Tax Alternatives for Washington State: A Report to the Legislature

Prepared Pursuant to
Chapter 7, Section 138, Laws of 2001

By the Washington State
Tax Structure Study Committee

William H. Gates Sr., Chair

Volume 1
Committee Report

November 2002

November 30, 2002

The Honorable Lisa Brown, Chair
Senate Ways and Means Committee
Post Office Box 40482
Olympia, Washington 98504-0482

The Honorable Jeff Gombosky, Chair
House Finance Committee
Post Office Box 40600
Olympia, Washington 98504-0600

Dear Senator Brown and Representative Gombosky:

We are pleased to present to the Ways and Means Committee of the Senate and the Finance Committee of the House of Representatives the report of the 2002 Washington State Tax Structure Study Committee. As required by our legislative mandate, this report provides a systematic analysis of Washington's existing tax structure and provides recommendations for alternatives to improve the tax system.

We believe that the analysis in this report provides a comprehensive evaluation of our tax structure, and that the recommendations and alternatives developed by the Committee will provide valuable guidance to policy makers. It is also our hope that this report will serve to bring an understanding of tax issues and problems to a significant number of citizens.

The research in this report is governed by the principles of taxation outlined in our charge: equity, stability, economic neutrality, economic vitality, transparency, administrative simplicity, and harmony with other states. It was the Committee's goal to provide alternatives and recommendations that advance each of these principles.

Because of the depth of knowledge and experience possessed by the members of this Committee, this report should have lasting significance as a policy tool. Each member brought to the project valuable skills and technical expertise, but more importantly all were receptive to learning new ideas and willing to devote their time and energy to this study.

We would also like to express our sincere gratitude to the Department of Revenue staff members who devoted so much time and technical expertise to the work of this Committee. In addition, we would like to acknowledge the valuable input of the Advisory Group and the numerous Washington citizens who took the time to share their views with the Committee.

Thank you for this opportunity.

Sincerely,

William H. Gates Sr.
Chair

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Acknowledgments

The Washington State Tax Structure Study Committee appreciates the contributions to this report from the Committee members, the Department of Revenue staff members, Technical Subcommittee members, Advisory Group members and others who participated in this study. We regret that it is impossible to name all the people who provided valuable input to this study report, but we would like to make a special acknowledgment of the contributions of the people named below.

Committee Members

We would like to acknowledge the extensive time, effort, and expertise that each Committee member devoted towards this study and report. The Committee was a diverse but cohesive group of individuals who each contributed their energy and skills to this project, and we would like to expressly recognize each member's contributions to this collaborative endeavor.

Governor's Appointee

William H. Gates Sr., Bill and Melinda Gates Foundation – *Committee Chair*

Legislative Appointees

Senator Lisa Brown, Washington State Senate
Representative Jack Cairnes, House of Representatives
Representative Jim McIntire, House of Representatives
Gary Strannigan, Former Washington State Senator

Academic Appointees

John Beck, Gonzaga University
Neil Bruce, University of Washington
Dick Conway, Dick Conway & Associates
Lily Kahng, Seattle University
Debra Sanders, Washington State University
Hugh Spitzer, University of Washington – *Committee Vice Chair*

We would also like to acknowledge the contributions of former Washington State Senator Dow Constantine. Mr. Constantine was a co-sponsor of the enacting legislation for this study and served as a member of the Committee until his appointment to the King County Council.

Department of Revenue Staff Members

The following Department employees were the principal staff contributors to the research and analysis of the tax study. These individuals provided core support to the Committee throughout the duration of the study and the phases of study design, economic analysis, and development of

alternatives. Staff members from several divisions played key roles in supporting the economic research and policy analysis completed by the Committee.

Executive Division

Will Rice, Acting Director of the Department of Revenue – *Executive Sponsor of Study*

Sue Meldazy, Project Manager – *Committee Liaison, Study Design, Overall Study Coordination*

Cyndi Mikota, Administrative Assistant – *Organizational Assistance to Committee*

Research Division

Mary Welsh, Assistant Director – *Research Staff Manager, Study Design Leadership*

Lorrie Brown, Ph.D., Economist – *Principal Economic Analyst and Study Design*

Diane Mielke, Administrative Assistant – *Meeting Coordination and Minutes*

Legislation and Policy Division

Russ Brubaker, Assistant Director – *Tax Policy and Legal Guidance to Committee*

Nicole Stewart, Tax Policy Specialist – *Principal Contact for Advisory Group*

In addition to the core staff members, many other Department employees provided support to the Committee.

Research Division – *Technical Assistance on Economic Modeling, Fiscal Impacts, and Report Drafting*

Byron Angel
Becki Gilyard
Don Gutmann
Van Huynh
Skeets Johnson
Margaret Knudson
Scott Maddox
Fanny Nyaribo-Roberts
Ray Philen
Steve Smith
Don Taylor
Diana Tibbetts
Stan Woodwell

Legislation and Policy Division – *Legal, Administrative and Policy Assistance and Report Drafting*

Leslie Cushman
Cliff Ellenwood
Cindy Evans
Debbie Glover
Claire Hesselholt
Beulah Holman
Alan Lynn
Greg Potegal
Amy Rotter
Julie Sexton
Donn Smallwood
Anne Solwick
Jim Thomas

Audit Division	Bob Heller	*Legal Review of Chapter 5*
Taxpayer Services Division	Chris Donahue	*Graphic Design*
	Mike Gowrylow	*Public Relations*

Technical Subcommittee Members

The in-depth research and analysis found in this report is the result of a collaborative effort among Committee members and staff from the Department of Revenue, Office of Financial Management, Senate Ways and Means Committee, House Finance Committee and the Washington Research Council. The Committee greatly appreciates their thoughtful, expert contributions.

Rick Peterson	House Finance Committee
Terry Wilson	Senate Ways and Means
Kriss Sjoblom	Washington Research Council
Irv Lefberg	Office of Financial Management
Wolfgang Opitz	Office of Financial Management
Carol Jenner	Office of Financial Management

Advisory Group

The Tax Structure Study was required by law to include an Advisory Group of various representatives of business, state and local government, labor, taxpayers, and other advocacy groups. At the close of the study the Committee's electronic mailing list included almost 200 individuals who represent a much larger constituency of organizations and interested parties. We would like to acknowledge the valuable input of the Advisory Group and the numerous Washington citizens who took the time to share their thoughts and issues with the Committee.

Introduction and Summary

No one likes paying taxes. However, raising money to pay for a community's government and services has been a fixture of organized human existence for thousands of years. The challenge is (as it has always been) how to best structure the tax system so it is considered fair by community members, does not interfere with productivity, and provides sufficient resources for the services that the public demands.

The Washington State Tax Structure Study Committee was created by statute to report to the Legislature on how well Washington's current tax system works and how it might be changed to better serve the citizens of the state in the twenty-first century. This committee is different in composition from the prior tax reform commissions. Rather than being composed of interest group representatives, the majority of the Committee members were professors specializing in public finance, tax economics, accounting, and tax law. Legislators from both houses and both political parties were also members of the Committee.

The Committee evaluated Washington's tax system based on principles outlined in the legislation. Those principles include, among others, fairness, stability, adequacy and the effect of the tax system on Washington's economic vitality.

The Committee concludes that our current system is fundamentally inequitable to low- and middle-income people, unfair to many businesses, and subject to sharp fluctuations in revenue. The Committee also finds that while our tax structure, which was put in place in 1935, might have worked well for a mid-twentieth century manufacturing economy, it doesn't work well in today's economy with its greater dependence on the service sector. If this current trend continues, our tax structure will be even less adequate in the future. Furthermore, the rapidly expanding "Internet economy" is eroding our retail sales tax base. This impedes Washington's ability to collect its fair share from economic activities occurring over the Internet.

In this report, the Committee outlines a number of major and minor alternatives that the Legislature could implement to bring Washington's tax system into the twenty-first century. Serious and fundamental changes are warranted. Rather than providing a single "best" solution, the Committee provides the Legislature and the Governor with a variety of choices. In several instances, the Committee recommends particular alternatives among the various choices because these alternatives will be more effective in solving targeted defects in our tax system. The alternatives outlined in this report can be "mixed and matched" to provide significant improvements in the overall system. However, it must be emphasized that by implementing a change meant to resolve one defect, the Legislature may aggravate other problems within our tax system.

Any tax system in a modern industrialized society is bound to be complicated. Change is likewise complicated and time consuming. Solutions are not simple–nor is this report. We encourage interested parties to read the entire report carefully. The Committee has attempted to write an understandable document, but a state's tax structure is not reducible to short sound bites.

The major alternatives and other adjustments described in this report can be used to restructure a tax system. The benefits would be a tax system that is:

- Substantially fairer to low- and middle-income people.
- More equitable in its treatment of businesses.
- More effective in supporting the state's economy.
- Considerably more compatible with the federal tax system and consistent with the taxing systems used by most other states.

The Committee feels that the broad array of choices and the recommendations in this report provide plausible alternatives to Washington's tax system. This report lays a foundation for our elected leaders and our citizens to make informed choices that will help Washington grapple with the problems of our existing tax structure and turn it into a system that is truly effective in the twenty-first century.

Recommendations

In developing replacement and incremental alternatives, the Committee focused on the following problem areas: regressivity, adequacy, volatility, neutrality, economic vitality, and simplicity. This section provides a summary of the recommendations the Committee includes in its final report. Although the report contains many other alternatives deemed worthy of discussion and consideration, the Committee believes that the following alternatives deserve special attention. It should be noted that the Committee proposes alternatives and recommendations with an eye to revenue neutrality, consistent with the charge it received from the Legislature.

Replacement Alternatives

If the Legislature chooses to replace major taxes in the current tax system, the Committee recommends:

1. **A subtraction method business value added tax to replace the business and occupation (B&O) tax.**

   Replacing the B&O tax with a value added tax eliminates the "pyramiding" effect as goods move through the production chain, thereby addressing the Committee's concerns with economic neutrality and competitiveness. A majority of the Committee members recommend this alternative.

2. **A flat rate personal income tax to reduce the state sales tax rate and eliminate the state property tax. Share all or part of the state property tax relief with local governments and/or local schools.**

   The Committee developed the personal income tax alternative in response to a number of concerns about the existing tax system.

Regressivity: Low-income households pay a larger proportion of their income in taxes than do higher income households. This option would address these concerns by imposing a tax on income earned in Washington, thus redistributing the tax burden across income groups.

Federal Tax Burdens: Changing to a personal income tax would allow households to export a portion of their state tax burden to the federal government because state income taxes are deductible in the federal income tax computation. This will significantly reduce the federal income tax burden on Washington taxpayers.

Vitality: Since businesses pay a significant percentage of the retail sales tax, reduction of this tax will cause a shift of overall tax burden from businesses to households. A reduction in the relative business tax burden would improve Washington's competitive position with other states.

Adequacy: Decreasing the state sales tax rate should reduce the impact of revenue loss from cross-border and remote shopping. Diminishing the incentive for cross-border and remote shopping also improves the competitive position of Washington retailers.

The Committee recommends both a flat rate and a graduated rate income tax. However, a greater number of Committee members supported a flat rate income tax versus a graduated rate income tax.

The Committee recommends the elimination of the state portion of the property tax because the property tax is unpopular, yet the public appears more accepting of local property taxes for local purposes. Accordingly, the Committee suggests that the Legislature consider replacing the state property tax levy and granting local school districts or other local governments additional levy authority.

Incremental Alternatives

The following incremental changes are recommended for adoption except where inconsistent with replacement recommendations. The Committee realizes that some of these alternatives will increase revenue and others will decrease revenue. To maintain revenue neutrality, it would be necessary to either generate additional revenue from another source to offset the effects of those alternatives that reduce revenues or reduce revenue from another source to offset the effects of those alternatives that increase revenues. The Committee recommends the following incremental alternatives.

1. Address adequacy.

- ***Extend the sales tax to consumer services.***

To broaden the sales tax base, this alternative recommends including certain personal services such as beauty and barber services. The Committee developed this alternative in

response to research showing significant erosion of the tax base due to a shift in consumption from tangible personal property to services.

- ***Extend the 0.5 percent excise tax currently applied to watercraft to motor homes and travel trailers as well. Consider increasing the rate from 0.5 percent to 1 percent on all three types of property.***

Research shows that motor homes, travel trailers, and boats are another source of leakage from the tax base. Many are used as substitutes for vacation homes, which are subject to the property tax. This alternative would expand the Washington tax base.

- ***Review tax exemptions every ten years to make sure economic and social goals are achieved.***

This alternative is in response to concerns that the state economy and business practices are changing so rapidly that exemptions may outlive their usefulness. This alternative helps ensure fair application of tax incentive programs by requiring a periodic review of whether the programs are meeting established policy goals.

- ***Avoid dedicated taxes.***

The Committee recommends avoiding dedicated taxes that bear no clear relationship between taxpayers and those who receive benefits. Research indicates these taxes are costly for businesses to comply with and government to administer.

2. Address volatility of the current tax system and also the volatility in any replacement tax system that may be enacted.

- ***Create a constitutionally mandated "rainy day fund."***

This alternative supports creation of a rainy day fund to address the volatility of the existing tax system and the volatility in any replacement system that may be enacted. Research demonstrates that constant rate, constant base tax revenues grow faster than the economy in good economic times and contract more than the economy in poor economic times. The proposal is to create a constitutionally mandated rainy day fund with automatic triggers for saving and spending the reserve funds.

3. Simplify tax administration.

- ***Streamline the sales tax.***

The Committee supports the efforts of the Streamlined Sales Tax Project to enact uniform sales tax definitions and other measures of tax simplification. These efforts will facilitate the possibility of subjecting remote sales (such as e-commerce) to state tax requirements. The ability to tax remote sales would also help stem erosion of the retail sales tax base. This would also help the competitive position of Washington retailers.

- ***Simplify local B&O taxes.***

The Committee also supports the ongoing efforts of local governments, business representatives, and legislators to develop a simplified municipal B&O tax structure that satisfies the goals and concerns of its stakeholders.

4. Improve economic vitality.

A number of alternatives mentioned earlier address economic vitality. The flat rate personal income tax shifts the relative tax burden from businesses to households. The streamlined sales tax project also diminishes the sales tax collection burden on Washington retailers.

- ***Increase the small business B&O tax credit from $35 to $70 a month and index the credit to adjust with inflation.***

Research reveals that new businesses pay a relatively high tax burden. Increasing the B&O credit decreases the state tax burden on small new businesses.

- ***Exempt construction labor from sales tax.***

This alternative addresses economic vitality and harmony with other states. Washington State is one of the few states that imposes sales tax on construction labor. Exempting the labor portion of construction would make our treatment of these costs consistent with other states, including Oregon. Implementing this significant exemption would require a corresponding increase in another tax in order to maintain revenue neutrality.

5. Address regressivity.

- ***Continue to impose an estate tax in the amounts of the state credit allowed under prior federal law.***

This alternative addresses regressivity by maintaining a current tax on high net worth households. Washington State did not conform its estate tax system to the changes made in 2001 to the federal estate and generation skipping transfer tax programs. This proposal would continue to impose Washington's existing estate tax in the amounts of the state credit allowed under federal law prior to the reductions and eventual repeal authorized in the federal Economic Growth and Tax Reform and Reconciliation Act.

Chapter 1: Committee Charge

Creation of the Washington State Tax Structure Study Committee

The Washington State Tax Structure Study Committee was created by Engrossed Substitute Senate Bill (ESSB) 6153 to report to the Legislature by November 30, 2002, on "how well the current tax system functions and how it might be changed to better serve the citizens of the state in the twenty-first century."

As far back as the 1920s, special tax study groups have met to examine Washington's tax structure. Over the last 80 years, several such studies, about one each decade, have brought together distinguished collections of legislators, civic leaders, and other citizens to recommend improvements to Washington's system of taxation. Very often the studies sprang out of fiscal crises, such as the 1982 study conducted during the most severe recession since the Great Depression. Other studies led to the establishment of administrative structures for collection of the tax. Our current tax structure and administration is, in large part, based upon the work of these committees. The 2002 Tax Structure Study differed significantly from previous studies in its membership, approach, and result.

In past studies, the study committee has consisted of legislators, business representatives, and civic leaders, but very few academics. The 2002 Committee consisted of eleven members appointed by the Governor, legislative leadership and the Department of Revenue. Committee members included six academic scholars in economics and tax policy, four members representing the Legislature, and one member appointed directly by the Governor. Governor Gary Locke appointed William H. Gates Sr. who was selected by the Committee to serve as Chair.

Instead of responding to a particular problem or crisis, this study is intended as a blueprint for policy choices with relevancy currently and for years to come. Several previous study groups adopted a set of tax principles to guide their examination of Washington's tax structure. The 2002 study took this analysis a step further by formulating conclusions and designing alternatives based on the advancement of these principles.

While previous study groups were directed to provide recommendations, the 2002 study group was charged with developing multiple alternatives to the existing tax system. Alternatives, to the extent possible, were to be designed to increase the harmony between Washington's and its neighbors' tax systems, to assist commerce

and business creation, and to encourage home ownership. Alternatives were to be guided by:

- Simplicity of administration and collection;
- Economic neutrality among taxpayers;
- Fairness among taxpayers;
- Stability; and
- Transparency (i.e., taxpayer awareness of how, when, and how much taxes are paid).

The Legislature charged the Committee with developing alternatives that "range from incremental improvements in the current tax structure to complete replacement of the tax structure." In developing alternatives, the Committee was asked to consider the effects of tax incentives, including exemptions, deferrals and credits. ESSB 6153 also provided that: "Most of the alternatives presented by the committee to the legislature shall be revenue neutral and contain no income tax."

The Committee systematically analyzed Washington's entire tax system according to each of the generally-accepted principles of taxation. The systematic analysis yielded conclusions about the strengths and problems of Washington's tax system as a whole. Some of these conclusions supported common knowledge about Washington's tax system–while other conclusions were surprises. The Committee designed tax structure alternatives to address the key problems that were highlighted by the analysis. In designing these alternatives, the Committee selected the most effective options to address the problems, with knowledge that sometimes these alternatives may not be politically feasible.

Chapter 2: Tax Principles

Principles for a Well-Designed Tax System

In ESSB 6153, the Committee was directed to evaluate the existing state tax system and to develop multiple alternatives guided by several principles or criteria for a well-designed tax system. The Committee used the following commonly-accepted working definitions for these principles in its determinations.

Commonly-Accepted Definitions

Adequacy/Stability/Elasticity. A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base.

- *Adequacy* is the ability of the tax system to provide for growth in revenue adequate to fund normal growth in public services as the state's population and economy expand. *Long-run elasticity* (LRE) is a measure of that adequacy. A tax system that has an LRE equal to 1.0 generates revenue growth commensurate with the growth rate of the overall economy. If a tax system has an LRE that is significantly less than 1.0, revenue will grow at a lower rate than the overall economy, posing adequacy problems.

- *Stability* is the ability of the tax system to provide the revenue necessary to maintain public services notwithstanding fluctuations in economic activity over the business cycle. The *short-run elasticity* (SRE) is a measure of the stability of the tax system. A tax system of normal stability has an SRE equal to 1.0 and generates short-run fluctuations in revenue comparable in magnitude to contemporaneous fluctuations in economic activity. A more stable tax system has an SRE that is less than 1.0 and will generate fluctuations in revenue that are smaller than contemporaneous fluctuations in economic activity. The converse is true for a less stable tax system with an SRE greater than 1.0.

Equity/Fairness. A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity. These norms typically define fairness according to the relationship between the amount of taxes paid (or borne) by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government programs. Three widely-accepted norms of fairness considered by the Committee are:

- *Vertical Equity*. This principle of fairness requires that the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to

pay the tax. Specifically, taxes paid as a percentage of income should not unduly burden taxpayers with limited ability to pay the tax. Some would view this principle as satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. Others believe that the principle requires that taxes paid as a percentage of income should be higher for taxpayers with more income than those with less income (a progressive tax burden). To our knowledge, almost no one believes that taxes paid should be a higher percentage of income for less affluent taxpayers than for those with more income (a regressive tax burden).

- *Benefits Received*. A tax may be considered fair if the taxes paid are matched by benefits received by a taxpayer from the government. This principle is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers. Such "benefit taxes" are impractical for much of government spending because the "benefits" received cannot be determined for each taxpayer. Therefore, this principle is relevant mainly for certain types of selective excise taxes which act like user fees, such as the motor vehicle fuel tax. It also applies to taxes that have much in common with insurance premiums, such as employment security and industrial insurance taxes.

- *Horizontal Equity*. According to this principle, taxpayers with similar abilities to pay a tax should pay comparable amounts of the tax. More generally, the principle of horizontal equity enjoins the government from levying taxes that have arbitrary and peculiar distributions of tax burdens across taxpayers or from levying dissimilar tax burdens on taxpayers that are not justified by differences in their ability to pay or by distinctions in the benefits they receive from government programs.

Economic Vitality and Harmony with Other States. A good tax system should not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises located in other states. At a minimum, this requires the following:

- The state tax system should not unduly burden enterprises located or considering locating within the state of Washington relative to the business tax systems of other states that offer a comparable non-tax business environment.

- The state tax system should be harmonized with those of other states in order to prevent, or provide relief from, double or multiple levels of taxation on the same economic activity. Similarly, the tax system should minimize the opportunities for selective tax avoidance that would allow some firms to shift their taxable activity out of the state and thereby raise the tax burdens on other firms within the state.

- The state tax system should support a stable economic infrastructure conducive to a vital and growing economy. It should not subject the state economy to fiscal crises that create a climate of fiscal and economic uncertainty.

Economic Neutrality and Efficiency. A good tax system should not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which increases the tax burden on the residents of the state. There are two important methods for minimizing the burden on state residents of raising a given amount of state tax revenue:

- Different production and consumption activities should be subject to the same effective rate of tax. Such a *neutral* tax system is efficient when taxpayers make decisions based on economic advantages rather than tax advantages.

- The state should minimize the tax burden on state taxpayers by choosing a tax system that maximizes the extent to which taxes can be *exported* (paid by nonresidents). An example of exporting is facilitating Washington taxpayers' abilities to take full advantage of deducting state and local taxes on their federal income tax returns. This deductibility allows the taxpayers to shift part of their state and local tax burden to the federal government by reducing federal taxes paid.

Transparency and Administrative Simplicity. People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

Home Ownership. The tax system should facilitate, or at least not impede, the ability of individuals and families to purchase and maintain a home consistent with their standard of living.

Interaction of Principles

The Committee recognized that in certain instances the advancement of some principles may conflict with the maintenance or advancement of others. In other cases, the advancement of several principles may be complementary. The possibilities of conflict include:

- Exempting necessities from taxation may increase fairness but reduce neutrality. For example, the exemption for groceries under the retail sales tax (RST) reduces the neutrality of the tax and induces households to purchase more of the exempted categories of goods. However, because low-income households spend disproportionately more on necessities, these exemptions reduce the regressivity of the RST, and therefore serve to advance vertical equity.

- A tax that collects regular amounts of revenue regardless of fluctuations in economic activity increases fiscal stability but imposes a steady burden on taxpayers at times when they are less able to bear them. Such taxes are also pro-cyclical (i.e., they exacerbate the state business cycle). On the other hand, a tax for which revenue fluctuates more than economic activity increases the chance of a fiscal crisis, yet it is counter-cyclical and acts as an economic stabilizer.

- The vertical equity principle may conflict with the benefit principle of fairness, such as in the case of motor fuel and cigarette excise taxes. Although such excise taxes may be justified by the transportation and health benefits received by the taxpayer, they increase the regressivity of the tax system and burden lower-income people disproportionately.

- Actively promoting home ownership requires a non-neutral tax structure. Whereas a neutral tax structure treats all forms of consumption alike, including housing services (whether rented or owned), promoting home ownership would require a preferential treatment for expenditures on owner-occupied housing.

Given the potential conflicts among the principles, the Committee sought tax structure alternatives that could balance competing objectives and, where possible, take advantage of complementarities among the principles. The primary areas where the Committee found complementarities are as follows:

- Broad-based, uniform taxes with fewer exemptions can advance the principles of adequacy, stability, neutrality, and horizontal equity. The broader the tax base, the greater the tendency for revenue to grow and fluctuate in concurrence with overall economic activity. Also, a uniform tax rate structure treats different taxpayers even-handedly while minimizing the distorting impact of taxation on taxpayer decisions.

- A more transparent tax structure may be complementary to increased competitiveness. A major cause of non-transparency occurs when taxes levied on businesses are passed on to consumers in the form of higher prices—the so-called "hidden" taxes. When business taxes cannot be passed on, competitiveness is reduced. Increasing the fraction of taxes levied on households relative to taxes levied on businesses makes the tax system both more transparent and more competitive.

Taxpayer Perceptions and Considerations

Although the principles defined above represent a consensus of most tax experts about good tax system design, the perceptions of ordinary taxpayers as revealed by surveys and by studies conducted by behavioral scientists may operate in addition to, or in some instances in opposition to, these principles.

In this regard, two questions especially concerned the Committee.

- In addition to the principles enunciated above, what factors might influence taxpayer perceptions as to the fairness of a particular tax relative to another?

- What factors influence taxpayer perceptions as to how burdensome a tax is relative to the objective burden as measured by the revenue collected?

In the Committee's investigation of these matters, the following observations were made:

- Taxpayers seem to be unusually averse to "lumpy" taxes (a tax paid all at once is "lumpy"). Unexpected lumpy taxes are the least popular.

- Taxpayers may be more resistant to taxes that are transparent than to taxes that are hidden in the prices of the goods they buy. Thus, the principle of transparency may conflict with the political feasibility of certain tax reforms because the replacement of hidden taxes with transparent taxes may be perceived as an overall tax increase.

- Taxpayers prefer taxes they think they can control through their own actions, such as taxes on discretionary purchases. This preference conflicts with the principle of neutrality, which ranks as superior a tax system that minimizes such taxpayer control.

- Surveys in other states have found that many taxpayers list the retail sales tax as the "most fair" because everyone pays the same rate of tax. However, sales taxes are regressive because low-income taxpayers spend a larger portion of their incomes than do high-income taxpayers. Thus a tax that is perceived as fair in one respect is considered unfair according to the principle of vertical equity.

- People dislike taxes to which they are not accustomed.

- Taxpayers have a sense of "reciprocity." Hence, they are less resistant to ear-marked taxes where they perceive the benefit of a tied government service. Another example of reciprocity is that people are more likely to comply with a tax when they perceive that other taxpayers comply.

While taxpayer perceptions should not take priority over the accepted principles of good tax system design, it is wise to take note of them when evaluating the existing tax system and any potential alternatives. The operative principle here was best expressed by Abraham Lincoln who said, "A universal feeling, whether well or ill-founded, cannot be safely disregarded." Also, discrepancies between taxpayer perceptions and the principles of good tax design identify issues on which it is particularly important to inform and educate voters about the objectives of proposed reforms.

Chapter 3: Current Washington State Tax Structure

Possible Ways to Tax

There are three general types of taxes common to most state and local governments. One type of taxation is imposed on the assessed valuation of asset ownership including real, personal, and intangible property. A second type, common to most states, is imposed on personal and corporate net income. The final type is imposed on transactions and measured by the gross proceeds of each sale. Of these three methods for imposing taxes—property, income, and excise taxes—Washington state and local governments rely on property and excise taxes. Washington does not impose taxes on net income.

Property taxes are applied annually to the value of taxable real and personal property. They are collected semi-annually. Real property includes land and structures, while personal property comprises items that are generally movable. The major type of taxable personal property in Washington is business machinery and equipment. Household items, business inventories, and intangibles like stocks and bonds are exempt. Property taxes have traditionally been the major source of revenue for local governments, and local jurisdictions in all states levy this type of tax. Washington is one of nine states that also has a significant property tax levy at the state level.

The state portion of the property tax constitutes a quarter of all property taxes. The state levy is for the support of common schools, however, this levy comprises less than 30 percent of the state's funding of public K-12 education. County treasurers collect the tax on behalf of the state based on a county's market value of property in relation to the statewide market value of all property.

Income taxes for persons and corporations are measured by the net income received by individuals, households, and business entities. Typically, these taxes are computed on an annual basis. Through withholding and estimated payments the actual payments may be made more frequently than annually. The federal income tax, including a tax on individuals, estates, trusts, and corporations, is the most visible income tax. Income taxes are also levied by most states: 45 states impose a corporate net income tax and 43 states levy a personal income tax (41 are broad-based taxes and two are restricted to interest and dividends). Only Washington, Nevada, South Dakota, and Wyoming do not impose any form of income tax.

Excise taxes basically apply to sales transactions. Most commonly, they are taxes measured by the selling price of a good or service. Some well-recognized excise taxes in Washington are the retail sales tax, cigarette tax, and motor fuel tax. Washington's business and occupation (B&O) tax, measured by gross receipts, has been deemed an excise tax rather than an income tax by the State Supreme Court. All taxes levied in Washington, except for property taxes, represent some form of excise tax. Since the comprehensive Revenue Act of 1935, excise taxes have been the principal source for funding state government in Washington.

Another excise tax levied in over 100 countries worldwide is the value added tax (VAT). The VAT imposes a tax on the value added to a product or service at each stage of its manufacture or distribution. This tax is usually levied by national governments. There have been some subnational governments that levy a form of the VAT including the Province of Quebec, and two states–Michigan and New Hampshire.

Brief History of Washington's Taxes

Washington State has had two major tax systems: the first based on the nineteenth century agricultural economy, and the second structured for the manufacturing and commercial focus of the twentieth century.

Pioneer settlers had one major asset: land. Farmers' sales and cash income were unpredictable from year to year, so lawmakers thought that excise taxes would be unstable. Therefore, Washington territorial and state governments, as well as local governments, relied heavily on the property tax to finance schools, roads, courts, law enforcement and land recording offices, practically the sum total of government activity in the nineteenth century.

As Washington entered the twentieth century, the state's population increased and many people moved from farms into the bustling urban areas. In 1900, six out of ten Washingtonians lived on farms. By 1930 only four out of ten lived in rural areas, and just two out of ten actually lived on farms.

The growing population and the manufacturing/commercial economy demanded improved government services causing property taxes to increase, nearly doubling in the decade prior to 1920. This put tremendous stress on the rural economy. Farmers recognized that they were paying high taxes on land that was not always profitable, while both the banks they borrowed from and the businesses they bought from were paying fairly low taxes. This led to a 1920s movement to reduce property taxes, to tax assets other than land, and to introduce new taxes better suited to a business economy.

In 1932, initiatives sponsored by the Grange, teachers, and organized labor enacted both a "40-mill limit" on property taxes and a graduated income tax. Both measures passed overwhelmingly, but the business community promptly challenged the income

tax in court. To tide the state budget over until litigation was resolved, the 1933 Legislature "temporarily" imposed the B&O tax, a tax on gross business receipts. The B&O tax itself was also challenged in court.

In September 1933, Washington's high court by a 5-4 vote rejected the graduated income tax, labeling it an unconstitutionally nonuniform "property tax." The court simultaneously upheld the B&O tax as an "excise tax," also on a 5-4 vote. The income tax was gone, and the B&O tax was here to stay.

Demands for governmental services continued to rise along with Depression demands for social services and for public works projects that would create jobs. In 1935, the Legislature enacted the comprehensive Revenue Act that added a retail sales and use tax. The basic structure of Washington's current tax system was now in place: a property tax primarily on real estate, a B&O tax on business receipts, and a sales tax on consumers. With a few additions and some tweaking, this system remains today—a tax structure suited well enough for an economy based on commercial agriculture, manufacturing, resource extraction, and locally-based commerce.

Comparative State and Local Revenue Sources

Total general revenues for the state and all local governments in Washington amounted to $33.4 billion during Fiscal Year 2000, according to figures compiled by the U.S. Census Bureau. (See Table 3-1.) State and local taxes make up 59.1 percent of the total. Other major revenue sources include charges for services (e.g., college tuition and charges by public hospitals) and grants from the federal government. General sales taxes (including gross receipts business taxes) represent the largest type of tax in Washington, accounting for 47.6 percent of total state and local taxes.

Chart 3-A

Washington State and Local Taxes as a Share of General Revenues
FY 2000

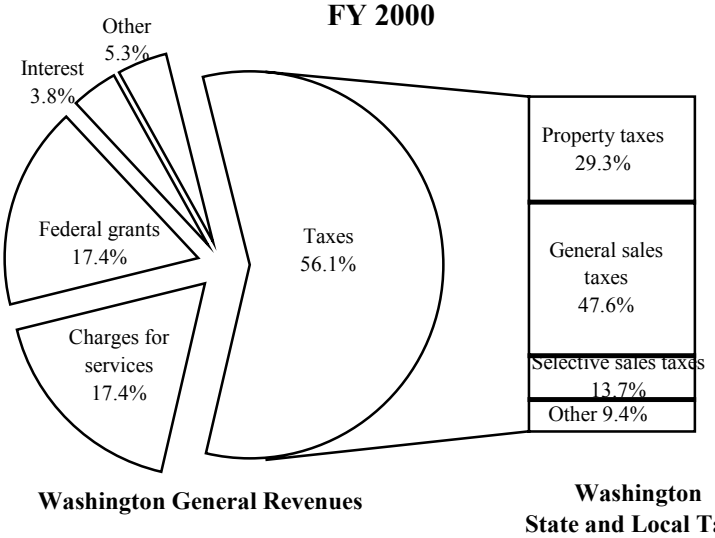


Table 3-1

Washington State and Local Government
General Revenues for Fiscal Year 2000
Dollars in Millions

Revenue Source	State Govt.	Local Govt.	Total
Taxes:			
Property taxes	$1,697.7	$3,794.9	$5,492.6
General sales taxes*	7,739.0	1,179.8	8,918.8
Selective sales taxes**	1,945.3	617.2	2,562.5
All other taxes	1,185.4	574.6	1,760.0
Subtotal	12,567.4	6,166.5	18,733.9
Charges for Service	2,146.3	3,680.6	5,826.9
Federal Grants	5,094.8	732.7	5,827.5
Interest Earnings	595.3	663.1	1,258.4
Intergovernmental Transfers	95.5	6,851.4	- - -***
All Other General Revenue	754.9	1,024.5	1,779.4
TOTAL GENERAL REVENUES	$21,254.2	$19,118.8	$33,426.1***

*Includes state and local business taxes measured by gross sales or gross receipts.
**Includes taxes on motor fuel, alcoholic beverages, tobacco products, and public utilities.
***Duplicative intergovernmental transfers are excluded from the total.

Source: U.S. Department of Commerce, Bureau of the Census; FY 1999-2000.

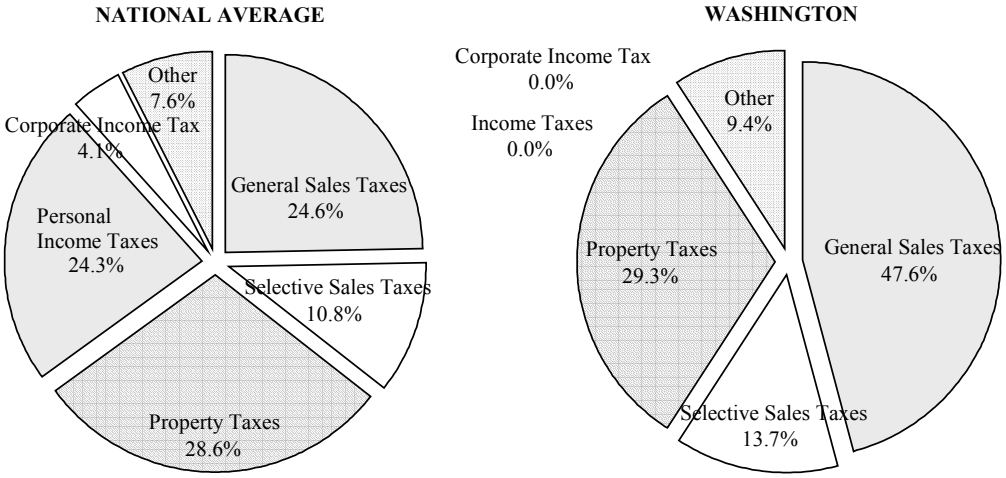
Washington's Major Taxes

There are at least 50 different taxes authorized in Washington State law for the state and/or local governments. As noted previously, Washington's taxes are either a form of property tax or, in most instances, a form of excise tax. This section provides more detail on several of the significant taxes in our state.

Retail Sales Tax

The retail sales tax and its companion use tax represent by far the largest tax source in Washington. As noted above, general sales taxes (including gross receipts taxes, which are a form of sales tax) produce 47.6 percent of total state/local taxes in this state. This degree of reliance on a single type of tax is greater than for any other tax source in any state, except the property tax in New Hampshire (61.9 percent).

Chart 3-B
Washington Relies on General Sales Taxes More Heavily than the National Average
State/Local Taxes - Fiscal Year 2000



Retail sales and use tax collections in FY 2002 amounted to $5.8 billion for the state and $1.7 billion for local governments. On a per capita basis, retail sales/use taxes averaged $1,253 for each Washington resident (including the amount paid directly by businesses).

The current 6.5 percent state retail sales tax rate has remained unchanged for nearly 20 years. However, local sales/use tax rates have grown steadily since they were first authorized in 1970. The combined state and local tax rate now ranges from 7 to 8.9 percent.

Forty-six states, plus the District of Columbia, impose a sales tax; only Delaware, Montana, New Hampshire, and Oregon avoid this type of tax. Washington's 6.5 percent state tax rate is exceeded only by the 7 percent rate in Rhode Island and Mississippi (neither of which allow local sales taxes). The combined state and local rates in King County (8.8 percent) and in the urban area of Snohomish County outside of Everett (8.9 percent) are nearly the highest sales tax rates in the country. Compared to other major metropolitan areas, only the city of New Orleans is believed to have a higher rate (9 percent).

The tax applies to items purchased at retail, i.e., for consumption by the buyer, including purchases by individuals and businesses. Originally, the tax applied only to sales of tangible personal property. Over the years the tax base has been extended to some services such as construction labor, repair, lodging, and some participatory recreational activities. However, most personal and professional services are not taxed. Motor vehicle fuel and utility services are not subject to tax. In 1977, voters passed an initiative to exempt food for off-premises consumption. In 1995, the Legislature exempted purchases of machinery and equipment used directly in manufacturing.

Business and Occupation Tax

The truly unique element of Washington's tax system is the B&O tax: a gross receipts tax levied on businesses. Forty-five states impose a traditional corporate net income tax, similar to the federal tax. Of the other states, Michigan levies a form of value added tax, Nevada relies on taxes on the gaming and entertainment industry, South Dakota utilizes special taxes on contractors and banks, and Wyoming receives significant revenues from severance taxes (e.g. taxes on oil and minerals).

Washington's B&O tax is measured by gross sales, gross income, or the value of products produced within the state. No deductions are allowed for the cost of materials, wages paid to employees, or other operating expenses. As noted in Table 3-1 above, the Census Bureau classifies the B&O tax as a general sales tax, since no other state levies a similar gross receipts tax on all business activities. Unlike the retail sales tax, the B&O tax is levied on business receipts from all sales, not just receipts from retail sales.

The state B&O tax generated nearly $2 billion in FY 2002, about 17 percent of all state tax revenues. In contrast, corporate taxes in most other states generally produce a much smaller share, on average about 4.2 percent of total state revenues.

B&O tax rates depend upon the specific activity in which a firm engages. Because of the very broad tax base, the tax rates are quite low. Except for services, which are taxed at 1.5 percent, the other tax rates are less than one-half of 1 percent: manufacturing and wholesaling, 0.484 percent; retailing, 0.471 percent; processing of certain agricultural products, 0.138 percent; and travel agents and a few other activities, 0.275 percent. The only major activities not subject to B&O tax are agricultural production and the rental of real estate.

Firms are taxed on the final activity in which they engage in Washington. For example, if a manufacturer produces an item in the state and sells it at wholesale to another firm in Washington, the manufacturer is actually taxed as a wholesaler. If the same manufacturer sells the item to another firm located outside the state, the manufacturer is taxed under the manufacturing classification, since manufacturing is the final activity performed in Washington. Except for a few service-related activities, there is generally no apportionment of income for multistate operations–either the firm has “nexus” for its activities undertaken in this state or it does not.

In addition to the state tax, 37 municipalities levy a similar gross receipts tax at lower rates than the state rates. There is no statutory or administrative connection between the state tax and the city taxes. Under current law, counties are not permitted to levy gross receipts taxes.

Property Tax

With the growth of excise taxes at the state and local level, the property tax has decreased somewhat in overall significance, but it still remains the major tax source for financing of local governments. The state property tax levy is the third largest of all state revenue sources behind the state retail sales tax and business and occupation tax.

Property tax levies due in Calendar Year 2002 total $5,978 million. The largest portion was for local school districts, which accounted for 31.7 percent of all levies. The state levy, which also benefits schools, accounted for 24.2 percent. Thus, K-12 public education represented 55.9 percent of total property tax levies. Of the remaining 44.1 percent, county government received 17.8 percent, cities received 13.9 percent, and all other local taxing districts (libraries, fire districts, etc.) received 12.4 percent.

Both the State Constitution and statute require that the state property tax levy be used in support of the common schools. Article IX, Section 2 of the State Constitution states that "the entire revenue derived from the common school fund and the state tax for common schools shall be exclusively applied to the support of the common schools." The state is required by statute to levy property taxes each year "for the support of common schools" to be paid into the state general fund, except for certain amounts which are directly deposited into the student achievement fund and distributed to school districts. However, the Legislature is not prohibited from amending the statute to modify the mechanism for funding the common schools.

Property taxes are based on the assessed value of the property. County assessors generally determine assessed value for residential and commercial properties. Although in Washington the state is responsible for valuation of some types of property such as intercounty utilities and commercial vessels. Regular levy rates (those provided by law without a vote of the electorate) are limited by the State Constitution to 1 percent of the fair market value of the property. Voter-approved special levies increase the statewide average effective tax rate to approximately 1.2 percent of market value. By virtue of an initiative passed by the people in 2001, the annual increase in regular levy revenues for all taxing districts is now limited to 1 percent, unless the voters authorize a higher growth rate.

In FY 2000, per capita state and local property taxes in Washington ranked the sixteenth highest for states. Property taxes in relation to personal income ranked the twenty-third highest. In recent years, the property tax burden in Washington has increased slightly relative to many other states. This trend is expected to reverse once the effect of the 1 percent annual regular levy growth limit adopted in 2001 is reflected in the data. Also, FY 2001 will include the full impact of elimination of the motor vehicle excise tax in 2000. This tax, the third largest state revenue source prior to its repeal, was included in the comparative data as a property tax, since it was levied as a tax in lieu of personal property tax.

Selective Sales Taxes

Washington makes extensive use of specialized taxes on specific products. In some cases these rates are higher than most other states. For example, the state's cigarette tax, at $1.425 per pack, is now among the highest in the country. Two sales taxes on liquor–a tax of 20.5 percent plus a tax of $2.44 per liter–are rolled into the price. These taxes, in conjunction with the state's liquor monopoly, result in one of the highest per capita revenues from alcoholic beverages of any state. The state's 23-cent tax on motor vehicle fuel, which is earmarked for roads, is exceeded by only 13 other states. A gross receipts tax on public utilities has the effect of a sales tax, since the tax is passed on to consumers of electricity, natural gas, water, transportation services, and certain other public services.

Comparative State and Local Tax Burdens

Washington's average burden for both state and local taxes is typically in the mid-range of all states. There are two principal methods for comparing tax burdens. Both start with the estimated total collections for state and local taxes (including taxes paid initially by businesses). The U.S. Census Bureau compiles these figures annually for all states. Dividing the total tax collections by either state population or the total personal income for the state gives two good measures of comparative tax burdens. The per capita measure is a good statistic for comparing what the average individual pays in state and local taxes (remembering that business taxes are also included). However, the tax per income calculation yields a better measure for comparing the ability of states to finance the cost of government services. Because of Washington's higher than average per capita personal income, the per capita tax ranking for this state is typically higher than the taxes per $1,000 of income figure.

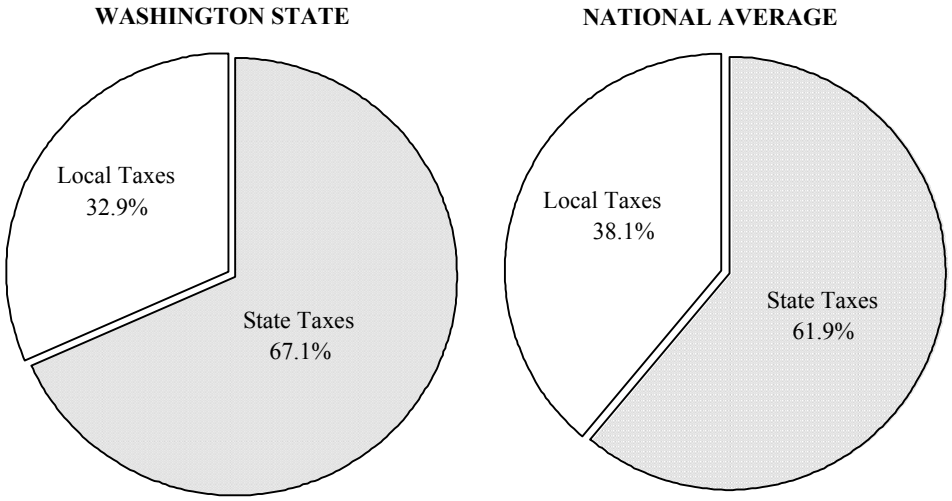
For FY 2000, Washington's state and local taxes per capita amounted to $3,178, which ranked it the fifteenth highest. Taxes in relation to personal income equaled $107.53 per $1,000 of income. By this measure of relative tax burden Washington was ranked thirty-second, which was well below the national average. It should be noted that FY 2000 tax burden figures include only six months of the impact of the repeal of the state's motor vehicle excise tax on January 1, 2000.

For the average of all states, total state and local tax revenues are split 38.1 percent for local governments and 61.9 percent for state government. In Washington, local governments receive a smaller percentage of the total state and local tax revenues– 32.9 percent for local governments and 67.1 percent for state government.

Property taxes account for over 70 percent of local tax revenues for the nation. Some states rely almost exclusively upon this source to finance local government (all New England states, Minnesota, Wisconsin, Montana, and Idaho). Only in two southern states (Alabama and Louisiana) does the property tax generate less than one-half of total local tax revenues.

Chart 3-C

Comparative Share of State And Local Taxes – FY 2000



Source: U.S. Census Bureau, 2000

Washington's reliance on property taxes (61.5 percent) to fund local government is relatively low, largely because the state levies a major portion of the property tax to finance schools. Few other states make a significant levy at the state level. Also, there are other programs such as community colleges which Washington finances with state revenues, whereas other states finance these at the local level and largely with property tax receipts. Table 3-3 shows the relative reliance upon major types of tax sources by all local government jurisdictions in each of the states. The latest data for FY 2000 were obtained from the Census Bureau and utilize common classifications of tax sources.

The general sales tax category represents taxes imposed on transactions of a wide variety of products. In addition to retail sales taxes, it includes gross receipts taxes measured by sales, such as the local B&O taxes levied by 37 cities in Washington. Besides Washington, other states provide broad authority for local jurisdictions to impose a sales tax in addition to the state sales tax. Such states include Alabama, Arkansas, Colorado, Louisiana, Missouri, New Mexico, Oklahoma, and Tennessee. In some of these states, local sales tax receipts approach 40 percent of all local tax revenues. Although the local sales and municipal B&O taxes in Washington represent a significant source of local revenue, they account for less than 20 percent of all local taxes.

The selective sales tax category includes taxes levied on particular products, e.g., cigarettes, alcoholic beverages, gasoline, utility services, etc. Nationally, they account for less than 5 percent of all local revenues. Washington's degree of reliance on these types of taxes, mostly municipal taxes on utility services, is twice the

national average. It should be noted that the figures reflect only taxes levied by local jurisdictions. In Washington, local governments also receive a share of some of these taxes which are actually levied by the state (e.g., the motor vehicle fuel tax).

A few states allow local jurisdictions to levy an additional income tax, usually restricted to a percentage of personal income. Local jurisdictions in Kentucky, Maryland, New York, Ohio, and Pennsylvania receive significant revenues from this source.

Table 3-2. State Government Finance
Percent Reliance on Maior State Tax - Fiscal Year 2000

	Property	General Sales	Selective Sales	Income	Other
Alabama	2.8%	26.4%	23.7%	35.9%	11.1%
Alaska	3.1	-	9.7	30.8	56.4
Arizona	3.7	44.8	12.5	34.8	4.3
Arkansas	9.9	35.0	13.5	35.0	6.5
California	4.0	28.0	7.4	55.1	5.5
Colorado	-	26.1	12.2	56.1	5.6
Connecticut	-	33.6	16.1	43.3	7.0
Delaware	-	-	13.6	45.7	40.8
Florida	3.1	60.5	16.6	4.8	15.1
Georgia	0.4	34.3	8.3	52.4	4.7
Hawaii	-	46.1	15.5	34.2	4.3
Idaho	-	31.4	12.9	45.9	9.7
Illinois	0.2	28.1	19.6	43.4	8.7
Indiana	0.0	35.4	14.4	46.3	3.8
Iowa	-	33.2	14.6	40.6	11.6
Kansas	1.0	35.9	11.6	44.0	7.5
Kentucky	5.1	28.2	17.4	39.1	10.2
Louisiana	0.4	31.6	25.5	27.7	14.8
Maine	1.1	31.8	12.9	46.1	8.0
Maryland	2.5	24.1	18.0	48.7	6.7
Massachusetts	0.0	22.1	9.3	64.1	4.6
Michigan	7.5	33.7	9.3	42.1	7.5
Minnesota	0.1	27.9	15.4	47.6	9.0
Mississippi	0.0	49.5	17.3	26.2	7.0
Missouri	0.2	32.5	14.5	44.5	8.2
Montana	15.5	-	24.4	43.7	16.4
Nebraska	0.1	34.5	14.0	44.1	7.3
Nevada	2.5	52.2	32.6	-	12.7
New Hampshire	27.9	-	32.8	22.3	17.0
New Jersey	0.0	30.4	14.8	47.1	7.7
New Mexico	0.9	40.1	13.5	27.8	17.7
New York	-	20.5	11.4	62.2	5.9
North Carolina	0.0	22.0	16.8	54.9	6.3
North Dakota	0.2	28.2	27.7	23.6	20.3
Ohio	0.1	31.8	14.2	45.1	8.8
Oklahoma	-	24.7	12.7	39.9	22.8
Oregon	0.0	-	12.2	75.8	12.0
Pennsylvania	0.5	31.4	15.1	37.7	15.2
Rhode Island	0.0	30.5	18.8	44.4	6.3
South Carolina	0.2	38.5	12.3	41.9	7.1
South Dakota	-	52.6	26.4	4.9	16.1
Tennessee	-	57.4	17.6	10.3	14.7
Texas	-	51.1	29.9	-	19.0
Utah	-	35.8	12.6	45.9	5.8
Vermont	27.3	14.5	18.1	32.1	8.0
Virginia	0.3	19.5	14.9	58.5	6.9
Washington	13.5	61.6	15.5	-	9.4
West Virginia	0.1	27.4	26.4	35.4	10.7
Wisconsin	0.7	27.9	12.7	51.9	6.8
Wyoming	10.5	38.3	11.2	-	40.0
U.S. Average	2.0%	32.3%	14.4%	42.1%	9.2%

Soucre: U.S. Dept. of Commerce, Census Bureau

Table 3-3. Local Government Finance
Percent Reliance on Maior State Tax - Fiscal Year 2000

	Property	General Sales	Selective Sales	Income	Other
Alabama	39.0%	39.2%	6.4%	2.9%	12.5%
Alaska	80.7	12.0	4.4	-	2.9
Arizona	69.0	23.3	3.9	-	3.8
Arkansas	44.4	45.2	8.4	-	2.1
California	63.2	19.3	8.5	-	9.0
Colorado	59.9	31.4	3.5	-	5.3
Connecticut	98.7	-	0.0	-	1.3
Delaware	78.6	-	1.7	8.5	11.2
Florida	77.9	3.2	15.1	-	3.8
Georgia	60.4	29.8	6.7	-	3.1
Hawaii	78.6	-	11.6	-	9.8
Idaho	94.6	-	1.6	-	3.8
Illinois	82.8	5.1	9.4	-	2.8
Indiana	88.6	-	1.2	8.2	1.9
Iowa	89.5	5.9	1.7	1.3	1.7
Kansas	76.8	17.0	4.0	-	2.2
Kentucky	53.8	0.0	7.0	30.1	9.1
Louisiana	39.3	51.7	5.6	-	3.4
Maine	97.9	-	0.3	-	1.8
Maryland	57.4	-	3.3	32.0	7.3
Massachusetts	96.9	-	1.2	-	1.9
Michigan	89.4	-	1.4	6.2	3.0
Minnesota	94.2	0.7	2.1	-	3.0
Mississippi	92.0	-	3.5	-	4.5
Missouri	59.0	23.0	8.4	5.2	4.5
Montana	95.6	-	0.2	-	4.2
Nebraska	77.5	9.5	2.8	0.0	10.2
Nevada	63.8	5.7	14.8	-	15.7
New Hampshire	98.2	-	-	-	1.8
New Jersey	98.3	-	0.2	0.2	1.2
New Mexico	55.4	34.6	5.8	-	4.3
New York	55.8	17.5	2.8	19.3	4.5
North Carolina	75.2	18.7	1.9	-	4.2
North Dakota	88.1	8.6	1.3	-	2.0
Ohio	65.4	8.0	0.9	22.0	3.7
Oklahoma	54.0	39.9	3.8	-	2.3
Oregon	80.5	-	5.3	-	14.2
Pennsylvania	70.5	1.2	1.5	17.8	9.0
Rhode Island	98.6	-	0.1	-	1.3
South Carolina	84.4	3.1	4.4	-	8.1
South Dakota	78.2	17.2	0.3	-	4.3
Tennessee	61.5	26.7	5.5	-	6.3
Texas	79.9	13.5	4.1	-	2.5
Utah	68.8	22.1	4.6	-	4.5
Vermont	96.2	-	0.3	-	3.5
Virginia	70.6	8.8	10.4	-	10.3
WASHINGTON	61.5	19.1	10.0	-	9.3
West Virginia	83.6	-	3.6	-	12.9
Wisconsin	93.8	3.2	0.6	-	2.4
Wyoming	76.0	17.6	2.2	-	4.2
U.S. Average	71.6%	12.2%	5.0%	6.2%	5.0%

**Includes local B&O taxes.*

Soucre: U.S. Dept. of Commerce, Census Bureau

Table 3-4. State and Local Tax Collections Per $1.000 Personal Income
Fiscal Years 1996-2000

	Amount					Rank				
	1996	1997	1998	1999	2000	1996	1997	1998	1999	2000
New York	$144.42	$142.13	$141.92	$140.34	$141.18	2	2	2	1	1
Maine	129.48	134.47	144.46	139.08	138.64	6	3	1	2	2
Alaska	158.85	153.00	122.29	102.62	132.18	1	1	9	39	3
Wisconsin	133.33	128.22	129.10	127.08	129.44	3	5	4	3	4
New Mexico	126.36	127.72	131.39	121.73	126.74	7	6	3	7	5
Hawaii	131.63	126.63	125.89	123.01	126.45	5	7	6	5	6
Minnesota	131.86	128.86	127.69	123.26	123.87	4	4	5	4	7
Vermont	122.25	123.74	125.08	121.82	121.53	8	9	7	6	8
California	113.38	111.42	114.50	113.58	120.39	24	23	18	15	9
Connecticut	120.54	125.64	124.52	121.48	120.23	11	8	8	8	10
Utah	120.68	115.91	118.15	116.78	119.50	9	14	13	9	11
North Dakota	120.65	116.05	122.02	114.89	119.48	10	13	11	12	12
Rhode Island	114.85	117.49	117.15	115.56	118.11	20	10	14	11	13
Wyoming	117.28	116.93	122.04	113.41	117.74	16	12	10	16	14
West Virginia	112.66	114.07	112.30	116.65	116.33	25	15	25	10	15
Delaware	108.60	111.30	118.84	112.34	115.69	32	24	12	19	16
Idaho	115.58	112.48	113.76	112.63	115.43	19	20	20	17	17
Michigan	108.72	111.79	112.75	113.60	114.17	31	21	23	14	18
New Jersey	115.74	111.10	115.10	113.68	113.46	17	26	16	13	19
Ohio	111.38	110.03	110.35	109.86	112.90	27	28	26	23	20
Arizona	117.59	108.83	106.77	108.65	111.73	14	31	34	25	21
Kentucky	115.63	113.73	112.84	110.99	111.62	18	16	22	21	22
Iowa	117.45	111.22	109.80	107.95	111.09	15	25	27	28	23
Mississippi	114.30	109.65	109.73	110.54	110.75	22	29	28	22	24
Montana	111.02	113.65	113.78	108.85	110.53	28	17	19	24	25
Massachusetts	112.37	111.63	113.28	108.53	110.36	26	22	21	26	26
Maryland	106.43	105.38	107.86	104.63	110.01	38	38	30	38	27
Louisiana	102.71	109.58	109.02	108.02	109.57	43	30	29	27	28
Nebraska	118.92	113.39	112.36	107.66	109.44	13	18	24	30	29
Georgia	110.56	105.07	106.15	107.74	109.07	29	40	36	29	30
Kansas	113.74	112.57	115.74	107.59	108.72	23	19	15	31	31
WASHINGTON	119.79	117.49	115.00	111.25	107.53	12	11	17	20	32
Illinois	109.44	106.07	104.66	104.95	107.50	30	35	38	34	33
Oklahoma	107.69	107.50	107.17	104.78	106.67	35	32	33	35	34
North Carolina	108.58	105.83	107.40	105.52	106.60	33	36	31	33	35
Pennsylvania	106.47	106.62	107.27	107.18	106.56	37	34	32	32	36
Arkansas	107.89	105.14	106.51	112.62	106.50	34	39	35	18	37
Indiana	104.35	110.80	105.75	104.70	105.64	40	27	37	37	38
Oregon	106.65	106.75	100.96	100.19	105.60	36	33	41	45	39
South Carolina	105.01	102.28	103.50	104.75	104.82	39	41	39	36	40
Nevada	114.31	105.41	100.82	101.79	104.59	21	37	43	41	41
Colorado	102.97	100.99	100.87	102.24	103.53	41	44	42	40	42
Virginia	98.48	99.03	100.81	101.64	102.80	47	46	44	42	43
Florida	102.73	100.34	100.50	100.24	100.06	42	45	45	44	44
Missouri	100.62	101.58	101.57	101.56	99.45	46	43	40	43	45
Texas	102.51	101.61	98.71	96.79	96.87	44	42	46	46	46
South Dakota	100.80	92.15	97.80	95.06	94.56	45	47	47	47	47
Alabama	93.55	91.24	91.33	91.11	93.65	48	48	48	48	48
Tennessee	90.36	89.08	90.01	87.99	89.17	49	50	49	50	49
New Hampshire	89.13	91.03	88.39	88.37	88.18	50	49	50	49	50
U.S. Average	$112.99	$111.43	$111.70	$110.48	$112.28					

Table 3-5. State and Local Taxes Per Capita
Fiscal Years 1998-2000

	1998		1999		2000	
	Amount	Rank	Amount	Rank	Amount	Rank
Connecticut	$4,425	1	$4,536	1	$4,595	1
New York	4,318	2	4,515	2	4,578	2
New Jersey	3,698	3	3,878	3	3,903	3
Massachusetts	3,531	4	3,606	4	3,787	4
Minnesota	3,490	5	3,599	5	3,694	5
Alaska	3,279	7	2,841	22	3,687	6
California	3,022	14	3,167	12	3,545	7
Wisconsin	3,186	10	3,318	6	3,458	8
Maryland	3,126	11	3,202	11	3,454	9
Hawaii	3,293	6	3,303	7	3,384	10
Maine	3,225	8	3,258	9	3,343	11
Delaware	3,218	9	3,278	8	3,340	12
Rhode Island	3,117	12	3,226	10	3,256	13
Illinois	2,959	15	3,131	14	3,241	14
WASHINGTON	3,038	13	3,148	13	3,178	15
Michigan	2,874	18	3,032	15	3,167	16
Vermont	2,911	16	3,004	16	3,080	17
Colorado	2,763	21	2,987	17	3,073	18
Wyoming	2,901	17	2,827	23	3,046	19
Ohio	2,750	23	2,869	20	3,016	20
Pennsylvania	2,802	20	2,934	18	2,979	21
Virginia	2,675	25	2,846	21	2,978	22
Nevada	2,727	24	2,925	19	2,915	23
Nebraska	2,751	22	2,775	24	2,906	24
Georgia	2,552	29	2,761	25	2,841	25
Kansas	2,805	19	2,748	26	2,833	26
Iowa	2,606	27	2,674	27	2,765	27
North Dakota	2,549	30	2,631	30	2,754	28
Oregon	2,479	33	2,574	33	2,751	29
Indiana	2,500	32	2,621	31	2,691	30
North Carolina	2,557	28	2,649	29	2,664	31
New Hampshire	2,416	36	2,590	32	2,652	32
New Mexico	2,637	26	2,568	34	2,639	33
Utah	2,459	34	2,567	35	2,630	34
Florida	2,545	31	2,663	28	2,624	35
Arizona	2,371	38	2,561	37	2,599	36
Missouri	2,449	35	2,565	36	2,558	37
Idaho	2,334	40	2,428	40	2,546	38
Kentucky	2,377	37	2,464	38	2,517	39
Texas	2,344	39	2,456	39	2,505	40
Louisiana	2,303	41	2,409	41	2,436	41
West Virginia	2,183	45	2,368	43	2,413	42
Oklahoma	2,240	43	2,313	45	2,391	43
South Carolina	2,187	44	2,333	44	2,379	44
Montana	2,291	42	2,312	46	2,363	45
South Dakota	2,158	46	2,255	47	2,299	46
Arkansas	2,143	47	2,382	42	2,230	47
Mississippi	2,057	49	2,198	48	2,214	48
Tennessee	2,079	48	2,142	49	2,185	49
Alabama	1,916	50	2,007	50	2,117	50
U.S. Average	$2,863		$2,992		$3,100	

Source: U.S. Dept. of Commerce, Census Bureau

Chapter 4: Key Conclusions from the Evaluation of the Current Washington Tax Structure

Introduction

This chapter presents the key conclusions and the Committee's view based on the evaluation of the current Washington State tax structure. At the end of the report there is a section titled "Methodology and Detailed Conclusions" that describes the methodologies used in the measurement of the tax system and more details about the conclusions.

The following analysis systematically measures the tax system as well as each tax individually against the following principles: equity, neutrality, economic vitality, stability, adequacy, simplicity, transparency, home ownership, and harmony with the tax systems of other states.

The scope of analysis was determined by the requirements of Engrossed Substitute Senate Bill 6153, the statute which created this study, and by questions posed by the Technical Advisory Subcommittee, the Advisory Group, and the Governor's Competitiveness Council. Significant conclusions in this chapter are derived from the answers to these questions.

Conclusions from the Analysis Organized by Principle

Equity

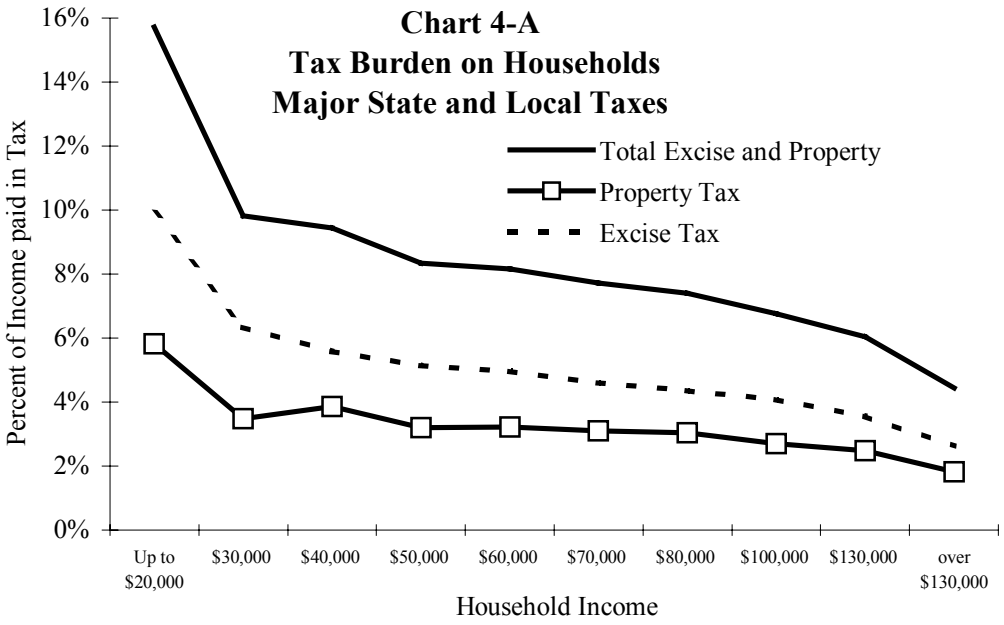
Most people agree that fairness requires relative tax burdens on households (taxes as a percentage of household income) to be the same for all households, or higher for households with higher incomes (i.e., a progressive tax system). Correspondingly, a tax system that imposes higher relative burdens on households with lower incomes (i.e., a regressive tax system) is considered inequitable. Fairness in business taxation requires that similar businesses bear similar relative tax burdens.

The finding for the Washington State tax system is that there are inequities for households and businesses.

Households

Washington's tax structure is regressive. The lowest income households pay 15.7 percent of income for total excise and property taxes, while the highest income households pay 4.4 percent of income for the same taxes. Sales tax is the main cause of regressivity.

Chart 4-A illustrates the regressive nature of Washington State's major state and local taxes. Excise taxes, which are dominated by the sales tax, have a relatively flat incidence for the middle-income households and is regressive for households at the high- and low-income ranges. The lowest income category (up to $20,000 in income) is composed of an eclectic group of households, some of which can skew the results for this category. For example, the under $20,000 category includes students who may have unreported financial support from their parents, unemployed workers who are only temporarily poor, and households with assets but little income. The source of the information for this chart is the Washington Excise and Property Tax Microsimulation model which combines information from the Consumer Expenditure Survey and the Washington State Population Survey (see page 99 in Chapter 9).



Source: Washington Excise and Property Tax Microsimulation Model

Businesses

For businesses, new and expanding businesses have a higher relative tax burden than their established counterparts. In an industry by industry comparison, average total tax rates vary from 0.93 percent to 2.06 percent for established firms and between 1.2 percent to 2.8 percent for new firms.

Despite these findings, surveys indicate that Washington's tax system would be perceived by the majority of businesses and individuals as being fair. Surveys of individuals in other states find that the sales tax is perceived to be the most equitable tax by a majority of survey respondents. A survey of Washington businesses shows that most businesses think that the Washington tax system does not hinder their ability to conduct business.

Neutrality

Neutrality requires that a tax system minimize the opportunities and incentives for taxpayers to alter their decisions in order to take advantage of differential tax treatment of economic activity.

The finding for the Washington State tax system is that it causes substantial non-neutralities for both businesses and households. The pyramiding of the B&O tax creates the main non-neutralities for businesses. Pyramiding of taxes is the payment of taxes by different companies on the same goods or services. This occurs when goods or services of one company are inputs for another's production and/or sales. Thus, a tax is paid multiple times on a product as it moves through the production chain.

The B&O tax pyramids an average of 2.5 times, but this rate varies considerably across industries. The B&O tax on many services pyramids at about 1.5 times, whereas for some types of manufacturers the rate of pyramiding is over five or six times. This causes effective B&O tax rates (the rate paid on the value added to goods and services by an enterprise) to vary considerably from industry to industry.

The tax system imposes non-neutral tax treatment of households because a significant fraction of consumer spending is untaxed. For example, certain types of spending, such as non-restaurant purchases of food and many consumer services, are not subject to the retail sales tax.

Economic Vitality

Economic vitality requires Washington State to offer a tax environment that is as conducive to firms choosing or maintaining their location in the state as that provided by states offering similar amenities. Likewise, the tax system should not impede businesses from expanding their operations in the state.

The finding is that Washington's tax system places a relatively high tax burden on low profit margin firms mainly because of the B&O tax. Due to the B&O tax, low profit margin firms and firms that are new or expanding may suffer a competitive disadvantage compared to their competitors in other states.

Firm location studies show that taxes matter in location decisions when other factors are equal. Business taxes are generally lower in Oregon. Since Washington and

Oregon are similar in many respects, lower business taxes could entice businesses to locate in Oregon rather than Washington.

The analysis of industries which are likely to have competitors in other states shows that many firms with higher profit margins enjoy lower tax burdens in Washington as compared to most competitor states.

Stability

Stability requires that the amount of revenue collected by the tax system fluctuate no more than, and preferably less than, the level of state economic activity over the business cycle. This allows the state to maintain established services without resorting to large changes in tax rates or in other variables of the tax system.

The main finding is that Washington's mix of taxes, primarily its heavy dependence on the retail sales tax, causes revenues to increase on average more than personal income during good economic times and less than personal income in economic downturns. This causes revenue shortfalls in economic downturns, precipitating destabilizing fiscal crises, while in good economic times, excess revenues may result in permanent tax cuts or the adoption of new spending programs. These, in turn, exacerbate the problems in subsequent economic downturns. Rainy day funds or reserves have not been effective at mitigating revenue fluctuations because of difficulties in building and maintaining adequate reserve funds during good economic times.

Analysis of the elasticity for Washington shows an overall elasticity of 1.2. This means that tax revenues are considerably more volatile than the economy, that is, tax revenues grow faster than the economy in good economic times and contract more than the economy in poor economic times. Table 4-1 shows short-run elasticity for the major taxes.

Table 4-1

Estimates of Short-Run Elasticities

Tax Base	Short-Run Elasticity
Sales and Use	1.4
B&O	1.4
Property	0.2
Public Utilities	-0.2
All Taxes	1.2

Although Washington's tax system is volatile overall, it has a number of stable elements, and during certain business cycles it is not as volatile as some other state tax systems. The property tax, on which Washington is more reliant than most states, is more stable than either a sales or income tax. Also, the sales tax, although volatile, is less volatile than a graduated personal income tax. There is no evidence that a flat

rate personal income tax in Washington would be less volatile than the sales tax. The B&O tax is not as volatile as a corporate income tax.

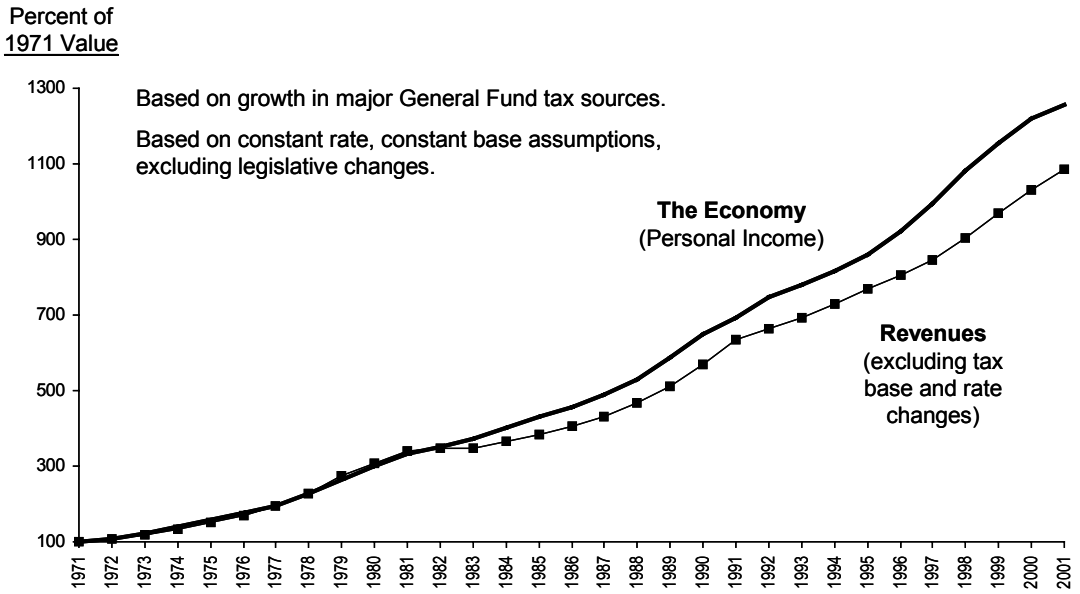
Adequacy

Adequacy requires that tax revenues grow commensurate with the demand for state government services, which evidence finds tends to grow at least as fast, or faster, than the state economy.

The findings show that the revenue elasticity (the percentage long-run change in revenue collected without changes in rates or base divided by the percentage long-run change in state income) is estimated to be less than 1.0, with some estimates as low as 0.9. An elasticity of 1.0 is needed for revenues to grow at the same rate as state income. The state expenditure elasticity (the percentage long-run change in government spending divided by the percentage long-run change in state income) is estimated at 1.01, indicating that the demand for government services has increased at a slightly greater rate than increases in state income.

Chart 4-B illustrates that over the past 30 years general fund revenues grew more slowly than total state personal income. Over this period, personal income has grown at an average annual rate of 8.8 percent whereas revenues (excluding tax base and rate changes) have increased at an annual rate of 8.3 percent, or 94 percent as fast as personal income. (See Appendix C – Details of the Analysis.)

Chart 4-B



Several reasons explain the failure of revenue to grow at the same rates as state personal income. These include the growing share of sales tax-exempt services in consumer spending and increased opportunities for households to avoid sales tax by

making purchases out of state. Also, voter initiatives have eroded the tax base, impacting both state and local tax adequacy.

Significant areas of economic activity are presently excluded from the tax base (see list below). The narrow and narrowing tax base exacerbates adequacy problems, as well as equity and economic vitality problems.

- Income of individuals
- Business inventories
- Intangible assets
- Rental of real property
- Agricultural production
- Investment income of nonfinancial business
- Food for home consumption

Not all components of the Washington State tax system contribute to adequacy problems. The property tax has a long-term elasticity greater than 1.0, which means that, at constant rates, it could have offset some of the long-term erosion from other sources.

Simplicity

Simplicity requires that a tax system not impose undue burdens of administration and compliance through complex and costly rules and record-keeping.

Most of Washington's taxes are relatively simple to administer for both government and households. The average Department of Revenue cost of collection is 69 cents per $100 of collections. The main reason is that households do not have to file tax returns. While the retail sales tax is very cost effective for the government to administer, a significant cost of administration is shifted to retailers who act as uncompensated collection agents. Costs of collecting sales tax are estimated to be $6.47 per $100 of total state and local sales tax collected for small retailers (those with annual Washington gross sales between $150,000 and $400,000) and 97 cents per $100 for large retailers (those with annual Washington gross sales over $1.5 million).

A Department of Revenue survey indicates that most business taxpayers make other uses of information gathered to file the state portion of their state tax return. The exception is coding for local jurisdictions for local sales tax.

The findings indicate that some Washington taxes are complicated for both taxpayers and tax administrators. Dedicated taxes are generally among the most complex by nature, both for taxpayers and for the administering agency. Consequently, they are more costly to collect. For example, the hazardous substance tax costs $4.26 for each $100 of collections. The litter tax costs $12.94 for each $100 of collections.

The local B&O tax is also complicated, mainly because of the lack of uniformity of local B&O tax definitions and inconsistent rules of apportionment. The recent development of a model ordinance that cities may voluntarily adopt is one solution designed to address the local B&O issues. Several cities have either adopted the model ordinance or have begun the process of doing so.

Transparency

Transparency requires that tax burdens be apparent to the households that ultimately bear the tax. In other words, households should be able to determine their overall annual state tax burden, including any taxes embodied in the prices of goods and services that they buy.

The finding is that a significant part of the Washington State tax system is not transparent to households. Taxes initially imposed on businesses, notably the B&O tax, constitute a larger share of state revenue in Washington than in most other states. To the extent that such taxes are passed on to consumers in the form of higher prices, the taxes are not transparent. In addition, most households are unaware of their annual sales tax burden even though sales tax paid on consumer purchases is explicitly stated on receipts and invoices.

Home Ownership

The Committee was asked to consider the impact of the state tax system on the affordability of home ownership.

The finding is that a significant number of homeowners have high property tax burdens as a percent of income. Eleven percent of households pay 6 percent or more of their income in property taxes. Many of these households are low-income working families that seem to have suffered a change in circumstances. About 74 percent of homeowners with property taxes over 6 percent of income are under age 65, and about 65 percent of these have incomes under $30,000.

Almost 50 percent of homeowners have property tax burdens less than 3 percent of income.

Property tax does not play a large role in the affordability of homes. Affordability index analysis shows that in all but three counties, Kittitas, San Juan and Jefferson, median income households could afford homes more expensive than the median-priced homes. Removing property taxes from costs in the affordability index did not change the results. This implies that principal and interest on a mortgage have a much greater effect on the ability of a household to afford a home. However, for first-time homebuyers, the property tax makes a marginal difference in affordability.

Harmony with Other States

Harmony between Washington's tax system and those of other states requires that economic activities not be subject to markedly different tax rates simply by crossing a state border. Also, the tax system should avoid multiple taxation of economic activity by several states. On the other hand, the taxing system should not encourage businesses and households to avoid taxes by taking advantage of differences in the taxes of Washington and its neighboring states.

The finding is that Washington's unique tax system poses significant problems of tax harmonization. Because of the lack of a personal income tax, Washington has one of the highest sales tax rates and one of the broadest sales tax bases in the nation. The high sales tax creates a significant incentive to shop out of state and causes equity problems for Washington retailers. The combination of Washington's high sales tax and the absence of a sales tax in Oregon causes retail trade and consequently sales tax revenues in the counties bordering Oregon and Idaho to be very sensitive to changes in tax rates. Sales and revenues in the 14 counties bordering Oregon and Idaho would increase by an estimated 22 percent if the sales tax differential were eliminated. The high sales tax also exacerbates problems with remote sales. Washington residents purchase an estimated 6 percent more products remotely per capita compared to average per capita purchases because of Washington's higher sales tax.

Committee's View on the Findings

The question of the fundamental quality of our tax structure is really a question of the relative importance of different tax principles. The Committee's view is that the current structure is so flawed in meeting the most important criteria that it must be judged as unsatisfactory.

Washington's taxes are paid disproportionately by that segment of our citizens whose income is the lowest. The Committee believes that a fair system of taxation is one in which contributions to state revenue are at least proportional across the spectrum of incomes. Ours is among the worst in the nation on this count.

There is great value in having harmony with other states and particularly with neighbor states. Our tax structure is quite unique and its differences make opportunities for taxpayers to engage in behaviors to avoid taxation. Prominent among such phenomena is the stream of traffic from our state across the Columbia River to buy goods in Oregon to avoid sales tax. A further example is the unnatural division of business activity within a company in order to locate certain activities out of this state to avoid the B&O tax.

Our proportion of state taxes collected from businesses compared to households is dramatically different from norms: 46 percent from business in Washington compared to a western states average of 30 percent.

Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax on goods as they move through the production chain is a fundamental problem that requires correction.

The differentiation made by the federal income tax rules in permitting deduction of state income taxes but not of state sales taxes represents a loss to our taxpayers who itemize. The inability to deduct sales tax amounts to about $500 million in loss each year to Washingtonians.

Our heavy reliance on the retail sales tax exposes us to the very patent diminishing of the sales base. It is clear that out-of-state and Internet purchasing is on a continuous rise, and there is no assurance that a means can be devised to enable us to impose a tax on these transactions.

Chapter 5: Principal Constraints

Introduction

The purpose of this chapter is to outline certain constraints that may affect the state's ability to make substantial changes to the tax structure. These constraints fall into several categories: legal considerations contained in the state and federal constitutions; issues dealing with local government funding restrictions; and practical considerations related to the administration of new taxes for both the administering agency and taxpayers.

Legal Considerations

In considering changes to Washington's tax structure, certain overarching principles embodied in the Constitutions of the United States and the state of Washington must be kept in mind. The purpose of this section is to summarize the major principles that could limit changes to the current tax structure.

- **Taxes shall be uniform upon the same class of property.**

Article VII, Section 1 of the Washington Constitution provides that all taxes shall be uniform upon the same class of property. Real estate is one class of property, and it must be taxed uniformly within any particular taxing district in Washington.

In a 1933 case, *Culliton v. Chase*, the Washington State Supreme Court declared that income is property. The court ruled that a graduated net income tax is unconstitutional because it does not uniformly tax a class of property: income. Although the case is almost 70 years old and its legal underpinnings have been weakened over the years, the case has not been overruled. Washington is now only one of two states that deem income to be property (Pennsylvania is the other).

- **There must be a connection, or nexus, between the government imposing the tax and the activity sought to be taxed.**

United States Supreme Court tax cases interpreting the Due Process and Commerce clauses of the United States Constitution require that there be a connection, or nexus, between the government imposing the tax and the activity sought to be taxed. Without nexus, the state has no authority to tax. A business has nexus under the Due Process clause if it systematically exploits a market by doing such things as directing advertising at potential customers in a state. A business has nexus under the

Commerce clause if it conducts activities in a state that enable it to establish and maintain a market for its sales.

A 1992 United States Supreme Court case, *Quill v. North Dakota*, held that a business with no physical presence in North Dakota and selling through the mail did not have nexus under the Commerce clause and could not be obligated to collect sales or use tax from its customers. Its application to other kinds of taxes is unclear.

- **A tax on interstate commerce is valid if it meets certain conditions.**

The Commerce clause of the United States Constitution vests authority in the Congress to regulate commerce with foreign nations and among the states. In the 1977 case of *Complete Auto Transit v. Brady*, the United States Supreme Court held that in the absence of Congressional action a state may impose a tax on interstate commerce, provided that the tax (i) is applied to an activity with a substantial nexus with the taxing state, (ii) is fairly apportioned, (iii) does not discriminate against interstate commerce, and (iv) is fairly related to the services provided by the state.

- **A state may not impose a net income tax on a business whose only contact with the state is to solicit sales of tangible personal property through employees or contractors**.

Although not a constitutional provision, one federal law should be mentioned. Public Law 86-272 prohibits a state from imposing a net income tax on a business whose only contact with the state is to solicit sales of tangible personal property through employees or contractors. This law does not apply to the business and occupation (B&O) tax, which is measured by gross receipts.

- **The Legislature has very broad discretion in the area of taxation. One class may be taxed and another may be exempted from tax.**

The Equal Protection clause of the United States Constitution and the Privileges and Immunities clauses of the United States and Washington Constitutions each require that persons be treated equally under similar circumstances. In the area of taxation, however, the Legislature has very broad discretion. One class may be taxed and another may be exempted from tax. As long as the distinction between classes is reasonable and not arbitrary or capricious, the differential treatment is valid.

- **The state may not impose a tax within a local jurisdiction for local government purposes.**

Article XI, Section 12 of the Washington State Constitution prohibits the state from imposing a tax within a local jurisdiction for local government purposes. Instead, the state may grant municipalities the authority to impose specified taxes for local purposes.

- **The Washington State Constitution mandates that state taxes not be released or commuted.**

Article XI, Section 9 of the Washington Constitution mandates that state taxes not be released or commuted. In a 1984 case, *Bond v. Burrows*, the Washington State Supreme Court held that a mechanism to allow residents of border counties to pay a lower rate of state sales tax than residents of other counties violated this provision. Taxes must be applied uniformly, including uniformity as to rates, within a jurisdiction and within a class of taxpayers. However, the Legislature has considerably more latitude in making distinctions between excise taxpayer groupings than between groups of property taxpayers.

- **The United States and Washington Constitutions both prohibit the state from passing any law impairing existing contracts.**

Article I, Section 10 of the United States Constitution and Article I, Section 23 of the Washington Constitution both prohibit the state from passing any law impairing existing contracts. Bonds and other evidences of indebtedness are contracts between the borrowing government and the lending bond owner. Accordingly, the state may not repeal a tax expressly pledged to outstanding bonds, such as the motor vehicle fuel tax, which is frequently pledged to repay highway bonds. These constitutional provisions constrain the time period within which an existing tax can be replaced. At the state level, none of the three major taxes (B&O tax, state property tax, and the retail sales tax) have been expressly committed to bond debt service. But the Legislature has permitted a number of special local excise taxes to be promised to bond debt service, including local real estate excise taxes, various local sales and use taxes, and local option motor vehicle excise taxes.

Practical Considerations

In addition to constitutional limitations, there are significant practical considerations related to the administration and collection of taxes.

Successful tax administration is based on a system of voluntary compliance. Washington's existing tax system is structured to allow taxpayers to identify taxable activities, calculate tax liability and remit tax payments with a tax return summarizing the taxable period. The role of the Department of Revenue is to provide the education and infrastructure to assist taxpayers in this endeavor. Taxes that are too difficult for taxpayers to measure and remit voluntarily or taxes that are too complex or costly to enforce will detract from a system of voluntary compliance**.**

The principles listed below identify certain areas of tax administration that will affect the burden on both taxpayers and the Department of Revenue. However, there may be circumstances where the Legislature and Governor apply policy goals for a particular tax or program that override these guidelines.

- Taxpayers should be easily identifiable. They should be defined as a separate group using simple, easy to apply, and verifiable criteria.

- The tax rate should be simple and direct so taxpayers can easily calculate how much tax they owe.

- The tax should be based on an easily understood and identifiable activity or business event so potential taxpayers can self assess and pay the tax correctly.

- The taxable activity should be objective and easily measured by both the taxpayer and the Department of Revenue. For example, the retail sales tax is applied to the selling price of an item. The amount paid in the retail transaction is easy to measure and not subject to debate. A tax base that is difficult to measure is subject to dispute by both the taxpayer and the administering agency. For example, a tax on intangible goods would be extremely complex to implement due to the difficulties of measuring value for both taxpayers and the Department.

- Tax rates should be predictable. They should not commence or terminate according to the balance in a given fund; neither should the rate increase or decrease according to the fund balance. Such changes confuse taxpayers and result in either underpayments or overpayments and higher administrative costs to manage these mistakes.

- Taxpayers should be able to determine how much tax is owed rather than relying on the state to determine each taxpayer's liability. Individual treatment drives administrative costs higher, whereas generalized administrative practices keep costs low. This is a fundamental principle of a voluntary tax system. The existing enforcement difficulties surrounding the use tax on tangible personal property owned by individuals is related to this principle. The Department has no direct contact with individuals or transactions to enforce this tax, except in the cases of motor vehicles and other purchases that are subject to licensing requirements. These enforcement difficulties arise for other potential taxes as well, such as a personal property tax on property owned by individuals.

Chapter 6: Value Added Tax – A Major Replacement Alternative

Introduction

In its authorizing legislation, the Legislature required the Committee to be guided by the principle of neutrality in developing alternatives. A broad-based income tax is a common method of achieving neutrality. One option that achieves neutrality is the so-called value added tax (VAT). Unlike an income tax, a VAT is collected from a limited number of registered taxpayers, usually commercial enterprises, similar to the existing business and occupation (B&O) tax system.

The base of taxation for all tax systems is either property or some measure of economic activity carried out by the taxpayer. Ideally the base is chosen both as a measure of ability to pay the tax and as a measure of the privilege enjoyed by the taxpayer in carrying out the activity within the state. Retail sales and gross receipts are such measures under our existing system. Under a VAT, the increase in the value of goods and services contributed by the taxpayer's activity is chosen as the measure of taxable activity.

The Committee proposes three different possibilities of value added taxation for the state: 1) a subtraction method business VAT, 2) a goods and services tax (GST), and 3) a progressive VAT. Although the proposals differ in several respects, they all address the problem of tax pyramiding and non-neutrality that occurs under the current B&O tax. Pyramiding occurs under the B&O tax because goods and services that are inputs into higher stages of production are taxed multiple times as they move through the production or service chain.

By comparison, a VAT avoids pyramiding by taxing only the value that is added by an enterprise to the goods and services it sells, not their gross value. By avoiding pyramiding, the VAT subjects all final goods and services to the same level of taxation, thereby achieving greater neutrality and greater fairness.

Pyramiding also occurs when the retail sales tax (RST) is levied on business-to-business sales. The GST option described below addresses pyramiding of the retail sales tax, as well as the pyramiding of the B&O tax. In addition to addressing neutrality, the GST option replaces both the RST and the B&O tax embedded in consumer prices with a single tax that is completely transparent to the consumer. A

GST is more amenable to taxing services as well as tangible goods than is the current RST.

Finally, the progressive VAT option described below addresses the problem of regressivity that is inherent in taxes of this type by incorporating a form of low-income taxpayer relief.

Major Problem Addressed

To better understand the difference between B&O and value added taxation, consider the following simplified example. In the production and sale of wood cabinets, there are several stages in the process, each of which is often performed by a different enterprise. One enterprise harvests the timber, another mills the lumber, a third manufactures the cabinets, and a final enterprise sells the cabinets to the ultimate consumer at the retail stage. Other enterprises, such as wholesalers, may also be in the chain.

Under a B&O tax, the total value of a good is taxed when it is sold from one enterprise to another in the production chain. This total value includes the value of intermediate products along the way. The value of the timber is embedded in the value of the lumber, the value of the lumber is embedded in the manufactured cabinets, and so on. The gross value of the product at each stage includes taxes paid on intermediate products, so the tax accumulates (pyramids) as it moves through the production chain. Analysis of Washington's current tax system shows that the B&O tax in total pyramids 2.5 times. The amount of pyramiding varies considerably by industry.

Under a VAT, the taxable base is the value added at each stage of production. In the above example, the lumber mill pays tax on the value it adds by milling raw timber into lumber, and the manufacturer pays tax on the value it adds by turning lumber into cabinets. The value of the timber embedded in the value of lumber is not taxed again as lumber sales, nor is the value of lumber embedded in the cabinet taxed again as cabinet sales, and so on. Value added is taxed once at every stage, but not more than once, so the total effect is equivalent to taxing just once the full value of final goods and services sold to ultimate consumers.

The pyramiding of the B&O tax causes non-neutral tax treatment to the advantage of vertically integrated enterprises and to the disadvantage of non-vertically integrated businesses. Enterprises that are vertically integrated escape multiple levels of taxation because intermediate products produced within the enterprise for itself are not subject to tax until the product is sold to another entity. Non-vertically integrated enterprises buy intermediate products on which B&O tax has already been paid and are taxed again when they sell the enhanced products. The B&O tax encourages enterprises to vertically integrate that would not otherwise do so in order to avoid the higher taxes that arise through pyramiding. (For more detail on the problem of pyramiding and non-neutralities, see Chapter 9.)

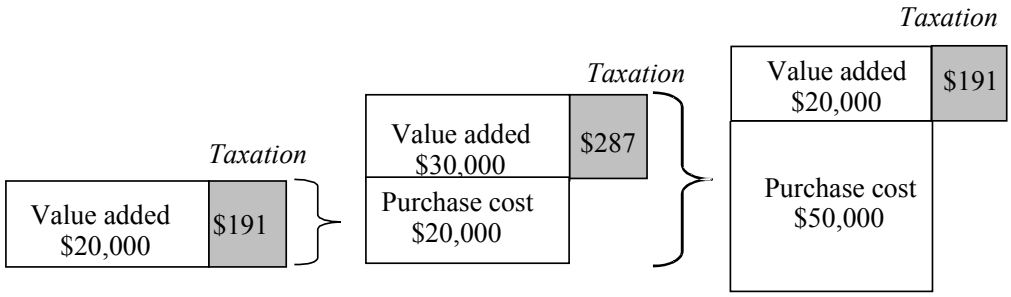
Pyramiding also causes non-neutral taxation because it occurs to different degrees in different industries. Goods and services subject to more stages of production will have taxes that pyramid into higher effective rates. This is equivalent to taxing different goods and services at different rates, causing non-neutralities.

The following diagrams illustrate a value added tax versus a B&O tax.

Chart 6-A

Business Value Added Tax Illustration

Raw Materials Producer		**Manufacturer**		**Retailer**	
Gross Sales	$20,000	Gross Sales	$50,000	Gross Sales	$70,000
Minus Purchases	$0	*Minus Purchases*	$20,000	*Minus Purchases*	$50,000
Value Added	$20,000	Value Added	$30,000	Value Added	$20,000
VAT at .96%	**$191**	**VAT at .96%**	**$287**	**VAT at .96%**	**$191**

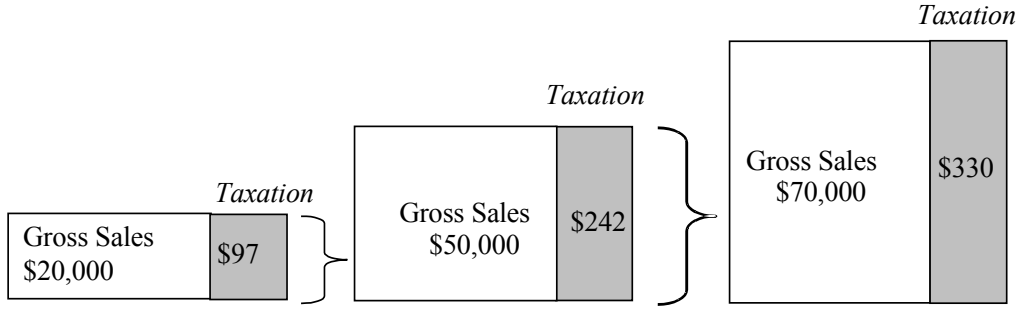


Total Tax = $669

Chart 6-B

Business and Occupation Tax Illustration
(Illustration assumes that tax is not passed on.)

Raw Materials Producer		**Manufacturer**		**Retailer**	
Gross Sales	$20,000	Gross Sales	$50,000	Gross Sales	$70,000
Tax at .484%	**$97**	**Tax at .484%**	**$242**	**Tax at .471%**	**$330**



Total Tax = $669

Mechanics of the VAT

As with any other tax, policy makers must choose among several ways in which a VAT can be designed and administered. In choosing which VAT options to propose, the Committee exercised its best judgment as to which forms would be most appropriate and workable for a state tax system.

Different Definitions of Value Added

VATs can differ according to how they treat purchases of assets used in a business (producer durables). The so-called *consumption-type VAT* treats purchases of producer durables (capital expenditures) exactly the same as purchases of intermediate products and subtracts them from the tax base. The *gross product VAT* includes the value of producer durables in the tax base. An intermediate form, known as an *income VAT*, would exclude the depreciation part of capital costs from value added.

Different Ways VATs Treat Imports and Exports

Another difference among value added taxes is how they treat imports and exports of goods and services to and from the state. Some VATs are primarily *origin based*; others are primarily *destination based*. An origin-based tax is levied on production within the state regardless of whether the good or service is consumed in state or out of state. The B&O tax is primarily origin based, although it has mechanisms to exempt some part of the value of exports so that Washington-produced goods and services can compete. The subtraction method business VAT described below is also primarily an origin-based tax.

Destination-based taxes are levied on goods and services consumed in the state regardless of where they are produced. Under this type of tax, goods and services produced in Washington that are destined for export are not taxed, and goods produced out of state but consumed in Washington are taxed. The retail sales tax is a destination-based tax. The GST described below is a destination-based VAT.

Different Ways to Calculate Tax Liability Under a VAT

Value added taxes can be classified according to how they require taxpayers to calculate their tax liability. Under a *subtraction method VAT*, enterprises pay tax on the value of their gross receipts minus the costs of intermediate goods and services they purchase in the course of doing business. Under an *invoice method VAT* (which includes the GST), enterprises pay tax on the value of their gross receipts minus a credit for taxes paid on their purchases of intermediate goods and services as recorded on their business invoices. Under an *addition method VAT*, enterprises calculate the tax base by starting with the entity's profit and adding costs of production such as labor and costs of capital. However, each of these calculations yields essentially the same value added base.

Alternative VAT Proposals

#1. Subtraction Method VAT

Proposal: Replace the B&O tax with a 2.2 percent subtraction method business value added tax.

Description:

Purpose: To improve neutrality by eliminating the pyramiding in the B&O tax.

Tax Incidence: All businesses with nexus in Washington would pay the tax on activity that takes place in Washington State.

Rate and Yield: 2.2 percent VAT required to replace the B&O tax loss of $2,278 million in CY 2005.

Tax Base: Gross receipts less cost of intermediate goods. The subtraction method VAT is the simplest way for businesses to measure their value added.

Imports: Imports of intermediate goods would be treated as origin based. In other words, imports would be fully deductible. Unitary accounting would be required for multistate enterprises to avoid tax evasion.

Exports: Enterprises would multiply their gross receipts from all sales by a three-factor apportionment ratio (sales, property, payroll) in order to maintain the competitiveness of the current business tax system.

Exemptions: Limited exemptions could be implemented on an entity/activity basis. No exemptions are assumed in the 2.2 percent rate.

Treatment of Capital Expenditures: The proposal does not exclude capital expenditures or depreciation from the tax base. However, excluding capital expenditures or depreciation could be allowed as a mechanism to make Washington businesses more competitive.

Problems Addressed: The subtraction method business tax would eliminate pyramiding that is caused by the B&O tax. The tax is more neutral and fair because value added is a better measure of the actual economic activity conducted by an enterprise than is gross receipts, and all forms of activity are taxed at the same rate regardless of industry or firm production structure. Like the B&O tax, the VAT is burdensome to businesses in their unprofitable years, but to a lesser degree because the cost of intermediate goods is not subject to tax.

The relative household/business incidence would not change since one business tax replaces another business tax.

Problems Created: The subtraction method VAT is more complicated to administer than the B&O, both for business and the Department of Revenue, because purchases of intermediate goods and services must be measured and monitored. There are additional opportunities for tax evasion and avoidance by taxpayers.

Similar Taxes Imposed Elsewhere: New Hampshire and Michigan both have addition method VATs. The addition method value added taxable base calculation starts with profit and adds compensation, interest paid, rent paid, and depreciation. New Hampshire currently has an addition method business VAT of 0.75 percent assessed on the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the business enterprise, after special adjustments and apportionment. Enterprises with more than $150,000 in gross receipts are subject to the tax. Michigan has a modified addition method VAT called a single business tax (SBT) at a rate of 2 percent as of December 2001. The SBT provides several exemptions, deductions and credits from value added and is apportioned by means of sales, property and payroll.

Although the methodologies for determining the taxable base differ, the subtraction method VAT and the addition method VAT have essentially the same tax base. The Committee proposes the subtraction method rather than the addition method because it is simpler for businesses to calculate and more similar to the existing B&O tax.

In the 1980s, Representative Dan Grimm proposed legislation in Washington for a subtraction method VAT with apportionment of exports. The legislation did not pass.

A majority of the Committee recommends that the Legislature replace the B&O tax with a subtraction method business value added tax.

#2. Goods and Services Tax

Proposal: A 9 percent GST to replace both the B&O tax and the state retail sales tax.

Description:

Purpose: Eliminates pyramiding and resulting non-neutralities. Broadens the tax base. Creates a more transparent tax system.

Tax Incidence: The legal incidence of the tax is on the purchaser whether the taxpayer is a business or an individual.

Rate and Yield: 9 percent GST rate to replace the state retail sales tax and the B&O tax loss of $8,945 million in CY 2005.

Tax Base: The tax base is equal to sales at every stage of production, including wholesale and retail transactions, with a credit for taxes paid on intermediate goods and services purchased by registered taxpayers.

This is essentially a destination-based tax on the value of goods and services consumed in the state.

The tax would be paid on all products and services, including those currently exempt under the retail sales tax, such as personal and professional services. Agricultural production and rental of real estate would also be included.

Exemptions: Food, prescription drugs and medical services would be exempt.

Imports: Tax would be paid on imported goods and services. Goods purchased by the final consumer out of state would be subject to use tax.

Exports: Exported goods can be "X-rated." Out-of-state sales are not taxed while taxpayers receive a credit for X percent of the tax paid on their intermediate goods. If X equals 100 percent, the exports are said to be zero-rated (conventional in national VATs), meaning that no state tax is collected on the value of goods and services exported from the state. If X equals zero, state tax is embedded in exported goods. X is chosen to achieve competitiveness objectives.

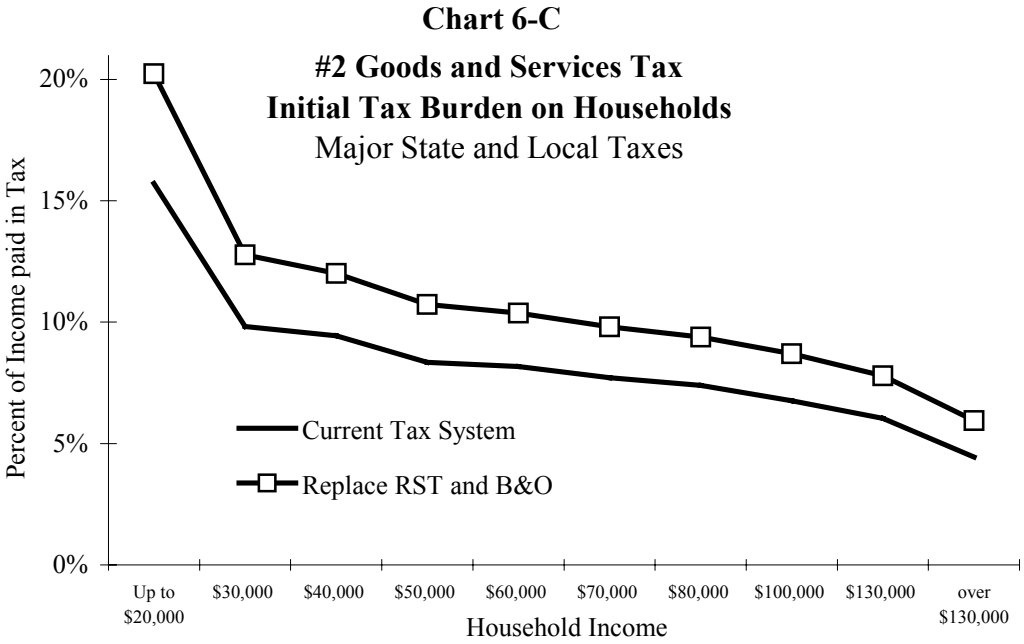
Local Sales Tax: Local sales tax would continue to be collected by retailers.

Problems Addressed: Like the subtraction method VAT, the GST would improve economic neutrality and equity by eliminating pyramiding.

The GST also broadens the tax base to include personal and professional services, agricultural production and rental of real estate. Some of these activities are difficult to tax under a retail sales tax because they would pyramid. Businesses purchase

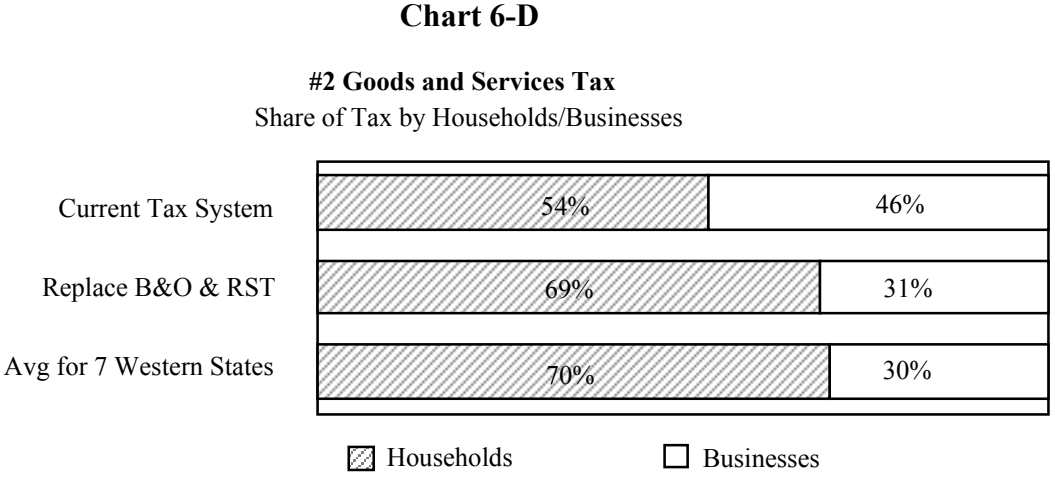
professional services, a portion of which becomes an implicit part of their output, and a portion of which becomes an implicit part of overhead. The portion that is implicit in output could then become taxed again. Since the GST eliminates pyramiding, pyramiding would not be an obstacle in base broadening.

Chart 6-C



Source: Washington Excise and Property Tax Microsimulation Model

Chart 6-D



Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

The destination-based GST replaces the origin-based B&O, therefore increasing competitiveness. The choice of X allows policy makers to choose the most appropriate value for competitiveness.

A GST is more transparent than the B&O tax. B&O taxes that are passed down to consumers are hidden. The share of tax paid by households increases from 54 percent under the current system to 70 percent under the GST proposal. The share of tax paid by business decreases from 46 percent under the current system to 30 percent under the GST proposal.

The relative reliance on different taxes does not change under this proposal.

Problems Created: The GST is a novel tax for a single state. Although multistage sales taxes like the GST are used in many countries around the world, including Europe and Canada, there are few operating examples of GST-type VATs implemented by sub-national governments in any country.

The GST would involve more administrative and compliance costs than the B&O and retail sales taxes.

The GST is subject to the same harmonization problems as the current RST, including remote and cross-border shopping.

Similar Taxes Imposed Elsewhere: Quebec has a destination-based invoice method provincial VAT, and three Maritime Canadian provinces have provincial VATs harmonized with the federal VAT.

The European VATs use the invoice method to determine tax liability similar to the GST. The tax base for European VATs is consumption. For the invoice method this means that the enterprise would receive a credit for the tax shown on invoices for capital good purchases as well as for intermediate goods. The VATs are "destination based" taxes in which taxes are imposed by the jurisdiction in which the buyer is located. Exports are not taxed by the jurisdiction in which the goods are produced (zero-rated); imported goods are taxed by the jurisdiction in which they are sold. If an enterprise imports intermediate goods from another country and uses them in its production process, there is no tax on the invoice for these intermediate goods to take as a credit against the tax on the value of the goods the enterprise produces.

No state in the United States has a GST type of VAT.

While not favored by the majority of the Committee, it was agreed that the GST is appropriate for consideration.

#3. Progressive VAT

Proposal: Progressive VAT at 3.9 percent reduces state RST to 3.5 percent and replaces B&O.

Description:

Purpose: Eliminates pyramiding and broadens the tax base, thereby increasing neutrality. It also reduces the regressivity of the tax system.

Tax Incidence: This is a tax on both businesses and wage earners.

Rate and Yield: 3.9 percent progressive VAT to reduce the RST to 3.5 percent and replace the B&O tax. This VAT rate maintains revenue neutrality to cover a $5,242 million tax loss in existing taxes in CY 2005.

Registered taxpayers include all enterprises with nexus in the state and all persons employed in the state. Enterprises, employees of taxable enterprises, and employees of nontaxable organizations including government agencies all pay the same tax rate on value added above a $30,000 exemption.

Tax Base: The business tax base is equal to gross receipts by all enterprises less costs of intermediate goods and services and the cost of wage compensation paid to employees in the state.

Employees are required to register as taxpayers and must pay tax on wages received from employers in the state. Wages are a measure of the employee's value added in the state.

The tax is essentially an origin-based value added tax split between the businesses and employees who are considered value-adding entities in their own right.

Exemptions: $30,000 exemption per registered taxpayer.

The tax exemption applies to all registered taxpayers. Employees of nontaxable organizations such as government employees have the same exemption.

The extension of an exemption to the employee component of value added relieves tax burdens on low-income earners and makes the tax progressive. There is no need to exempt taxes on necessities for this purpose.

Imports: Purchases of imported intermediate goods and services by enterprises are fully subtracted.

Exports: For exporting enterprises, some form of apportionment of the business part of the tax may be applied in order to mimic the destination (competitive) component

of the current business tax system. This is already described in the subtraction business VAT (Option #1).

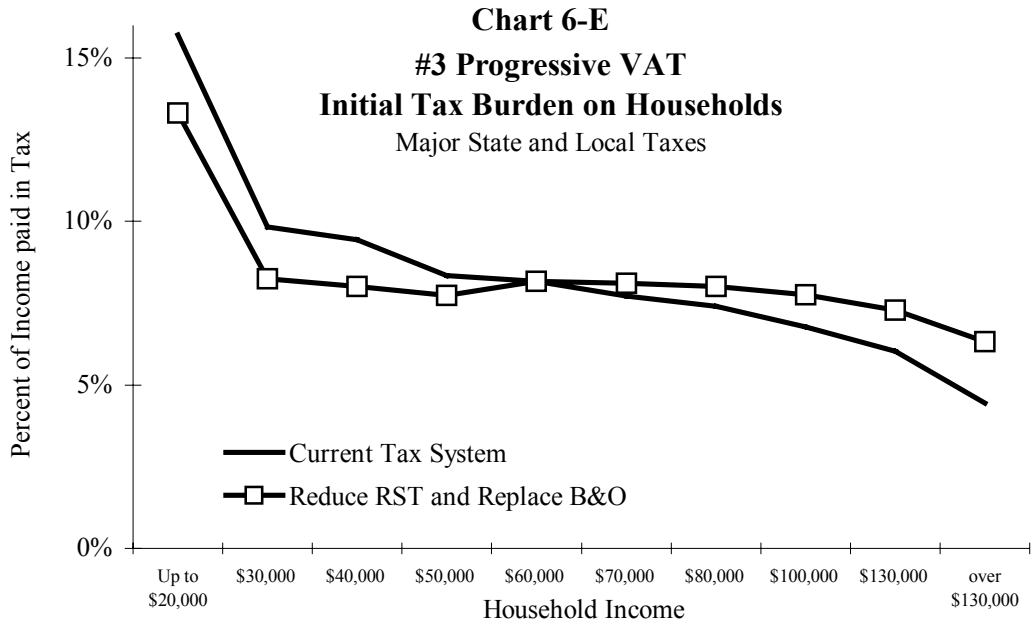
Local Sales Tax: Local sales tax would continue to be collected by retailers.

Economic Impacts: When the progressive VAT reduces RST and replaces B&O, the household tax burden increases from 54 percent under the current system to 59 percent. The business burden decreases from 46 percent to 41 percent.

The relative reliance on general sales tax decreases from 49 percent to 43 percent.

Problems Addressed: The progressive VAT, like the other two VATs proposed, is more neutral because it eliminates the pyramiding of the B&O tax and is levied on a broad base.

The wage and salary portion of the tax is less regressive than the retail sales tax because the $30,000 exemption targets tax relief to low-income households.

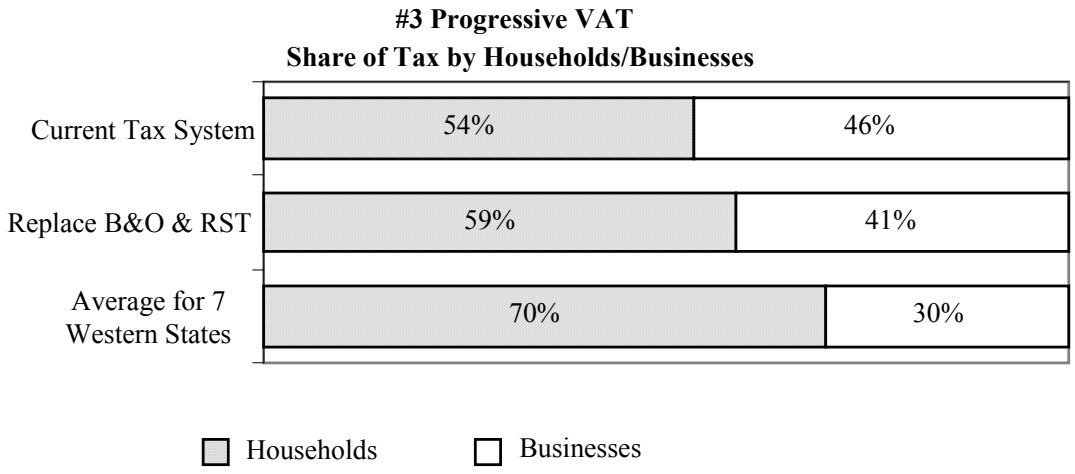


Source: Washington Excise and Property Tax Microsimulation

Individual taxpayers may be able to export a portion of the wage and salary tax to the federal government by deducting the tax from their federal income tax.

Replacing the B&O and the sales tax shifts some of the tax burden onto households and off businesses. The share of tax paid by households increases from 54 percent under the current system to 59 percent under the progressive VAT proposal. The share of tax paid by business decreases from 46 percent under the current system to 41 percent under the proposal.

Chart 6-F



Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

Problems Created: Like the subtraction method VAT and the GST, the progressive VAT is more complex than the current system, although no more complex than an income tax.

The progressive VAT significantly increases the number of registered taxpayers by including employees in the tax net.

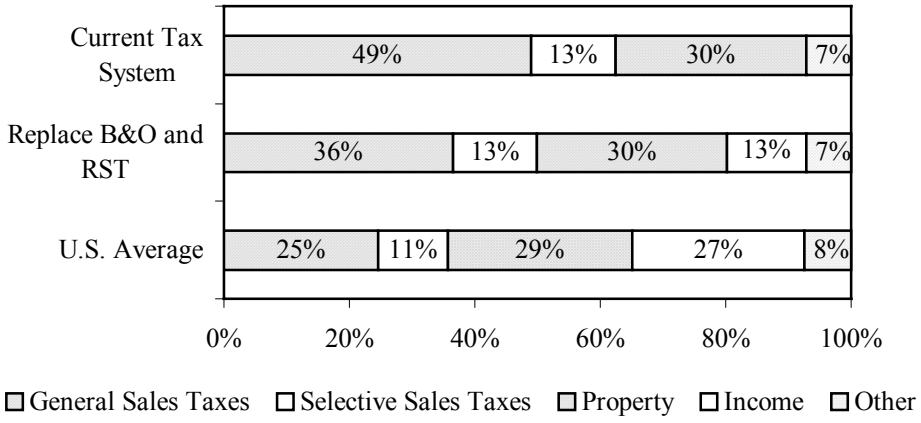
The tax may be considered an income tax by the courts and voters. Apportionment is needed to ensure that the business component of the tax does not reduce competitiveness.

Similar Taxes Imposed Elsewhere: Although a tax of this type has been advocated as a replacement for the federal income tax since President Reagan, it has not been implemented anywhere in the world at this time. As an untried tax, there are probably additional, unknown challenges to implementation and administration.

Replacing the B&O and a portion of the state sales tax shifts Washington's high reliance on gross receipts taxes to a tax at least partially based on employee wages and salaries. Washington's mix of taxes would become more similar to the U.S. average.

Chart 6-G

#3 Progressive VAT
Percent Reliance on Major State and Local Taxes



While not favored by the majority of the Committee, it was agreed that the progressive VAT is appropriate for consideration.

Chapter 7: Income Tax – A Major Replacement Alternative

Introduction

The question of an income tax has been debated in Washington ever since the 1930 McInnes Commission, in which a state income tax was a major recommendation. That Commission's income tax proposal was enacted by a 1932 initiative but was overturned by a 1933 State Supreme Court decision. In view of the fact that a state income tax was subsequently recommended numerous times without success, the Committee considered carefully the question of putting forward such a proposal once again—this time as a major replacement alternative. There are reasons for doing so, and in this introduction we attempt to articulate them.

In practice and in theory, only five tax bases exist that are of sufficient size and breadth to support modern state government—retail sales, gross receipts, net income, property, and value added to products and services. Gross receipts and sales are the bases of Washington's current tax system, and retail sales forms at least part of the base in 45 other states. Income is an important part of the tax base in 46 states, but not in the state of Washington. Value added is not used in any state, except for relatively insignificant business taxes in two states.

Thus, simply put, there are very few major alternatives for measuring a tax base, and for this reason alone, a state income tax must be listed among the major replacement alternatives in this report.

Besides the limited set of replacement alternatives, analysis supports our putting forward a state income tax as a replacement alternative. These reasons, which are enlarged upon later in this chapter, can be classified into two categories—the *intrinsic advantages* of the income tax itself and the *resulting advantages* of replacing an existing tax.

Intrinsic Advantages of a State Income Tax

- State income tax payments are deductible from federal taxable income for itemizing taxpayers.
- An income tax provides for growth in tax revenues commensurate with the growth in the demand for state government services, which historical evidence indicates grows at the rate of state income, or faster.

- An income tax provides for a less regressive tax system.
- An income tax is based on one measure of ability to pay – income.
- An income tax is relatively neutral and efficient because it has a broad base and a low rate.

Resulting Advantages of a State Income Tax

- A state income tax allows for a more competitive tax structure, comparable with those of other states, because the state can reduce the high percentage of revenue collected from businesses.
- A state income tax allows for a more rational assignment of taxes between the state and local governments because the state can reduce its unusually high property tax.
- A state income tax allows for an increase in tax harmony with other states and a reduction in tax avoidance via Internet and cross-border shopping because the state can reduce the high retail sales tax rate.
- A state income tax allows for a less regressive tax system because the state can reduce regressive sales and property taxes. It also allows for features, such as tax credits, that can mitigate undue burdens of sales and property taxes on specific groups of residents.

This chapter illustrates three forms of state income taxes: a flat rate tax on federal adjusted gross income of individuals, a graduated rate tax based on federal adjusted gross income of individuals, and a corporate net income tax. There are an almost unlimited number of possible ways to structure an income tax and use it to replace or reduce existing taxes. For purposes of illustrating how the first two options might be applied, the Committee considered four potential levels of replacing existing state taxes:

1) Reduction of the state retail sales/use tax rate from 6.5 percent to 3.5 percent.

2) The same degree of sales tax reduction, plus elimination of the state property tax levy.

3) Total elimination of the state retail sales/use tax.

4) The elimination of both the state retail sales tax and the state property tax.

In the third option, a flat rate personal income tax is combined with a corporate income tax to reduce the retail sales tax, the state property tax, and the business and occupation (B&O) tax. Each of the packages is designed to be revenue neutral for Calendar Year 2005, the initial year in which the proposal is presumed to be implemented.

The income tax alternatives are designed to replace state taxes only. The Committee decided not to address local taxation primarily because of long-term bond

obligations tied to local revenues. However, local taxes are considered in the following illustrations of household tax burdens.

Finally, it appears a personal or a corporate income tax similar to any of the models presented would require a constitutional amendment. However, this conclusion is subject to some question. Please see the discussion in Appendix B.

Major Problems Addressed with Personal and Corporate Income Taxes

In the Introduction, we listed the advantages of a state income tax in point form. In this section, we describe the advantages in more detail.

The impact of an individual state income tax would be significantly offset for households that itemize their federal income tax deductions. As noted earlier, as a result of the federal Tax Reform Act of 1986, state income taxes are deductible for federal tax purposes, while the state sales taxes paid by households are not. It is estimated that Washington residents pay an additional $500 million annually in federal tax because of the inability to deduct state sales taxes. Replacing the state sales tax entirely with a personal income tax would save Washington itemizers $1.45 billion a year if a flat rate income tax were adopted. The savings increase to almost $2 billion a year if a graduated rate personal income tax is adopted. The net effect of tax savings and tax increases are discussed at the end of this chapter.

Table 7-1

Federal Tax Savings for Households Under Personal Income Tax Alternatives Tax Year 2001

Alternatives	Flat Rate	Federal Tax Savings ($millions)	Graduated Rates	Federal Tax Savings ($millions)
State Sales/Use Tax from 6.5% to 3.5%	2.6%	$680	1.0, 2.7, 4.5%	$725
State Sales/Use Tax to 3.5%, State Property Tax to 0%	3.8%	$999	2.2, 3.5, 6.0%	$1,046
State Sales/Use Tax to 0%	5.5%	$1,450	2.7, 5.7, 8.7%	$1,542
State Sales/Use Tax to 0%, State Property Tax to 0%	6.7%	$1,790		

Note: Top federal marginal rate in tax year 2001 is 39.1%.

Federal tax savings from a personal income tax are considerably higher than the sales tax savings for two main reasons. First, households pay 64 percent of the sales tax in Washington, whereas they would pay 100 percent of the personal income tax. Note that a portion of the household tax savings is shifted from business tax savings. Since businesses pay less tax, they also export less to the federal government. Second, the sales tax is regressive. Therefore, a sales tax is borne more heavily by

the poor who typically do not itemize, whereas a personal income tax is borne more heavily by itemizers. There are more itemizers at the higher income levels. In the option to completely replace the state sales tax with a flat rate 5.5 percent personal income tax, itemizers account for over two-thirds of the base taxable income.

Table 7-2

Percent of Washington Households That Itemize
CY 1999

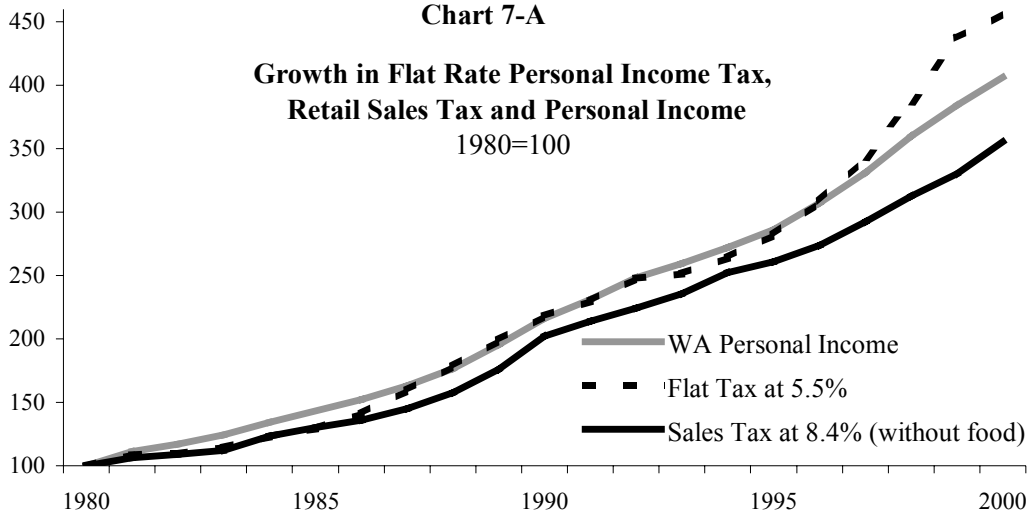
Adjusted Gross Income	Percent Households That Itemize	Adjusted Gross Income	Percent Households That Itemize
$0-10,000	2.7%	$60,000-80,000	66.3%
$10,000-20,000	10.0%	$80,000-100,000	77.6%
$20,000-30,000	17.0%	$100,000-200,000	81.9%
$30,000-40,000	28.5%	$200,000-500,000	79.7%
$40,000-50,000	42.5%	> $500,000	61.7%
$50,000-60,000	56.1%	Average	32.9%

Adequacy

Historical evidence from all 50 states analyzed by Committee member Dick Conway shows that state and local spending, net of federal transfers, tends to rise as fast as state income, or faster. Department of Revenue research indicates that, with a constant rate and base definition, retail sales tax revenue grows at a slower rate than state income (a measure of the size of the state economy), posing adequacy problems. Evidence indicates that revenue from a state income tax would grow at a rate comparable to the growth rate of state income over the long run.

Chart 7-A

Growth in Flat Rate Personal Income Tax, Retail Sales Tax and Personal Income
1980=100



Stability

Investors generally agree that a balanced and diversified portfolio of assets is less risky and more stable than a concentrated portfolio. Similarly, a tax structure that includes a variety of taxes will provide for a more stable source of revenue for state government over the long run. Although many of the taxes typically move together over a business cycle, they do not move in lock step, hence a combination of tax sources is more stable than either one alone.

Also, research shows that a sales tax base that exempts food is less stable than one that includes it (Holcombe and Sobel, 1997, p. 158). Because of Washington's heavy reliance on the retail sales tax, groceries are exempted from tax in order to reduce the regressivity of the state tax burden. An income tax is not regressive, hence policy makers have latitude to include groceries in the sales tax base if a more stable sales tax revenue stream is desired. For estimates of the volatility (short-run elasticity) of existing tax types, the flat rate income tax, and combinations of the tax mix, see Appendix C.

Competitiveness

Currently, businesses pay 46 percent of state and local taxes in Washington, as compared to 30 percent for the average of the seven Western states. This share is one of the highest in the nation. The Committee agrees that high business tax burdens reduce the economic vitality of the state, discourage firms from locating their operations here, and invite firms already located in Washington to consider other locations. Furthermore, to the extent that businesses in Washington are able to shift part of this burden to the buyers in the form of higher prices, such taxes represent a hidden burden on the buyers and contribute to a nontransparent tax structure.

Without an alternative tax base, the state has few options for reducing this business tax burden. The business and occupation tax, for example, is the second largest source of state tax revenue, and it would be difficult for the state to raise this revenue by increasing the unpopular state property tax or increasing the retail sales tax rate, which is already one of the highest in the nation. With a personal and corporate income tax system, the B&O tax burden can be reduced to bring the share of tax revenues collected from households and firms in Washington in line with shares in other states.

Fairness

Personal income taxes can be structured to address the problem of equity or fairness of the overall tax system. The Committee considered standard deductions, personal exemptions, and graduated rates to achieve progressivity in the personal income tax alternatives. Thus, depending upon the degree of reliance upon this type of tax, income taxes can offset the regressive impact of other state and local taxes.

States such as Washington that do not impose income taxes have particularly regressive tax systems when viewed apart from the federal tax burden. The municipal government of the District of Columbia conducts an annual study of household tax burdens in the largest city of each state as a proxy for the entire state. The study for Calendar Year 2000 indicates that the six states with the most regressive tax systems are Alaska, Texas, Washington, Wyoming, Nevada, South Dakota, and Tennessee. Analysis by the Committee confirmed that when evaluating the total tax system–local, state and federal–all states have progressive taxes and the differences among states are not as great.

Corporate net income taxes may be considered to be more equitable than gross receipts business taxes because the tax liability is linked to the firm's profitability. However, the corporate tax would introduce non-neutral tax treatment of corporations compared to unincorporated businesses and of equity financed investments compared to debt financing. Replacing the B&O tax with a corporate net income tax would eliminate the pyramiding of our tax system and the resulting non-neutral tax treatment of businesses.

Mechanics of Income Taxes

Personal Income Taxes

Forty-three states have personal income taxes. State individual income taxes are usually tied in varying degrees to the federal Internal Revenue Code (IRC) personal income tax statutes. This creates a number of administrative efficiencies for states and it makes it simpler for taxpayers to comply. A state income tax scheme can vary from the federal tax code by excluding certain income, providing different personal exemptions or deductions, and by fixing a different amount for the standard deduction.

Since most state income taxes are based on the federal tax, most states adopt the federal definitions as contained in the IRC and base their state tax on the amount of adjusted gross income (AGI) as calculated for the federal individual income tax. Some states then allow a personal exemption and/or standard or itemized deductions as defined by state law rather than federal definitions before the state tax rates (either flat or graduated) are applied. The state tax rates are substantially lower than the federal rates. However, the bracket break points for a graduated income tax may be based on the federal tax.

Some states simplify their tax computations by imposing their state tax as a percentage of federal income tax liability. This, in effect, incorporates all of the federal definitions, exemptions, and rate structure. The only decision made by the state legislature under this type of state income tax is the tax rate.

Basing state taxes at least partially upon the federal tax helps to reduce the cost of administering the state income tax. Nonetheless, the costs at the state level can be

significant. The actual cost to administer a state income tax would depend upon the type of tax. Initially, there would be significant expenditures for development of computer systems and preparation of tax forms. Subsequently, the principal expenditures would shift to processing of returns, follow-up audit and compliance activities. Further analysis would be necessary to develop a cost-of-collection estimate.

The Department of Revenue collects state and local excise taxes principally from business entities. Presently, there are approximately 375,000 firms that submit tax returns on a monthly, quarterly, or annual basis. Under an income tax system the number of taxpayer accounts would increase by at least 2.3 million, as almost all households would be required to submit annual income tax returns (plus quarterly estimated payments for some), and employers would have to make monthly withholding payments on behalf of their employees.

Corporate Net Income Taxes

Corporate net income tax is currently levied in 46 states. All of these states either adopt or heavily refer to the federal Internal Revenue Code for definitions of taxable income, although most states allow additional items to be deducted and also require certain federally deducted items to be added back. The application of corporate income tax by states is complicated by multistate firms that derive income in more than one state and by the intricacies of corporate organization.

By federal law, a firm generally must have both a permanent physical presence and employees within a state to be subject to tax when the corporation is subject to tax in more than one state. Attribution of profits among those states may be done through "separate accounting" at the establishment level within a state. It may also be done through "apportionment" based on payroll, property, and sales. Apportionment methods are not uniform–some states double-weight sales or more heavily weight sales. Further complications are caused by the complexities of corporate organizations, with holding companies and parent-subsidiary relationships. Some states tend to treat corporations within a holding company as separate entities. Others have pursued a "unitary" approach, viewing the overall corporation as the taxable entity.

Income Tax Alternatives

#4. Flat Rate Personal Income Tax

Proposal: Significantly reduce or replace the state retail sales/use tax and possibly replace the state property tax levy with a single rate personal income tax. The purpose is to reduce Washington's extreme reliance on these regressive taxes. Broadening the tax base to include income would create a diversified tax system that grows at a rate more comparable to the growth in the economy. The business and

occupation tax would remain in place for all business entities organized in corporate, partnership, or sole proprietorship form.

Description:

Incidence: All individuals and households residing in Washington would be subject to the income tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income.

Tax Base: Adjusted gross income of individuals calculated for federal tax purposes, less the following state standard deduction (amounts to be indexed for inflation):

- Single taxpayers, $5,000
- Head of household, $7,000
- Married, filing jointly:
  - $7,000 if one spouse is employed
  - $10,000 if both persons are employed
- Elderly or disabled, an additional $1,000

Also, this model would allow a personal exemption of $2,900 (amount to be indexed for inflation) for taxpayers and each dependent. Further, it would allow credit for any state B&O tax paid (noncorporate businesses) and for any state income tax paid to another state.

An option to this proposal would be to allow additional targeted tax relief to the working poor (as a percentage of the federal earned income credit) and families with child care needs (as a percentage of the federal tax credit).

Rate and Yield: The income tax rate would depend upon the amount of existing state revenue to be replaced. Three options are illustrated below:

Table 7-3

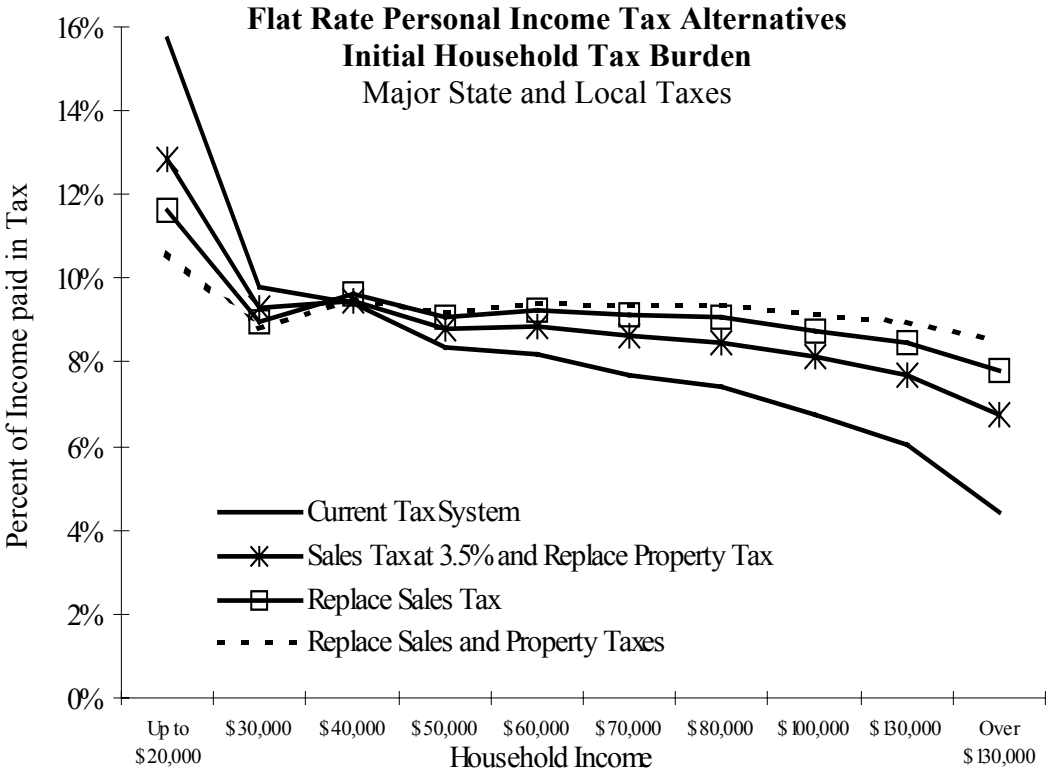
Flat Rate Personal Income Tax Alternatives
CY 2005

	Existing Taxes Reduced or Replaced	Revenue Neutral Income Tax Rate
A	Reduce state sales/use tax from 6.5% to 3.5%	2.6%
B	Reduce state sales/use tax to 3.5% and replace state property tax	3.8%
C	Replace state sales/use tax	5.5%
D	Replace state sales/use tax and state property tax	6.7%

Problems Addressed: Even with a flat rate income tax, some degree of progressivity would result from the personal exemptions and standard deductions. Flat rate income taxes would make our tax system less regressive and, with complete elimination of the state retail sales tax, nearly proportional. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved.

Washington's tax system changes from regressive to proportional depending on the extent to which sales tax is reduced and property tax is replaced with a flat rate income tax structure.

Chart 7-B



Source: Washington State Excise and Property Tax Simulation Model

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

There is no evidence that a flat rate personal income tax is less volatile than the retail sales tax. However, a tax structure that contains a personal income tax and a retail sales tax with food in the base can be less volatile than Washington's current tax structure.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

A major shift of tax burden from businesses to individuals would occur under this proposal. This is because corporations would experience a significant reduction in state sales/use tax (and the state property tax levy in Option B) but would pay no income tax. They would continue to pay the B&O tax, however, which is based on gross income. Reduction in reliance upon the retail sales/use and property taxes would improve Washington's business climate, since the current sales and property taxes are viewed by prospective firms as deterrents to investment in this state.

Chart 7-C
Flat Rate Personal Income Tax
Share of Tax by Households/Businesses

Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

Problems Created: Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and continue to administer an income tax. The costs would not be significantly different whether the income tax rates were flat or graduated. The administrative burden would also extend to individuals, who would have to file tax returns.

Even though the proposal is estimated to be revenue neutral overall, there would be a very major shift of tax burden from businesses to individuals. This is because corporations pay a significant share of the retail sales/use tax and the state property tax levy.

Under each of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax, even with the complete elimination of

the state sales and use tax. As well, coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based state income tax with state-defined exemptions and deductions. Eight of these states employ a flat tax rate: Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania, Rhode Island, and Vermont. To varying degrees the options would make our tax mix more like other states because most states impose a personal income tax.

Chart 7-D

Percentage Reliance on Major State and Local Taxes

Source: U.S. Census Bureau, Government Finances, 1999

A majority of the Committee recommends the adoption of a flat rate personal income tax to be used to reduce the state sales and use tax rate and eliminate the state portion of the property tax. The state portion of the property tax should be made available to local governments and/or schools.

A majority of the Committee considers the use of the proceeds of an income tax appropriate for any of the following:

- **To reduce the state sales and use tax rate,**
- **To eliminate the state sales and use tax,**
- **To reduce business taxes, and/or**
- **To eliminate the state property tax and share all or part of it with local governments and/or schools.**

#5. Graduated Rate Personal Income Tax

Proposal: Significantly reduce or replace the state retail sales/use tax and possibly the state property tax levy with a graduated rate personal income tax. The purpose is to reduce Washington's extreme reliance on these regressive taxes and raise the same amount of revenue via an income tax. This proposal features the same three revenue reduction options as in #4, but the income tax rate structure differs. The replacement of both the state retail sales and property taxes is not proposed.

Description:

Incidence: All individuals and households residing in Washington would be subject to the tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income.

Tax Base: Same as under Proposal #4 above.

An option to this proposal would be to base the state tax on federal taxable income, rather than AGI. The difference between the two measures of base are itemized deductions such as interest and charitable contributions. This would eliminate the need for state determination of personal exemptions and standard deductions. Instead, the Legislature would implicitly adopt these elements as provided in federal law. This would allow a deduction for any state taxes paid by taxpayers who itemize deductions for their federal tax return. This proposal, as in Proposal #4, allows a credit for state income taxes paid to other states and B&O taxes paid within Washington.

Rate and Yield: The graduated rate structure would be patterned after the brackets for the federal income tax. Three sets of taxable income brackets and income tax rates would be provided for (1) single taxpayers and married couples filing separately, (2) heads of households, and (3) married couples filing jointly. The taxable income amounts for each of the three brackets would be indexed for inflation and therefore would be adjusted each year.

The actual tax rates would depend upon the amount of existing state revenue to be replaced. Three of the options in proposal #4 are illustrated below:

Table 7-4

Graduated Rate Income Tax Alternatives
CY 2005

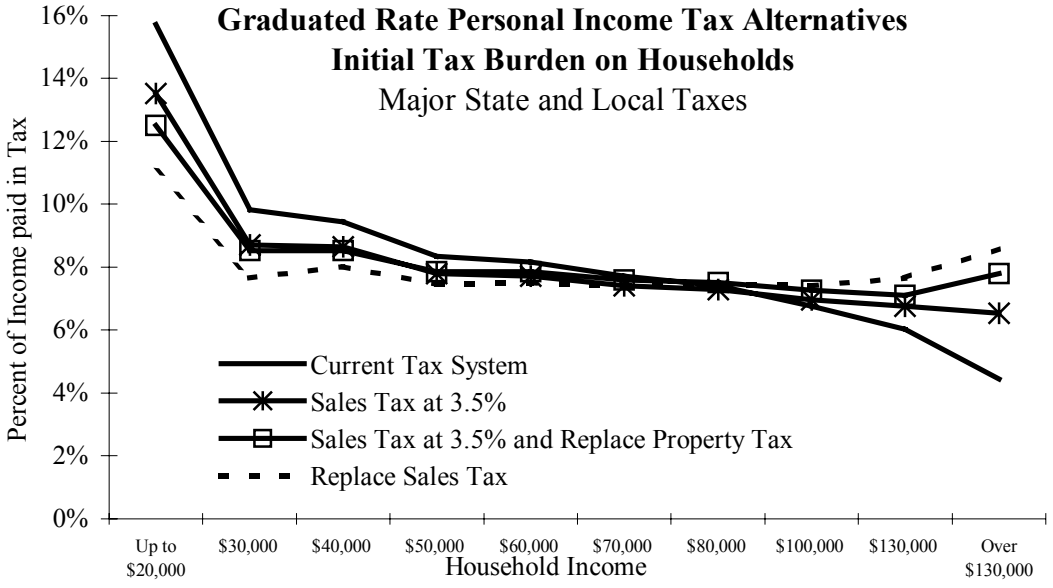
		Revenue Neutral Rates for Joint Returns		
Existing Taxes Reduced or Replaced		$0 to 49,900	$49,900 to 120,650	$120,650 and over
A	Reduce state sales/use tax from 6.5% to 3.5%	1.0%	2.7%	4.5%
B	Reduce state sales/use tax from 6.5% to 3.5%and eliminate state property tax	2.2%	3.5%	6.0%
C	Eliminate state sales/use tax	2.7%	5.7%	8.7%

Note: The income break points for single filers are $0 to 24,950, up to $60,325 and over $60,325.

Problems Addressed: Any of these options would significantly reduce the retail sales tax burden in Washington and decrease the regressivity of the state tax structure. With a graduated rate structure there would be a greater degree of progressivity than under Proposal #4. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved.

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

Chart 7-E



Source: Washington State Excise and Property Tax Simulation Model

Reduction in reliance upon the retail sales/use or property tax would improve Washington's business climate, since the current sales and property taxes are viewed by prospective firms as deterrents to investment in this state.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

A major shift of tax burden from businesses to individuals would occur under this proposal, increasing competitiveness. This is because corporations would experience a significant reduction in state sales/use tax (and the state property tax levy in Option B) with no corresponding income tax liability.

Chart 7-F
Major State and Local Taxes Paid Directly by Households and Businesses

Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

Problems Created: Graduated personal income tax is more volatile than sales tax or property tax. It is also more volatile than a flat rate personal income tax.

Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and continue to administer an income tax. The costs would not be significantly different whether the income tax rates were flat or graduated.

The administrative burden would also extend to individuals, who would have to file tax returns.

Even though the proposal is estimated to be revenue neutral overall, there would be a major shift of tax burden from businesses to individuals. This is because

corporations pay a significant share of the retail sales/use tax and the state property tax levy.

Under each of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax, even under Option C in which the entire state tax would be eliminated. Coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based state income tax with state-defined exemptions and deductions. Thirty-three of these states employ a graduated rate structure. To varying degrees the three options would make our tax mix more like other states because most states impose a personal income tax.

Chart 7-G

Percentage Reliance on Major State and Local Taxes

Source: U.S. Census Bureau, Government Finances, 1999

A majority of the Committee recommends the adoption of a graduated income tax, but more members favor the flat rate personal income tax.

#6. Flat Rate Personal and Corporate Income Tax

Proposal: Significantly reduce the state retail sales/use tax, eliminate the state B&O tax, and possibly eliminate the state property tax levy. These revenues would be replaced with a flat rate personal and corporate income tax. The purpose is to reduce Washington's extreme reliance on the regressive sales tax and the pyramiding problem caused by the B&O tax.

Description:

Incidence: All individuals and households residing in Washington would be subject to the tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income. Corporations doing business in Washington would be subject to tax on their net income, which would be apportioned to this state.

Tax Base: Same as under Proposal #4 above. The personal income tax would be based on AGI less the following deductions, personal exemptions, and credits:

Standard deduction (amount indexed for inflation):

- Single taxpayers, $5,000
- Head of household, $7,000
- Married, filing jointly:
  - $7,000 if one spouse is employed
  - $10,000 if both persons are employed
- Elderly or disabled, additional $1,000

Allow a personal exemption of $2,900 (amount indexed for inflation) for taxpayers and each dependent.

Allow credit for any state income tax paid to another state.

An option to this proposal would be to allow additional targeted tax relief to the working poor (as a percentage of the federal earned income credit) and families with child care needs (as a percentage of the federal tax credit).

The corporate net income tax would be based on federal taxable income as defined in the IRC. Thus, it would implicitly adopt all of the deductions as allowed under the federal corporate net income tax. For corporations doing business in multiple states, income would be apportioned to Washington using a standard three-factor formula. The ratios of in-state sales, property, and payroll compared with the firm's totals would each account for one-third of the apportionment. An alternative apportionment formula would double-weight the sales factor.

Rate and Yield: The flat rate income tax would be the same for both individuals and corporations. There are two options for this proposal. Both would reduce the state retail sales/use tax by 3 percent and totally eliminate the state business and

occupation tax. The first would also eliminate the state property tax levy. The personal and corporate income tax rates necessary to accomplish these reductions would be as follows:

Table 7-5

Personal and Corporate Income Tax Alternatives
CY 2005

		Revenue Neutral Tax Rates	
	Existing Taxes Reduced or Replaced	**Personal Income Tax Rate**	**Corporate Income Tax Rate**
A.	Reduce state sales/use tax from 6.5% to 3.5% Eliminate the B&O and state property tax	5.0%	5.0%
B.	Reduce state sales/use tax from 6.5% to 3.5% Eliminate the B&O	3.8%	3.8%

Problems Addressed: Either of these options would significantly reduce the retail sales tax burden in Washington, and some degree of progressivity would result from the personal exemptions and standard deductions. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved. Reduction in reliance upon the retail sales/use tax would also improve Washington's business climate, since the current sales tax is viewed by prospective firms as a deterrent to investment in this state.

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

Exportability of corporate income tax is not an issue because corporations can export any state or local tax.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

Elimination of the state B&O tax would shift taxation of business from the volume of activity (i.e., gross sales) to reflect profitability. This would particularly help new and expanding firms and could encourage these types of businesses to locate in Washington.

The shift from B&O to corporate income tax would eliminate pyramiding.

Problems Created: Replacing B&O with a corporate income tax would increase the volatility of the tax structure because corporate income tax is more volatile than B&O.

This proposal creates a problem for households who will see their tax burden increase as it shifts from corporations. This is because corporations pay a significant share of the retail sales/use tax and the state property tax levy, as well as the majority of the B&O tax. While this could make business taxes more similar to those levied in other states, it would entail a significant increase in the share of state/local taxes borne directly by individuals.

Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and administer a new income tax. The costs would not be significantly different whether the income tax rates were flat or graduated. Further, auditing of corporate net income tax returns would be much more complex than auditing the B&O tax, as firms are allowed to deduct their costs of doing business. On the other hand, the Department of Revenue would be able to piggyback its audit efforts on the federal audits of corporations since state and federal income taxes would be on the same base.

The administrative burden would also extend to individuals, who would have to file tax returns.

Under both of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax. Coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based personal income tax and a corporate net income tax. Five states levy a corporate income tax but no personal income tax. In nearly all of these states with the combination, the rates for the personal income tax are graduated. Further, only Colorado levies the same flat rate income tax rate on both sectors.

The majority of the Committee recommends, in addition to a personal income tax, a corporate income tax to replace the B&O tax.

Net Changes in Taxes Initially Paid by Businesses and Households

The personal income tax alternatives outlined in this chapter result in overall net decreases in tax paid by Washington taxpayers. While personal income taxes increase the taxes initially paid by households, there are offsetting benefits. The benefits are reductions in existing taxes and tax savings due to the ability to deduct personal income tax from the federal return. Taxes paid initially by businesses decrease overall with some offsetting loss in the ability to deduct existing taxes as business expenses.

The net tax changes for both businesses and households are summarized in the following tables. Tables 7-6 and 7-7 show the overall net tax changes for both businesses and households. Table 7-8 summarizes the net tax change for typical households. The household tax calculations in these tables are based on the assumption of initial incidence (i.e., the tax is borne by the entity that pays it). A significant fraction of retail sales and property taxes is paid initially by businesses, who may in fact pass on the tax to customers in the form of higher prices. No attempt has been made to determine the reduced indirect tax burdens on households that may result from the substitution of a personal income tax for sales and property taxes paid by businesses.

Table 7-6

Overall Net Taxes Initially Paid by Washington Businesses and Households
Washington Tax Structure Study Alternatives

	FLAT RATE PERSONAL INCOME TAXES ($MILLIONS)			
BUSINESSES	**Option A 2.6% Rate Reduce State RST**	**Option B 3.8% Rate Replace State Prop Tax, Reduce RST**	**Option C 5.5% Rate Replace State RST**	**Option D 6.7% Rate Replace State Prop Tax and State RST**
State Taxes Paid by Businesses				
Sales Tax	-$1,037	-$1,037	-$2,334	-$2,334
Property Tax	$0	-$654	$0	-$654
Federal Tax Savings / Loss				
Due to loss in deduction for state taxes as business expenses	$363	$592	$817	$1,046
Net Change in Taxes Initially Paid by Business	-$674	-$1,099	-$1,517	-$1,942
HOUSEHOLDS				
State Taxes Paid by Households				
Sales Tax	-$1,864	-$1,864	-$4,197	-$4,197
Property Tax	$0	-$919	$0	-$919
Personal Income Tax (includes non corp businesses)	$2,946	$4,490	$6,678	$8,222
Federal Tax Savings / Loss				
Due to deductibility of personal income tax	-$680	-$999	-$1,450	-$1,790
Due to loss in deductions for state property tax	$0	$129	$0	$129
Net Change in Taxes Initially Paid by Households	$402	$837	$1,031	$1,445
Net Tax Savings to WA Taxpayers	$272	$262	$486	$497

Table 7-7

Overall Net Taxes Initially Paid by Washington Businesses and Households
Washington Tax Structure Study Alternatives

	GRADUATED PERSONAL INCOME TAX OPTIONS ($MILLIONS)		
	Option A 1.0, 2.7, 4.5% Reduce RST	**Option B 2.2, 3.5, 6.0% Replace State Prop Tax, Reduce RST**	**Option C 2.7, 5.7, 8.7% Replace State RST**
BUSINESSES			
State Taxes Paid by Businesses			
Sales Tax	-$1,037	-$1,037	-$2,334
Property Tax	$0	-$654	$0
Federal Tax Savings / Loss			
Due to loss in deductions for state taxes as business expenses	$363	$592	$817
Net Change in Taxes Paid by WA Business	-$674	-$1,099	-$1,517
HOUSEHOLDS			
State Taxes Paid by Households			
Sales Tax	-$1,864	-$1,864	-$4,197
Property Tax	$0	-$919	$0
Personal Income Tax (including non corp. businesses)	$2,938	$4,511	$6,575
Federal Tax Savings / Loss			
Due to deductibility of personal income tax	-$725	-$1,046	-$1,542
Due to loss in deductions for state property tax	$0	$129	$0
Net Change in Taxes Paid by WA Households	$349	$811	$836
Net Tax Savings to WA Taxpayers	$325	$288	$681

Table 7-8

Net Change in Taxes Initially Paid by Average Households
Washington Tax Structure Study Alternatives

	Household Income				
	$25,000	**$50,000**	**$75,000**	**$100,000**	**$200,000**
FLAT RATE PERSONAL INCOME TAX OPTIONS					
A 2.6 % Personal Income Tax	-$97	$143	$358	$749	$1,922
Reduce state RST to 3.5%					
B 3.8% Personal Income Tax	-$133	$213	$592	$1,239	$3,142
Reduce state RST to 3.5% and replace state Property Tax					
C 5.5% Personal Income Tax	-$224	$269	$712	$1,526	$3,981
Replace state RST					
D 6.7% Personal Income Tax	-$260	$339	$947	$2,015	$5,202
Replace state RST and replace state Property Tax					
GRADUATED PERSONAL INCOME TAX OPTIONS					
A 1, 2.7, 4.5% Personal Income Tax	-$275	-$284	-$192	$415	$2,452
Reduce state RST to 3.5%					
B 2.2, 3.5, 6% Personal Income Tax	-$311	-$223	$11	$801	$3,616
Reduce state RST to 3.5% and replace state Property Tax					
C 2.7, 5.7, 8.7% Personal Income Tax	-$537	-$473	-$247	$919	$4,748
Replace state Retail Sales Tax					

Notes: The options change household taxes as follows: (1) Household taxes increase by personal income taxes and the reduction of federal tax savings due to elimination of the state property tax. (2) Household taxes decrease by retail sale tax and property tax reductions. They also decrease by federal tax saving due to the deduction of state personal income tax.

Chapter 8: Improving the Current Tax System – Incremental Alternatives

Introduction

This chapter focuses on maintaining the basics of the current tax system based on the business and occupation (B&O) tax, the retail sales tax, and a statewide school property tax. The chapter outlines several incremental alternatives, each of which is designed to address at least one of the problems of the current tax system. These alternatives are not packaged but stand alone. Some of them would increase revenue and others would decrease revenue. To maintain revenue neutrality, as outlined in the Committee charge, it would be necessary to either generate additional revenue from another source or reduce revenue from another source to offset the fiscal impacts. The chapter is organized into six problem areas—regressivity, adequacy, volatility, neutrality, economic vitality, and administrative simplicity.

Regressivity

An important finding about the Washington State tax system reported in Chapter 4 is that high-income households pay a lower percentage of taxes compared to other households. In other words, the current system is very regressive. Households with income greater than $150,000 pay 4.4 percent in taxes compared to those with income under $20,000, who pay 15.7 percent. A way to incrementally address the regressivity problem is to impose taxes on the highest income households.

One tax that falls mainly on high-income households is the estate tax. Under current law, for 2003 only, estates over $700,000 are required to file Washington State estate tax returns. Two-thirds of the taxable estates are over $1 million in value and account for 90 percent of the tax collections. In 2001, the United States Congress adopted the Economic Growth and Tax Reform and Reconciliation Act (EGTRRA). Among other changes, this act provided for a gradual repeal of the federal estate tax. If the state of Washington conforms with the federal repeal of the estate tax, the absence of this progressive tax will make Washington's tax system even more regressive at the upper end. By not repealing the estate tax, the state would maintain this element of progressivity.

Continue to impose an estate tax in the amounts of the state credit allowed under prior federal law

Description: Washington State did not conform its estate tax system to the federal changes made by the EGTRRA to the federal estate and generation skipping transfer tax programs. (During the 2002 session, Washington's Legislature did not vote to conform to the changes made by Congress.) This proposal would continue to impose Washington's existing estate tax in the amounts of the state credit allowed under federal law prior to the changes made by EGTRRA in 2001.

Current Tax Base: Washington's filing threshold for estate tax returns is $700,000, and Washington collects 100 percent of the state estate tax credit. The federal estate tax filing threshold is currently $1,000,000 and will only allow a credit of 75 percent of the state estate tax credit in 2002. This results in some estates having to file a Washington return but not having to file a federal estate tax return. All estates will have to pay the additional 25 percent of the state estate tax credit to Washington. (Washington's threshold will top out at $1,000,000 in 2006; the federal threshold will be $3,500,000 by 2009.)

Current Tax Rate: Washington's top marginal tax rate will remain at 55 percent for taxable estates over $3 million. The federal top marginal rate is currently 50 percent for taxable estates over $2.5 million (reduced to 45 percent by 2007).

Estimated Revenue Impact at the Current Rate: The estate tax (current law, no repeal) is forecast to yield the following:

FY 2003: $105.6 million
FY 2004: $111.0 million
FY 2005: $114.8 million

Problems Addressed:

Regressivity – This proposal prevents an increase in regressivity by maintaining an existing tax on high-income households.

Adequacy – This proposal would retain a part of the current tax base.

Problems Created:

Simplicity – This tax is not consistent with the ultimate repeal of the federal tax code. Not conforming makes it necessary for some taxpayers (all taxpayers after total federal repeal) to file estate tax returns in Washington.

Similar Programs in Other States: After the 2001 enactment of the EGTRRA and changes to the federal estate tax, many states have taken legislative action in response to the reductions and eventual repeal of the tax. As of October 2002, 25 states impose "pick up" taxes that conform to the changes in the federal Internal Revenue Code (IRC). Twenty-six states, including Washington, and the District of Columbia have laws that do not conform to the IRC.

A majority of the Committee recommends that the Legislature continue to impose an estate tax in the amounts of the state credit allowed under prior federal law.

Adequacy

A major problem that the Committee believes the state should address is adequacy. The analysis of the current tax system found two main sources of tax base erosion:

- Erosion of the sales and property tax base from changes in consumption patterns.
- Erosion from permanent tax changes instituted during good economic times either by the Legislature or by initiative.

Erosion of the tax base causes problems for long-term adequacy. Erosion also can cause inequities by giving exempt taxpayers, goods or services an unfair competitive advantage. Non-neutralities can also result from erosion as taxpayers have incentives to shift behavior from taxable to nontaxable activities or purchases. Furthermore, the taxpayers and goods and services that remain in the tax bases may be taxed at higher rates to compensate for erosion. This can exacerbate the inequities and non-neutralities.

It should be noted that because Washington does not have a personal income tax like most states, tax bases for existing taxes need to be broad compared to other states in order to keep rates from being inordinately high.

Erosion of the Tax Base Caused by Shifting Consumption Patterns

Since the adoption of the sales tax in 1935, consumption patterns have shifted more and more from tangible personal property to services. The shrinking base of tangible goods has been subject to increasingly higher sales tax rates. One way to address the shrinking sales tax base is to extend retail sales tax to consumer services.

Another source of erosion from shifting consumption patterns is remote sales. Over the past several years, remote sales have risen exponentially due to the rapid growth of the Internet. Although remote sales are subject to use tax, few individuals make use tax payments.

Property tax is also eroded by shifts in consumption. The alternative that addresses this revenue loss is to extend the watercraft excise tax, which is an excise tax in lieu of property tax, to the market value of motor homes and travel trailers that can be used as homes. Motor homes, travel trailers, and boats can be attractive substitutes for second homes and vacation houses. This alternative will offset the revenue loss due to erosion of the property tax base as consumption patterns shift from stationary vacation homes to mobile vacation homes.

Another alternative that would broaden the tax base is to extend the personal property tax to motor vehicles. The reasoning behind this alternative is that motor vehicles are significant assets that escape property taxation.

Erosion of the Tax Base Caused by Initiatives and Legislative Changes

One of the findings from the analysis of Washington's current system is that tax initiatives occur at least in part as a response to the upside of volatility. During good economic times, tax revenues grow faster than personal income. Because of this, there is a demand for reduced taxes, and those lowered tax rates can come back to haunt the general fund when the economy goes sour and tax revenues plummet. By shifting from general taxes to user fees, changes in revenues will become more closely tied to actual changes in the usage of government services. Taxpayers will more clearly see the connection between their user fees and their benefits received and can make individual choices about behavior that will result in fees.

Another alternative to address tax base erosion is to review and target business incentives and exemptions. In good economic times, the Legislature is able to invest in Washington's economy by providing business incentives and exemptions designed to bolster the economy. These exemptions become a permanent part of the tax system because exemptions and incentives are rarely repealed, even after they cease to be an effective means of stimulating the economy. The narrowing of the tax base caused by the accumulation of these exemptions puts more of a tax burden on non-exempt entities. This alternative proposes to periodically review exemptions and incentives with the intent of removing those that do not yield the promised benefits or those that have outlived their useful life. The broadening of the tax base would provide opportunities for the Legislature to provide new, more efficient exemptions.

Descriptions of the Alternatives Intended to Primarily Address Adequacy

Extend sales tax to consumer services

Description: There are hundreds of service activities that are not subject to sales tax. These services fall into the general categories of business services, financial services, medical services, and consumer services. A select set of services such as consumer services (e.g., beauty shops, amusement, recreation, and cable TV) could be made subject to the retail sales tax. This proposal would add selected consumer services to the definition of a retail sale, changing the business classification for those services from service to retail and lowering the B&O tax rate from 1.5 percent to 0.471 percent. Overall revenues would increase with the addition of the 6.5 percent state sales tax and local sales taxes on selected services. This proposal would require a statutory change.

Proposed Tax Base: Consumer services would be added to the retail sales tax base and to the retail B&O category.

Proposed Tax Rate: 6.5 percent state sales tax, appropriate local sales taxes. Retailing B&O at 0.471 percent.

Estimated Revenue Gains: $229.6 million in CY 2005

Problems Addressed:

Adequacy – This proposal would tax a significant and growing area of consumption that is not currently subject to retail sales tax.

Equity issues – Some untaxed consumer services are substitutes for some taxed goods. For example, video rentals are currently subject to retail sales tax, and movie theatre tickets are currently exempt from retail sales tax. Taxing consumer services would resolve these inequities.

Neutrality – The inequities mentioned above can encourage consumers to shift from taxed goods to untaxed services.

Problems Created:

Regressivity – Most consumption taxes, including a tax on services, are regressive because lower income households consume a larger portion of their incomes. However, a tax on these services is not as regressive as taxes on most goods. (See Table 8-1.)

Tax harmony – Few states tax consumer services.

Impact on Households:

Table 8-1

Sales Tax on Consumer Services as a Percentage of Household Income

Household Income	Tax as Percent of Income
0 - $20,000	0.5%
$20,000 - $30,000	0.3%
$30,000 - $40,000	0.3%
$40,000 - $50,000	0.3%
$50,000 - $60,000	0.2%
$60,000 - $70,000	0.2%
$70,000 - $80,000	0.2%
$80,000 - $100,000	0.1%
$100,000 - $130,000	0.2%
Over $130,000	0.3%

Similar Programs in Other States: No state taxes more personal services than Washington currently does. Under this proposal, Washington would tax even more personal services than all other states.

A majority of the Committee recommends that the Legislature extend the retail sales tax to consumer services.

Streamlined sales tax

Description: Washington, 33 other states, and the District of Columbia have enacted legislation allowing for their participation in the development of a modernized sales tax system, called the Streamlined Sales Tax Project. The purpose of this project is to develop a simpler, more uniform, and technologically advanced system for the administration of sales taxes. Changes in the retail economy and technology advancements have made modernization of the sales tax system a priority for both retailers and tax administrators.

The Committee proposes that Washington join with other states in enacting legislation conforming to the Streamlined Sales Tax Project. This legislation will modernize the sales tax system for the twenty-first century. Achieving this goal will substantially reduce the burden on sellers of complying with sales tax collection, particularly those operating on a multistate basis. The project reached an agreement on some initial streamlining details on November 12, 2002, and states are expected to

submit the first round of implementing legislation during their next legislative sessions.

Uniform legislation in Washington would include common definitions and simplified administration provisions.

Proposed Tax Base: The new definitions will result in some changes to the tax base, although it is expected that overall collections will remain substantially the same.

Proposed Tax Rate: Not applicable.

Estimated Collections: Not applicable.

Problems Addressed (assuming that this alternative would lead to collection of sales tax on remote sales):

Erosion of the tax base – Remote sales are increasing at the expense of store sales. If this proposal leads to collection of retail sales tax on remote sales, it will eliminate a significant source of erosion.

Other equity issues – Store-based retailers and remote sellers that also have store sales are obligated to collect retail sales tax from consumers. Pure remote sellers with no nexus are not obligated to collect retail sales tax. By obligating pure remote sellers to collect retail sales tax, this inequity would be eliminated.

Neutrality – Some people shop on the Internet to avoid sales tax. Collection of sales tax would end this non-neutrality.

Economic vitality – The obligation for all sellers to collect retail sales tax would improve the competitive position of retailers with a physical presence in Washington.

Simplicity – Uniformity would make collection of sales tax much simpler for multistate retailers.

Tax harmony – Washington's sales tax definitions would be the same as other states.

Problems Created: Washington State could lose some degree of tax autonomy.

Similar Programs in Other States: Washington, along with 33 other states, and the District of Columbia, have enacted legislation allowing for participation in the development of a modernized and consistent sales tax system.

A majority of the Committee recommends that Washington join with other states in enacting uniform legislation that will modernize the sales tax system for the twenty-first century.

Extend the existing 0.5 percent watercraft excise tax to motor homes and travel trailers. Consider increasing the 0.5 percent rate to 1 percent on all three types of property.

Description: Currently there is an annual watercraft excise tax of 0.5 percent on most non-commercial boats over 16 feet in length based on the fair market value. Travel trailers and motor homes are subject a statewide annual license fee of $30 and may be subject to local motor vehicle excise taxes in some jurisdictions.

This proposal would extend the 0.5 percent watercraft excise tax rate to motor homes and travel trailers in addition to boats. Policy makers should consider raising the rate to 1 percent.

Proposed Tax Base: Market value of motor homes, travel trailers, and boats.

Proposed Tax Rate: 0.5 percent or 1 percent.

Estimated Revenue Gains: CY 2005

- Add motor homes/travel trailers, rate remains 0.5 percent: $16.8 million additional
- Add motor homes/travel trailers, increase rate to 1 percent:
  Watercraft: $13.9 million additional
  Motor homes/travel trailers: $33.6 million additional

Problems Addressed:

Adequacy – Motor homes, travel trailers, and boats are sources of leakage from the tax base. Many are used as substitutes for vacation homes, which are taxed.

Regressivity – Upper income households spend more on average on motor vehicles, travel trailers, and boats as a percentage of income.

Other equity issues – This alternative would treat motor homes, travel trailers, and boats like other vacation homes.

Stability – Would increase the relative reliance on excise taxes in lieu of property taxes, which, like other taxes on property, tend to be more stable.

Transparency – The method of collecting the tax would increase transparency (visibility) in the Washington tax system.

Exportability – Would increase the relative reliance on "excise taxes in lieu of property taxes." These kinds of taxes are exportable to the federal government for individuals who itemize on their personal income tax returns.

Problems Created:

Simplicity – It may be difficult to maintain depreciation schedules.

Similar Programs in Other States:

Motor homes – A survey was performed of taxes in seven other western states. Of these states, Arizona, Nevada, Utah, Idaho, and California base the tax on fair market value. Oregon's tax is based on the length of the motor home or travel trailer. Montana charges a flat fee of $21.75 for motor homes and $11.75 for travel trailers.

Boats – Tax in Arizona, Oregon, Idaho, and Montana is based on the length of the boat. Tax in Utah is based on fair market value. Nevada and California charge annual fees.

A majority of the Committee recommends that the Legislature expand the watercraft excise tax base to include motor homes and travel trailers and consider increasing the tax rate to 1 percent.

Impose an in lieu of property tax on the market value of motor vehicles

Description: Under this proposal, motor vehicles would be taxed in a similar manner to other personal property. The Department of Revenue would provide schedules for valuing vehicles at 100 percent of market value. Details on how tax would be assessed and collected are yet to be determined.

Before 2000, the state levied an annual excise tax of 2.2 percent on each motor vehicle based on the manufacturer's suggested retail price. The depreciation schedule reduced the taxable value down to 10 percent of the original price in the thirteenth year. A voter initiative to repeal the tax was subsequently declared unconstitutional, but the Legislature eliminated the state tax effective January 2000.

Proposed Tax Base: Market value of motor vehicles designed for highway use.

Proposed Tax Rate: 1 percent.

Estimated Revenue Gains: CY 2005: $400 million

Problems Addressed:

Adequacy – Motor vehicles are significant assets that are not taxed.

Stability – Would increase the relative reliance on property tax, which is the most stable tax base.

Transparency – Would increase the relative reliance on property tax, which is a transparent tax.

Exportability – Would increase the relative reliance on property tax, which is exportable to the federal government for individuals who itemize on their personal income tax returns.

Problems Created:

Simplicity – It would be difficult for assessors to assess value. A statewide tax assessment and collection mechanism might need to be developed.

Tax harmony with other states – Most states impose an annual value-based tax on vehicles. Delaware, New Hampshire, North Dakota, South Dakota, Tennessee, Vermont, and West Virginia are among states that do not tax vehicles in such a manner. There are other states that tax on the basis of market value. Washington would not be unique. Oregon, however, does not impose such a tax on motor vehicles. This tax would therefore offer incentives for Washingtonians to register their cars in Oregon.

Impact on Households:

Table 8-2 provides the impact by income category of a motor vehicle tax based on the income category of the taxpayer.

Table 8-2

Tax on Market Value of Vehicles as Percentage of Income
(Based on 1998 Data)

Income Category	Tax as Percent of Income
Less than $10,000	0.7%
$10,000 - $25,000	0.3%
$25,000 - $50,000	0.3%
$50,000 - $100,000	0.2%
Over $100,000	0.1%

Similar Programs in Other States: According to a report published in 1998 by the National Conference of State Legislatures (NCSL), 20 states have no state or local property or value-based taxes on motor vehicles, 12 states have local property taxes at rates set by local jurisdictions, 16 states have state or local value-based taxes in lieu of property taxes at statewide rates, and 3 states have other local option taxes. (Note: The above figures add to 51 states; the NCSL counted the District of Columbia as a "state.")

While not favored by the majority of the Committee, it was agreed that the alternative to impose a 1 percent personal property tax on the market value of motor vehicles was appropriate for consideration.

Replace taxes on "private goods" with user fees

Description: Taxes and user fees are different. Taxes are compulsory payments to fund public services, and by definition there is not any necessary connection between those who pay taxes and those who receive services. User fees are charges paid directly by those who receive specific goods or services from government or by those whose activities burden the public.

User fees often make sense, given the public's increased concern about the level of taxes and the feeling that it is more fair to allocate costs to consumers when users can be readily identified. At the same time, the most important public goods, like schools and libraries, should remain as public goods financed by taxes.

The state should consider shifting a greater share—perhaps the entire share—of all highway and roads costs to motor vehicle users. This could be accomplished by higher gas taxes, tolls, and congestion pricing, or by fees that have an even closer relationship to impacts on our roads, such as weight-and-mileage charges. It would permit a reduction in the property tax. If motor vehicle user fees and taxes covered more of the cost of city and county roads, local property taxes could be reduced and/or shifted to other purposes. User fees can also be effective in allocating costs of environmental protection and clean-up directly to the activities that harm the public's natural resources.

Estimated Collections: Revenue neutral.

Problems Addressed:

Adequacy – User fees are more closely tied to government usage. Taxpayers will see more clearly the connection between user fees and benefits received, making citizens less likely to decrease growth in government via initiatives.

Other equity issues – Would shift taxes to those who receive the benefits.

Problems Created:

Simplicity – Some user fees are more difficult to administer than general taxes.

While not favored by the majority of the Committee, it was agreed that the alternative to replace taxes on private goods with user fees was appropriate for consideration.

Review exemptions and business incentives

Description: Several existing tax exemptions are necessary to comply with our federal and state constitutions and federal law. Other exemptions have been enacted by the Legislature or by voter initiative to define the tax base, encourage public service activities, improve the business climate, and improve tax administration. Once an exemption is enacted it is rarely repealed by legislative action, even though the reasoning or circumstances for original enactment may no longer be present.

Exemptions narrow the tax base and tend to make the structure more volatile. In particular, property tax exemptions result in increased taxes to the remaining taxable property. Excise tax exemptions can also result in tax shifts, to the extent taxing districts are able to increase rates.

The Legislature should consider establishing a schedule for a periodic review of all tax exemptions, grouped by purpose or function, to ensure that these exemptions continue to serve the public purposes for which they were enacted. The Legislature should also implement a sunset review of each new tax exemption prior to permanent enactment. A sunset review period could be between six and ten years.

Proposed Tax Base: Not applicable.

Proposed Tax Rate: Not applicable.

Problems Addressed:

Adequacy **–** This would give a mechanism to remove exemptions that either do not yield promised benefits or have outlived their useful life.

Economic vitality – Exemptions that outlive their purpose are rarely repealed. The accumulation of outdated exemptions can make it difficult for the Legislature to pass new, more efficient exemptions and incentives. This alternative will minimize the accumulation of outdated exemptions.

Problems Created: None.

A majority of the Committee recommends that the Legislature review exemptions and business incentives for economic or social goals every ten years.

Volatility

Analysis of the current tax system found that our tax system is very volatile. In good economic times, tax revenues increase more than personal income. In economic downturns, tax revenues decrease more than personal income.

Description of the Alternative Intended to Primarily Address Volatility

Create a constitutionally mandated rainy day fund

Description: One of the most effective ways of dealing with cyclical crises in state revenue could be a constitutionally mandated "rainy day fund." Although the Committee was charged with evaluating Washington's tax structure and recommending potential alternatives, a rainy day fund can help reduce the need for large cuts in state government spending during economic down times and reduce the need for tax increases when revenues decrease. Just as with a family budget, savings during high revenue periods can help offset problems when income decreases precipitously.

Rainy day funds are common nationwide. The vast majority of states, including Washington, have some form of fund for stabilizing the ups and downs in the health of the state's economy. Washington State has enacted statutes establishing various kinds of rainy day funds, including the mechanism in Initiative 601 that is meant to both dampen the growth of spending and provide some reserves.

Statutory rainy day funds have a major weakness: when times are good and revenue is strong, it is difficult for legislators to forego new spending initiatives. There is constant pressure on lawmakers to increase funding for worthy programs and to initiate new services to the public.

Similarly, when the economy takes a downturn, legislators find it difficult to maintain reserves until they are truly needed. Often, when state revenue becomes dangerously low, reserves have already been spent and taxes have not been increased sufficiently to provide the needed revenue. Then, legislators are forced to slash popular programs.

The potential approach outlined here is simple: a constitutional amendment would be adopted that would mandate a rainy day fund. Because the fund would be entrenched in the Constitution, in good times lawmakers would be required to annually add to the fund in an amount determined by a measure of the state's economy or the state government's income. These measures, or "triggers," could be the recent growth or decline of personal income, or forecast growth or decline in personal income, or the recent or forecast performance of state general revenues. These triggers operate somewhat differently, but the key is having a measure that is determined independently of the Legislature and is therefore free from political pressure. Any trigger that uses forecasting would depend upon estimates made by a state forecast

council whose independence would be protected by the requirement that its members be confirmed by a 60 percent vote of the State Senate.

During bad times, money would automatically be discharged from the rainy day fund into the general fund. The provision would also allow the Legislature to voluntarily add to the fund any time it chose and withdraw any amount from the fund at any time upon the affirmative vote of 60 percent of each house.

In the sample constitutional amendment in Appendix D, the term "good times" is defined as when the estimated growth of general state revenues for a fiscal year (adjusted for inflation) is more than a specified percentage, such as 1 percent or 3 percent. "Bad times" in the sample is defined as a year in which the estimated growth of general state revenues is less than zero.

Recognizing long-term changes in economic conditions and growth rates, the Legislature should be permitted, by a 60 percent vote of each house, to adjust the "trigger" points for depositing money into the rainy day fund, within fairly tight ranges.

If the balance in the fund reaches more than a specified level (e.g., 5 percent or 10 percent of estimated general state revenues in a fiscal year), a majority vote of the Legislature should be permitted to appropriate the surplus in the following fiscal year's budget.

A constitutional amendment should provide for a delay of implementation to allow the state to ramp up compliance with the mandatory savings provision.

One possible drawback of a constitutional rainy day fund is that it could force the deposit of surplus revenues when it is apparent that "good times" have already begun to turn. Furthermore, a constitutionally entrenched provision may not keep up with fundamental changes in the economy. In addition, the bond market and rating agencies may view a forced savings plan negatively because it could withdraw available funds when truly needed—this could increase the state's borrowing costs.

Some observers are concerned that a rainy day fund would be misunderstood by the public to be a budget surplus. This misunderstanding could lead to pressure on the Legislature or initiatives to reduce taxes and force a premature draw on the rainy day fund when state economic performance has not warranted a withdrawal. One way to prevent such a draw would be to use triggers based purely on economic performance (such as state personal income) rather than triggers based on general state revenues, which can be manipulated by the Legislature or by the public through the initiative process.

A draft of a possible constitutional amendment is set forth in Appendix D, together with additional materials on rainy day funds nationally. Also provided is a demonstration of how such a fund would have performed in Washington State if it had been in effect since 1989.

Problems Addressed:

Volatility – The rainy day fund would set aside revenues in the years that revenue growth exceeds income growth to use in years when revenues decrease more than personal income. This alternative addresses volatility of the current tax system and also the volatility in any replacement tax system that may be enacted.

Adequacy – Creation of a rainy day fund would help prevent permanent decreases in the tax base due to legislation or initiatives in good economic years.

Problems Created: None

A majority of the Committee recommends that a constitutionally mandated rainy day fund be created with objective criteria for deposits, maximum required balance, and withdrawals.

Neutrality

The analysis of the current tax system demonstrated that non-neutralities can be caused by pyramiding of the B&O tax. Analysis shows that the B&O tax pyramids 2.5 times on average. However, the pyramiding varies considerably between industries. B&O for many services pyramids about 1.5 times. B&O for some types of manufacturers pyramids over five or six times.

Although differing B&O rates ameliorate the differences in pyramiding somewhat, pyramiding still causes the effective B&O rate on value added to be much greater in some industries compared to others. Preliminary studies show the rate varies from less than 1 percent for trade and some services, to over 3 percent for some types of manufacturing (see page 106 in Chapter 9 for more details about pyramiding).

Since value added is the fundamental measure of economic activity, the difference in effective B&O rates on value added indicate non-neutralities and inequities between industries. The pyramiding also gives firms an incentive to vertically integrate because firms that vertically integrate are able to escape the pyramiding of the B&O tax.

One alternative to address the pyramiding of the B&O tax allows partial credits for B&O tax paid "upstream." For example, a credit against the manufacturing line could be taken for any B&O paid on components.

Description of the Alternative Intended to Primarily Address Neutrality

Allow partial credits for B&O tax paid "upstream"

Description: Conduct further study to identify B&O taxable activities that pay a relatively high effective B&O rate on value added. For these targeted activities, allow a partial credit for the B&O tax paid on inputs in order to lower the effective rate.

Problems Addressed:

Neutrality – Would decrease non-neutralities by reducing pyramiding in industries that currently have a high degree of pyramiding.

Economic vitality – Would increase the competitive advantage of Washington firms by lowering the B&O tax for some industries.

Problems Created:

Adequacy – Would decrease B&O tax collections.

Simplicity – Additional record-keeping would be required of firms taking the partial credit in order to keep track of B&O tax paid on upstream purchases.

While not favored by the majority of the Committee, it was agreed that the alternative to allow partial credits for B&O tax paid "upstream" was appropriate for consideration.

Economic Vitality

Analysis of the current tax system found three problems with economic vitality that should be addressed.

- Washington State's tax system differs considerably from other states' tax systems.
- For most types of businesses, total tax burden in Oregon is less than in Washington.
- Washington's tax system is burdensome to businesses in their unprofitable years, such as when they are expanding.

The alternative to exempt construction labor from retail sales tax addresses each of these problems. Washington is one of only seven states that imposes sales taxes on construction labor. Exempting labor construction from sales tax would make our treatment of construction activity consistent with other states, including Oregon.

Construction costs can be a large component of expansion costs. Exempting construction labor would considerably decrease the cost of this type of expansion.

The alternative to increase the B&O credit from $35 to $70 provides tax relief for some new businesses.

Descriptions of the Alternatives Intended to Primarily Address Economic Vitality

Exempt construction labor from sales tax

Description: Washington is one of only a few states that impose sales tax on the labor portion of a construction contract. Currently, the retail sales tax is imposed on the entire contract price for a custom-built home, including labor, materials, and other overhead.

This proposal would provide an exemption for that portion of the contract attributable to labor. Contractors would separately account for labor and overhead by separate invoices or some other mechanism. Sales tax would only apply to the overhead and materials portion of each contract.

Proposed Tax Base: Sales tax would only apply to overhead, materials, and other non-labor costs for construction contracts.

Proposed Tax Rate: 6.5 percent state sales tax, appropriate local sales taxes.

Estimated Revenue Loss: CY 2005: $400 million

Problems Addressed:

Economic vitality – Exempting construction labor would make our treatment of construction consistent with other states, including Oregon.

Regressivity – Exempting construction labor on home construction would lower the price of building new homes. Higher income households spend a smaller percentage of their income on homes.

Home ownership – This proposal covers both commercial and residential construction. Decreasing the cost of building homes could encourage home ownership.

Volatility – This would decrease the tax on a very volatile portion of the economy.

Tax harmony with other states – Washington would be consistent in taxation of construction compared to most other states.

Simplicity – Exempting construction labor from retail sales tax could allow contractors to pay sales tax on materials at the time of purchase instead of at the end of the project. This would help both retailers and contractors by eliminating the need for resale certificates and complex record-keeping.

Problems Created:

Adequacy – One of the reasons that Washington's sales tax base is broader than other states is because of the high reliance on sales tax. This alternative would significantly decrease the sales tax base. If implemented, alternative revenues would have to be provided.

Other States with Similar Programs: As of 1994, only seven states including Washington taxed labor construction. These states are Arizona, Hawaii, Kansas, Mississippi, New Mexico, South Dakota and Washington.

A majority of the Committee recommends that the Legislature exempt construction labor from retail sales tax if the exemption is revenue neutral (i.e. the loss of revenue is offset by another source of revenue).

Increase the B&O tax credit from $35 to $70

Description: Currently, small businesses are entitled to a credit against their B&O tax. The maximum credit available is $35 per month. The credit is phased out for larger businesses; as a business' tax liability increases beyond $35 per month, the

available tax credit is reduced in $5 increments until it is phased out completely. Taxpayers in all business classifications are entitled to this credit. Service businesses that have gross receipts below $28,000 per year have no tax liability. The threshold for B&O tax liability for retailers is $89,000 per year in gross receipts.

This proposal has two parts which would increase the credit amount currently available to small businesses.

The small business tax credit would be increased to $70 per month. The threshold for requiring filing of tax returns with the Department would be increased correspondingly to $56,000 for service businesses and $178,000 for retailers. This proposal would require a statutory change.

Proposed Tax Base: The B&O tax base would remain the same.

Proposed Tax Rate: The B&O tax rates would remain the same.

Estimated Collections: $28 million reduction in revenue.

Problems Addressed:

Economic vitality – Analysis shows that new firms and expanding firms have relatively high tax burdens. To the extent that small firms are new firms, this alternative would address the relatively high tax burden for some new firms.

Problems Created:

Equity – Not all small firms are new firms. Therefore, this alternative gives the firms that qualify a competitive advantage compared to larger firms that do not qualify for the credit. Some of the larger firms may have relatively high tax burdens because they are new or expanding.

Adequacy – Decreases tax revenues.

A majority of the Committee recommends that the Legislature increase the B&O tax credit from $35 to $70 and adjust periodically for inflation.

Administrative Simplicity

The Legislature directed the Committee to be guided by administrative simplicity in developing alternatives. Analysis shows that certain areas of Washington's tax system are complex for both taxpayers and the Department of Revenue to administer. The following proposals advance the principle of administrative simplicity and address issues relating to economic vitality.

Descriptions of the Alternatives Intended to Primarily Address Administrative Simplicity

Simplify local B&O tax

Description: Cities (but not counties) are authorized to impose a variety of fees and taxes on the privilege of doing business. Cities have considerable freedom to define the nature of the activities subject to the tax. Thirty-seven Washington cities impose local B&O taxes, which are paid by businesses directly to each of the local governments. However, there is no statutory requirement of uniformity in definitions or classifications of business activities either between cities or with the state B&O tax. Another area that lacks uniform treatment is the apportionment of income from activities that are performed in more than one jurisdiction. In recent years the business community has been increasingly vocal about their concerns of the negative effect of local B&O tax laws on the business climate, citing uniformity and simplicity as major issues. Local governments, in turn, cite concerns about local control over revenue sources.

There have been multiple efforts to develop solutions to these issues. The Association of Washington Cities and five major cities (Seattle, Tacoma, Everett, Bellevue, and Bellingham) developed a model B&O tax ordinance that cities may voluntarily adopt. Several cities have begun the process of adopting the model B&O ordinance. The Association of Washington Businesses and other business representatives have also developed proposals and submitted legislation that would go beyond the provisions of the model ordinance.

The Committee recognizes the areas of dispute and concern for local governments and business groups and the overarching goal of administrative simplicity inherent in this issue. In this proposal the Committee supports and encourages the ongoing work of the cities, business representatives, and legislators who have committed their time and effort to developing a solution to the above-mentioned issues.

Proposed Tax Base: Depending on which proposal is eventually implemented by cities or the Legislature, there could be substantial changes in local B&O tax bases for cities that currently impose a B&O tax.

Proposed Tax Rate: Not applicable.

Estimated Revenue Impacts: Cities currently collect $200 million in local B&O tax. Depending on which proposal is implemented, there could be substantial revenue shifts or losses for cities that currently impose these taxes.

Problems Addressed:

Neutrality – Neutrality could be improved if the ongoing work of stakeholders on this proposal results in more uniform taxation of businesses and addresses their concern about multiple taxation.

Economic vitality – There is also the potential for a positive effect on economic vitality for businesses operating in more than one jurisdiction.

Problems Created: None.

A majority of the Committee supports the ongoing efforts to simplify the local B&O tax.

Compensate retailers for collecting the sales tax

Description: This proposal would allow vendors to retain a portion of the retail sales tax collected as payment for collecting and remitting the retail sales tax to the state.

Currently, retailers collect and remit state and local sales taxes to the state, acting essentially as agents of the state. Washington does not provide compensation for these collection activities. More than half of other states (26 of the 45 states with a state sales tax) do provide such compensation.

This proposal would allow retailers to retain a percentage of the retail sales tax collected. Retailers would be able to retain up to 1 percent of collected retail sales tax. While not reducing the complexity of the system, it would give retailers more resources to administer it.

Proposed Tax Base: The retail sales tax base would remain the same, except the overall amount collected for the state general fund would be reduced by the amount of the retailer compensation.

Proposed Tax Rate: The retail sales tax rate would remain the same.

Estimated Revenue Loss: CY 2005: $113.9 million reduction in state retail sales tax collections.

Problems Addressed: This proposal would have a moderately positive effect on economic vitality since retailers would be able to cover the costs of collecting and remitting the retail sales tax .

Problems Created:

Adequacy – Although this proposal does not impact the tax base, it does decrease revenues.

While not favored by the majority of the Committee, it was agreed that the alternative to compensate retailers for collecting the sales tax was appropriate for consideration if there was an upper limit established for the amount of compensation.

Avoid or reduce dedicated taxes, except "user fees"

Description: Dedicated taxes are taxes where a portion or all of the future receipts are dedicated for a specific purpose. Dedicated taxes in Washington fall into three groups:

(1) Small taxes that fund regulatory programs and which are paid by those regulated.

(2) Taxes that closely resemble user fees because the taxes pay for services used by those who pay the tax (i.e. gas tax).

(3) Taxes that are earmarked to make them more acceptable to the public. For example, in November 2001 the voters passed Initiative 773, which added a 60-cent tax on each pack of cigarettes to fund health care programs.

Dedicating taxes restricts the Legislature's ability to meet changes in the public need for services. Dedicated taxes often have a narrow base, and sometimes declining funding sources make programs funded by dedicated taxes vulnerable.

The Committee recommends that, as a general practice, dedicated taxes be avoided. Taxes should not be dedicated to make them more acceptable to the public. Dedicated taxes are appropriately used when they are, in effect, user fees paid by those who are being regulated or paid by those who directly benefit from the programs or facilities funded. Specific programs should not be funded by dedicated taxes where there is little or no relationship between the programs and the taxpayers who pay for them.

Estimated Revenue Impact: Revenue neutral.

Problems Addressed:

Simplicity – This proposal would have a positive effect on administrative simplicity because dedicated taxes are generally more complex and costly to administer than larger, general fund taxes. Taxes that are costly for the Department of Revenue to collect are also more costly and complex for taxpayers.

Problems Created: None.

A majority of the Committee recommends that dedicated taxes be avoided or reduced except for "user" fees.

Committee member Representative Jack Cairnes proposed a set of incremental alternatives, which are as follows:

Goal	***Option***	***Fiscal Impact***
1. Be taxpayer friendly to businesses and households	• Municipal tax fairness/B&O apportionment. • Petition Congress to allow the deduction of sales tax from the federal tax return. • Reduce the regulatory burden on our businesses. • Fully conform with the federal estate tax repeal.	FY 2003: -$25.3 million FY 2004: -$51.8 million FY 2005: -$76.6 million
2. Promote home ownership	• Have growth management impact fees paid at the time of closing by the buyer.	Revenue neutral
3. Support education	• Provide additional funding through cutting timber off state land for schools.	*Increase DNR Harvest by: 10% = $8.7 million 20% = $17.4 million
4. Local tax simplification for the trucking industry	• Have the state collect local B&O tax for trucking industry and redistribute to cities. Have one rate and one set of tax rules for the local B&O for trucking companies. Problem: Currently, there are 37 cities that impose the local B&O tax. The tax rates and rules vary among jurisdictions. The trucking industry operates in all the jurisdictions in the state, and one rate and one set of tax rules would greatly simplify their compliance.	To be determined
5. Rainy day fund	• Develop a meaningful trigger to put money in and take money out of the rainy day fund.	Revenue neutral

*The dollar amounts include revenues from the timber sales that are earmarked for the school and university trusts and the state timber excise tax. Currently the state timber excise tax is deposited in the state general fund. This analysis assumes that the state timber excise tax from these sales is made available for education.

Chapter 9: Methodology and Detailed Conclusions

Equity

A good tax system should distribute the burden of taxation across taxpayers in a way that is considered fair and equitable. Fairness is defined by the relationship between the ability of a taxpayer to pay the tax and the benefits received by them from government activities and programs. The Committee examined several different types of equity issues with relation to tax fairness:

- Ability to Pay
- Benefits Received
- Horizontal Equity
- Intersectoral/Vertical Equity
- Perceived Equity
- Externalities

Conclusions

Ability to Pay

- Washington's tax system is regressive. The lowest income group ($20,000 or less) pays 15.7 percent of income for total excise taxes and property taxes. The highest income group pays 4.4 percent of income for the same taxes.

- Deductibility of taxes causes the tax system to be more regressive.

- When considering lifetime tax burden, Washington's tax system would still be regressive.

Horizontal Equity

- There is significant variation in tax as a percentage of income within income groups. Most of the variation in tax is caused by the sales tax. Sales tax varies considerably within income ranges because spending patterns vary. One factor that causes different spending patterns may be that within a given income group, households may have different expectations of permanent income (or long-term income). Another cause is that household size varies within the income groups.

- There is significant variation in taxes on business as a percent of gross income within industry groups. Property tax causes the most variation.

Intersectoral/Vertical Equity

- Overall, for excise and property taxes measured by initial incidence (who initially pays the tax), households pay 54 percent of the taxes and 46 percent is paid by businesses. According to the Utah Tax Commission Study, Washington has a much higher share of taxes paid by businesses than other Western states.

- Variation in total effective tax rates ranges from 1 percent for agriculture and wholesale to slightly over 2 percent for transportation, communication and utilities.

- Generally new businesses pay a higher effective tax rate than established businesses.

- Some significant activities are not subject to taxation in Washington State.

Perceived Equity

- Most business taxpayers do not perceive that Washington State's tax system has a negative effect on their ability to conduct business.

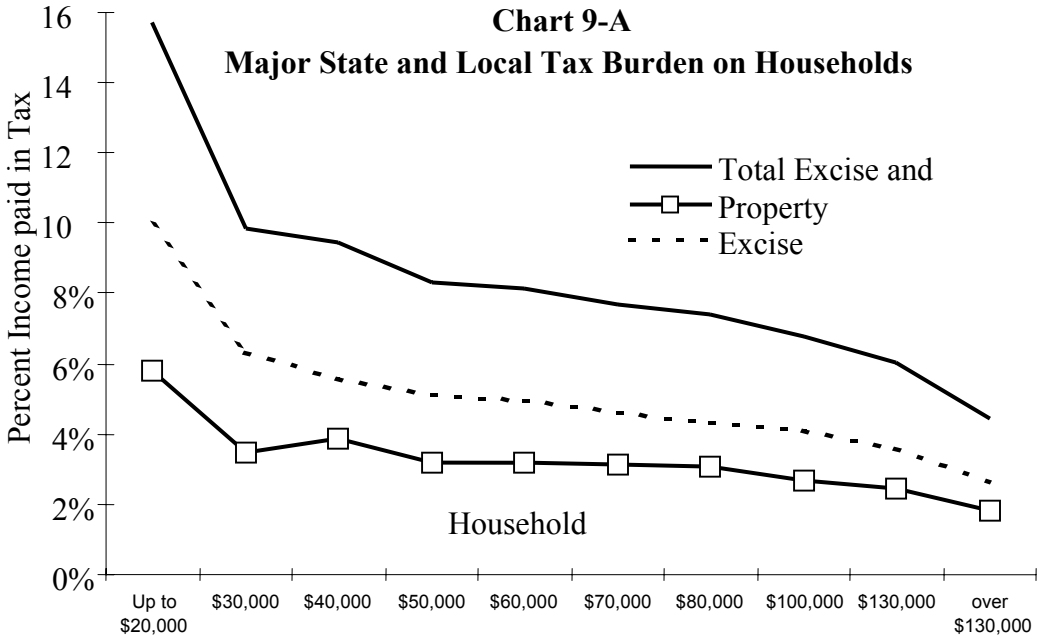
- Surveys show that taxpayers consider the retail sales tax to be the most fair in terms of treating taxpayers equally.

Ability to Pay

The equity principle requires that ability to pay be one factor in determining tax burden. Therefore, a high tax burden should not fall on low-income households. Similarly, high-income households should pay a larger percentage of their income in taxes. Washington's tax system is regressive.

Household Incidence of Excise Taxes

Chart 9-A illustrates the regressive nature typical of excise taxes, where lower income groups pay a higher percentage of their income in taxes (15.7 percent) than higher income groups do (4.4 percent). The sales tax has a relatively flat incidence for the middle-income households and is regressive for households at the high- and low-income ranges. Tobacco taxes are the most regressive. Note that the lowest income category (up to $20,000 in income) is composed of an eclectic group of households, some of which can skew the results for this category. For example, the under $20,000 category includes students who may have unreported financial support from parents, unemployed workers who are only temporarily poor, and households with assets but little income.



Source: Washington Excise and Property Tax Microsimulation

Table 9-1 shows percentages of income paid on excise and property taxes. Table 9-2 illustrates the same data using average dollars rather than percentages. Property taxes on rental housing are included in taxes paid by renters. The source of the information is the Washington Excise and Property Tax Microsimulation model which combines information from the Consumer Expenditure Survey and the Washington State Population Survey to estimate Washington household excise and property taxes by income group, household size, home tenure, and total spending. The model is used elsewhere in the study to illustrate the effects of alternatives on households.

Equity and Federal Deductibility of Washington State Taxes

Households export part of the cost of taxes by taking itemized deductions on their federal income tax returns. However, less than one-third of Washington households itemize deductions.

For Tax Year 1999, Washington households realized an estimated $520 million (0.4 percent of their adjusted gross income (AGI)) in federal income tax savings by claiming state and local property taxes as an itemized deduction. Over three-fourths of these savings went to households with AGI greater than $60,000. The 1986 Federal Tax Reform Act eliminated the deductibility of sales tax paid. If the full value of sales tax paid had been allowed as a federal income tax deduction for 1999, Washington households would have realized an additional estimated $523 million in tax savings. The majority of these savings would have accrued to higher income households.

Table 9-1

State and Local Excise and Property Tax
As Percent of Income
1999 Household Income Levels

	Retail Sales Tax	Other Excise Taxes*	Property Tax	Total Excise and Property Tax
Up to $20,000	6.7%	3.2%	5.8%	15.7%
$20,000 to $30,000	4.4%	1.9%	3.5%	9.8%
$30,000 to $40,000	4.0%	1.6%	3.9%	9.4%
$40,000 to $50,000	3.7%	1.4%	3.2%	8.3%
$50,000 to $60,000	3.7%	1.3%	3.2%	8.2%
$60,000 to $70,000	3.5%	1.2%	3.1%	7.7%
$70,000 to $80,000	3.3%	1.0%	3.1%	7.4%
$80,000 to $100,000	3.2%	0.9%	2.7%	6.8%
$100,000 to $130,000	2.9%	0.7%	2.5%	6.0%
Over $130,000	2.2%	0.4%	1.8%	4.4%

*Other excise taxes include alcoholic beverages tax, cigarette and tobacco tax, insurance premiums tax, public utility taxes, and gasoline tax.

Table 9-2

State and Local Excise and Property Tax
1999 Household Income Levels

	Average Income	Retail Sales Tax	Other Excise Taxes*	Property Tax	Total Tax
Up to $20,000	$11,689	$785	$372	$680	$1,837
$20,000 to $30,000	24,448	1,084	467	851	2,402
$30,000 to $40,000	34,096	1,355	545	1,317	3,217
$40,000 to $50,000	44,358	1,641	637	1,422	3,700
$50,000 to $60,000	53,791	1,975	688	1,730	4,393
$60,000 to $70,000	63,992	2,208	738	1,990	4,936
$70,000 to $80,000	74,000	2,454	766	2,257	5,477
$80,000 to $100,000	87,887	2,780	799	2,368	5,947
$100,000 to $130,000	112,086	3,244	754	2,771	6,769
Over $130,000	$206,840	$4,593	$834	$3,771	$9,198

*Other excise taxes include alcoholic beverages tax, cigarette and tobacco tax, insurance premiums tax, public utility taxes, and gasoline tax.

Distribution of Tax Burdens Based on Lifetime Income

Another way to analyze the equity of household burdens is to examine the tax burdens that a household incurs over a lifetime. The reason to examine lifetime tax burdens is that all households go through different income and spending phases, so that they may face proportionately higher tax burdens in some years and proportionately lower tax burdens other years. For example, a household can face proportionately high taxes in the years the members are college students, since they would be spending all of their income and going into debt. The same household in years before retirement can be enjoying a proportionately low tax burden because their members are in their high-earning years and are saving in anticipation of retirement.

The study, *Who Bears the Lifetime Tax Burden*, by Don Fullerton and Diane Lim Rogers, Brookings Institution, Washington D.C., 1993, found that when comparing lifetime income groups, both income distribution and tax burden are more equal than when comparing annual income groups. This is because many of the variations in annual incomes are caused by life-cycle changes in income. However, the study showed that despite some equalization, sales taxes and payroll taxes are lifetime regressive. Property taxes are lifetime progressive for property owners and lifetime regressive for renters. Federal income tax is lifetime proportional across middle-income groups and lifetime progressive at the very bottom and top of the income distribution.

Benefits Received

Another equity principle guiding tax policy is that to the extent possible, taxes should be tied to the benefits that households and businesses receive. Washington State has a higher percentage than the average state of total tax revenue generated by dedicated taxes. To some extent, dedicated taxes are tied to benefits received.

In Washington, large sources for dedicated taxes are motor fuels; cigarettes; insurance premiums taxes; and environmental taxes such as litter, oil spill, and hazardous substance taxes. The state property tax levy is dedicated to the support of common schools. On average, states dedicated slightly more than a fifth of their total tax collections in Fiscal Year 1997 for dedicated purposes. Washington dedicated 26.2 percent of its tax receipts in the same period, ranking Washington fifteenth in terms of the highest share of dedicated taxes. Taxes are generally dedicated to transportation, education, and local governments. See Appendix C-2 for more detail on dedicated taxes by state.

Horizontal Equity

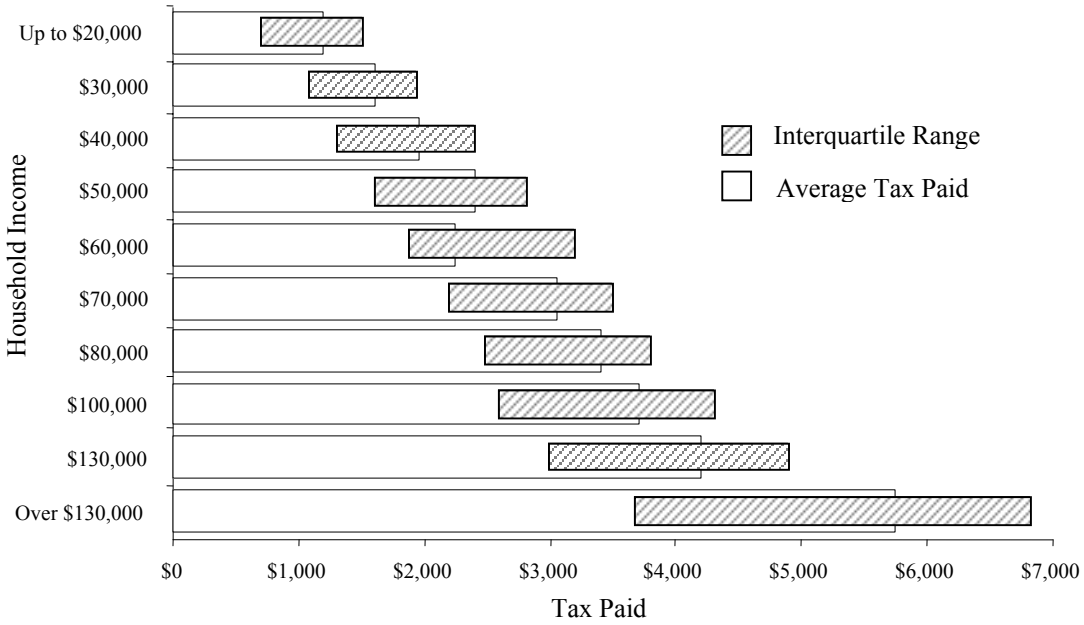
The principle of horizontal equity states that similarly situated businesses or households should face similar tax burdens. Similarly situated households are

generally considered to be those with similar incomes. Similarly situated businesses are generally considered to be those within the same industry and of similar size.

The following graphs illustrate the variation in tax within income groups. Chart 9-B shows the average total tax paid in each income category and the interquartile range of total tax paid. Chart 9-C shows average tax as a percent of income in each income category and the interquartile range of tax as a percent of income. Interquartile range represents the range of tax paid by those households within the middle of the distribution–the second and third quartiles (between 25 percent and 75 percent of taxpayers). The first and fourth quartiles are excluded to eliminate outliers and other distortions.

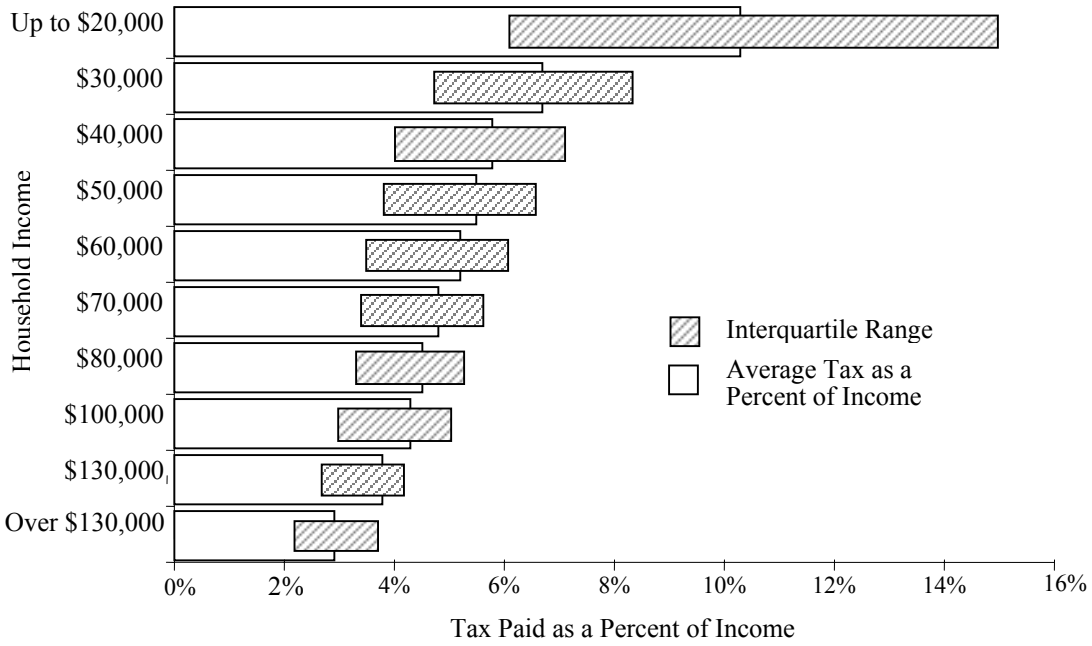
Chart 9-B

Average Excise Tax Paid and Interquartile Range



Source: Washington Excise and Property Tax Microsimulation Model

Chart 9-C
Average Excise Tax as a Percent of Income and Interquartile Range



Source: Washington Excise and Property Tax Microsimulation Model

This same analysis conducted by tax type shows that sales tax contributed the most to tax variation within income groups. (Details are in Appendix C-3.)

Outliers and distortions are especially a problem in the lowest income group. The lowest income group is an eclectic mix of households. One problem is that it includes households whose low-income status is only temporary, for example, unemployed households or new business owners. These households pay a very high tax as a percentage of income because they are basing their expenditures on their permanent income (the longer view of expected income).

Since permanent income and annual income can be quite different, thus causing higher tax variability within income ranges, the Department performed the same analysis using consumption ranges (outlays) instead of income ranges. The results show that the variation between consumption ranges is much smaller than the variation between income ranges (and more consistent from range to range). (See Appendix C-3 for details.) This is not surprising, since sales tax is the biggest driver in variation.

Horizontal Equity for Business

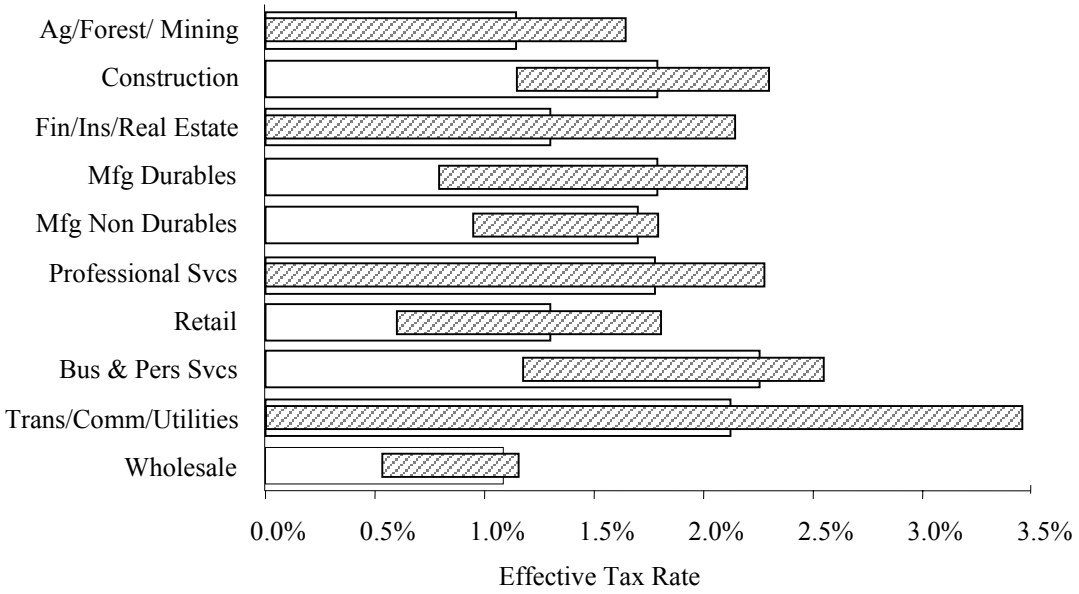
Chart 9-D shows the mean effective tax rate and the interquartile range for each industry group. There is much variation in tax rates within industries. Property tax

causes the most variation. This is because taxpayers' holdings of property relative to their gross income vary tremendously. Deductions and credits for specific industries are another factor in variation. Part of the variation within transportation and utilities, professional services, and financial services and real estate is caused by the multitude of business activities taxed at different rates within these specific sectors.

Information displayed in Chart 9-D is derived from a merged firm-level database including B&O tax, public utility tax, property tax, and sales taxes paid on purchases. Allocations of sales tax paid are based on Employment Security Department data on employees and wages and Washington Implan.

Chart 9-D

Effective Tax Rates by Industry



Geographic Variations in Tax Rates: Impact on Business Taxes and Profits

Property and sales tax rates vary throughout the state. The different rates can cause significant differences in profits based on where a firm is located. In the 1999 study *Tax Incentive Comparison of Six States and One Province*, the Department of Revenue estimated that a high tech call center's tax payments fall some 9 percent when the highest tax rates in the state are replaced by the lowest rates imposed in the state. For general manufacturing, total taxes can be as much as 23 percent lower in low tax locations. Semiconductor manufacturers, software, and biotech firms fell between these two ranges.

Different Taxation of Similar Items/Activities

Another way that inequities can occur in a tax system is through different taxation of similar items or activities. In Washington State, generally, taxpayers are treated similarly to others in the same business classification. Exemptions, credits, and other tax incentives that are available to one category of taxpayers are available to all taxpayers in that category. Tax rates apply equally to all taxpayers in that category.

However, there are anomalies. There are certain circumstances where similar activities are treated differently under the tax system, generally by specific legislative action to fulfill a desired purpose. An example is the disparate treatment of food products depending on the purchase location and type of food. The different taxation anomalies are too numerous to list in this chapter. However, a list is available in Appendix C-5. Although there are many anomalies, they do not constitute a large portion of the tax base.

Intersectoral/Vertical Equity

Intersectoral or vertical equity relates to tax burdens across different types of taxpayers. Although there is a recognition that taxes will vary for different entities, the principle states that no single group should face an undue tax burden, nor should a group escape taxation.

Business/Household

One measure of intersectoral equity is the business versus household shares of taxation. Table 9-3 shows the percentage of state and local taxes paid by households and businesses. Households pay 54 percent of the total state and local tax burden; businesses pay 46 percent. See Table 9-4 for shares by tax type.

Table 9-3

Tax Incidence of Household vs. Business
Major Washington State and Local Taxes
FY 2000 – State Taxes/$Millions

	Percent Share		Dollar Amount of Share		
	HH	Bus.	Household	Business	Total
Retail Sales/Use	64%	36%	$4,738	$2,635	$7,373
B&O Tax	0%	100%	0	1,855	1,855
Property Tax	58%	42%	3,161	2,251	5,412
Public Utility Tax	47%	53%	115	132	246
Total	54%	46%	$8,014	$6,873	$14,886

Note: Dollar amounts and percentage shares differ somewhat in this measure of initial incidence. Most other presentations herein are estimates for Calendar Year 2005 and include only the retail sales tax, property tax, B&O tax, and public utility tax.

Differences in Tax Rates Across Industries

Another method for analyzing vertical equity is to measure tax burdens across industries. Table 9-4 shows average effective tax rates across industries and by tax type. The mean effective business tax rate (tax due divided by gross income) varies from 1 percent of gross income for wholesale to 2.2 percent of gross income for the services industry.

Table 9-4

Average Tax Rates Across Industries
Calendar Year 2000

Standard Industrial Classification (SIC) Codes	PROP	SALES	B&O PUB UTIL	TOTAL
AG/ FORESTRY/ MINING - SICS 1-14	0.57%	0.18%	0.32%	1.14%
CONSTRUCTION - SICS 15-17	0.67%	0.45%	0.42%	1.77%
MANUF NONDURABLE - SICS 20-23, 26-31	0.59%	0.44%	0.41%	1.70%
MANUF DURABLE - SICS 24,25, 32-39	0.61%	0.38%	0.42%	1.78%
TRANS/COMM/ UTILITIES - SICS 40-49, 90s	0.48%	0.18%	0.93%	2.12%
WHOLESALE - SICS 50-51	0.32%	0.21%	0.44%	1.05%
RETAIL - SICS 52 - 59	1.10%	0.34%	0.41%	1.97%
FIN/INSURANCE/REAL ESTATE - SICS 60-67	0.40%	0.24%	0.64%	1.29%
SERVICES - SICS 70-79	0.95%	0.41%	0.72%	2.24%
PROFESSIONAL SERVICES - SICS 80-89	0.51%	0.30%	0.92%	1.83%

Differences in Tax Rates Between Small, Medium and Large Firms

Within an industry group, differences in firm size can affect sales, purchases, capitalization and other factors that can affect tax burden. Table 9-5 shows average effective tax rates by size of firm. The data show that large businesses pay a smaller share of property tax as a percentage of gross income than small businesses. For some industries, small businesses pay a smaller share of sales tax as a percentage of gross income than large businesses. B&O taxes are fairly consistent between large and small firms. For the overall tax rates there are differences between large, medium and small businesses. However, the differences are not consistently higher or lower. (See Appendix C-6 for details on average tax rates by industry and tax type.)

Table 9-5

Average Tax Rates by Size of Firm
Calendar Year 2000

SIC CODES	LESS THAN $5,000,000	$5,000,000 TO $25,000,000	GREATER THAN $25,000,000
AG/ FORESTRY/ MINING - SICS 1-14	1.15%	1.30%	2.36%
CONSTRUCTION - SICS 15-17	1.78%	1.63%	1.81%
MANUF NONDURABLE - SICS 20-23, 26-31	1.72%	2.11%	1.58%
MANUF DURABLE - SICS 24,25, 32-39	1.81%	1.66%	1.75%
TRANS/ COMM/ UTILITIES - SICS 40-49, 90s	2.10%	3.34%	2.52%
WHOLESALE - SICS 50-51	1.10%	0.66%	0.60%
RETAIL - SICS 52 - 59	2.04%	0.67%	0.62%
FINANCE/ INSURANCE/ REAL ESTATE – SICS 60-67	1.29%	1.54%	1.21%
SERVICES - SICS 70-79	2.26%	1.82%	1.63%
PROFESSIONAL SERVICES - SICS 80-89	1.84%	1.88%	1.82%

Differences in Tax Rates for New and Established Firms

Age of a firm can also affect tax burden. Table 9-6 shows average tax rates for new and established firms. New businesses pay a higher percentage of gross income in taxes than established businesses. In an industry by industry comparison, average total tax rates vary from 0.93 percent to 2.06 percent for established firms and between 1.2 percent to 2.8 percent for new firms. This is mainly caused by higher property taxes as a percentage of gross income. (See Appendix C-6 for details on average tax rates by industry and tax type.)

Table 9-6

Effective Tax Rates by New and Established Firms
Calendar Year 2000

SIC CODES	NEW FIRM	ESTABLISHED FIRM
AG/ FORESTRY/ MINING - SICS 1-14	2.30%	0.93%
CONSTRUCTION - SICS 15-17	2.09%	1.67%
MANUF NONDURABLE - SICS 20-23, 26-31	2.23%	1.58%
MANUF DURABLE - SICS 24,25, 32-39	2.39%	1.67%
TRANS/ COMM/ UTILITIES - SICS 40-49, 90s	2.31%	2.06%
WHOLESALE - SICS 50-51	1.20%	1.02%
RETAIL - SICS 52 - 59	2.99%	1.69%
FINANCE/ INSURANCE/ REAL ESTATE - SICS 60-67	1.60%	1.22%
SERVICES - SICS 70-79	2.80%	2.06%
PROFESSIONAL SERVICES - SICS 80-89	2.57%	1.67%

Administrative Equity–Equity and Noncompliance

Noncompliance contributes to inequity because the greater the noncompliance, the greater the tax burden that is shifted to other taxpayers. Washington's overall noncompliance rate is estimated to be 2.8 percent in 1991 and 3.4 percent in 1995.

Noncompliance varies by industry, size of firm, and age of firm. By industry, noncompliance ranges from 1.5 percent for the retail industry, to 5.3 percent for consumer services. The new business noncompliance rate is 6.4 percent, compared to 1.9 percent for established firms. Noncompliance ranges from 19.9 percent for the smallest firm size category to 1.7 percent for the largest firm size category. (More detailed data on noncompliance is included in Appendix C-8.)

Significant Activities Not Subject to Taxation in Washington

One source of vertical inequities are activities that are not subject to taxation. Following is a list of activities that are not subject to taxation in Washington State. (More detail is available in Appendix C-9.)

- Rental of real property
- Individual income
- Agricultural production
- Investment income of non-financial businesses
- Food for home consumption

Perceived Equity

Business Tax Perceptions

The Department of Revenue conducts periodic surveys of business taxpayers on their satisfaction with the administration of Washington's tax system. In the 2001 survey, 8 percent felt the tax system had a negative effect on their ability to conduct business, while 9 percent believed our tax system had a positive effect. The largest group (43 percent) was neutral about our tax system.

Household Equity Perceptions

The states of Minnesota, Georgia, Colorado, and Tennessee conducted surveys of citizens on issues of tax fairness. A common theme from these surveys is that taxpayers consider the retail sales tax to be the most fair in terms of treating taxpayers equally, understanding what is subject to tax and what is not, and based on ability to pay. It seems to be the least objectionable tax to increase when revenues are needed. Another theme from most of the surveys is that a flat rate income tax is perceived as preferable to one that is progressive with graduated rates. A flat income tax is perceived as fair because everybody pays at the same rate. For a more detailed summary, see Appendix C-10.

Taxation of Externalities

It is considered equitable to tax externalities since the cost of externalities is paid by the public as a whole.

Washington has several taxes that are intended to tax externalities. The most notable category is environmental taxes. A list of these taxes can be found in Appendix C-11.

Economic Neutrality

A good tax system does not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which increases the tax burden on the residents of the state. These distortions are manifested in Washington by tax pyramiding (imposing the tax several times as the product moves from firm to firm on its way to the consumer) and other economic inequities for businesses and individuals as follows:

Conclusions

- Pyramiding of the B&O tax causes non-neutralities.
- The B&O tax pyramids an average of 2.5 times. However, the pyramiding varies considerably between industries.
- Strategies to minimize tax are often inefficient and can be costly to implement. They also increase the complexity and the level of effort necessary to review and fairly enforce Washington's tax. Most of these strategies are designed to reduce the level of taxable income, rather than to avoid tax altogether.
- Some strategies which businesses use to reduce their Washington tax levels include: creating wholly owned subsidiaries to receive a portion of the income in another state, conducting a portion of the manufacturing operation in another state, creating holding companies, and creating a purchasing agent relationship with customers.
- Individuals illegally avoid use tax by making purchases through the Internet, via catalogs of businesses with no taxable nexus in Washington, and making purchases in states with a lower or no sales tax such as Oregon.

Pyramiding of the B&O Tax

The B&O tax is a gross receipts based tax; the tax is paid on the total value of the good or service. The total value would include the value of any incorporated good or service purchased from another business. To the extent that a business can pass B&O tax to its customer, the B&O tax becomes part of the value of the incorporated good or service. Therefore, pyramiding occurs under the B&O tax because goods and services that are inputs into higher stages of production are taxed multiple times as they move through the production chain.

Since value added is the fundamental measure of economic activity, the difference in effective B&O tax rates and B&O taxes on a value added base is an indicator of the extent of non-neutral tax treatment between industries. Firms have an incentive to vertically integrate in order to escape the pyramiding of the B&O tax.

Another problem with pyramiding is the inequities caused between industries. The B&O tax is estimated to pyramid an average of 2.5 times. However, the pyramiding varies considerably between industries. B&O tax for many services pyramids at about 1.5 times. B&O tax for some types of manufacturers pyramids five or six times. Table 9-7 shows differences in pyramiding by industry.

Pyramiding is measured by comparing effective B&O tax rates on a gross receipts base with effective B&O tax rates on a value added base. Effective tax rates on value added is determined by means of input-output data from the Washington State Implan model. Implan provides state-specific estimates of business-to-business purchases and can be used to attribute taxes to producing sectors according to their sales to businesses. The ratio of the two tax rates is a measure the degree of pyramiding of the B&O tax. Details of the analysis can be found in Appendix C-12.

Table 9-7

A Measure of Pyramiding of the B&O Tax

Sectors & SIC Codes	Tax Rate on Value Added	Effective B&O Rate	Pyramiding Index
4 MFG FOOD 20	2.0%	0.3%	6.7
11 MFG PETROLEUM REFINING 29	3.1%	0.5%	6.7
19 MFG AIRCRAFT & PARTS 372	2.6%	0.5%	5.3
12 MFG RUBBER & PLASTICS 30	2.0%	0.5%	4.3
15 MFG PRIMARY METAL 33	2.0%	0.5%	4.1
5 MFG APPAREL & TEXTILES 22-23	2.0%	0.5%	4.1
6 MFG LUMBER & WOOD PROD 24	1.9%	0.5%	4.0
21 MFG PROF & SCIENTIFIC INSTR 38	1.8%	0.5%	4.0
17 MFG IND/COMM/COMP M&E 35	1.9%	0.5%	3.9
7 MFG FURN & FIXTURES 25	1.8%	0.5%	3.7
20 MFG OTHER TRANS EQUIP 37	1.8%	0.5%	3.7
8 MFG PAPER PROD 26	1.7%	0.5%	3.7
14 MFG STONE/CLAY/GLASS 32	1.6%	0.5%	3.4
10 MFG CHEMICAL PROD 28	1.5%	0.5%	3.3
3 CONSTRUCTION 15-17	1.6%	0.5%	3.3
18 MFG ELECT M&E (NOT COMP) 36	1.4%	0.5%	2.8
13 MFG LEATHER ETC 31	1.4%	0.5%	2.8
35 MOVIES/AMUSE/REC 78-79	2.2%	0.8%	2.7
34 SVC MISC REPAIR 76	1.4%	0.5%	2.7
22 MFG MISC MFG IND 39	1.2%	0.4%	2.7
9 MFG PRINT & PUBLISHING 27	1.3%	0.5%	2.6
23 TRANSPORTATION ETC 40-47	1.8%	0.7%	2.5
2 MINING/QUARRY 10-14	1.2%	0.5%	2.4
16 MFG FABRICATED METAL 34	1.1%	0.5%	2.3
29 SVC LODGING 70	1.1%	0.5%	2.2
30 SVC PERSONAL 72	2.0%	1.0%	2.1
1 AG FOR FISHING 1-9	1.4%	0.7%	2.0
33 SVC AUTO REPAIR,SERV&PARK 75	1.0%	0.5%	2.0
24 COMMUNICATIONS 48	1.2%	0.6%	1.9
26 WHOLESALE TRADE 50-51	0.9%	0.5%	1.9
37 LEGAL/ENG/ACCT 81-89	2.1%	1.1%	1.8
32 SVC BUSINESS 73	1.6%	0.9%	1.7
27 RETAIL TRADE 52-59	0.8%	0.5%	1.6
36 SVC MEDICAL & HEALTH 80	2.0%	1.2%	1.6
28 FIRE 60-67	1.5%	1.0%	1.6
25 ELECTRIC,GAS&OTHER UTIL 49	3.2%	2.1%	1.5
31 SVC COMP/DATA/PROC SERVICES 737	1.3%	0.9%	1.4
Statewide	**1.5%**	**0.6%**	**2.5**

Other Economic Inefficiencies–Business

There is increased evidence in recent years of businesses developing strategies to decrease their tax base in Washington. Strategies to reduce tax liability require extra effort and cost by business to implement and maintain. These strategies are also complex for tax administration agencies to review and enforce. Some examples follow.

- Intellectual Property–A Washington corporation with intellectual property creates a subsidiary that is not subject to federal corporate income taxes. The subsidiary moves to a state that does not tax corporate income (e.g. Nevada). The intellectual property rights are transferred to this out-of-state subsidiary which receives the royalty income and pays dividends to the remaining Washington business. Dividends paid by a subsidiary to a parent are exempt.

- Manufacturing–Washington manufacturer forms an out-of-state subsidiary to be the primary manufacturer. The out-of-state subsidiary brings its own goods into Washington and contracts with the Washington manufacturer as a processor for hire to finalize the manufacturing process. The Washington manufacturer pays B&O tax on the contract payments it receives as a processor for hire instead of the full value of the goods.

- Purchasing Agents–A Washington wholesaler acting as a purchasing agent sets up contracts with its customers. The purchasing agent buys goods from manufacturers and passes them along to the retailers, receiving a commission for the service provided. The purchasing agent pays B&O tax on the commission income only and not on the entire value of the goods sold to the retailers.

- Real Estate Excise Tax–Real estate excise tax (REET) is assessed on the transfer of real property or of a controlling interest in an entity owning real property. REET is assessed when at least 50 percent of the interest in an entity owning real property is transferred within a 12-month period. In order to avoid REET on the transfer of controlling interest in an entity owning real property, a person may create several nominal transfers over the 12-month period (totaling less than 50 percent) with the larger transfers achieving controlling interest taking place beyond the 12-month period.

- Relocations–In the age of remote commerce and electronic businesses, it is no longer necessary for all portions of a business to be co-located. Businesses are able to relocate parts of their enterprise, especially those that do not deal with tangible personal property, to other states with more favorable tax treatments for that business activity.

- Sales Tax–Businesses that purchase large items such as planes or yachts may reduce their sales tax liability by creating separate holding companies. The holding company owns the plane and leases the plane to the original business on a

daily basis a few times a month. Since the holding company has purchased the plane for resale, there is no sales tax due at the time of purchase. The business is only required to pay sales tax on the occasional daily lease payments.

Other Economic Inefficiencies–Individuals

Washington individuals change their behavior in two ways because of the sales tax. They shop more on the Internet and through catalogs, and they shop more in Oregon and Idaho than they would if Washington did not have a sales tax. These changes in behavior cause extra effort and/or cost to the individual and are therefore inefficient.

Washington households spent an estimated $2.3 billion on remote sales in 2001. Out of that total, about 6 percent, or $147 million, was purchased because Washington has a higher than average sales tax. The avoidance estimate is based on a tax elasticity from Dr. Austan Goolsbee's paper, "In a World without Borders: The Impact of Taxes on Internet Commerce" (*Quarterly Journal of Economics*, Volume 115, Number 2, May 2000).

Washington households purchased an estimated $808 million in Oregon in 2001 because of the tax differential. These estimates are based on results from *The Effects of Tax Rate Differences on Retail Trade in Washington Border Counties* by Lorrie Jo Brown. For more detail on cross-border and remote sales, see the sub-chapter on Tax Harmony.

Goods purchased through these means are subject to the Washington use tax at the point of first use in the state. In general, collection of use tax from individuals is very difficult. However, the Department of Revenue does collect use tax from individuals on items that must be licensed and occasionally from those who voluntarily report use tax on items they purchase via the Internet or in other states.

Economic Vitality

A good tax system should not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises located in other states.

The evaluation of Washington's economic vitality contained in this section is compiled from studies conducted by the Department of Revenue over the past eight years.

Conclusions

- Overall the analysis shows that Washington's tax structure is comparable with competitor states with some exceptions by type of tax and firm type.

- A comparison of tax burden by tax type shows that for most of the firms, Washington's B&O tax is higher than all or most other states' income taxes.

- Property taxes paid by Washington businesses are about average.

- Low profit margin firms tend to suffer a competitive disadvantage compared to competitor states.

- Despite the fact that many new firms have low or negative profits, new Washington manufacturers have a slightly better competitive position than established manufacturers. This is mainly because industrial insurance rates, which comprise a large percentage of total tax burden for new businesses, are lower in Washington State.

- Most types of firms suffer a competitive disadvantage due to tax burden compared to firms in Oregon.

- Because of the machinery and equipment exemption for manufacturers and the warehousing remittance, Washington's sales tax burden is not high compared to other states for these industries. However, there is not conclusive evidence that any targeted incentive either does or does not cause new job growth in Washington.

- Taxes are not one of the most important factors in firm location. However, taxes do matter in location decisions when other factors are held equal.

- The manufacturing machinery and equipment exemption and the warehousing remittance have been effective in "leveling the playing field" for Washington State taxes compared to competitor states' taxes.

- However, statistical studies of both the manufacturing exemption and R&D incentives are not conclusive about the effectiveness of these incentives in

creating new jobs. There is not conclusive evidence that the incentives either did or did not cause new job growth.

In studies of the impact of taxes on the competitive position of Washington firms, the Department has simulated hypothetical firms for industries with out-of-state competitors. These firms are taxed under the tax systems of Washington State and competitor states. The hypothetical firms represent several different industries, small, large, new and established firms. Each hypothetical firm is created to be typical for the category it represents. In state-to-state comparisons, all aspects of the firm are held constant except for differences in state and local tax liability and the attendant differences in profit margins. In each analysis, tax burdens are compared over a long period of time, either 10 or 20 years. The net present value (NPV) of total taxes paid throughout the period are compared for each hypothetical firm.

Tax Rankings for Manufacturers

The following information is from the *Manufacturing Tax Study* by the Washington State Department of Revenue and the Advisory Committee for the Manufacturing Tax Study, December 1994, and has been updated to reflect more recent tax law changes. The analysis, summarized in Table 9-8, covers new and established firms for a period of ten years. The following are other factors of comparison.

Industries included:

- Food Products
- Lumber and Wood Products
- Paper Products
- Printing and Publishing
- Petroleum Products
- Primary Metals
- Electrical Equipment
- Aircraft and Parts
- Instruments
- Software

Comparative states–12, including Washington:

- Alabama
- Arizona
- California
- Colorado
- Florida
- Idaho
- Minnesota
- Montana
- North Carolina
- Oregon
- Texas
- WASHINGTON

Taxes included:

- Gross Receipts
- State Income Tax
- Unemployment Insurance
- Industrial Insurance
- State and Local Property Tax
- State and Local Sales and Use Tax

Table 9-8

Washington's Tax Burden Rank Out of 12 States Based on Ten-Year NPV Tax Burdens for Hypothetical Manufacturing Firms

Rank 1=Lowest Tax, Rank 12=Highest Tax

Industry	WA Rank New Firm	WA Rank Established Firm
Computer software	1	1
Food products	4	10
Lumber/wood products	5	5
Paper products	5	5
Printing/publishing	2	1
Petroleum products	3	10
Primary metals	3	6
Electrical equipment	5	3
Aircraft & parts	3	6
Instruments	6	3

Similar analysis was performed for the following industries with similar results: warehousing and distribution, semiconductor manufacturers, biotech, software originators, and high tech call centers. See Appendix C-13 for analysis and results for these industries.

Impact of Different Taxes on the Competitiveness of Washington Firms

The previous analysis shows that taxes differ across states. For certain types of firms, Washington taxes are higher, and for some, taxes are lower than in states that are home to competitor firms. But are the tax differences large enough to affect competitiveness? Table 9-9 shows a comparison of profit margins for some of the hypothetical firms analyzed above. Analysis for other firms is included in Appendix C-14. Since everything about the hypothetical firms is held constant except for taxes, the differences in profit margins are completely attributable to taxes.

Table 9-9

Comparison of Profit Margins of Hypothetical Firms
Ten-year average NPV profit margins under Washington's tax system
(In parentheses are the lowest tax state and the highest tax state.)

Industry and Firm Type	Profit Margin with WA Taxes	Highest Profit Margin (State)	Lowest Profit Margin (State)
Food Processing:			
New	3.50%	3.51% (N. Carolina)	2.14% (Florida)
Established	1.14%	1.72% (Alabama)	0.91% (Florida)
Primary Metals:			
New	-2.61%	-1.51% (N. Carolina)	-5.39% (Florida)
Established	0.32%	1.86% (Alabama)	-0.49% (Texas)
Computer Software:			
New	7.69%	7.78% (N. Carolina)	7.00% (California)
Established	3.20%	3.40% (N. Carolina)	2.84% (Florida)

Note that there can be a large difference in profit margins caused by taxes alone. However, many factors cause differences in profit margins. The Department analyzed the impact of these non-tax factors for actual Washington firms for the same industries as the hypothetical firms (*Tax Competitiveness Policy and Ranking of 12 States*, Department of Revenue Research Report, 1995). In this analysis, taxes are the only factor held constant, while everything else that affects profit margins varies. The variance in the profit margins of actual Washington State firms was larger than the variance in profit margins of hypothetical firms. In other words, the variance caused by all other factors is larger than that caused by taxes alone.

Tax Incentives and Economic Vitality

One way a state can improve the economic climate for firms is to provide tax incentives. Following is a discussion of existing tax incentives in Washington State and their effectiveness.

There are two major policy purposes of Washington's tax incentives: to improve competitiveness of Washington businesses, and to stimulate the economy by encouraging businesses to locate and stay in Washington State. Table 9-10 outlines Washington's major tax incentive programs and their objectives.

Table 9-10

Major Washington Tax Incentives

Program	Objective	Target
M&E Sales/Use Tax Exemption	Level playing field; retention, expansion; family wage jobs	Manufacturing; R&D; testing
R&D B&O Credit	Encourage early stages of research; high wage high-skilled jobs	R&D
R&D Sales/Use Tax Deferral	Encourage research; create jobs; spur manufacturing	R&D
Warehouse/Grain Elevator Sales/Use Tax	Facility location; increase global and regional trade; jobs	Wholesaling, warehousing and distribution
Sales & Use Tax Deferral Rural Counties	Family wage jobs	Manufacturing; R&D; testing
Rural B&O Rural Counties	Family wage jobs	Manufacturing; R&D

Effectiveness of Incentives in Terms of Competitiveness of Washington Firms

The manufacturing machinery and equipment sales tax exemption and the warehouse sales tax remittance have been effective in improving the competitiveness of Washington firms. Analysis using hypothetical firms showed that before these exemptions, Washington's tax system imposed one of the highest tax burdens compared to competitor states. Washington's tax ranking was eleventh or twelfth highest for most manufacturers and in the top half of states for most warehouses. As a result, most of Washington's tax rankings for the industries benefiting from the exemptions are currently among the lowest third of states. (See the table "Tax Burden Rankings for Washington" in Appendix C-13.)

Participation of Firms in Incentive Programs

Three studies were conducted to analyze the impact of incentive programs: *Economic Impacts of the Manufacturer's Sales Tax Exemption* by Rick Peterson, House Finance Committee staff, *High Technology R&D Tax Incentives Study* by the Research Division of the Washington State Department of Revenue and *Warehouse Tax Remittance Study* by Mark Matteson, House Finance Committee staff. The studies provided a profile of the Washington firms that participate in the incentive programs.

The studies show that the industries that enjoy the incentives contribute to Washington's economic vitality by creating jobs. Firms taking the manufacturing/R&D deferral hired 36,000 new employees over the five years of the

deferral program. Firms taking the B&O R&D credit hired 19,500 new employees, and those taking the rural sales and use tax deferral/jobs credit hired 3,800 employees. Firms taking the high technology R&D credit pay high wages and fill 60 percent of new jobs with Washington residents.

Is There a Connection Between New Jobs and the Incentive Programs?

These studies referenced above analyzed whether there were any ties between the new jobs and the incentives. Would these industries have created the same jobs without the incentives? The studies used econometric analysis to determine whether the tax incentives caused any of the growth in the industries. The studies were unable to find a causal relationship between job growth and the tax incentives.

Impact of Taxes on Firm Location

A review of the literature on factors that affect firm location decisions show that taxes are not one of the most important factors in firms' location decisions. The most important factors in firms' location decisions are market factors. Other important factors include transportation infrastructure, availability of a skilled labor base, existence of higher education, and availability of land. Although the studies showed that taxes are not one of the most important factors, they did show that taxes do matter on the margin, when other factors are held equal. (See Appendix C-15, "Factors that Influence Business Location.")

Although the Department's hypothetical firm analysis shows Washington's tax ranking to be in the lowest third for many industries, Oregon's tax ranking is lower than Washington's in almost every case. To the extent that location factors in Oregon and Washington are equal, the lower taxes in Oregon could attract businesses away from Washington.

Impact of Washington Taxes on New Businesses

The hypothetical firm analysis shows that for new manufacturing firms, high B&O taxes are ameliorated by low industrial insurance rates. Therefore, compared to other states, new Washington manufacturers do not face an inordinate tax burden. However, manufacturing is not representative of all new firms. Industrial insurance is not as large a percentage of total tax burden for some other industries. Because of the high B&O tax that some industries face relative to corporate income tax, new businesses in some industries could face an inordinate tax burden in Washington.

Analysis of total effective tax rates shows that new firms tend to have a higher overall effective tax rate than existing firms.

Nonetheless, taxes do not seem to impede the ability to start a new business. According to the Corporation for Enterprise Development's (CFED's) *2001 Development Report Card for the States*, the state of Washington is one of the top

five states for the category "Entrepreneurial Energy." The report card also shows that Washington has the highest rate of new business starts-ups.

The CFED report card also shows that Washington has the highest number of business closures. To at least some extent, the higher number of firm closures are a result of the higher number of start-ups. There remains a possibility that taxes may be affecting firm closures, but there is no clear evidence.

Stability

A tax system should be stable so that policy makers can have a dependable source of revenue and taxpayers can have predictable taxes.

Conclusions

- Washington's tax system is volatile, with a short run elasticity of 1.2.

Stability is the ability of the tax system to provide the revenue necessary to maintain public services notwithstanding fluctuations in economic activity over the business cycle. The short-run elasticity (SRE) is a measure of the stability of the tax system. A tax system of normal stability has an SRE equal to 1.0 and generates short-run fluctuations in revenue comparable in magnitude to contemporaneous fluctuations in economic activity. A more stable tax system has an SRE that is less than 1.0 and will generate fluctuations in revenue that are smaller than contemporaneous fluctuations in economic activity. The converse is true for a less stable tax system with an SRE of greater than 1.0.

Analysis of short-run elasticity for Washington showed an overall elasticity of 1.2. This means that tax revenues are considerably more volatile than the economy; tax revenues grow faster than the economy in good economic times and contract more than the economy in poor economic times. Table 9-11 shows short-run elasticity for the major taxes.

Table 9-11

Estimates of Short-Run Elasticities

Tax Base	Short-Run Elasticity
Sales and Use	1.4
B&O	1.4
Property	0.2
Public Utilities	-0.2
All Taxes	1.2

Sales and use tax is the most volatile revenue source. B&O tax also has an elasticity greater than 1.0.

The SRE relates constant base, constant rate revenues from 1970 to 2000 with personal income for the same period. Rate and base changes are removed from the revenue data so that the inherent volatility of the tax system can be measured. The methodology for measuring the short-run elasticity is a standard double-log regression model. The data was transformed by 1) using the personal income deflator to change the nominal data to real data, 2) taking the log of the variables, and 3) removing the inherent trend from the time series data. Details of the analysis are included in Appendix C-16.

Adequacy of State Revenues

A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base.

The demands for public services and revenues available to meet them are analyzed in reference to economic growth. Personal income growth is the best available measure of economic growth and is used here to examine the productivity of Washington's tax system and the demand for public services. Personal income includes all income earned by Washington households: wages, self-employment income, interest, dividends, rent, social security, and other "transfer payments."

Conclusions

Revenue Growth

- General fund revenue, in the absence of legislation, has historically grown about 5 to 10 percent more slowly than personal income.

- Taken together, historical revenue growth, trends in consumer spending habits, and the effects of recent voter-approved tax reduction measures suggest that general fund revenue under Washington's present tax system is likely to grow 10 to 15 percent more slowly than personal income (or the general economy) in the long run.

Expenditure Growth

- Policy decisions to impose longer prison sentences for serious crimes, to increase access to health care for poor and low-income families, and to address the special education needs of handicapped and bilingual children are the main reasons why spending growth has moved in tandem with personal income growth.

- Due in large part to rapidly rising health care costs, total state government expenditures will have a tendency to continue growing in tandem with, or even slightly exceeding, personal income growth.

- Increased utilization of health care and special education services also contributed significantly to expenditure growth.

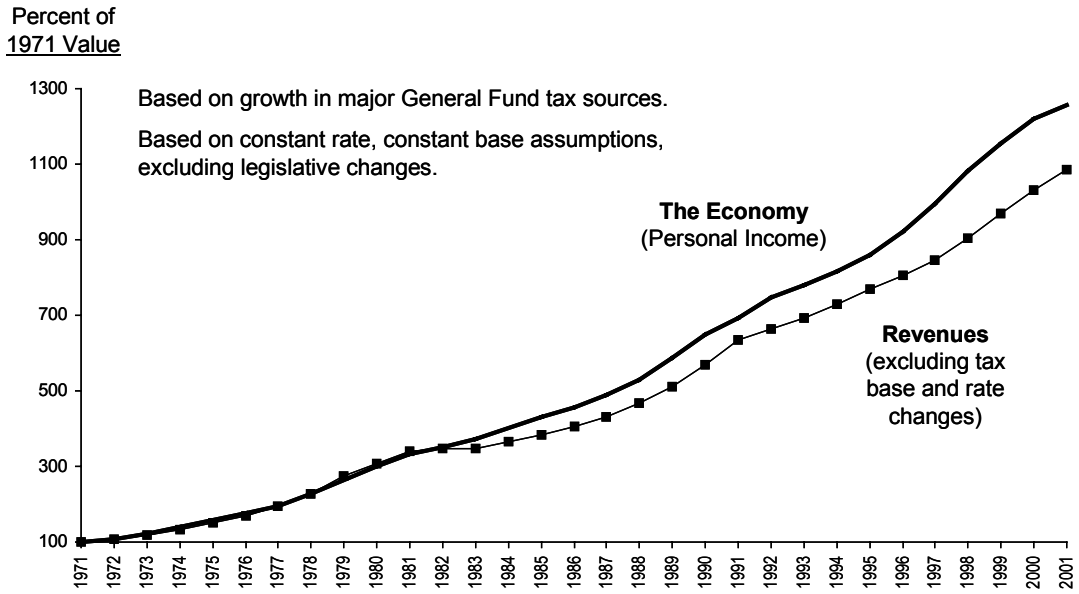
Revenue Growth Compared with Economic Growth

Excluding legislative changes to general fund taxes, over the past 30 years general fund revenues grew more slowly than total state personal income, as shown in Chart 9-E. Legislative changes are excluded from the analysis because the goal is to measure the inherent productivity of Washington's system of general taxes, i.e., the capacity of the tax system to respond to public demands without raising taxes.

Defined as the rate of revenue growth divided by the rate of personal income growth, revenue elasticity for Washington's general fund taxes measures how responsive the tax system is to changes in personal income.

Over the past 30 years, personal income has grown at an average annual rate of 8.8 percent, while revenues (excluding tax base and rate changes) have increased at an annual rate of 8.3 percent, or 94 percent as fast as personal income. Thus, the long-term revenue elasticity of Washington's general fund taxes, based on 30 years of experience, is 0.94. Other studies find that long-term elasticity is somewhere between 0.9 and slightly under 1.0, with the preponderance of evidence suggesting that it is closer to 0.9. (See Appendix C-21 for detailed analysis.)

Chart 9-E



Revenue elasticity appears to be declining and is expected to fall to between 0.85 and 0.90 over the next decade (see Table 9-12). This decline is due to the passage of voter-approved initiatives to reduce taxes and to the erosion of the sales tax base (discussed in the harmony and neutrality subsections of this chapter). Initiatives that have reduced the growth in revenues are as follows:

- Referendum 47 and Initiative 747 reduced allowable growth in state and local property taxes. Due mostly to these voter-approved measures, annual state property tax growth has declined from 7.1 percent in the 1986 to 1997 period to 4.5 percent since 1997.

- Starting with state Fiscal Year 1999, Referendum 49 eliminated the general fund portion of the motor vehicle excise tax (MVET), one of the faster growing sources of general fund revenue.

Table 9-12

Elasticity Over Past Periods

	Average Annual Personal Income Growth	Average Annual Revenue Growth*	Elasticity
Past 30 Years	8.8%	8.3%	0.94
Past 20 Years	6.9%	6.0%	0.87
Past 10 Years	6.1%	5.5%	0.91
Forecast	5.9%	5.0%	0.85

*Average annual revenue growth excludes tax base and rate changes.

Expenditure Growth Compared with Economic Growth

Expenditure elasticity measures how responsive public expenditures are to changes in personal income. Expenditure elasticity is defined as the rate of public spending growth compared with the rate of personal income growth (or spending growth divided by personal income growth).

As shown in Table 9-13, operating expenditures of all state and local governments (including the federal revenues these governments spent), have grown slightly faster than U.S. personal income during both the 1980s and 1990s. For the 20-year period from 1980 to 2000, the expenditure elasticity for all state and local governments was 1.06–that is, spending grew 6 percent faster than income. (See Appendix C-21.)

Table 9-13

State and Local Government Finances

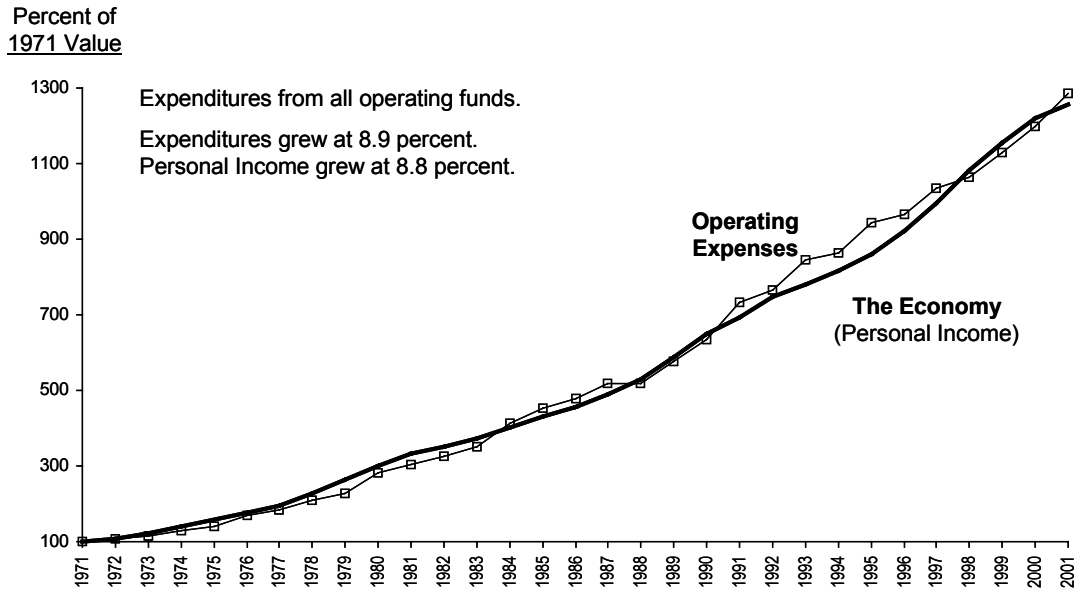
	Average Annual Percent Change			**Implicit Elasticity***		
	1980-1990	**1990-2000**	**1980-2000**	**1980-1990**	**1990-2000**	**1980-2000**
Current expenditures	7.9	6.1	7.0	1.0	1.1	1.1
Consumption expenditures	7.7	5.5	6.6	1.0	1.0	1.0
Transfer payments to persons	9.6	7.8	8.7	1.2	1.4	1.3
Other expenditures	12.6	-2.5	4.8	1.6	-0.5	0.7

*Growth rate relative to personal income growth rate

The result is similar for Washington State government. Over the past 30 years, state government operating expenditures from all funds (including federal revenues spent through the state budget) have grown slightly faster than state personal income. For the 1971- 2001 period covered in Chart 9-F, expenditures grew at an annual average rate of 8.9 percent, while total state personal income grew 8.8 percent per year–an expenditure elasticity of 1.01.

Chart 9-F

Growth in Personal Income and State Operating Expenses



Washington's expenditure limit established in Initiative 601 constrains state spending to "the fiscal growth factor," inflation plus population growth. (Recent changes to the provisions of Initiative 601 effectively allow spending to grow somewhat faster.) However, inflation and population factors comprise only about 70 percent of personal income growth. They do not address other important budget drivers that explain why government spending has had a tendency to move in tandem with economic growth. Government services are considered "normal goods." This means that as income rises, demand for government services such as roads and education increase just as demand for consumption goods such as houses and automobiles rise with income. Four types of factors place pressure on public spending to exceed personal income growth:

- Special demographic factors–When specific population budget drivers, like the age 5 to 17 school population, grow much faster than the general population.

- Utilization–When utilization rates for government services increase due to changing social or economic conditions (e.g., the proportion of children needing rehabilitation or protective services).

- Policy–When policymakers choose to expand or enhance a public service (in response to perceived demands).

- Extraordinary inflation–When specific inflation budget drivers, like the price of health services ("health care inflation"), grow much faster than general inflation.

Population growth and expansion of eligibility have played a relatively small part compared with medical services cost growth. Except for a brief period in the mid-1990s, the cost per case of serving poor families in Medicaid and providing insurance to private and public sector employees increased by double digits on an annual basis since the 1980s, triple that of the general price increase in the economy. Rising costs per case in health care go beyond traditional inflation. They include:

- The introduction of new procedures, tests, and expensive technology.
- The introduction of new drugs and advertising to drive the demand for new drugs.
- Increases in utilization of medical services, due especially to an aging population.

The three areas of the budget most responsible for this growth–areas where policy, utilization, or extraordinary inflation accounted for more than 70 percent of spending growth–were health care, corrections, and K-12 special programs.

- In health care, spending rose sharply because of (a) policy choices to expand health insurance coverage for poor and low-income families, (b) higher utilization of medical services due to availability of new tests, procedures, and technology, and (c) rapid price increases (for the same services) above general inflation.

- In corrections, policy changes raising prison sentences for drug and sex offenders resulted in rapidly increasing costs for the state's prison system.

- In K-12 special programs, policy decisions to devote more resources to the special needs of handicapped and bilingual students, together with increased utilization of these services, contributed to rapid spending growth.

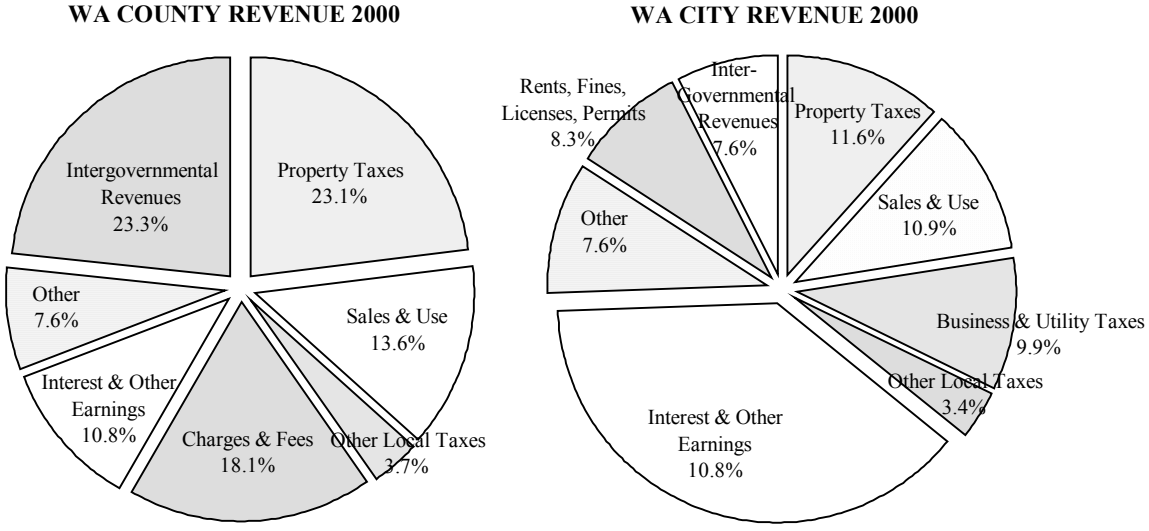
Adequacy of Local Revenues

Under Washington's Constitution, state government controls both the tasks assigned to local governments and the authority to impose municipal taxes to help carry out those tasks.

There are two categories of local governments in Washington. Cities and counties are general purpose governments that provide public health and safety protection, public services and facilities such as parks, and utility services like water, sewers and electricity. "Special purpose governments" such as school districts, public utility districts, ports and hospital districts have narrow jobs defined by statute. The revenue sources made available to general purpose governments are broader than for special purpose entities. Cities and counties may impose regular property taxes, special excess property tax levies, various excise taxes and a number of fees and charges for services or commodities rendered to the public. Counties have fewer tax sources available; for example, there is no authority for a county B&O tax. Chart 9-G illustrates the relative percentages for each type of tax for counties and cities.

Taxes must be expressly granted to local governments by the Legislature, and special purpose governments have been allowed fewer tax sources than are available to cities and counties. For example, school districts have no local regular property tax levy—the state collects a portion of the regular property tax and redistributes it among the schools statewide. Water and sewer districts rely solely on user charges for operating costs, and voted excess property tax levies are quite rare among these special purpose districts.

Chart 9-G



In 2000, 23 percent of the current expense and road funds in Washington's counties came from local property tax levies, while 18 percent came from the retail sales tax and other local taxes. In the same year, 12 percent of city general funds came from the property tax and 24 percent came from the retail sales tax and other excise taxes.

However, rural and suburban communities without large commercial sectors rely much more on the property tax to make ends meet.

Remote sales, reductions in the sales tax base such as new deductions and exemptions, and initiatives significantly affect local revenues. Local tax losses due to remote sales are close to $200 million a year. Since 1970, new sales and use tax exemptions resulted in $300 million less local tax revenues a year.

The recent "tax revolt" as witnessed in several anti-tax initiatives has severely reduced local revenue and affected the level of service provided by local governments. I-747 and I-695 indirectly reduced state income and therefore reduced the amount of money to assist municipalities. The repeal of the state motor vehicle excise tax eliminated the equalization mechanism that allocated additional revenues to cities and counties without large business taxpayers. I-747 capped the growth in local regular property tax revenues to 1 percent per year. I-695 caused an overall reduction of $779 million in local revenues during the 1999-01 Biennium, and I-747 is projected to cause local government property tax losses amounting to a reduction of $119 million in CY 2004.

The state and local tax systems are closely intertwined, and the state government ultimately controls them. Changes to one affect the other and affect the level of services that the state has assigned to municipalities. Further, if the statewide tax structure were materially changed, corresponding adjustments would have to be made in the municipal tax system. For example, if the city B&O tax were eliminated along with the state B&O tax, revenues for cities imposing the local tax would decline by an average of 10 percent. Many cities and counties rely heavily on basic and special retail sales and use taxes, so changes in how the sales tax is imposed or collected by the state could have an effect on those political subdivisions. Finally, many local governments have pledged special excise taxes to repay bonds (e.g., the rural county sales tax, hotel-motel taxes, and sales and motor vehicle taxes for transit). Under state and federal provisions banning government actions that impair contracts, those taxes may not be reduced or eliminated until the bonds are retired—even if the bonds are set to remain outstanding for 25 years.

Simplicity

Rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

Conclusions

Washington's tax system comports with this principle as follows:

- The cost to the Department of Revenue to administer state and local taxes was 69 cents per $100 collected which is relatively low compared to personal income tax states. Also, costs to the state are low because retailers act as uncompensated agents of state and local governments by collecting the sales tax.

- Tax sources that are dedicated to fund specific programs are considerably more costly to collect than other taxes.

- Most taxpayers make other uses of information gathered to file the state portion of their state tax return. The exception is coding for local jurisdictions for local sales tax.

- Complexity of local B&O tax also causes problems for Washington businesses. There is a lack of uniformity of local B&O tax definitions and inconsistent rules of apportioning B&O tax.

- Retailers face costs of collecting sales tax, for which they are not compensated.

Costs of Business Taxpayer Compliance

Businesses pay their taxes to the Department of Revenue either annually, quarterly, or monthly. About 66,500 taxpayers report monthly, about 148,000 quarterly and 140,000 annually. Approximately 250,000 do not report because their income is below the minimum threshold of $28,000.

Because Washington does not have a personal income tax, it is one of nine states that does not require individuals to file tax returns.

Reasons for Collecting and Organizing Information

In order to determine tax liability and file tax returns, businesses use some information that is collected for other purposes, such as federal income tax or other business operations. However, some information is collected only for purposes of filing the Washington State Combined Excise Tax Return (CETR). In the 2001 Taxpayer Satisfaction Survey, taxpayers were asked about which information had to be kept solely for the purpose of filing the Washington State CETR. For the three

major types of information required to fill out the CETR, approximately 30 percent of taxpayers determine gross income by tax classification only for purposes of filling out the CETR. Approximately 36 percent collect deduction information only for the CETR, and about 65 percent collect data on local retail sales coding only for the CETR.

Based on the 2001 Taxpayer Satisfaction Survey, taxpayers spend an average of 7 hours and 20 minutes collecting and organizing data for filing the CETR each reporting period. The survey results also indicated that taxpayers spend an average of four hours filling out and filing the tax return. (Detail of the amount of time spent on particular activities related to preparing and filing tax returns are included in Appendix C-17.)

Local Government Taxes

Thirty-seven Washington cities impose local B&O taxes, which are paid by businesses directly to each of the local governments. However, there is no statutory requirement for uniformity in definitions or classifications of business activities either between cities or with the state B&O tax. Another area that lacks uniform treatment is the apportionment of income from activities that are performed in more than one jurisdiction. In recent years the business community has been increasingly vocal about their concerns of the negative effect of local B&O tax laws on the business climate, citing uniformity and simplicity as major issues. Local governments, in turn, cite concerns about local control over revenue sources.

There have been multiple efforts to develop solutions to these issues. The Association of Washington Cities and five major cities (Seattle, Tacoma, Everett, Bellevue, and Bellingham) developed a model B&O tax ordinance that cities may voluntarily adopt. Several cities have begun the process of adopting the model B&O ordinance. The Association of Washington Businesses and other business representatives have also developed proposals and submitted legislation that would go beyond the provisions of the model ordinance.

The Committee recognizes the areas of dispute and concern for local governments and business groups and the overarching goal of administrative simplicity inherent in this issue. In this proposal the Committee supports and encourages the ongoing work of the cities, business representatives, and legislators who have committed their time and effort to developing a solution to the above-mentioned issues.

Administrative Costs of Collecting Taxes

In Fiscal Year 2001, the Department spent about 69 cents to collect $100. One reason for the low cost of collection is that Washington does not have a personal income tax and therefore does not have to process tax returns from individuals.

Some taxes are much more costly to collect than other taxes. Table 9-14 shows estimates of collection costs by tax type for the major taxes. (Costs of all taxes are included in Appendix C-18.)

Table 9-14

Costs to the Washington State Department of Revenue of Collecting State Taxes

Tax Type	Cost Per $100 of Collections
Retail Sales Tax	$0.27
Use Tax	$3.06
Business and Occupation Tax	$0.75
Public Utility Tax	$1.18

State and local property taxes are collected both by county treasurers, while valuation functions and other administrative duties are the responsibility of local county assessors and the Department of Revenue. Cost information for the local government portion of these administrative functions is not readily available.

The Washington State Department of Revenue also collects and distributes local sales taxes. Local taxes cost $1.06 per $100 to collect.

Dedicated taxes are generally more complex by nature, both for taxpayers and for the administering agency. Consequently, they are more costly to collect. For example, the hazardous substance tax costs $4.26 for each $100 of collections. The litter tax costs $12.94 for each $100 of collections.

Generally, the cost of collecting taxes correlates with the cost to taxpayers of complying with Washington's tax system; taxes that are difficult for the Department of Revenue to collect are generally difficult for taxpayers to file.

Costs to Retailers of Collecting State and Local Sales Tax

One reason that the cost of collecting retail sales tax is so low is that a large portion of the collection burden falls on retailers. The 1998 DOR study, *Retailers' Cost of Collecting and Remitting Sales Tax*, estimated that the total cost of collecting and remitting sales tax is $6.47 per $100 of total state and local sales tax collected for small retailers, $3.35 per $100 for medium retailers, and 97 cents per $100 for large retailers. For purposes of the study, small retailers are defined as those with gross annual Washington sales between $150,000 and $400,000, medium retailers with sales between $400,000 and $1,500,000, and large retailers with sales over $1,500,000. The costs include any activity the retailer has to perform related to sales tax collections and remittance that they would not have to do if they were not obligated to collect and remit sales tax. The table in Appendix C-19 details the costs of collections by type of cost.

The costs associated with collecting local sales tax are estimated to be 3.3 percent of total local collections for small retailers, 1.89 percent of total collections for medium retailers, and 0.31 percent of total collections for large retailers.

As of 1998, 26 of the 45 states that have a retail sales tax allow vendors to keep a portion of the sales tax collections as a way of compensating retailers for collecting and remitting sales tax as agents for state and local government. Washington State does not compensate retailers in this way. In some of these states, costs to retailers are substantially higher because retailers must remit sales taxes to each local government separately.

Timing of Tax Payments

Taxes are considered to be "lumpy" if the timing of the tax payment and/or the amount of the payment is burdensome to taxpayers. Property taxes, real estate excise taxes, and watercraft taxes are lumpy taxes. Most other taxes are not considered lumpy because they are paid more frequently and in smaller amounts.

Transparency

Taxes should be transparent, not hidden from taxpayers.

Conclusions

- Washington has taxes that are not transparent to taxpayers, including B&O tax passed down to consumers and business sales tax passed down to consumers.
- The B&O tax pyramids, causing a higher effective tax rate on value added than is transparent.

Transparency and Business Taxes

To the extent that business taxes are passed on to households, business taxes are not transparent because they are rolled into the price of goods and not explicitly stated. Washington has several business taxes, the main business tax being the B&O tax. Other business taxes include wholesale level taxes such as the cigarette and tobacco products taxes and liquor taxes. (See Appendix C-20 for a detailed list of non-transparent taxes.)

Transparency and Sales Tax

Sales tax paid by business and passed down via the costs of goods is also hidden. Sales tax on consumer purchases is somewhat transparent. The sales tax is explicit in each purchase. However, over the span of a year, the summation of tax paid becomes lost; few taxpayers are cognizant of total sales tax paid within a year.

Pyramiding of the B&O Tax

To the extent the taxes pyramid, they are not transparent. The cumulative tax that is paid over a production process is not explicitly stated. The B&O tax pyramids an average of 2.5 times. This means that on average, the explicitly stated B&O rate is about 40 percent of the actual B&O tax paid on goods and services produced and/or sold in Washington State. (For more detail on pyramiding of the B&O, see the sub-chapter on neutrality.)

Home Ownership

This sub-chapter analyses the impact of taxes on the ability to purchase and retain a home.

Conclusions

- For a sample of typical homes bought under different circumstances and in different counties, taxes range from about 6 percent to 10 percent of the purchase price.

- Property taxes do not play a large role in affordability. Principal and interest on a mortgage have a much greater role in the ability of a household to afford a home. In fact, property taxes play a smaller role in affordability in less affordable counties compared to more affordable counties.

- Almost 50 percent of homeowners pay less than 3 percent of their income in property taxes. About 70 percent of homeowners pay under 4 percent of their income in property taxes.

- About 11 percent of homeowners pay over 6 percent of their income in property tax. About 26 percent of these are senior citizens. Many are low-income working families that have suffered a change in circumstances.

- Washington State has two property tax relief programs for senior and disabled citizens. Most homeowners that have high property taxes as a percentage of income do not qualify for the programs because of age or income.

Taxes and the Ability to Purchase a Home

Tax liability on the purchase of a home differs depending on whether the home is a new house built on speculation (spec-built), a new custom-built house, or an existing house.

Real estate excise tax is the liability of the seller, but can be paid by the purchaser if taxes have not been paid. REET is due on the transfer of the property on all three types of homes. Because only the land is transferred in the case of the custom-built home, REET is paid only on the value of the land.

Since the purchaser is the final consumer of the goods and services which go into a custom-built home, the purchaser of a custom-built home pays sales tax on the value of all the materials and construction labor in the contract. In the case of spec-built homes, the builder is the final consumer of the goods and services used to build the home. Therefore, the builder pays sales tax on purchases of materials and construction labor from subcontractors.

In reality, taxes are passed on to others in part or in full based on market conditions. For consistency and simplicity, the home buyer is assumed to pay 100 percent of the sales tax and REET. Analysis of taxes on median-priced homes in different jurisdictions shows that taxes range from about 6 percent to 10 percent of the purchase price of a home. (See Appendix C-23 for detailed examples.)

Both retail sales tax rates and real estate excise tax rates vary by jurisdiction. Table 9-15 shows the highest and lowest rates of each of the taxes.

Table 9-15

Retail Sales Tax and Real Estate Excise Tax Rates

	Lowest rate	Highest rate
Retail sales tax	7.0%	8.9%
Real estate excise tax	1.28%	2.78%

Taxes and the Ability to Qualify for a Home Loan

Property taxes can play a role in the ability to qualify for a mortgage. The rule of thumb for making mortgage loans is that the mortgage payment plus property taxes on the home plus homeowner insurance should not exceed 28 percent of the purchaser's income. Property taxes constitute 4.6 percent of the median household income based on a median-priced home.

In order to analyze whether property tax affects the ability to qualify for a home loan, the Department compared affordability indices with and without property tax for each Washington county. The affordability index measures whether the median-priced home in each county can be purchased with the median-priced income given the 28 percent rule. Analysis showed that in all but three counties, Kittitas, San Juan and Jefferson, median income households could afford homes which were more expensive than the median-priced homes. In Kittitas, San Juan, and Jefferson counties, median income households could not afford the median-priced home. This result is the same whether property taxes are included or not. Therefore, property taxes do not have a significant impact on the ability to qualify for a home.

This analysis was also done for first-time home buyers. This index compares median income for first-time homebuyers with the qualifying income needed for a house priced at 85 percent of the median price. First-time home buyers are assumed to have median incomes at 70 percent of median county income. Also, lower down payments and higher mortgage rates are assumed. This analysis shows that in 16 counties median income first-time homebuyers cannot afford the median home. In six of these counties, median homebuyers' income is close enough to the amount needed to qualify for the median home that property tax does make a difference in the ability to qualify. The conclusion is that for first-time homebuyers, property tax can make a marginal difference in the ability to qualify for a home. The affordability charts and indices are in Appendix C-24.

Taxes and the Ability to Retain a Home

Property Tax Burdens

Property tax rates vary from 0.7 percent of a home's market value in San Juan County to 1.48 percent in Garfield County. Property tax rates in Washington counties can be found in Appendix C-25.

In 2000, Washington State ranked twenty-third highest in terms of property taxes as a percent of personal income. Washington's property taxes were $31.53 per $1,000 of personal income. Motor vehicle excise tax, considered to be in-lieu of property tax, is included in the Census data from which these calculations are derived. The MVET was eliminated effective in 2000. The U.S. average was $32.07 in 2000. (See Appendix C-26 for a comparison of property taxes per $1,000 of personal income for all states.)

Property taxes can impact a homeowner's ability to retain their home under some circumstances, including the following scenarios. Home values rise, but the homeowner's income is fixed. Market conditions cause a sharp increase in home values, greater than increases in salaries. The homeowner's salary decreases dramatically because of job loss, disability, divorce, or other reasons.

Table 9-16 shows the distribution of property tax payments as a percentage of income by income categories. The table shows that almost 50 percent of homeowners pay less than 3 percent of their income in property taxes. About 70 percent of homeowners pay under 4 percent of their income in property taxes. Almost 6 percent of homeowners pay over 8 percent of their income in property taxes, and almost 20 percent pay over 5 percent of their income.

Table 9-16

Percent of Homeowners by Household Income and Property Tax as a Percent of Income
Calendar Year 1999

	Less than 3%	3% to 6%	Over 6%	Total
Income	Percent	Percent	Percent	Percent
Less than $15,000	1.51%	0.55%	2.05%	4.11%
$15,000 to $25,000	2.87	1.86	1.67	6.39
$25,000 to $37,500	3.14	6.45	2.93	12.53
$37,500 to $50,000	3.62	7.46	1.75	12.83
$50,000 to $62,500	5.65	6.92	1.01	13.58
$62,500 to $75,000	5.42	5.44	0.52	11.39
$75,000 to $100,000	11.20	5.42	0.98	17.59
$100,000 to $150,000	9.35	3.34	0.31	13.00
Over $150,000	6.87	1.66	0.05	8.57
Total	49.62%	39.13%	11.26%	100.00%

Source: Homeowner Property Tax Model 2002

Table 9-17 illustrates the distribution of homeowners by the percentage of income paid in property taxes. The table is also broken into two age groups: homeowners above age 65 and homeowners under age 65.

Table 9-17

Number of Homeowners by Percent of Income Paid in Tax and by Age

Property Tax as a Percent of Income 2002	Person's Age				All
	Under 65		Over 65		
	Households	Percent	Households	Percent	Households
Less than 3%	654,006	83.12	132,787	16.88	786,793
3% to 6%	483,129	80.04	120,509	19.96	603,638
Over 6%	128,207	73.56	46,087	26.44	174,294
All	1,265,342	80.87	299,383	19.13	1,564,725

Source: Homeowner Property Tax Model 2002

Characteristics of Homeowners with Relatively High Property Taxes

Over 174,000 households have property tax payments equal to or greater than 6 percent of household income. This represents 11 percent of all homeowners. Typical property taxes as a percentage of income range from 1.73 percent of income for households with incomes over $130,000 to 5.77 percent of income for households with incomes under $20,000. Therefore, 6 percent is higher than an average or typical property tax burden for any income group.

Of the 174,000 households with relatively high property taxes, 26 percent are over age 65 and 74 percent are under age 65. Although over-age-65 households do not constitute the majority of households with high property taxes, they are a disproportionately high percentage. Over-age-65 homeowners are only 19 percent of all homeowners. Table 9-18 shows characteristics broken down by age of homeowners with relatively high property taxes.

Homeowners with Property Taxes Over 6 Percent That Are Over Age 65

The majority of homeowners age 65 and older with high property taxes as a percentage of income seem to be on a fixed income. Many probably do not receive income other than Social Security. A significant percentage of these homeowners are probably widows and widowers. High growth in the value of their home and/or considerably reduced post-retirement income are the most likely causes for their relatively high property tax burdens.

Homeowners with Property Taxes Over 6 Percent That Are Under Age 65

Either high growth in home values and/or drastic changes in income have caused these homeowners to pay disproportionately high property taxes. Up to 25 percent could have had a sudden change in income due to unemployment or disability. Others may have had reduced income due to divorce. A large percentage of households under age 65 with high property taxes appear to have children (at least 40 percent). In addition to high property taxes, many of these families bear the costs of mortgages and the costs of raising children.

Table 9-18

Characteristics of Homeowners with Property Tax Payments Over 6 Percent of Income by Age (percentages are approximate)

	Homeowners over 65 with property tax greater than 6% of income	**Homeowners under 65 with property tax greater than 6% of income**
Percent with income 30K and under	70%	65%
Percent that receive Social Security	95%	20%
Percent that receive either pensions, unemployment insurance or worker's compensation	40%	25%
Percent with only one household member	40%	25%
Percent with more than 2 family members	2%	40%
Percent that own their house free and clear	80%	30%
Percent with houses assessed over $270,000	45%	45%

Property Tax Relief

The state of Washington has two programs to provide property tax relief for senior and disabled citizens. The first program provides varying levels of exemption for disabled homeowners and senior citizens (age 61 and over) with income under $30,000. All senior and disabled citizens in the program are exempt from special property tax levies. Those with incomes under $18,000 are additionally exempt from regular property tax levies on the greater of the first $50,000 in assessed value or 60 percent of assessed value. Those with incomes between $18,000 and $24,000 are additionally exempt from regular property tax levies on the greater of the first $40,000 in assessed value or 35 percent of assessed value (no greater than $60,000 in assessed value).

In addition to the tax exemption, the assessed value of participants' properties is frozen from the time that they enter the program.

The other program is a property tax deferral for senior and disabled citizens. All disabled homeowners and seniors (age 60 and over) with incomes under $34,000 are eligible to defer their property taxes until the house is sold or until time of death. However, since most senior citizens that are eligible for the deferral are also eligible for the exemption, very few opt to take the deferral.

Harmony with Other States

Conclusions

- Washington ranked thirty-second in 2000 in terms of state and local tax collections per $1,000 income.
- Washington's tax system is unique.
- Retail trade and state and local sales tax revenues in the Oregon and Idaho border counties are very sensitive to changes in tax rates.
- Sales and revenues in the 14 counties bordering Oregon and Idaho would increase by an estimated 22 percent if the sales tax differential were eliminated.
- Remote sales caused an estimated state sales tax loss of $138 million to $148 million in Calendar Year 2001.
- Washington residents purchase an estimated 6 percent more products remotely per capita compared to average per capita purchases because of Washington's higher sales tax.

Unique Features of Washington's Tax System

- Washington's relative business tax burden is higher than in any other Western state.
- Washington is one of seven states with no personal income tax and one of six states with no corporate income tax.
- Washington's B&O tax is unique.
- Because of heavy reliance on sales tax, Washington's tax rate is the third highest in the nation, and the sales tax base is broader than average.
- Selective sales taxes are also among the highest in the nation.

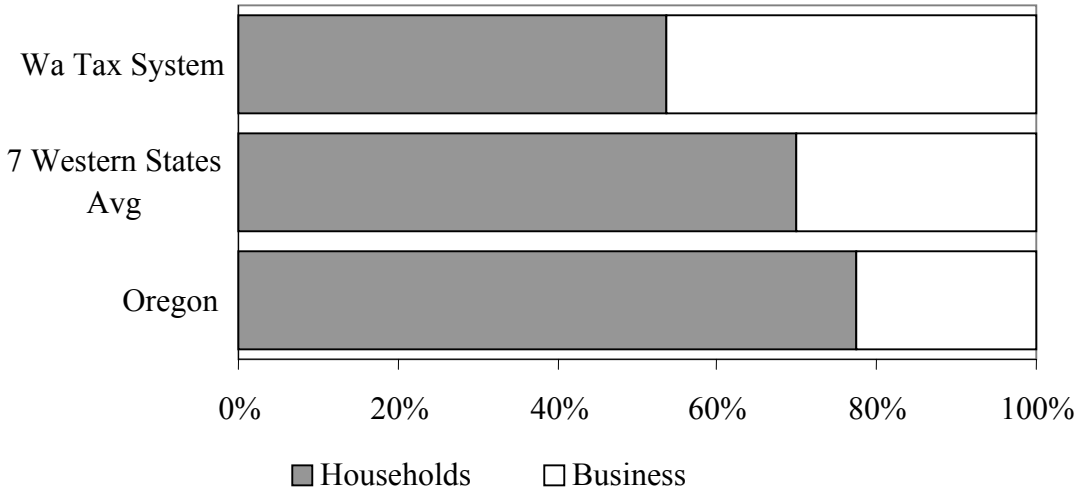
See Chapter 3 for more details on how Washington differs from other states.

Business/Household Share

The share of total state/local taxes paid initially by businesses is high in this state. An annual study performed by the Utah Tax Commission concludes that Washington taxes on businesses are higher than in the other Western states selected for analysis (see Chart 9-H). Conversely, household taxes in Washington are the lowest of these same states.

Chart 9-H

Household/Business Shares of Major State and Local Taxes



Sales Tax Leakage

Border Loss

Because of the high sales tax rate, Washington suffers from two major sources of tax leakage. The first source is tax evasion along Washington borders. The sales tax differential between Clark and Multnomah counties is the greatest in the country, and this creates significant tax compliance difficulties, harming both in-state retailers and local governments. The second source of leakage is tax avoidance via remote sales.

Residents of Washington jurisdictions that border Oregon and Idaho have an incentive to shop across the border to avoid paying higher sales tax. Washington state and local sales tax varies from 7 percent to 8.9 percent. Idaho has a maximum state and local sales tax of 7 percent. Oregon has no sales tax.

Although goods purchased out of state are subject to use tax, it is nearly impossible to enforce use tax collections from individuals. (The exception is use tax collections on vehicles and vessels. Since these have to be registered, use tax is collected on these purchases.) Many individuals are not even aware of the use tax liability.

The border tax differential causes problems for both Washington retailers and Washington revenues. Washington retailers suffer a competitive disadvantage because of the loss of sales to Oregon and Idaho. State and local governments lose revenues because of the loss of sales. Over the long run, the competitive advantage of locating in Oregon or Idaho increases the retailing sector in those states compared to Washington State. The larger selection of goods offered by the larger retailing sector is an additional draw for Washington residents. This exacerbates the problems for retailers and revenues.

In his paper, "The Border Tax Problem in Metropolitan and Non-metropolitan Areas of Washington" (*Western Tax Review*, Winter 1992), John Beck estimates that elimination of the sales tax differential in Oregon and Idaho would increase taxable retail sales and revenues by an estimated 22 percent in the 14 counties that border Oregon and Idaho.

Remote Sales

Remote sellers are not required to collect retail sales tax from customers unless they have substantial nexus in the state. In 1992, the United States Supreme Court said the sales tax is too burdensome on interstate commerce to require sellers to collect tax for states in which sellers don't have substantial nexus. *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). Although purchasers are required to pay use tax on their remote purchases, few do.

This sets up a fundamental issue of unfairness between in-state retailers and their competitors selling remotely (e.g., catalog and e-commerce sellers). The in-state sellers must collect sales tax, but their remote competitors may not be required to collect tax on the very same transaction. Additionally, for the multistate sellers who are currently required to collect sales taxes because of their physical presence, the cost of compliance is a significant burden.

State sales tax losses from remote sales are estimated to be $138 million to $148 million in CY 2001 and $152 million to $185 million in CY 2002. Growth rates in remote sales have been estimated to have been about 25 percent in each of the last couple of years. Such high growth rates could continue for the next several years.

Although all states with sales tax suffer from remote sales leakage, Washington's remote sales are estimated to be higher because of the high sales tax. Based on an elasticity calculated by Austan Goolsbee in his paper *In a World without Borders: The Impact of Taxes on Internet Commerce*, Washington's remote sales are over 6 percent higher per capita because of the higher sales tax in Washington.