WashACE

COMPETITIVENESS BRIEF

Washington Alliance for a Competitive Economy

CB 06-07 November 17, 2006

RESTORING THE GENERAL FUND IN 2007

THE BOTTOM LINE

For reasons of sound fiscal policy, increased transparency and accountability, and to assure that the state's highest priorities are securely and adequately funded, it's time for the Legislature to consolidate the "near general fund" accounts and restore the integrity of the state general fund.

When the Legislature passed Senate Bill 6078 in 2005, lawmakers formally acknowledged that several important dedicated accounts are virtually indistinguishable from the state general fund. In preparing the 2007-2009 budget, the governor and Legislature should take the next logical step and fold these accounts into the general fund. By doing so, they would increase fiscal transparency and accountability, principles central to the state's "priorities of government" budget process.

BACKGROUND

Initiative 601, passed by the voters in 1993, limited the growth in general fund state spending to a "fiscal growth factor" tied to inflation and population. The limit applied to the state general fund only. That restriction created an incentive for citizens and lawmakers to establish other tax-supported funds not subject to the I-601 spending cap.

And there was another wrinkle.

In 2000, the Legislature amended I-601 to allow the spending limit to be increased when money is transferred into the general fund. This provision, which was intended to complement the initiative's original language lowering the limit when money was transferred from the general fund to another account, created what insiders called "the two-way street. (For a more complete discussion of the effect of transfers on the limit, see our brief [WRC 2001].)

In practice, the two-way street became an expressway allowing lawmakers to reach any spending destination they wanted by manipulating transfers to bump up the limit. Such manipulation is at the center of a lawsuit filed by several organizations, including the Evergreen Freedom Foundation and the Washington State Farm Bureau, challenging tax and spending increases in the state's 2005-2007 budget. Last spring, Superior Court Justice James Allendoerfer found that the Legislature transferred funds solely to increase the limit and ordered spending lowered and invalidated some tax increases. The decision is being appealed, but going forward the transfer issue has been partially resolved. SSB 6078 addresses the problem by bringing "related funds" under the limit.

An earlier Washington Alliance for a Competitive Economy brief criticized SSB 6078 for weakening the voter-approved tax and expenditure limit. (WashACE 2005) In that brief, we said:

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> The extension of the spending cap to additional funds, flawed as this effort is, would nonetheless appear to be a strengthening of I-601. Yet the legislation begs the question of why allow the dedicated funds to exist at all. Why not consolidate them, with their revenue sources, into the general fund?

Here, we take a closer look at the near general fund and the potential for such consolidation.

NEAR GENERAL FUND INCLUDES "RELATED FUNDS"

For several years, state budget analysts have reported on the general fund and the "near general fund," which includes accounts that channel spending toward programs and services that are virtually indistinguishable from traditional general fund activities – education or health care, for example. In SSB 6078, the Legislature extended the spending limit to capture these "related funds," which include the Health Services Account, the Violence Reduction and Drug Enforcement Account, Public Safety and Education Account, Water Quality Account, and the Student Achievement Fund. After this bill was passed, lawmakers created the Education Legacy and Trust Account, which is similar in nature to the other related funds.

Here's a brief overview of the funds.

- ***Health Services Account (HSA).*** The Legislature created the HSA in 1993. Since then, it has rarely enjoyed any fiscal health. Its revenue sources, primarily tobacco and alcohol taxes, grow slowly, while spending demands increase rapidly. The HSA provides funding for the Basic Health Plan.
- ***Violence Reduction and Drug Enforcement Account (VRDEA).*** With a nebulous and elastic mission, VRDEA funds may be used to fund incarceration, to reimburse local governments for the cost of implementing criminal justice legislation, to support drug task forces, transfers to the HSA, and to fund community networks to support families and children. Revenues flow to the fund from an assortment of taxes and fees, including firearms dealer license fees, and alcohol and tobacco taxes.
- ***Student Achievement Fund (SAF).*** Created by Initiative 728, passed in 2000, the SAF earmarked a share of lottery funds and the state property tax. The initiative restricted the use of funds to specified purposes: class size reduction, extended learning, professional development, early learning, and certain building improvements. Given that these are established priorities, it's not much of a restriction.
- ***Public Safety and Education Account (PSEA).*** The PSEA has a similarly wide-ranging mission, allowing it to fund programs ranging from traffic safety education to crime victims' compensation, and indigent defense. Revenues to the fund come from fees, fines, forfeitures, penalties, reimbursements or assessments by the courts.
- ***Water Quality Account (WQA).*** The WQA provides funding to assist in water pollution control activities and facilities. Tobacco taxes provide a large share of the money going into the account.

- ***Education Legacy Trust Account (ELTA).*** Created in 2005, the ELTA deposits money into the SAF and funds additional enrollments and financial aid for higher education and other educational improvement activities. The money comes from tobacco taxes and the estate tax. Because spending demands exceed anticipated revenues, the fund is expected to require GFS support within the next five years (OFM 2006).

Revenues for these accounts have steadily grown as a share of the NGFS, increasing from three percent in 1990 to nearly nine percent in the FY 2007 allotment. The 2007 breakdown is shown in Figure 1.

Figure 1: FY 2007 Near General Fund Allotments

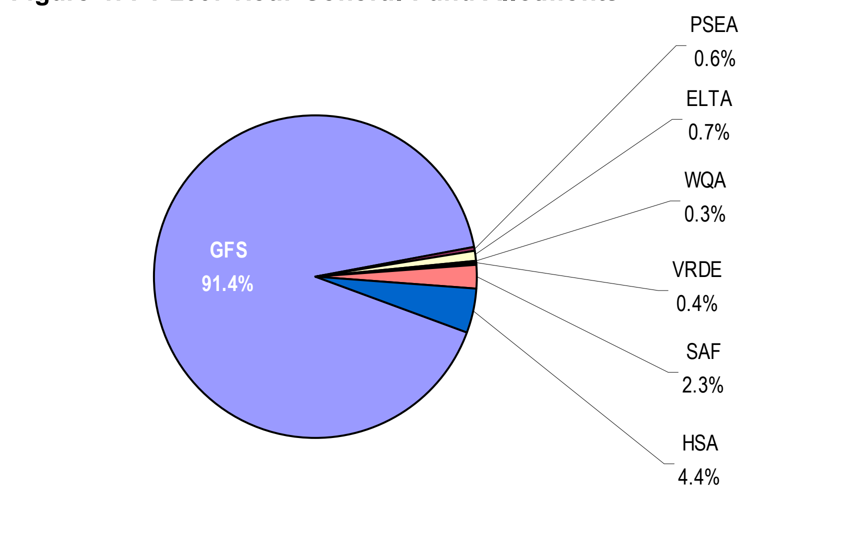
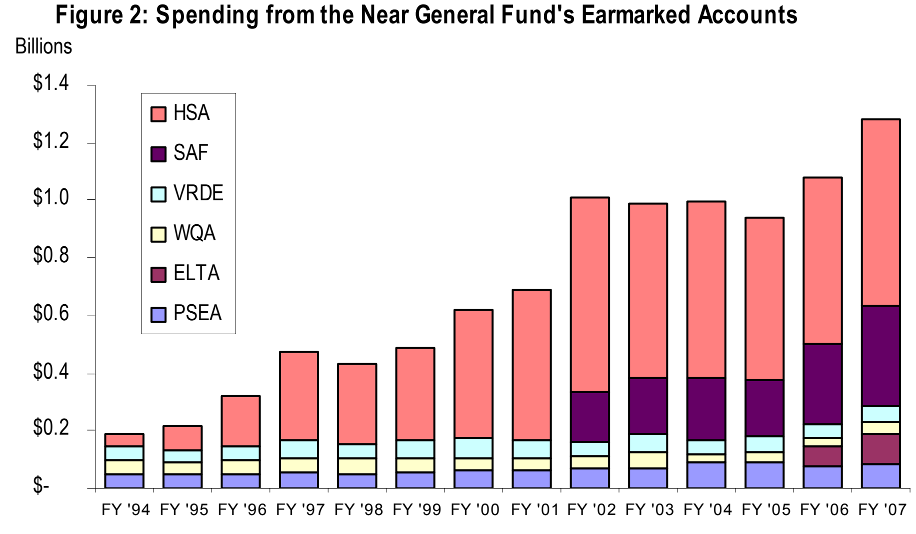


Figure 2 shows the revenue growth in each of these accounts since 1994. Increases in tobacco taxes spiked the Health Services Account in 2002. Reflecting the narrow tax bases and the in-and-outs of transfers, the numbers bounce around some.

Even were these accounts relatively stable, there is little justification for setting them outside the normal general fund budget process. Each of them supports activities that should properly be considered part of the general fund. But the major accounts, the Student Achievement Fund, the Health Services Account, and the Education Legacy Trust Account support activities that cannot be sustained by their revenue sources. The predictable, inevitable shortfalls will create a drain on the general fund. By placing these funds under the state's expenditure limit, the Legislature acknowledged their interdependence.

The state's successful Priorities of Government budget process explicitly recognizes the importance of evaluating programs without regard to funding streams: "Teams are asked to focus only on maximizing results for citizens through evidence-based strategies, and to ignore fund source and statutory restrictions that stand in the way." (OFM 2005) That process facilitates decision-making based on state objectives.

Figure 2: Spending from the Near General Fund's Earmarked Accounts



Under Governor Chris Gregoire an important dimension has been added to this outcome focus. Her Government Management, Accountability and Performance (GMAP) program, established by Executive Order 05-02 in February 2005, concentrates on increasing accountability and accomplishment through rigorous program evaluation. The effort directly complements and enhances the state's POG program.

In *The Price of Government*, David Osborne and Peter Hutchinson—Hutchinson was Gov. Gary Locke's consultant in the first POG process—repeatedly emphasize that the budgeting process must be transparent to citizens, open, flexible, and accountable if the benefits of the POG philosophy are to be fully realized. The diversion of revenues to dedicated accounts to fund activities that would otherwise be funded out of the state general fund frustrates the process. These dedicated accounts exemplify the single-purpose "silos" that the POG seeks to eliminate.

While the dedicated accounts attempt to ensure that certain high-priority government services (education, health, security, environmental protection) are securely funded from a guaranteed revenue stream, the effort fails. The POG framework better ensures long-term security for high-priority programs, assuring that those activities citizens' value are delivered efficiently and effectively.

Dedicated accounts lock away future revenues and force spending on specific programs or strategies. They do not allow flexibility in the face of changing citizen preferences, economic performance, innovative strategies, or shifts in tax revenues. Osborne and Hutchison urge legislators to set total revenue levels rather than spending levels for a budget, and then use their time to focus on what really matters: buying the results that citizens value at the lowest cost (Osborne and Hutchison 2004, p. 61). This "budgeting for outcomes" allows for creative thinking about how best to deliver the desired results each time a budget is prepared. Legislation that rigidly locks spending at certain levels and to certain strategies is doomed to be inefficient and become obsolete.

Earmarked funds, though an attempt to create transparency and accountability, ultimately detract from a citizen's ability to track revenues, spending, and results. Once funds have entered one of Washington's dedicated accounts, it is much more difficult to tell where or how they are spent compared to revenues exiting the general fund. As stated in 1996 by the WRC, "earmarking revenues, creating dedicated accounts, and moving expenditures "off-budget" violate sound fiscal practice and frustrate public understanding of state spending and taxation." (WRC 1996, p. 1) It is no surprise that citizens fail to understand how funding for water pollution control projects should be provided by alcohol and tobacco taxation.

The state's major dedicated accounts provide funding for services already at the top of the state's priority list. In the past, dedicated accounts were used by the legislature to show that they could be trusted to ensure funding for the state's highest priorities. On occasion, citizens themselves have insisted on fund dedication, as in the case of the Student Achievement Fund established by Initiative 728. But that approach, which was also an attempt to secure funding above the I-601 limit, does not work over the long-term.

Conclusion

The Washington Alliance for a Competitive Economy has previously cited the principle problems with earmarking. The major objections are familiar and readily apparent. Earmarking frustrates priority setting. Dedicated funds make it difficult for citizens to understand the state budget. When general fund taxes are earmarked, the state's revenue structure is weakened.

But for those who cling to the illusion that tax dedication protects their priorities, perhaps the best argument is not one based on policy, but rather on practicality. Earmarking simply doesn't work. As we did in an earlier WashACE report , we cite the National Conference of State Legislatures, whose analysts found "a high quality revenue system minimizes the use of tax earmarking. … State programs may be placed in jeopardy if they are funded solely by earmarked revenues because there is no guarantee of a consistent revenue stream (stability) nor of adequate ongoing revenue (sufficiency)." (WashACE 2005; NCSL 2002)

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