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

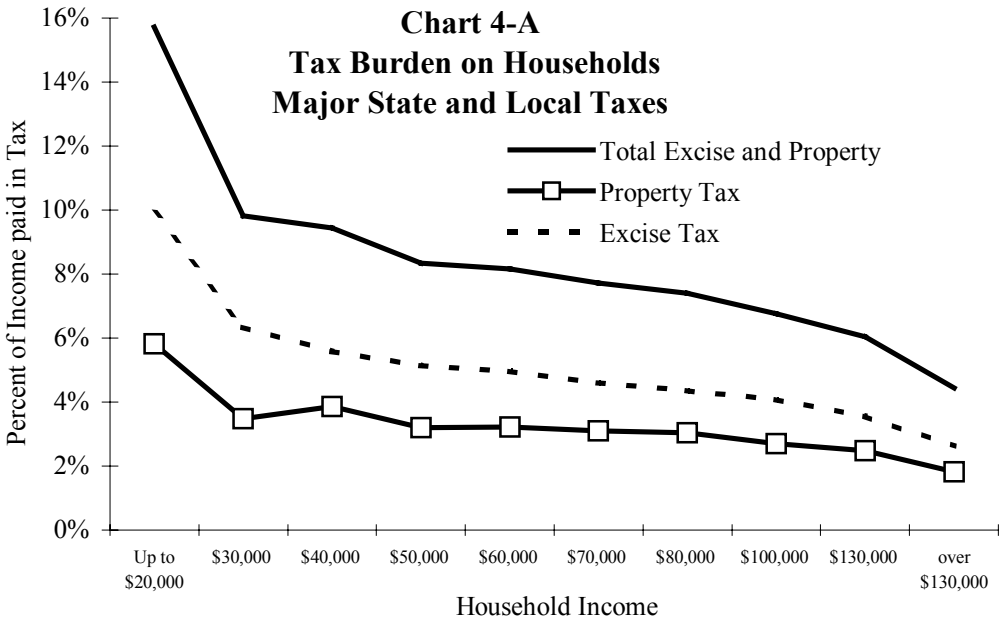
Most people agree that fairness requires relative tax burdens on households (taxes as a percentage of household income) to be the same for all households, or higher for households with higher incomes (i.e., a progressive tax system). Correspondingly, a tax system that imposes higher relative burdens 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.

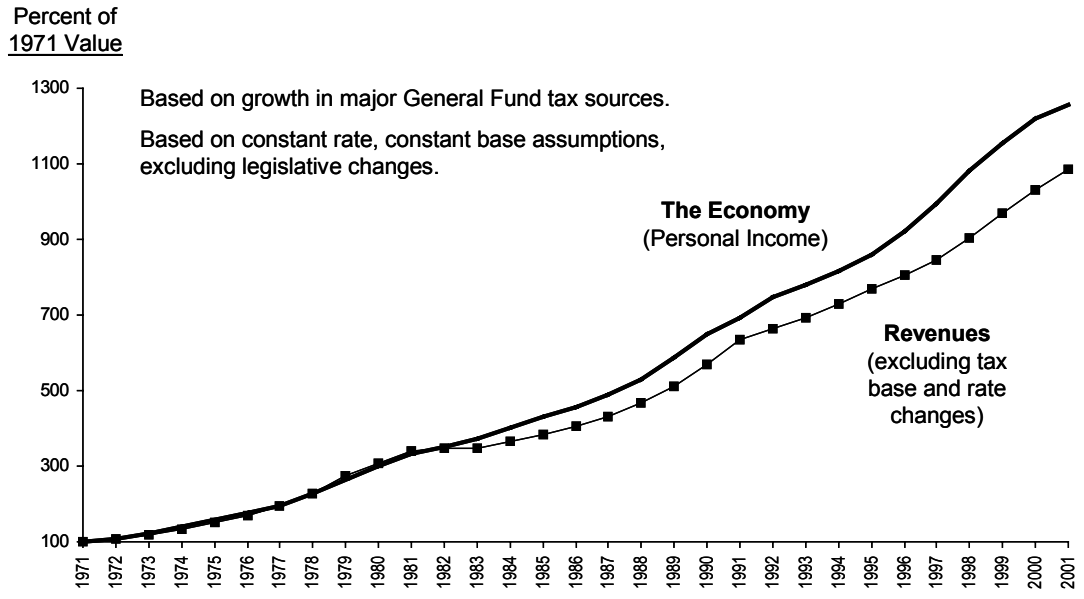
Adequacy

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.