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Governor



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February 17, 2010

TO: The Honorable Frank Chopp, Speaker of the House
The Honorable Lisa Brown, Senate Majority Leader
The Honorable Mike Hewitt, Senate Minority Leader
The Honorable Richard DeBolt, House Minority Leader

FROM: Christine O. Gregoire, Governor *Chris*

SUBJECT: A BALANCED APPROACH FOR HARD TIMES

In December, I presented an “all-cuts” budget to address a \$2.6 billion shortfall in our state’s two-year spending plan. As I said then, I cannot support that budget due to its devastating impact on the people of Washington. In January, I submitted to the Legislature a list of programs that I propose to restore. These programs, which I believe are vital to the health and recovery of our state, cost \$768.5 million to fund. Below I outline how I propose to fund these programs.

Before I do that, let me assure you that Washington is not alone in facing a fiscal deficit. Forty-eight states have addressed or still face shortfalls in their budgets for fiscal year 2010, totaling \$193 billion or 28 percent of state budgets – the largest gaps on record. These numbers suggest that states will have dealt with a total budget shortfall of at least \$350 billion for 2010 and 2011.

Like Washington, other states have had to look to new revenue. According to the National Association of State Budget Officers, 29 states have raised over \$24 billion in new taxes and fees. Of these states, 13 have Republican governors and 16 have Democratic governors.

Washington, along with the nation, is weathering the worst recession since the Great Depression. People have lost jobs. Businesses have closed. Foreclosures have increased. Small local and regional banks continue to be exposed to loan defaults, particularly in the commercial sector. As both businesses and consumers spent less and saved more, revenue and confidence declined.

There are, however, strong indications that the economy is turning around. Chief Economist Arun Raha notes that initial claims for unemployment insurance continue to decline. Positive job growth in Washington is expected early in 2010. Building permits are up more than 30 percent since April 2009, mainly in single-family home permits. Automotive sales are rebounding even when the effects of the federal “cash for clunkers” program are excluded. As a result, state revenues are no longer on the downslide.

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This is not a typical recession and our economy remains fragile. Credit to small businesses remains depressed. The construction sector, especially commercial, is still weighing down the recovery, and the return of consumer confidence remains tentative. Nonetheless, there is much we can and must do to encourage our state's economic recovery.

First, we must take action to create jobs and stimulate new private investment. I have proposed a plan to create as many as 40,000 jobs over the next three years. I have proposed legislation to create a \$2,000 B&O tax credit for new jobs to encourage small businesses to hire. I have also proposed legislation to make it easier for employers to qualify for the current B&O tax credit for new jobs. In addition, to persuade businesses to invest today rather than tomorrow, my proposal for projects of statewide significance provides permit assistance and a B&O tax credit for capital investments. We estimate this proposal will stimulate \$2 billion in private investment in Washington during the next two years.

Second, we need to continue on the path of government reform. I am pleased that the Legislature is moving forward on my proposals to reduce the number of boards and commissions, and to transfer programs and functions to reduce costs and align agency missions. But, we must do more.

I have proposed the partial or complete closure of 10 state facilities so that we operate more efficiently, save money, and provide better care. This includes the closure of two of the state's five residential habilitation centers because I believe our citizens with developmental disabilities need to be served in communities. By closing underused buildings and changing the way we care for these citizens, we can free up funds to extend better care for more clients. Likewise, downsizing the facilities we use for juvenile rehabilitation will save money and enable the state to site and design smaller and better facilities in communities where the majority of young offenders live. Lastly, we need to take advantage of the investments we have made in highly efficient prisons by closing underperforming facilities. My 10-year plan on facilities closures will save the state \$180.5 million.

Lastly, we need to manage our fiscal crisis.

The February revenue forecast provides signs that the economy is stabilizing, but we are not out of the woods yet. Revenues are flat and caseloads have grown. We now face a \$2.8 billion budget gap. As difficult as the choices are, I believe we must address this year's gap with a balance of cuts and revenue.

The legislative process will undoubtedly create a different list of cuts and restorations as the priorities of the Legislature and the public emerge. However, I am confident that we all want to protect our children, our most vulnerable, our health, and our future.

I expect that Washington will receive additional resources through the Federal Medicaid Assistance Percentage (FMAP). We estimate that amount to be \$435 million for this budget cycle. I am thankful for the assistance of our Congressional Delegation in supporting this vital funding.

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Today, I am proposing new revenue that in combination with federal revenue will fund my restoration list. There are understandable pressures to restore much more, but the budget choices we make must prepare us for the 2011-13 budget.

I have already introduced several proposals to improve our revenue system. These changes represent good tax policy – by addressing several court cases, eliminating tax policies that unfairly benefit out-of-state businesses, closing tax loopholes and revising ineffective tax exemptions.

As I evaluated a wide array of revenue ideas, I kept several criteria in mind. First, I considered whether a tax proposal would jeopardize our prospects for recovery. Second, where possible, I sought to generate revenue from discretionary purchases rather than necessities. Third, I believe that products that negatively impact our environment or public health should be taxed to pay the cost of their effects. Fourth, I considered the effect on our 2011-13 budget. Attached is a chart that outlines my proposal. In total, my revenue proposals raise an additional \$605 million in 2009-11.

I had hoped Congress would have acted by now, but it has not. Consequently, my proposal assumes that the FMAP money our state receives is in our ending fund balance. While I am confident we will eventually receive FMAP money, I cannot accept the risk that the budget could be pushed out of balance.

While there are positive signs in our economy, recovery remains fragile. Until our economy is on a certain and upward path, we will need to be vigilant in managing the budget. This ending fund balance of \$512 million will help cushion against the ups and downs our economy may take. Recovery will not happen overnight and it will continue to challenge us through the next biennium.

The additional 2011-13 challenge we must tackle is education. My number one priority is for the children in our state to have good schools and great teachers. Not included in this proposal is a long-term funding strategy for K-12 education. While we are making efforts this legislative session to improve our schools and compete for federal Race to the Top funding, we need to work together to develop a stable and consistent funding source for K-12 education.

It is my obligation to submit a revenue proposal to fund the program restorations I have requested. I know the Legislature must balance its budget, which may represent different priorities, a different approach to revenue, and a different ending fund balance. I respect the process and offer my assistance.

The task ahead may appear daunting, but I believe we can work together to get the job done.

Attachments

A Balanced Approach for Hard Times

Book 2 Restorations

Education

GFS Dollars in Millions

1 Restore and increase K-12 levy equalization to assist local school districts with lower than average property tax base	\$ 165.01
2 Restore higher education State Need Grant Program to serve 12,300 students	\$ 146.44
3 Restore K-12 all-day kindergarten, gifted program, Reading Corps	\$ 42.01
4 Restore Early Childhood Education and Assistance Program for 1,500 low-income 3-year-olds	\$ 10.50
5 Restore Middle School Career and Technical Education Program to give students hands-on science and math-related learning opportunities	\$ 1.94
Education Subtotal	\$ 365.90

Health Care

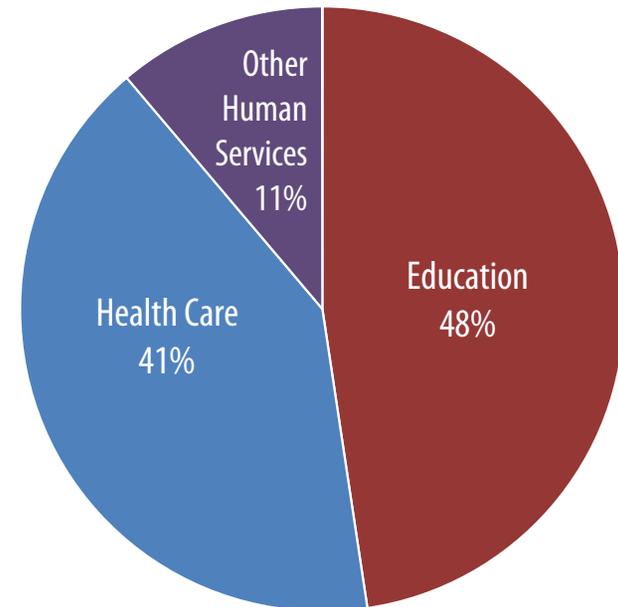
6 Fund Basic Health Plan to insure 60,000 Washingtonians	\$ 160.58
7 Restore maternity support services to 50,000 pregnant women	\$ 24.47
8 Restore vision, dental, podiatry, physical therapy services for low-income adults	\$ 18.18
9 Restore hospice care to provide end-of-life services to 2,600 adults	\$ 6.16
10 Restore drug treatment and detox services to 12,800 clients	\$ 5.39
11 Retain services to low-income temporarily disabled adults without children	\$ 84.47
12 Continue services to HIV/AIDS clients and HIV/AIDS prevention and education	\$ 4.86
13 Restore mental health services to low-income adults, children, families	\$ 7.03
14 Restore Apple Health Insurance Program to 16,000 children	\$ 4.11
15 Restore children's public health nurses	\$ 0.71
16 Restore Family Caregiver Support Program to provide respite care to families who care for relatives at home	\$ 0.63
Health Care Subtotal	\$ 316.60

Other Human Services

17 Continue high-quality care for needy seniors and persons with disabilities	\$ 28.54
18 Partially restore Working Connections Child Care option to provide subsidized child care to working families or those training for jobs	\$ 39.50
19 Restore senior citizens services that provide meal assistance, transportation, other services that keep clients in their homes	\$ 8.85
20 Restore funding to foster care families	\$ 4.14
21 Continue Developmental Disabilities Flexible Support Grants for low-income persons	\$ 2.00
22 Address Crime Victims Compensation Program shortfall	\$ 1.55
23 Retain supplemental mental health services for jails	\$ 1.15
24 Provide regional law enforcement training	\$ 0.28
Other Human Services Subtotal	\$ 86.00

Grand Total Restorations **\$ 768.50**

Book 2 Restorations



A Balanced Approach for Hard Times

Book 2 Revenues

GFS Dollars in Millions

*2009-11
Biennium*

<i>Creating a Fair Business Climate</i>	
1 Economic nexus	\$ 73.07
2 Addressing loopholes & abusive tax avoidance transactions	\$ 11.60
Subtotal	\$ 84.67
<i>Restoring Legislative Intent</i>	
3 HomeStreet Bank court case (first mortgage interest B&O deduction)	\$ 8.60
4 Repeal B&O tax exemption for direct sellers (Dot Foods related*)	\$ 3.70
5 Agrilink court case (B&O preferential rate for processing meat)	\$ 4.08
Subtotal	\$ 16.38
<i>Eliminating Preferential Tax Treatment</i>	
6 Eliminate the B&O exemption for bullion	\$ 0.21
7 Clarify taxation of corporate boards of directors fees	\$ 2.10
8 Suspend sales tax exemption for livestock nutrient management	\$ 1.30
9 Repeal the B&O tax credit for syrup tax paid	\$ 7.70
Subtotal	\$ 11.30
<i>Restoring Critical Services</i>	
10 MTCA/hazardous substance tax - rate increase to 2.0%	\$ 148.00
11 Tax on bottled water sales @ 1 cent per ounce at wholesale	\$ 134.70
12 Carbonated beverages @ 5 cents per 12 ounces at wholesale	\$ 93.60
13 Cigarette tax from \$2.025 to \$3.025/pack and OTP at cigarette rate	\$ 88.80
14 Impose sales tax on candy and gum	\$ 28.00
Subtotal	\$ 493.10
Grand Total New Revenue	<u>\$ 605.45</u>

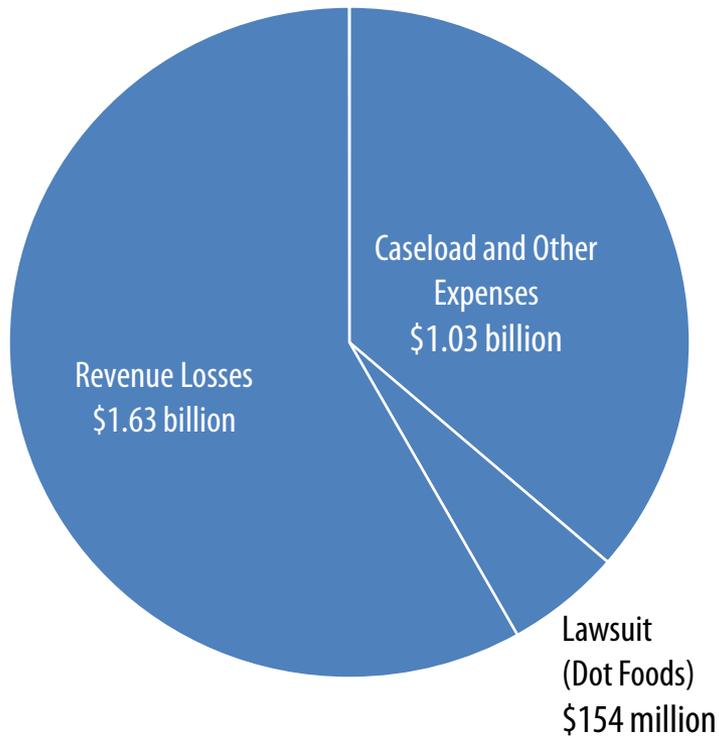
*Does not include revenues related to Dot Foods case fix contained in HB 2971, requested by the Department of Revenue.

A BALANCED APPROACH FOR HARD TIMES

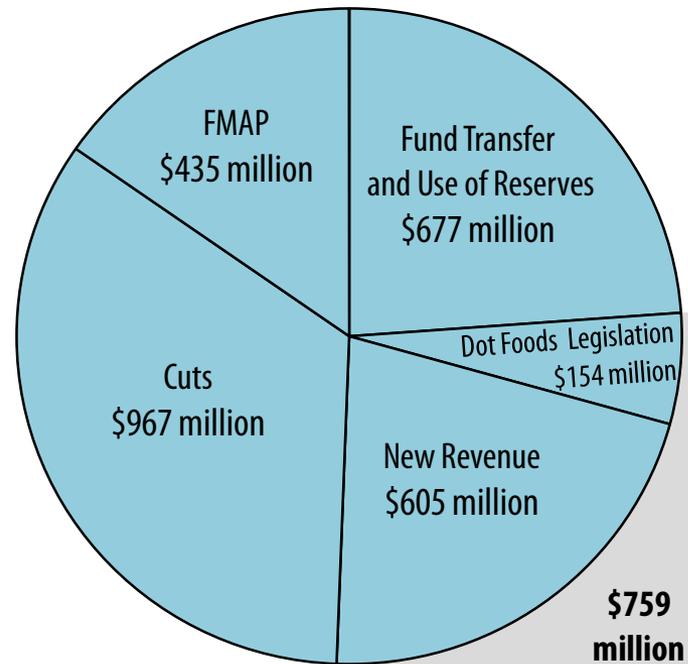
GOVERNOR'S PROPOSED BOOK 2 BUDGET

FEBRUARY 2010

Problem \$2.8 Billion



Solution \$2.8 Billion



A Balanced Approach for Hard Times

REVENUE PROPOSALS

CREATING A FAIR BUSINESS CLIMATE

Economic Nexus

Under current law, Washington businesses pay taxes while many direct out-of-state competitors do not. This proposal updates our laws to reflect the borderless economy of the 21st century by requiring out-of-state businesses to pay the same taxes that their in-state competitors now pay. Many Washington businesses with out-of-state sales will see their taxes go down. This legislation would generate \$73.1 million this biennium.

Close Loopholes and Tax Avoidance

Closing tax loopholes is essential and the fair thing to do. Some taxpayers have created and exploited loopholes to purposely avoid paying real estate excise tax, sales tax and use tax. Closing these loopholes would save the state \$11.6 million this biennium.

RESTORING LEGISLATIVE INTENT

Repeal B&O Tax Exemption for Direct Sellers (Dot Foods Court Case)

Due to a court ruling that expands the reach of the direct sellers exemption, large out-of-state businesses that sell products in Washington state now benefit from legislation designed to exempt “door-to-door” sellers and “in-home parties.” This legislation would assure that in-state businesses are competing on a level playing field with out-of-state businesses. It would also encourage more local businesses to remain in the state. Restoring this exemption to its original intent would offset a recent \$153.6 million forecast reduction. It would also generate \$3.7 million this biennium.

Clarify First Mortgage Interest B&O Tax Deduction (HomeStreet Bank Court Case)

In 1970, the Legislature enacted a tax deduction to reduce the cost to homeowners of purchasing a home. Banks took advantage of this consumer benefit by deducting fees for loans they sold on the secondary market. New legislation to restore the state’s position will make this deduction sensible again and serve homeowners, not banks. Righting this wrong would save the state \$8.6 million this biennium.

Clarify B&O Rate for Butchers (Agrilink Court Case)

In 2005, the state Supreme Court extended preferential B&O rates intended to benefit meat packers to any business that manufactures or wholesales products containing even a tiny amount of meat. It was not legislative intent that large companies making products such as canned chili benefit from a lower tax rate. Restoring the original intent of the Legislature would raise \$4.1 million this biennium.

ELIMINATING PREFERENTIAL TREATMENT

Eliminate Outdated B&O Tax Exemption for Gold Bullion

Wholesalers and retailers of gold bullion should pay B&O tax on their sales like other retailers now do. Eliminating this outdated 1985 exemption would save the state \$210,000 this biennium.

Suspend the Sales and Use Tax Exemption for Livestock Nutrient Management

Current law exempts companies from paying tax on purchases related to livestock nutrient management equipment. Both the Washington Cattlemen's Association and the Dairy Farmers of Washington have suggested that during this time of great need for the state, these exemptions be excluded. This would save the state \$1.3 million this biennium.

Repeal B&O Tax Credit for Syrup Tax Paid

Companies that use syrup to produce carbonated beverages currently receive a B&O tax credit that completely offsets any syrup tax paid. Why have a syrup tax if it generates no revenue? This credit costs the state \$7.7 million a year in foregone revenue.

Require Directors to Pay Tax on Corporate Board of Director Fees

Members of corporate boards of directors can receive substantial compensation for their services, yet no tax is collected on the amount that corporations pay them. This loophole would be closed by clarifying that these fees are not exempt from B&O taxation, which would generate \$2.1 million this biennium.

RESTORING CRITICAL SERVICES

Increase the Hazardous Substance Tax

This proposal increases the hazardous substance tax rate from 0.7 percent to 2.0 percent to protect Washingtonians from the effects that harmful pollutants have on the environment. The hazardous substance tax rate has not been revised in more than 20 years even though pollution levels and the cost of cleanup have risen dramatically. During this recession, this will provide revenue as well as ensure important environmental safeguards are in place. This proposal would raise \$148 million for the General Fund this biennium. It also would raise \$66.5 million this biennium to prevent oil spills and clean up the Puget Sound and Washington's lakes and rivers.

Excise Tax on Bottled Water

Bottled water is a discretionary purchase. This proposal would require wholesalers to pay a tax of 1 cent per ounce on bottled water. It would generate \$134.7 million this biennium.

Excise Tax on Carbonated Beverages

Carbonated beverages are a discretionary purchase. Their consumption leads to growing public health issues, including childhood obesity and diabetes. Through an excise tax of 5 cents per 12 ounces, this proposal would raise \$93.6 million this biennium.

Increase Cigarette and Tobacco Products Tax

Tobacco, in all forms, continues to be a major health hazard. Increasing the price of cigarettes and tobacco products reduces consumption, especially among young people. While some may be concerned that higher taxes may lead people to buy contraband tobacco products, we will need to ensure enforcement. This increase would raise \$88.8 million this biennium.

Sales Tax on Candy and Gum

Candy and gum, both discretionary purchases, are currently classified as food and thus exempt from sales tax. This proposal would extend sales tax to candy and gum, encourage healthier food choices and raise \$28 million this biennium.

A Balanced Approach for Hard Times

Governor's 2010 Supplemental Budget Proposal

2009–11 Balance Sheet

February 2010

General Fund - State Dollars in Millions

Revenues

Beginning fund balance	\$	189
November 2009 revenue forecast	\$	28,843
February 2010 forecast update (includes loss for Dot Foods case)	\$	(118)
Fund transfers/other adjustments (enacted)	\$	874
Required transfer to Rainy Day Fund	\$	(252)
Transfer of related fund balances	\$	89
	\$	<u>29,625</u>

Governor's 2010 supplemental changes

Transfers from other funds to General Fund	\$	396
Use of Rainy Day Fund	\$	229
Budget-driven revenue	\$	(1)
Legislation on B&O tax exemption for direct sellers (Dot Foods)	\$	154
New revenue proposals	\$	605
Job package	\$	(15)
	\$	<u>30,993</u>

Expenditures

2009–11 enacted budget	\$	30,918
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Governor's 2010 supplemental changes

Maintenance level changes (with February update)	\$	852
Use of new Federal Medical Assistance Percentage (FMAP) funds	\$	(435)
Net expenditure changes	\$	(853)
	\$	<u>30,481</u>

Reserves

Projected General Fund ending balance	\$	512
Projected Rainy Day Fund ending balance		0