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Revenue Trends 1.1: Grow the Economy, Create Jobs, and Protect the Middle Class with New Revenue

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

Washington state's economic recovery and its prospects for future growth depend upon additional resources to maintain education, health care, and other investments that promote a strong state economy. To do this, steps are needed that would strengthen Washington state's outdated revenue system, so it can adequately support the needs of a competitive 21st century workforce and create jobs.

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

- **State tax resources will be $2.7 billion short of needs in the coming budget cycle:** Without a change in course by policymakers, tax revenues during the 2013-15 budget cycle will not be enough to maintain existing investments and fund court-mandated improvements to Washington state's education system.

- **Tax collections will remain far below adequate levels:** State tax revenues remain $1.4 billion (8.3 percent) below pre-recession levels, after adjustment for inflation. Moreover, state revenues are not projected to reach pre-recession levels for the foreseeable future.

- **Washington state trails the nation in revenue recovery:** Due to the state's flawed tax structure, revenues are recovering more slowly compared to the nation as whole. Nationwide, state tax revenues had topped pre-recession levels as of June 2012. But in Washington state, they have yet to do so.

- **Antique revenue system will prevent a full economic recovery:** Washington state's 1930s-era revenue system is not suited to a 21st century economy and will not help the middle class prosper. Revenue collections have lost considerable ground compared to the broader state economy, falling 30 percent between 1995 and 2012. This trend is projected to continue.

Policymakers have numerous options for improving the state's flawed revenue system. In the short run, they can end wasteful tax breaks – as Governor Inslee has proposed – and extend the sales tax to include modern consumer services, such as financial advice, hair and nail salons, and satellite and cable TV. To build a more robust revenue system in the long term, they can tax high-end capital gains, which are profits on the sale of corporate stocks, bonds, and other financial assets bought and sold mostly by wealthy Washingtonians.

Failing to address the state's deteriorating revenues would undermine the tenuous economic recovery by forcing additional cuts to schools, senior services, health care, and other core investments.

Gaping revenue shortfalls projected

In the wake of the Great Recession, tax resources in Washington state remain far below the amount needed to maintain investments that support a strong state economy. While the March 2013 forecast from the ERFC showed a modest, $40 million improvement in general state tax collections for the upcoming 2013-15 budget cycle, revenues remain deeply depressed – about $2.7 billion short of the amount needed to sustain existing levels of public services and fund court-ordered improvements to Washington state's schools.[1,2]

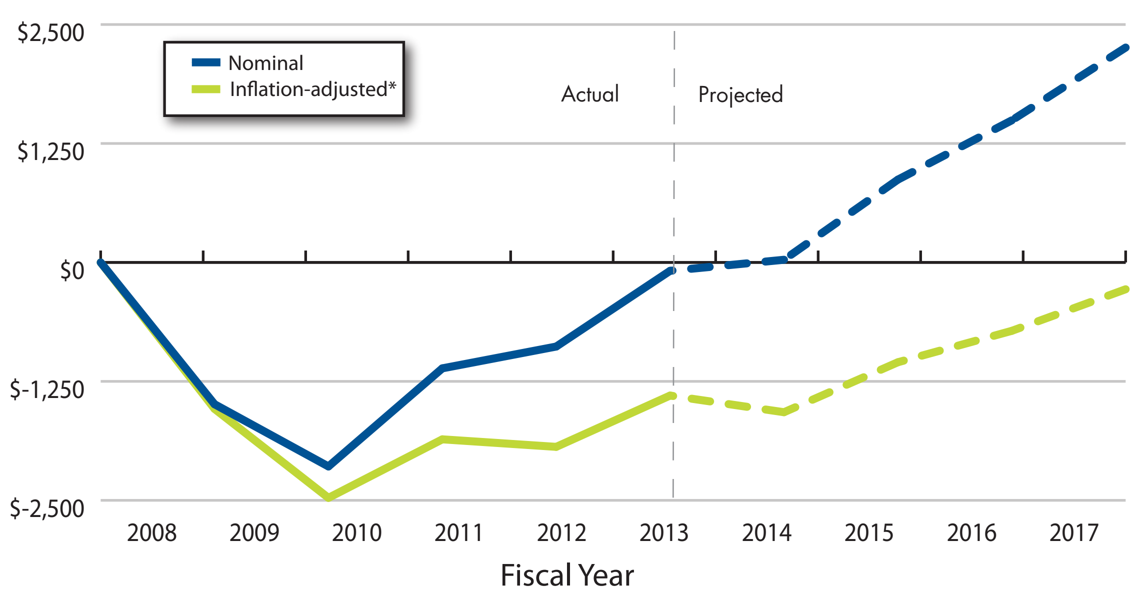
State tax resources have been growing for several years, but they have yet to recover to 2008 levels, their highest point prior to the recession. As Figure 1 shows, before adjustment for inflation, collections hit the low point in 2010, coming in about $2.2 billion (14 percent) below pre-recession levels. For the current fiscal year, which ends in June 2013, revenues are still projected to be about $88 million (0.6 percent) below their pre-recession peak. Tax collections are not projected to reach pre-recession levels until the fiscal year that ends in June 2014.[3]

Once inflation is taken into account, it's clear that revenues will not actually recover by 2014. That's because costs have risen significantly since 2008. Figure 1 also shows state tax collections after adjustment for inflation, including rising fuel and energy prices that have increased the cost of heating class rooms and fueling buses, police cars, and ambulances.

In inflation-adjusted dollars, revenues will be $1.6 billion (9.3 percent) below their previous peak by the end of the 2014 fiscal year. State tax revenues are projected to remain considerably below pre-recession amounts as far out as 2017, the extent of ERFC's current projections. In that year, revenues will be $282 million (1.7%) below 2008 levels.[4]

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 and BLS. Near General fund, state-only revenue. *Real (2012) dollars adjusted using the CPI.

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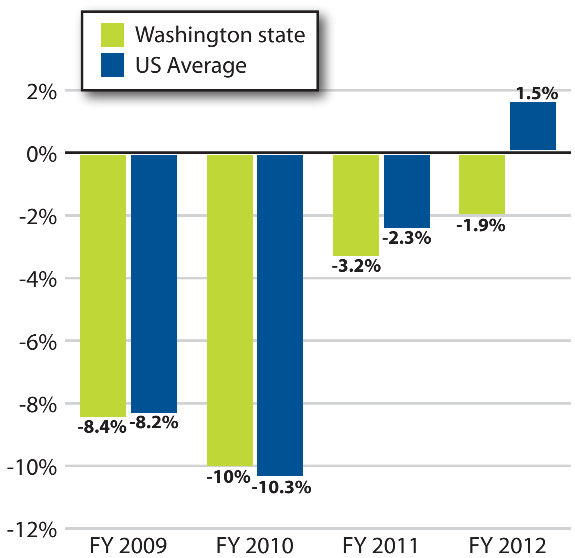
Washington state trails nation in revenue recovery

Washington state ranks in the bottom third of states for the return of state tax revenues to pre-recession levels. As Figure 2 shows, in the first two years of the recession, revenue declines in Washington state closely tracked the national average, falling to about 8 percent below pre-recession levels in 2009 and 10 percent below in 2010 (before adjustment for inflation).

Figure 2. 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



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

Since 2011 revenue growth in Washington state has been slow relative to the rest of the nation. While state tax collections nationwide had surpassed pre-recession levels by 1.5 percent by fiscal year 2012, in Washington state they remained nearly 2 percent below the 2008 levels.[5]

In 2012, Washington state's revenue recovery ranked 35th in the nation. By contrast, Oregon's revenue recovery ranked 3rd (see Appendix Figure A).

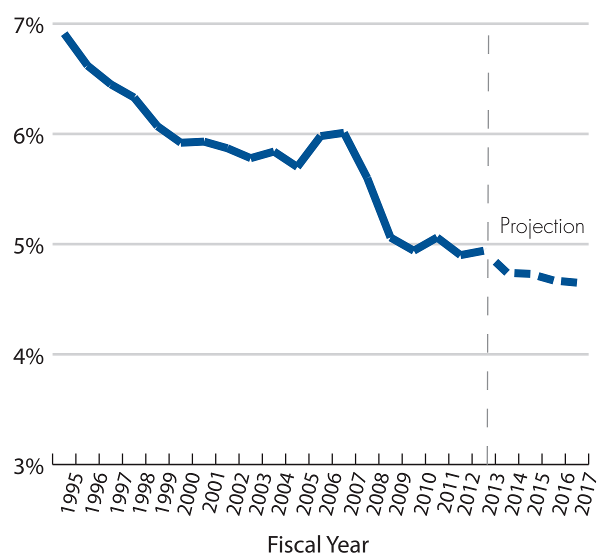
Flaws Undermining Our Recovery

Washington state's outdated 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 booming stock market. As a result, the state's revenue system has been unable to keep up with rising needs, leading to shrinking resources for schools, safe communities, and other important public priorities.

Figure 3 shows that Washington state's revenue has declined by about 30 percent relative to the broader state economy since 1995.[6] Revenue collections as a share of total state personal income – a measure commonly used by economists to judge the adequacy of state tax systems, fell to less than 5 percent today from about 7 percent of the state economy in 1995. If nothing is done, state revenues will continue to lose ground against the broader economy, falling to 4.7 percent by 2014 – a 50-year low, according to an analysis from the State Office of Financial Management.[7]

Figure 3. Revenue System Cannot Keep Pace With State Economy

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

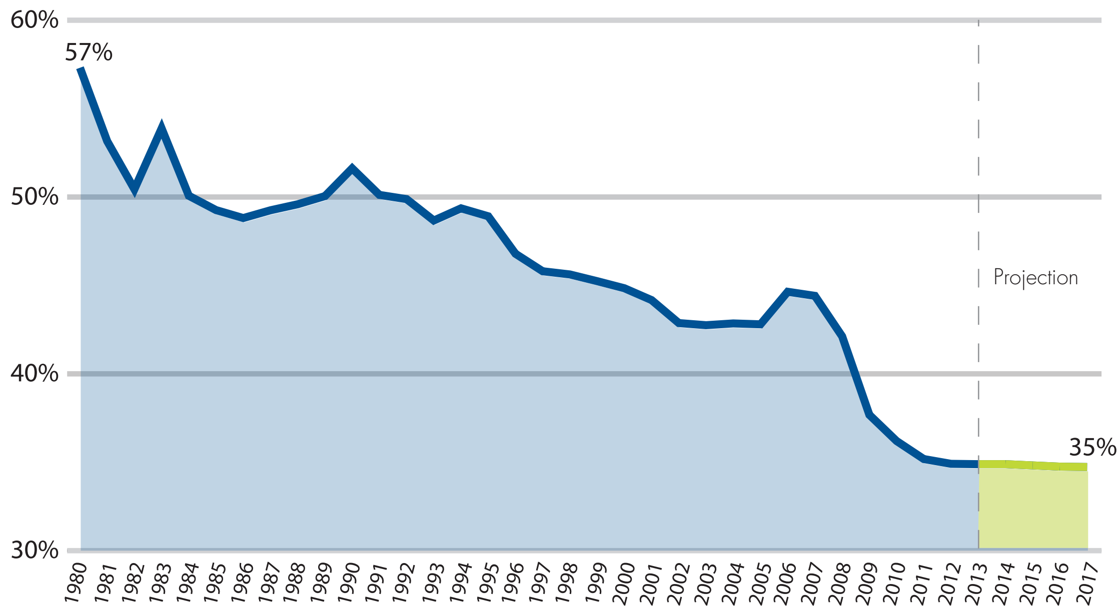


Source: BPC analysis; data from ERFC. *Projected values for fiscal year 2013 through 2017.

The major culprit is the state's reliance on the retail sales tax. When the sales tax was enacted in 1935, consumers spent most of their incomes on cars, appliances, tools, and other durable goods. 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 began. Consumers also purchase many goods from out-of-state sellers via the Internet, but the state is barred by federal law from requiring the sellers to collect sales tax on the transactions.

Figure 4. 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.

Figure 4 shows the 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 declining unless the sales tax is applied to more of the things Washingtonians spend most of their money on.[8]

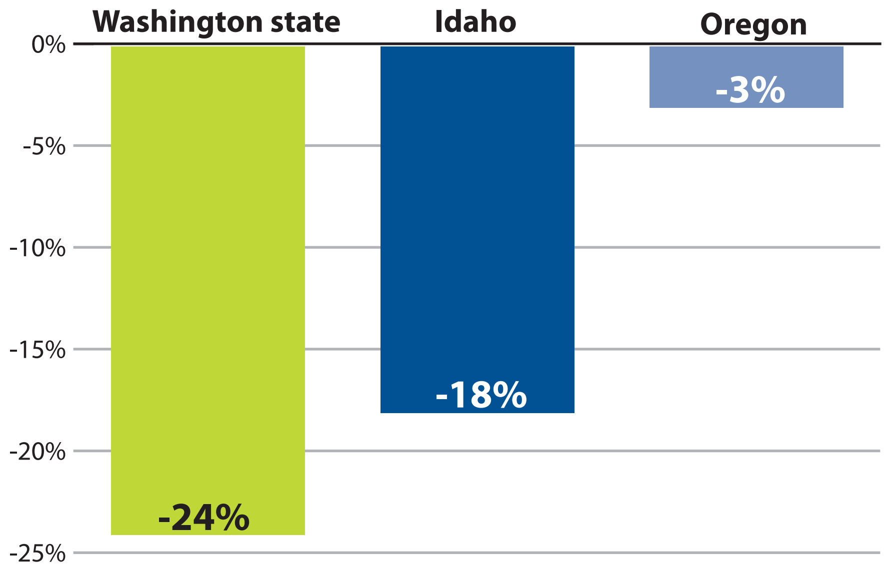
More Robust Tax System = Faster Recovery

States with a more diverse mix of taxes have been faster to recover from the recession than Washington state. Since the beginning of the recovery, 28 states have experienced faster-than-expected revenue growth, according to the Center on Budget and Policy Priorities. In 23 of these states, that was due largely to revenues generated from taxes that Washington state lacks, such as income and capital gains taxes.[9]

States with more balanced revenue systems have also held up better over time. Figure 5 compares Washington state's revenue system with its two neighbors, Idaho and Oregon. While revenues as a share of the economy in Washington state declined by nearly 25 percent since 1992, Idaho experienced a smaller 18 percent drop, while revenues in Oregon fell by less than 4 percent.[10]

Figure 5. 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.

Acknowledgments

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Sources

1. Economic & Revenue Forecast Council, March 2013, Economic and Revenue Forecast. General fund tax revenue only. Near general fund tax collection are projected to be $108 million lower than previously forecasted, largely due to a recent State Supreme Court ruling that eliminated the state estate tax for married couples.

2. Budget & Policy Center calculations; data from ERFC, OFM, and the Joint Task Force on Education Funding. The $2.6 shortfall breaks down as follows: $1.3 billion current services shortfall; $1.4 billion is the minimum "down payment" for basic education reform as determined by the Joint Task Force on Education Funding.

3. Budget & Policy Center calculations; data from the Economic and Revenue Forecast Council's March 2013 forecast.

4. Budget & Policy Center calculations; data from the Economic and Revenue Forecast Council's March 2013 forecast and the Bureau of Labor Statistics.

5. Budget & Policy Center calculations; quarterly state revenue collections data from the Nelson A. Rockefeller Institute of Government.

6. Budget & Policy Center calculations; revenue data from the Economic and Revenue Forecast Council's March 2013 forecast; total state personal income data from the Bureau of Economic Analysis.

7. Office of Financial Management, The Distribution of Income, Wealth, and Taxes Across Washington Households, 2012, p. 55. http://www.ofm.wa.gov/reports/income_wealth_report.pdf

8. Budget & Policy Center calculations, taxable retail sales data from the Economic and Revenue Forecast Council.

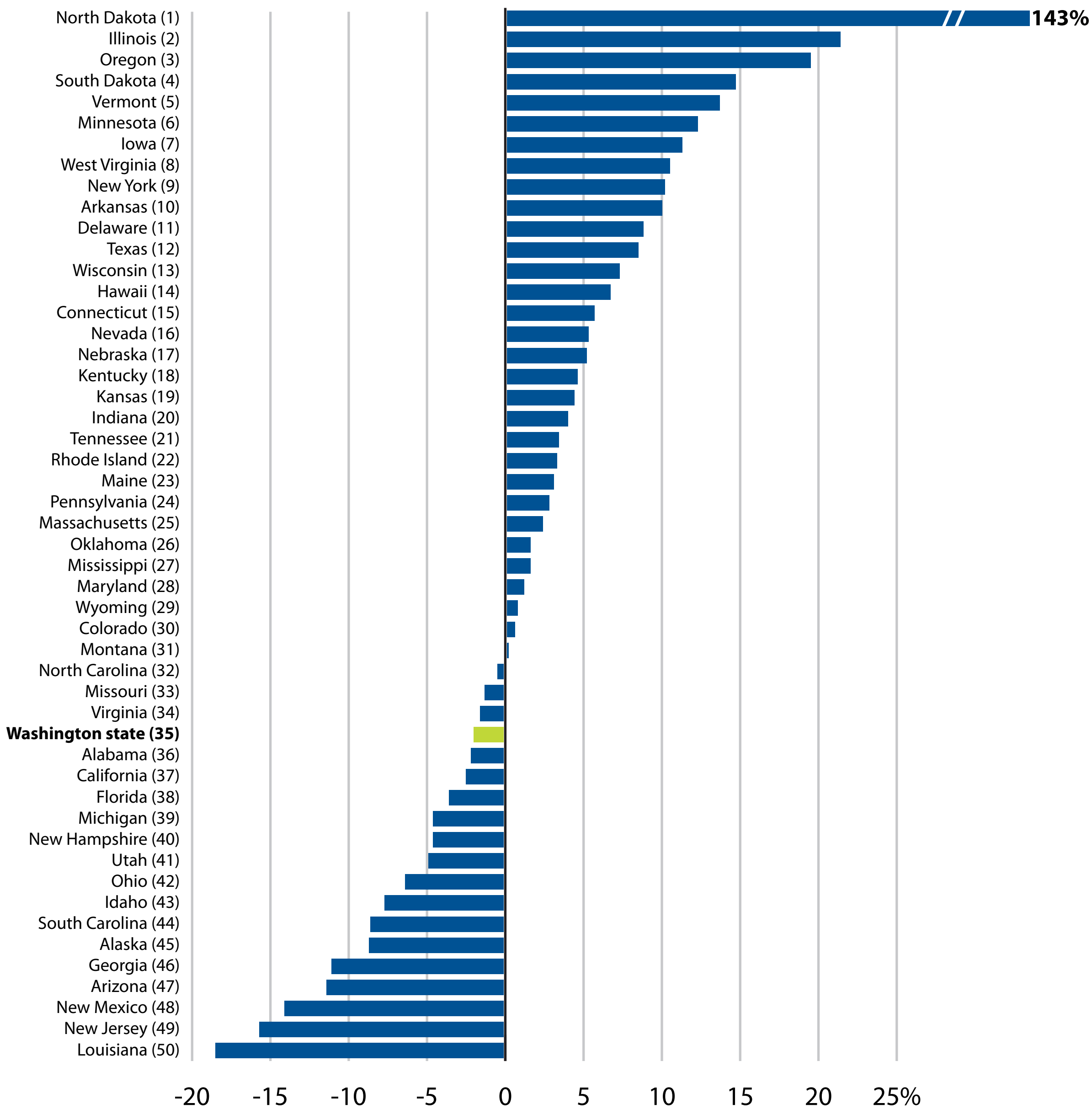
9. Michael Leachman, Michael Mazerov, Vincent Palacios, and Chris Mai, State Income Tax Cuts: A Poor Strategy for Economic Growth, Center on Budget and Policy Priorities, March 2013. http://www.cbpp.org/cms/index.cfm?fa=view&id=3936

10. Budget & Policy Center Calculations; state revenue data from the U.S. Census Bureau; state total personal income data from the Bureau of Economic Analysis.

Appendix Figures

Appendix Figure A: Washington State Trails Nation in Revenue Recovery

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

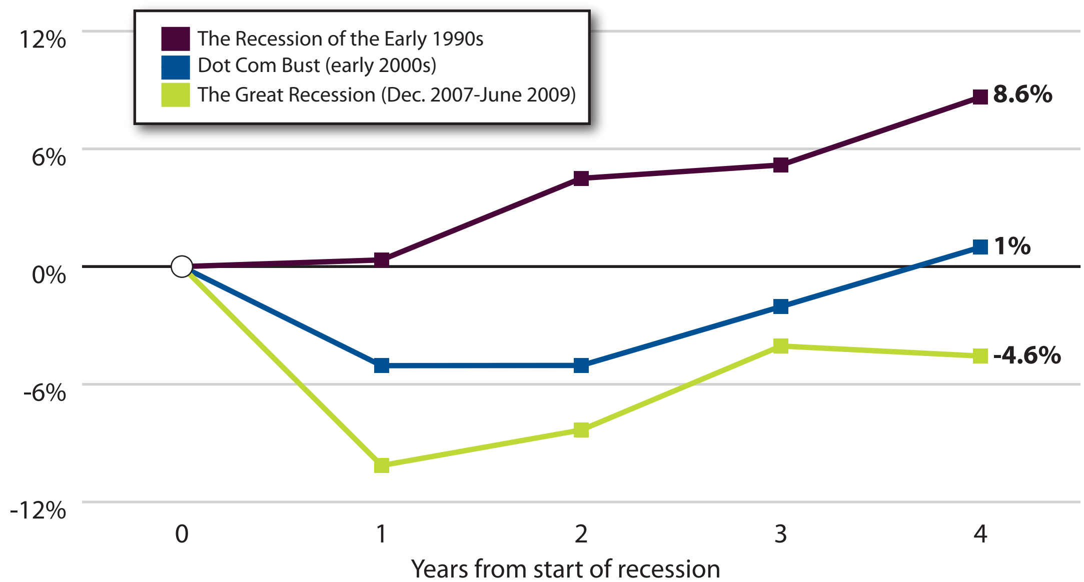


Budget & Policy Center analysis; data from the Rockefeller Institute of Government

Appendix Figures

Appendix Figure B: 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