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# Revenue Trends 1.2: Economic Recovery Will Be Tied to Changes in Washington State's Revenue System

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## Revenue Trends, a quarterly analysis of data and projections that impact public investments in Washington state.

Over the next few years, significant investments must be made in education, health care, and other vital services to ensure that more Washington state families experience the benefits of an expanding economy. Our antiquated revenue system must be reformed in order to make this possible.

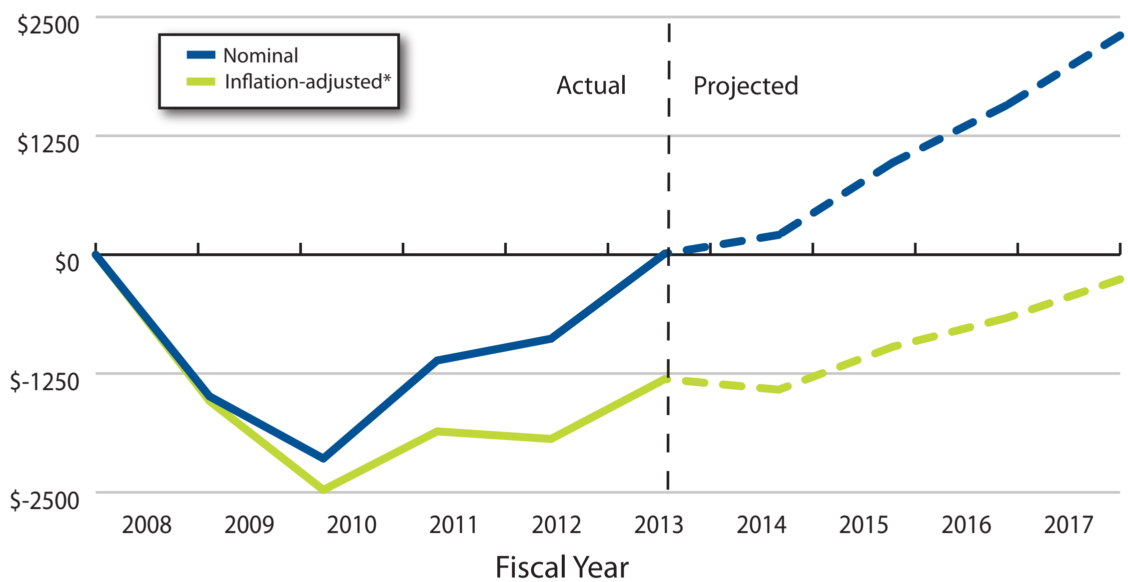
This second edition of Revenue Trends examines the June 2013 revenue forecast from the state Economic and Revenue Forecast Council (ERFC) and what it means for Washington state's tax system and investments in safe, healthy, and well-educated communities. The most recent forecast shows:

- **Revenue still well below pre-recession levels:** Despite positive news in this month's forecast, state tax collections in the current fiscal year remain $1.3 billion below 2008 levels, after adjustment for inflation. State revenues are not projected to reach pre-recession levels for at least the next four years.
- **Anticipated growth in revenue will not keep up with rising costs of the state's priorities:** Economic growth alone will not be enough to ensure adequate revenue in upcoming budget cycles. Required investments in education are anticipated to grow at a much faster pace in the coming years compared to growth in tax collections.
- **Washington state's revenue recovery trails the rest of the country:** Revenue collections in other states are recovering much more rapidly in comparison to Washington state. States with more balanced revenue systems that include an income tax, instead of relying so heavily on sales taxes, have seen significant boosts in tax collection. This is in large part due to recent growth in income and capital gains tax revenue, which Washington state does not have.
- **Flaws in our revenue system are preventing a stronger recovery:** Washington state's 1930s-era revenue system is not suited to a 21st century economy and no longer allows for adequate investment in important public services. Revenue collections have lost considerable ground compared to the state economy, falling 30 percent between 1995 and 2012. This trend is projected to continue.

Solutions to both our current and long-term revenue issues exist. Closing ineffective or outdated tax loopholes would generate significant resources that could be used to invest in

## Figure 1. Revenues Remain Below Pre-Recession Levels

Change in state revenue collections from previous economic peak (2008), dollars in millions.




Source: BPC analysis; data from ERFC - Near General fund, state-only revenue. *Real (2012) dollars adjusted using the CPI.

public priorities like safety, economic security and education. In the long-term, policymakers should address the flaws of our revenue system, starting with enacting an excise tax on capital gains, expanding the sales tax to a broader range of consumer services and more heavily scrutinizing tax breaks.

## Revenue Still Well Below Pre-Recession Levels

The June 2013 forecast showed positive signs of economic growth, with anticipated revenue collections increasing more than $231 million for the upcoming 2013-15 budget cycle.[1] While the economy appears to be on a slow but stable path to recovery – and with it available tax resources -- the state is still feeling the devastating effects of the Great Recession. The sheer depth of the last economic downturn means that revenues remain well below – and will continue to remain below -- pre-recession levels.

State tax resources have been recovering for several years, but they have yet to rebound to 2008 levels, their highest point prior to the recession. As Figure 1 shows, revenue collections bottomed out in fiscal year 2010 at roughly $2.1 billion (14 percent) below 2008 levels. For the current fiscal year, which ends in June 2013, revenues are just now at their pre-recession levels, but that's before taking into account inflation which has raised the cost of providing services to Washingtonians.[2]

After taking into account rising costs, it's clear that revenues will not recover by 2014. In inflation-adjusted dollars, revenues will still be $1.3 billion (7.7 percent) below 2008 levels this year and are expected to dip again in 2014 before improving. State tax revenues are projected to remain under pre-recession levels in 2017, which is as far out as the state predicts. Even then revenues will be $258 million (1.7%) below 2008 levels.[3]

## Revenue Growth Won't Keep Pace

Economic growth alone will not be enough to provide the resources necessary to reinvest in important public priorities while also meeting the court-ordered McCleary decision, which requires the state to fully fund K-12 education. Average biennial revenue growth since 2011 is approximately 7.6 percent.[4] By contrast, the McCleary decision requires education investment to grow by an average of 78 percent per biennium in the next five years – a $4.5 billion investment by 2018.[5]

As shown in the figure below, fully meeting our McCleary obligation would constitute nearly 12 percent of Near General Fund-State revenues by 2018.[6] As the investment in K-12 education expands, fixing the problems with our revenue system will be critical to ensuring that we are capable of adequately investing in other parts of the budget.

## Washington State Trails Nation in Revenue Recovery

Washington state ranks in the bottom third of states for the return of state tax revenues to pre-recession levels. In the first two years of the recession, revenue declines in Washington state were similar to the national average, falling to about eight percent below pre-recession levels in 2009 and 10 percent below in 2010, before adjustment for inflation. But since 2011, Washington state's revenue recovery has been slow relative to the rest of the nation. While state tax collections nationwide surpassed pre-recession levels by 1.5 percent in fiscal year 2012, in Washington state they remained nearly two percent below the 2008 levels (see appendix figures A, B).

### *More Robust Tax System = Faster Recovery*

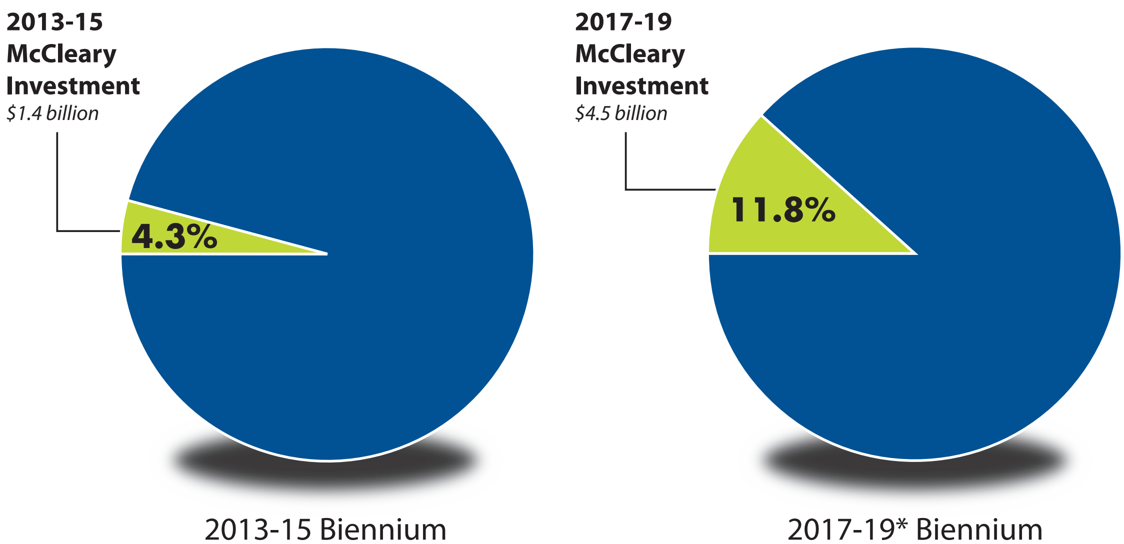
States with a more diverse mix of taxes have been quicker to recover from the recession than Washington state, which does not have an income tax and instead relies heavily on sales taxes.

State personal income taxes for the first half of the 2013 fiscal year were up eight percent relative to the same time period a year ago. In contrast, state sales tax revenue grew much more slowly and was up only 2.6 percent nationally and 5.2 percent in Washington state.[7]

A recent report from the Center on Budget and Policy Priorities sums it up. "… [S]tates without income taxes are missing out on revenue. Part of the recent revenue boost reflects the fact that income taxes are better at growing with the economy than sales or other taxes."[8]

**Figure 2. Additional Revenue is Critical to Sustained Investments in Education and Other Important Priorities**

Investment required by the McCleary court decision as a share of projected Near General Fund-State revenues




Source: Budget & Policy Center calculations; data from ERFC and Joint Task Force on Higher Education Funding | *BPC calculation of NGF-S revenue in 2017-19 biennium based off of past growth since FY 2012.

States with more balanced revenue systems have also fared better over the long-term. Revenues as a share of the economy in Washington state have declined by nearly 25 percent since 1992, while neighboring Idaho experienced a significantly smaller drop of 18 percent and Oregon's revenue fell by less than 4 percent (Appendix figure C).[9]

## Systemic Flaws Undermining Our Recovery

Washington state's outdated and flawed tax system is one of the main reasons for the state's slower-than-average revenue recovery. Without a personal income tax or a tax on capital gains, the state is failing to benefit from significant, and rapidly growing, portions of the economy, such as the stock market. As a result, the state's revenue system has been unable to keep up with rising needs, the higher cost of providing services, and a growing population. This has led to shrinking resources for many important public priorities.

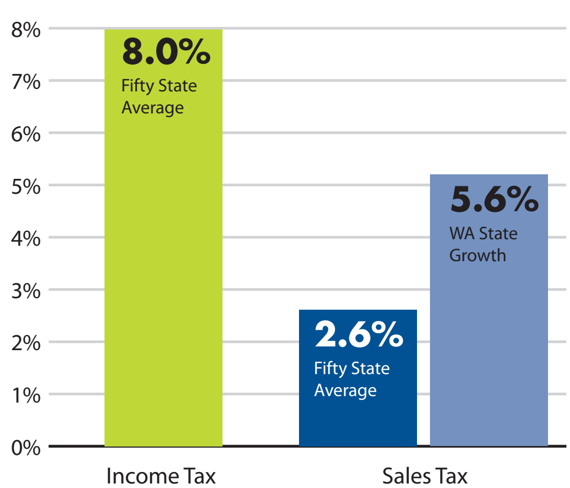
> "By 2017, revenue as a share of the economy will be about 67 percent of what it was in 1995."

Figure 4 shows that revenue as a share of the economy has fallen dramatically since the mid-1990s. Revenue collections as a share of total state personal income – a measure commonly used by economists to judge trends in long-term revenue adequacy, fell to less than 5 percent this year from about 7 percent of the state economy in 1995. If nothing is done, state revenues will continue to lose ground, falling to 4.7 percent by 2014 – a historic low. By 2017, revenue as a share of the economy will be about 67 percent of what it was in 1995.[10]

The major driving force is the state's overreliance on the retail sales tax. When the sales tax was enacted in 1935, consumers spent most of their incomes on tangible goods such as household items and tools. In the modern economy, consumers spend most of their incomes on services like health care, financial advice, and cable and satellite TV, which are not taxed in Washington state and did not exist when the sales tax was put in place. Consumers also purchase many goods from out-of-state sellers via the Internet, but the state is

### Figure 3. Washington State Missing Key Components of a Robust Revenue Recovery

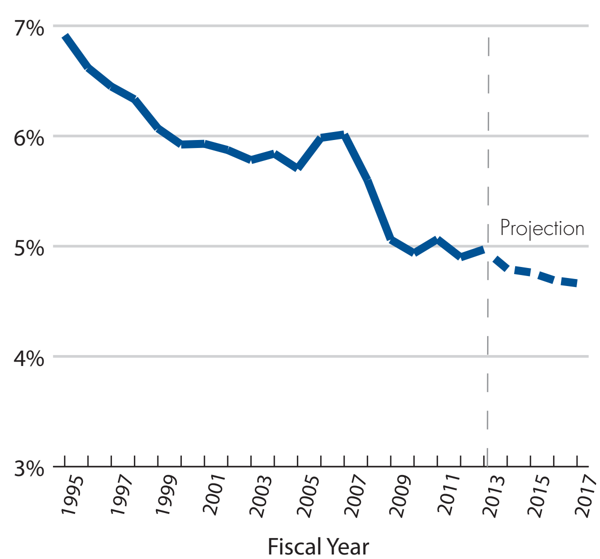
Year-over-year change in state tax collections by type, first half of FY 2013




Source: Budget & Policy Center calculations; data from Nelson A. Rockefeller Institute of Government

### Figure 4. Revenue System Cannot Keep Pace With State Economy

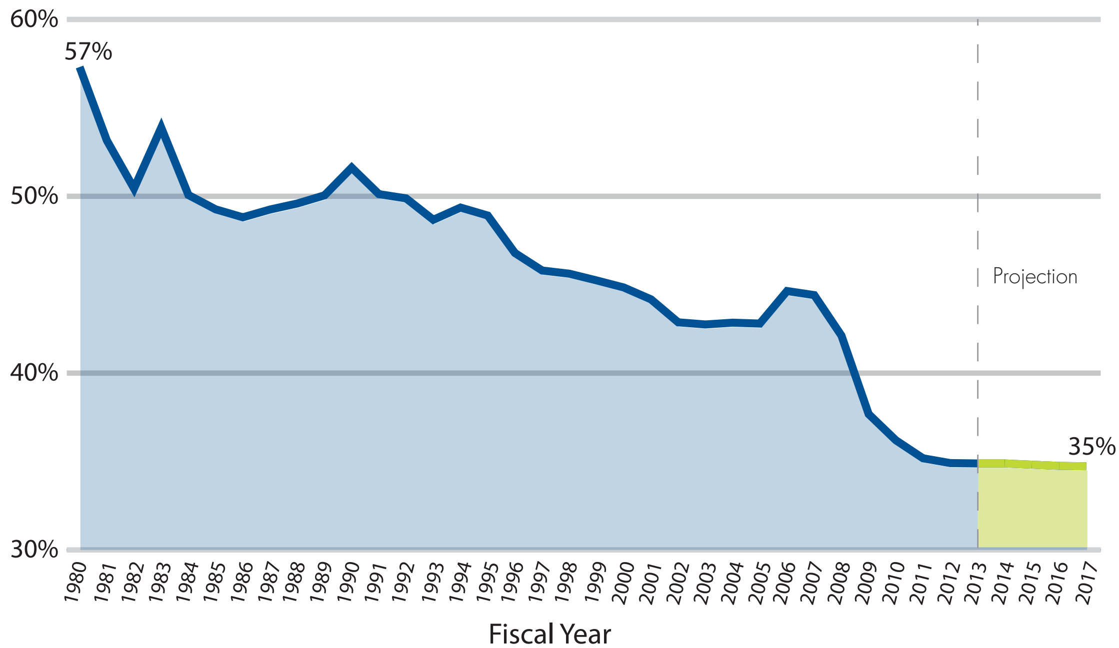
Total Near General Fund as a share of personal income from fiscal year 1995 to 2017*




Source: BPC analysis; data from ERFC. *Projected values for fiscal year 2013 through 2017.

## Figure 5. Taxable Retail Sales Have Plummeted as a Share of the Economy

Taxable retail sales as a percent of state personal income for fiscal year 1980 to 2017*




Source: BPC analysis; data from ERFC. *Projected values for fiscal year 2013 through 2017.

barred by federal law from requiring the sellers to collect sales tax on these transactions.

Figure 5 shows the tax consequences of this dramatic shift in consumer behavior. In 1980 the scope of products subject to the state sales tax amounted to about 60 percent of Washington state's total economy. Today, they amount to less than 35 percent of the economy, and will continue to decline unless the sales tax is applied to the things Washingtonians now spend their money on.[11]

*Revenue Trends, a quarterly analysis of data and projections that impact public investments in Washington state. The first edition, April 2013: Revenue Trends 1.1 can be found here.*

## Acknowledgments:

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## Sources:


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2. Budget & Policy Center calculations -- ERFC, Economic and Revenue Forecast, June 2013.
3. Budget & Policy Center calculations -- ERFC, Economic and Revenue Forecast, June 2013. Adjusted for inflation using Bureau of Labor Statistics (BLS) national Consumer Price Index (CPI)
4. Budget & Policy Center calculations -- ERFC, Economic and Revenue Forecast, June 2013
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projects NGF-S revenues out to 2015-17 biennium. 2017-19 estimate is based off of biennial revenue growth since the 2011-13 budget cycle.

7. Budget & Policy Center calculations -- The Nelson A. Rockefeller Institute of Government, “State Government Tax Revenue by State” http://www.rockinst.org/government_finance/revenue_data.aspx

8. McNichol, Elizabeth “States Should React Cautiously to Recent Income Tax Growth: April Surge Provides Opportunity to Invest in Infrastructure, Boost Reserves” Center on Budget and Policy Priorities, http://www.cbpp.org/cms/?fa=view&id=3972; Jun 13, 2013

9. Budget & Policy Center calculations – state revenue data from the U.S. Census Bureau; State total personal income data from the Bureau of Economic Analysis (BEA).

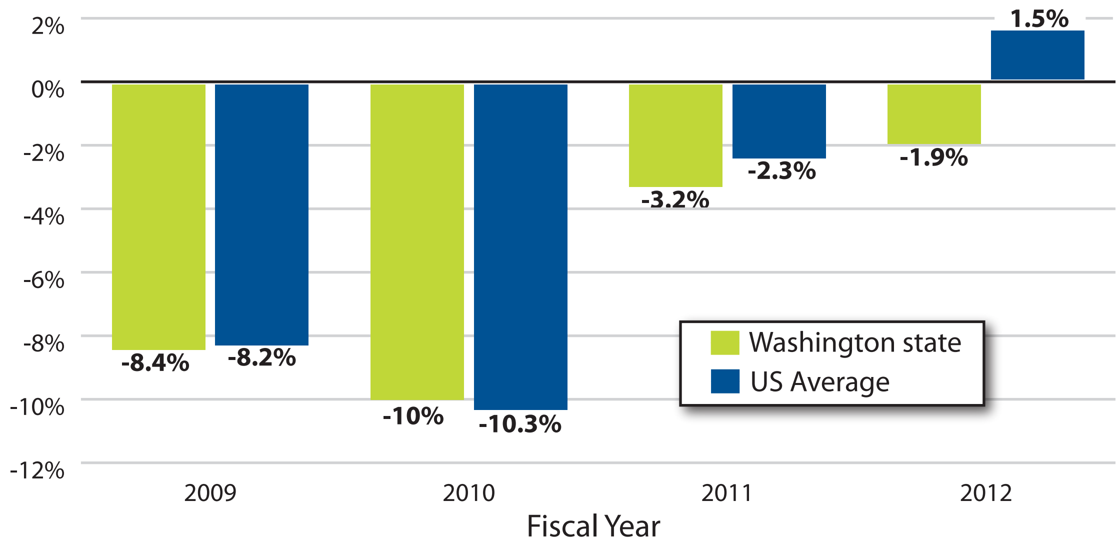
10. Budget & Policy Center calculations -- ERFC, Economic and Revenue Forecast, June 2013; State total personal income data from the BEA.

11. Budget & Policy Center calculations –ERFC, Economic and Revenue Forecast, June 2013

## Appendix Figures

### Appendix Figure A: Washington State Trailing Nation in Revenue Recovery

Percent change in revenue collections since the start of the recession based on 2008 levels, for United States and Washington state

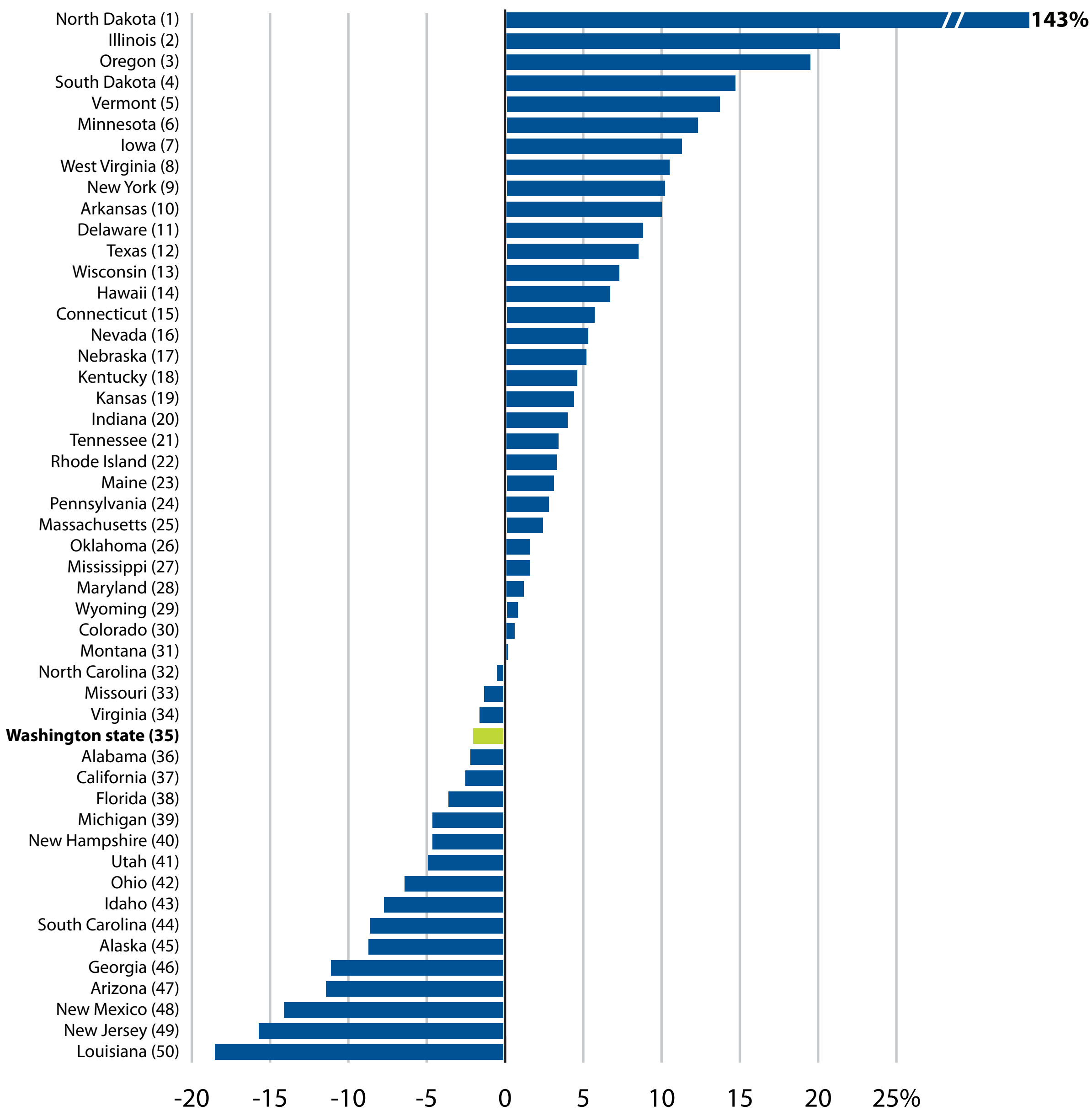



Source: Budget & Policy Center calculations; data from Nelson A. Rockefeller Institute of Government

## Appendix Figures

# Appendix Figure B: Washington State Trails Nation in Revenue Recovery

Percent change in state tax collections from 2008 levels by state and rank

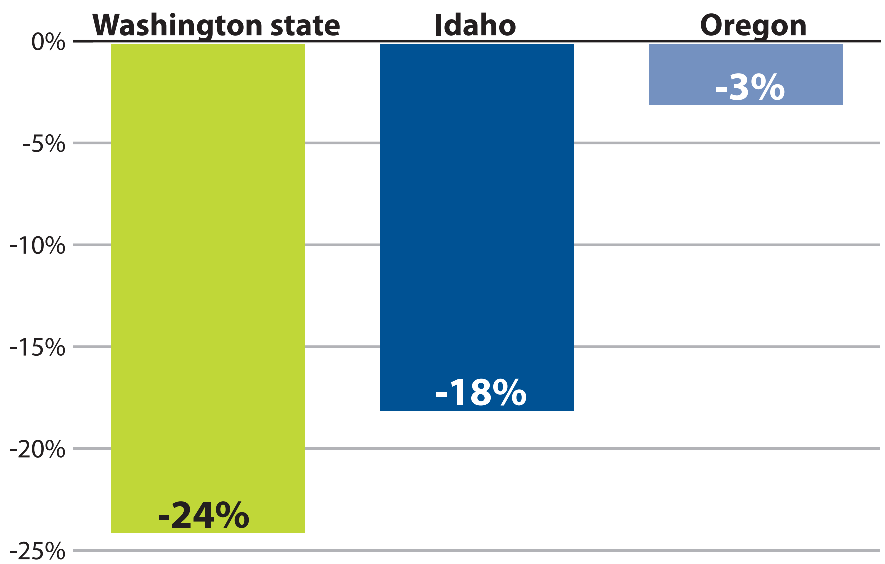



Budget & Policy Center analysis; data from the Rockefeller Institute of Government

## Appendix Figures

### Appendix Figure C: Neighboring States' Tax Systems Are More Robust

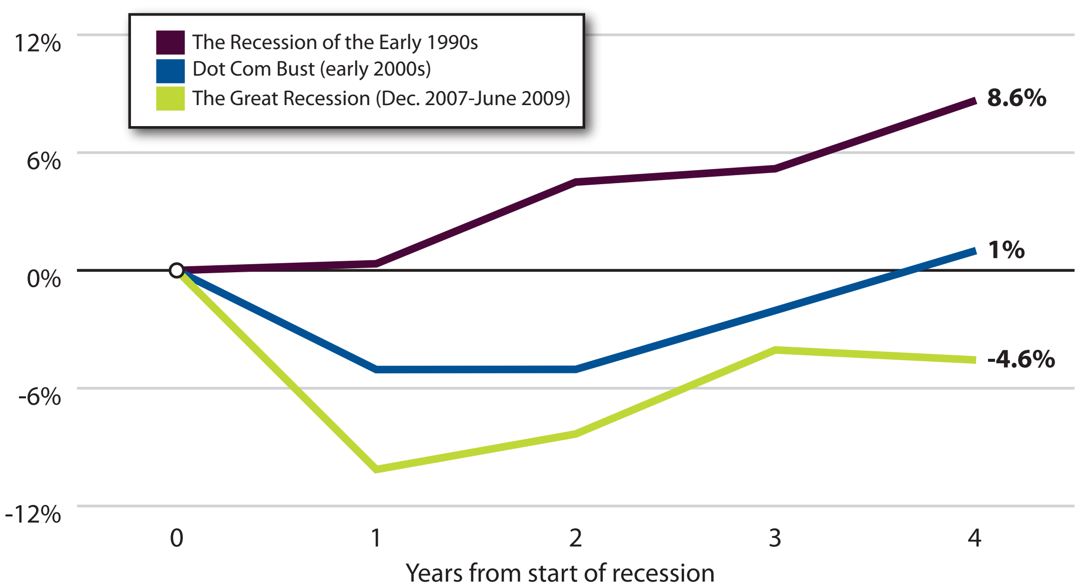
Percent change in state revenue collections as share of total state personal income, 1992-2012, Washington state, Idaho, and Oregon.




Source: Budget & Policy Center Analysis, data from the US Census Bureau and BEA.

### Appendix Figure D: Revenue Recovery Lags Previous Recessions

Percent change in general fund revenue since start of recession, adjusted for inflation*




Source: Budget & Policy Center Analysis; data from ERFC and BLS