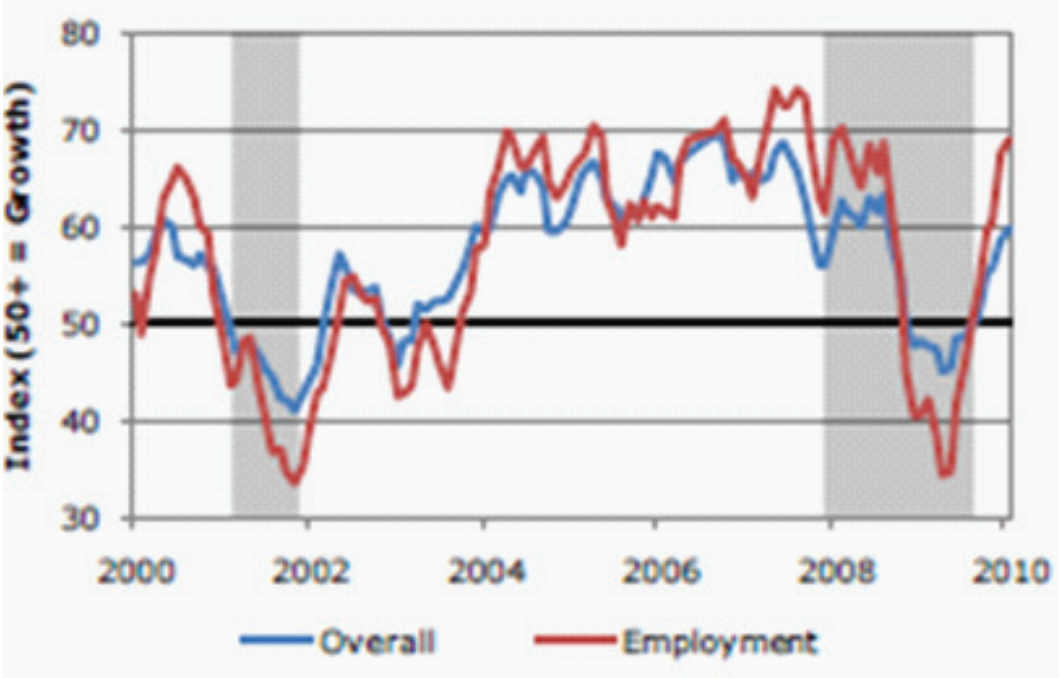
Sources: WA State ESD, ERFC; data through December 2009; Washington State Economic and Revenue Council 2010.

Political Context

Historically a progressive state, Washington is thought of as safely Democratic. Since 2006, Democrats have controlled the governorship and both chambers of the state legislature. More specifically, the House is comprised of 61 Democrats and 37 Republicans, while the Senate is comprised of 31 Democrats and 18 Republicans. Despite the substantial Democratic majorities, the regular session ended without a passed balanced budget, an outcome that reflected some contentious politics being played out in the state. No Republicans voted for any Democratic tax and budget proposals, and they vowed not to cooperate with any "new taxes" of any kind. Meanwhile, Democrats could not agree among themselves, which contributed to the perception that the Democrats were not capable of "getting things done."

Republicans may be able to capitalize on the latest budget, as they can largely blame Democrats for the tax increases; Republicans steadfastly refused to support

Figure 5. National Association of Purchasing Managers—Western Washington; Overall and Employment, 3-Month Moving Average



Source: National Association of Purchasing Managers—Western Washington; Data through January 2010; Washington State Economic and Revenue Council 2010.

any of the hikes. However, Democrats can also fight back, explaining that while Republicans are good at complaining they provided no viable alternatives to the tax increases.

The special session came to a close in the early morning hours of Tuesday, April 13, 2010, and activity occurred right up to the very end of the session. On Monday night, April 12, Governor Gregoire visited the Senate floor, a rare occurrence in Washington. At that point the Senate had not passed a bill that would move approximately $230 million from the state's rainy day account into the General Operating Budget, which the state arguably needed to complete its budget. In order to remove monies from the Rainy Day Fund, the Senate requires a three-fifths vote. The Senate leadership did not think they had the votes, and were not planning on voting on the bill, presumably relying upon the possibility that federal funds would be allocated to the state that would then be used in place of these reserved funds.

A clearly angry governor paid a visit to Senate Majority Leader Brown's office around 11 p.m. that Monday night. The governor told reporters "I have a problem"

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just prior to going to see Brown. The governor expected the rainy Day money would be utilized, which would then allow the budget to allocate the federal funds elsewhere and not spend them until the federal funds are actually transmitted from the federal government (Camden 2010b). Ultimately, the governor's efforts were successful; all of the $229 million reserved in the Rainy Day Fund was transferred to the state general fund (Legislative Evaluation and Accountability Program Committee 2010), demonstrating the governor's influence in the legislature, at least in this special legislative session. The Rainy Day Fund is now projected to have a zero balance by the end of the 2009-2011 biennium (Washington State Office of the Governor 2010a), thereby utilizing all of the state's cash reserves—another indication of Washington's dire financial circumstances.

Other Political Players: Private Sector Interests in Olympia

Microsoft is Washington's second-largest employer (behind Boeing), and typically has a great deal of influence in the state legislature. Microsoft has lobbied the state legislature on tax and business-related issues, but at times also makes its position known on other issues as well. Most recently, Microsoft attempted to influence the renovation and design plans being made to repair state Route 520, a floating bridge (the longest in the world) that serves the Puget Sound area's residents. Microsoft, as expected, is also very focused on taxes in the state of Washington. The corporation asserts that the legislature should focus its efforts on making the state number one in education and transportation, and should reduce B&O taxes to create a competitive advantage in the state for business location and operations (Eaton 2010).

Microsoft currently has no plans to move its headquarters out of the state. However, the corporation also acknowledges that if the state does not start improving its business climate soon, it may relocate to Massachusetts, California, or North Carolina. Clearly, the state has a vested interest in creating an environment that will keep Microsoft around permanently. Brad Smith, Microsoft's general counsel and senior vice president for legal and corporate affairs, argues that the state should diversify its economy, though it should retain a strong showing in aerospace and bioscience.

Certainly, the legislature takes note when Microsoft takes a public position on any significant issue, especially because it remains headquartered in the state. However, there is a perception by some that Boeing and Weyerhaeuser, corporations that have moved their headquarters to other states but still have a significant presence in Washington, have lost much (or at least some) of their political influence in Olympia (Eaton 2010). Whatever decisions are made regarding their corporate headquarters, as long as these two major companies remain among the top three

employers in the state they will surely continue to enjoy much influence in the state political scene.

2010 Budget Cuts: A More In-Depth Look by the Education Policy Area

Washington places a heavy emphasis on K-12 education, as befitting the "paramount duty" provision in the state's constitution regarding public education. This high level of attention given to K-12 education means that higher education receives relatively less emphasis, a fact that was manifested in the size of the overall budget cuts made to higher education this year. The supplemental budget passed by the legislature includes a significant cut to education and a net reduction of $68.2 million in state support for higher education. The state's two research universities, the University of Washington and Washington State University, are adversely affected by these cuts and as a result are searching for alternative sources of revenue, as are other public and land-grant universities in other states (Blankinship 2010; Perry 2010).

Overall, Washington's four-year college budgets have been reduced by approximately 20 percent for the biennium, and both research universities—Washington State University and the University of Washington—are increasing tuition by just over 30 percent over the next two years to make up for much of the budget gap (Center on Budget and Policy Priorities 2010). University presidents and governing board members in Texas, Wisconsin, Georgia and Washington—led by University of Washington President Mark Emmert—are actively lobbying the federal government for increased funds to help with the day-to-day maintenance of running these public institutions.

The deepest cuts for higher education will come through reductions in everyday university operations such as administrative services, student support services, course offerings, and other savings, which will occur at each of the six baccalaureate granting schools during the coming academic year (Washington Higher Education Coordinating Board 2010). The 36 community and technical colleges throughout the state will have a much smaller reduction due in large part to the receipt of continued funding for worker training programs. In respect to these programs, community and technical colleges are giving priority to programs in the area of aerospace, primary health care, long-term care for elders, advanced manufacturing, construction, and forest products, each of which will benefit the state economy once those graduates enter the workforce (Washington State Office of the Governor 2010b).

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Conclusions

The 2010 Supplemental Budget for the state of Washington has raised some key political questions. Primarily, the difficulty encountered in gaining agreement among majority party legislators on the temporary tax increases necessitated by the economic downturn have raised major questions once more about the regressive tax structure in the state, and whether an income tax of the sort enacted in Oregon in January of 2010—i.e., the "high earners tax" established by initiative (Measure 66)—should be introduced to take some of the burden off middle and working class taxpayers. The long-time advocate of progressive tax reform, Bill Gates Sr., is leading this effort in the face of vocal opposition from the active Tea Party adherents in the state.

While the track record on income tax proposals is not a good one in Washington, the current difficulties and the example of such a progressive measure being voted into law in Oregon may provide added incentive and positive talking points for reform advocates. In the meantime, the November elections will provide a telling assessment of the political sentiment motivating the state's electorate. Regardless of who ends up in a majority in the legislature, Republicans are likely to pick up seats in both the House and Senate in this next round of elections, and this will make life even more difficult for the Democratic governor as a new set of budget woes lies in waiting as the state legislature and governor attempt to construct a new biennial budget for 2011-2013.

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