WASHINGTON STATE TAX STRUCTURE STUDY

Equity Findings

Ability to Pay

- All excise taxes are regressive to one degree or another when measured by income.
- The total of excise and property taxes represent an average of 16.1 percent of the income for the lowest income group ($20,000 or less) and 4.6 percent of income for the highest income group (over $130,000).
- Over a lifetime, taxes become less regressive. The sales tax is regressive over a lifetime, while the property tax is lifetime progressive for property owners.

Benefits Received

- States dedicated slightly more than one-fifth (21.7 percent) of their tax revenue for statutory or constitutionally required reasons to specific programs or purposes in 1997. Washington dedicated 26.2 percent in the same period.

Horizontal Equity

- There is significant variation in tax as a percent of income within income groups. This is driven by sales tax.
- There is less variation as a percent of spending within spending groups. Spending groups are considered to approximate permanent income.
- There is significant variation in taxes 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 51 percent of the taxes, 45 percent is paid by business, and 4 percent by government and others.
- Effective tax rates for all taxes (as a percent of gross income) range from 1 percent for agriculture and wholesalers to slightly more than 2 percent for transportation, communications, and utilities.
- Small businesses pay a higher effective property tax rate than large businesses. New firms pay a higher overall effective tax rate than established firms. However, there are no consistent differences between small and large firms for sales tax and B&O/public utility taxes.
- Excise tax exemptions shift the burden on the remaining taxable activity in the long run if tax rates increase. Property tax exemptions result in an immediate tax shift for the remaining taxable property.

- The overall rate of noncompliance for Washington's excise taxes is about 3 percent. For new firms the rate is about 6 percent, due primarily to lack of knowledge about the law.
- Significant activities not subject to taxation in Washington are:
    - Income of Individuals
    - Business Inventories
    - Intangible Assets
    - Rental of Real Property
    - Agricultural Production
    - Investment Income of Nonfinancial Business
    - Food for Home Consumption

Perceived Equity

- In the 2001 Taxpayer Satisfaction Survey, the largest group of Washington taxpayers (43 percent) expressed the opinion that taxes neither help nor hinder their ability to conduct business.
- Based on taxpayer surveys in four states, the sales tax is considered the most fair tax and the least objectionable to increase when revenues are needed.
- A flat rate income tax is preferred to one that is progressive with graduated rates, because everyone pays at the same rate.

Externalities

- Cities and counties are authorized to collect development fees to mitigate the impact of housing developments on schools, roads, fire protection and other infrastructure needs.
- Forty states impose one or more taxes specifically designed to generate revenue from activities perceived to be harmful to the environment.

Equity Questions

Ability to Pay

1) How do business taxes affect regressivity when passed through to households?
2) How regressive is our tax system (on both an income and wealth basis)?
3) Is our system regressive when looking at lifetime equity?
4) To what extent can households shift or export taxes to business, the federal government, etc.?
5) What taxes are on income, assets, and consumption?

Benefits Received

6) Do people/entities that receive benefits from the state pay a corresponding amount of tax for the benefits?

7) Which of our taxes are tied to benefits received? What percentage are these taxes compared to the tax system? How does that percentage compare with other states?
8) Regionally, where are taxes generated and where are they spent?
9) To what extent are taxes targeted and earmarked?

Horizontal Equity (Equity among similarly situated taxpayers)

10) Do similar households (with similar income/household size) pay similar amounts of tax?
11) Do taxpayers engaged in similar activities pay similar amounts of tax?
12) Do similar taxpayers in different locations pay significantly different taxes because of local taxes?

Intersectoral/Vertical Equity

13) What percentage of tax is paid by business? By households?
14) Do businesses in different industries have similar tax burdens?
15) Do big and small businesses within the same industry have similar tax burdens?
16) Do new businesses and established businesses have similar tax burdens?
17) When new exemptions are created, do tax increases shift to other taxpayers?
18) Are our taxes administered equitably?
19) Are there any sectors or groups that don't pay a proportionate share of tax?
20) Are there significant activities that are not subject to taxation?

Perceived Equity

21) Do taxpayers think our tax system is fair?
22) Which taxes do taxpayers think are fair?

Externalities

23) Do activities that create negative impacts pay a proportionate tax?

Ability to Pay

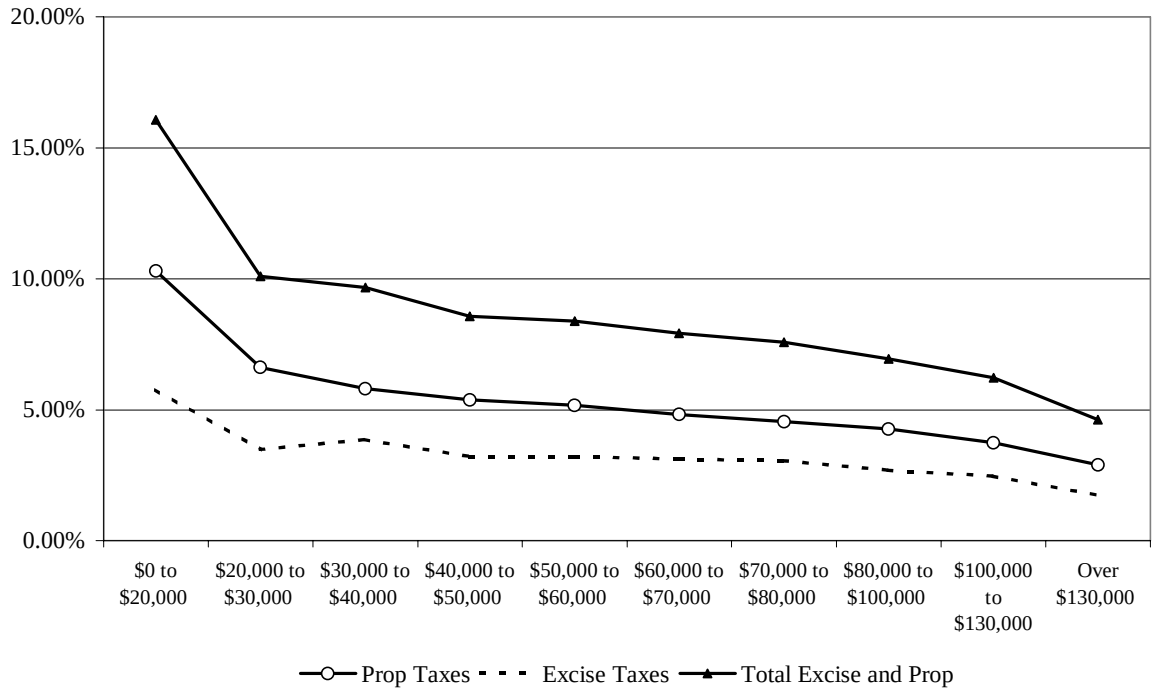
Household Incidence of Excise Taxes

The Washington Excise and Property Tax Microsimulation model can be used to illustrate the distribution of both current excise taxes and proposed alternatives. The model combines information from the Consumer Expenditure Survey and the Washington State Population Survey and can show estimated household excise and property taxes by income group, household size, home tenure, and total spending.

The chart below shows estimated excise taxes paid by households as a percent of income. Table 3 illustrates the regressive nature typical of excise taxes, where lower income groups pay a higher percentage of their income in taxes (16.1 percent) than higher income groups do (4.6 percent). Note from Table 1 below that the sales tax has a relatively flat incidence for the middle range of consumers with the high and low ends more regressive. Note also that tobacco taxes are the most regressive. Table 2 shows the average dollar amounts of tax paid and Table 3 shows percentage of income paid on excise and property taxes.

Chart 1

State & Local Excise and Property Taxes as a Percent of Income



Source: Washington Excise and Property Tax Microsimulation Model

WASHINGTON STATE TAX STRUCTURE STUDY

Table 1: STATE AND LOCAL EXCISE TAX AS PERCENT OF INCOME

Average of All Imputation Groups	Total Excise Taxes	Sales Tax	Alcohol Taxes	Ins Tax	Tobacco Taxes	Utility Taxes	Gas Tax
1999 HOUSEHOLD TOTAL INCOME							
$0 to $20,000	10.30%	7.12%	0.28%	0.24%	1.15%	0.56%	0.95%
$20,000 to $30,000	6.61%	4.70%	0.15%	0.17%	0.60%	0.33%	0.65%
$30,000 to $40,000	5.81%	4.21%	0.17%	0.15%	0.45%	0.25%	0.58%
$40,000 to $50,000	5.37%	3.93%	0.13%	0.14%	0.41%	0.22%	0.53%
$50,000 to $60,000	5.17%	3.89%	0.14%	0.13%	0.35%	0.20%	0.46%
$60,000 to $70,000	4.81%	3.65%	0.12%	0.12%	0.30%	0.18%	0.44%
$70,000 to $80,000	4.55%	3.51%	0.12%	0.11%	0.25%	0.16%	0.39%
$80,000 to $100,000	4.26%	3.35%	0.11%	0.10%	0.21%	0.14%	0.35%
$100,000 to $130,000	3.74%	3.07%	0.08%	0.09%	0.12%	0.12%	0.27%
Over $130,000	2.89%	2.47%	0.06%	0.05%	0.07%	0.08%	0.15%

Table 2: STATE AND LOCAL EXCISE AND PROPERTY TAX BY INCOME

Average of All Imputation Groups	Total Excise And PropTaxes	Total Excise Taxes	Prop Tax
1999 HOUSEHOLD TOTAL INCOME			
$0 to $20,000	1,885	1,204	680
$20,000 to $30,000	2,467	1,616	851
$30,000 to $40,000	3,299	1,981	1,317
$40,000 to $50,000	3,804	2,382	1,422
$50,000 to $60,000	4,511	2,781	1,730
$60,000 to $70,000	5,068	3,078	1,990
$70,000 to $80,000	5,625	3,367	2,257
$80,000 to $100,000	6,112	3,744	2,368
$100,000 to $130,000	6,963	4,192	2,771
Over $130,000	9,556	5,785	3,771

Table 3: STATE & LOCAL EXCISE AND PROPERTY TAX AS PERCENT OF INCOME

Average of All Imputation Groups	Total Excise And PropTaxes	Total Excise Taxes	Prop Tax
1999 HOUSEHOLD TOTAL INCOME			
$0 to $20,000	16.07%	10.30%	5.77%
$20,000 to $30,000	10.09%	6.61%	3.48%
$30,000 to $40,000	9.67%	5.81%	3.86%
$40,000 to $50,000	8.57%	5.37%	3.21%
$50,000 to $60,000	8.38%	5.17%	3.21%
$60,000 to $70,000	7.91%	4.81%	3.11%
$70,000 to $80,000	7.59%	4.55%	3.05%
$80,000 to $100,000	6.95%	4.26%	2.69%
$100,000 to $130,000	6.21%	3.74%	2.47%
Over $130,000	4.62%	2.89%	1.73%

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. Tax savings for itemizers account for 0.4 percent of Adjusted Gross Income.

Table 4 shows that federal income tax deductibility of property tax makes our tax system slightly less regressive on the lowest and highest ends of the income scale. However, for all other income ranges, deductibility increases with income.

Table 4
FEDERAL INCOME TAX SAVINGS FOR WASHINGTON HOUSEHOLDS TAKING PROPERTY TAX DEDUCTIONS, CY 1999

Adjusted Gross Income	% Households who Itemize	PropertyTax Savings as % of AGI
$0-10000	2.7%	0.3%
$10000-20000	10.0%	0.2%
$20000-30000	17.0%	0.2%
$30000-40000	28.5%	0.2%
$40000-50000	42.5%	0.3%
$50000-60000	56.1%	0.4%
$60000-80000	66.3%	0.5%
$80000-100000	77.6%	0.6%
$100000-200000	81.9%	0.6%
$200000-500000	79.7%	0.5%
> $500000	61.7%	0.1%
Average	32.9%	0.4%

Amount of Tax Exported to the Federal Government

- Property Tax--For Tax Year 1999, Washington households realized an estimated $520 million 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.

- Motor Vehicle Excise Tax--Prior to Initiative 695 and the subsequent elimination of the MVET by the Legislature, the excise in lieu of property tax was deductible. For Tax Year 1999, this resulted in an estimated $90 million in personal income tax savings for Washington taxpayers.

- Sales Tax--While state and local income taxes are deductible, 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 estimated $523 million in tax savings.

Distribution of Tax Burdens Based on Lifetime Income

The study, Who Bears the Lifetime Tax Burden by Don Fullerton and Diane Lim Rogers, Brookings Institution, Washington DC, 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 lifetime groups and lifetime progressive at the very bottom and top of the income distribution.

Benefits Received

Dedicated Taxes by State

On average, states dedicated slightly more than a fifth of their total tax collections in Fiscal Year 1997 for purposes defined in statute or the constitution. Of the dedicated total 87 percent was dedicated to the following three purposes: transportation, education, and local governments. The percent of tax receipts dedicated in Washington for this period was 26.2 percent, ranking Washington 15th in terms of the highest dedicated share of taxes.

In Washington large sources for dedicated taxes are motor fuels, cigarette, environmental taxes such as litter, oil spill and hazardous substances taxes, insurance premiums taxes and the business and occupation tax. The state property tax levy is dedicated to the support of common schools.

Historically for all states, the percent of dedicated state taxes has remained relatively stable in the last 20 years. Studies covering the years between 1979 and 1997 show the national average to be between 21 percent and 24 percent. This represents a significant decline from 1954 when the dedicated tax share was 51 percent. For Washington, the historical figures show the dedicated portion to range from 26 percent to 29 percent between the 1979 and 1997 study periods, with a high of 35 percent in 1954. See Tables 5 and 6 for summary statistics.

See Appendix 1 for more detail on dedicated taxes by state.

Table 5
DEDICATED TAX AS A PERCENT OF TOTAL TAX COLLECTIONS ($000)

	Total Collections	Total Dedicated	% Dedicated	WA Rank
All Dedicated Taxes				
Washington	$10,482.3	$2,743.7	26.2%	15
U.S. Total	$416,098.7	$90,215.8	21.7%	
Excludes Highway User Taxes				
Washington	$9,039.8	$1,720.1	19.0%	15
U.S. Average	$382,017.5	$58,463.4	15.3%	

Table 6
PERCENTAGE OF TAX COLLECTIONS DEDICATED

State	1954	1963	1979	1984	1988	1993	1997
Washington	35%	30%	29%	26%	29%	30%	26%
U.S. Average	51%	41%	23%	21%	24%	24%	22%

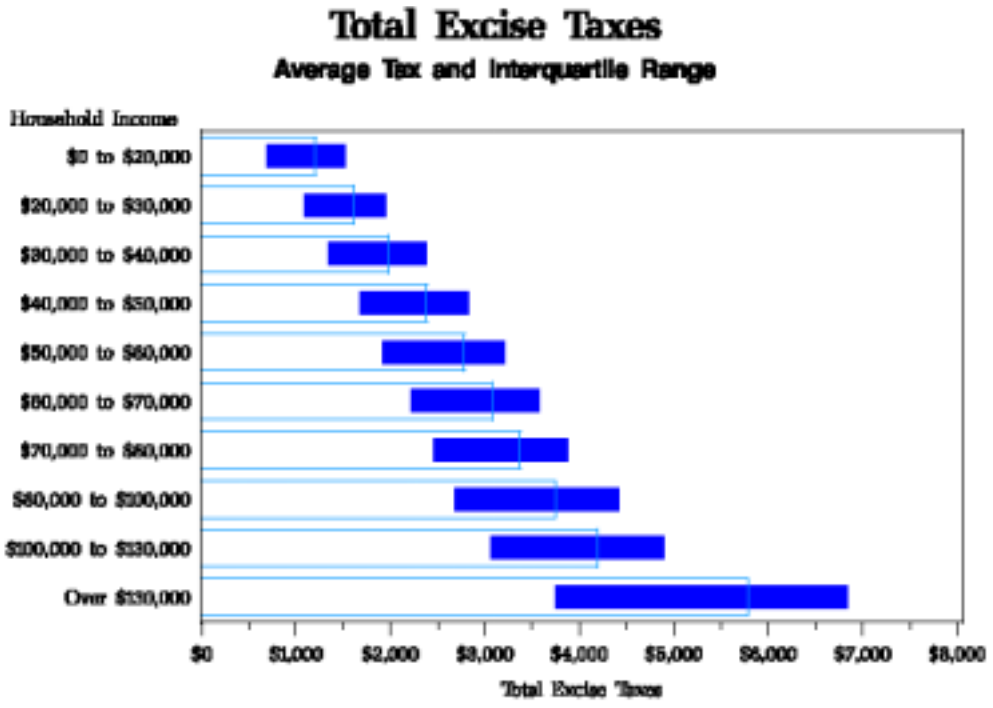
Horizontal Equity

Horizontal Equity for Households

The following graphs illustrate the variation in tax within an income group. Charts 3 shows average tax as a percent of income in each income category and the interquartile range of tax as a percent of income. Chart 4 shows the average total tax paid in each income category and the interquartile range of total tax paid. Interquartile range represents the range of tax paid by those households within the middle of the distribution--the 2nd and 3rd quartiles (between 25% and 75% of taxpayers). The 1st and 4th quartiles are excluded to eliminate outliers and other distortions.

Chart 3

Chart 4



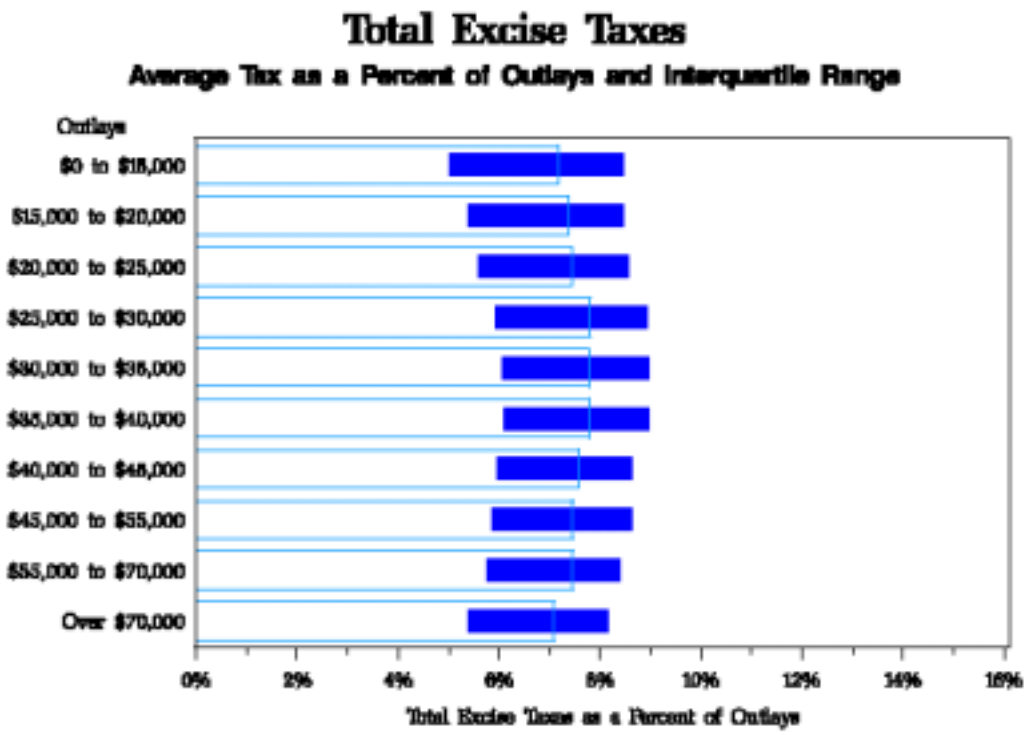
Source: Washington Excise and Property Tax Microsimulation Model

This same analysis conducted by tax type shows that sales tax contributed the most to tax variation within income groups. (Details are in Appendix 2.)

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).

Because permanent income and annual income can be quite different, thus causing higher tax variability within income ranges, we did the same analysis using consumption ranges (outlays) instead of income ranges. The results are shown in Chart 5. The variation within consumption ranges is much smaller than the variation between income ranges (and more consistent from range to range). This is not surprising, since sales tax is the biggest driver in variation.

Chart 5



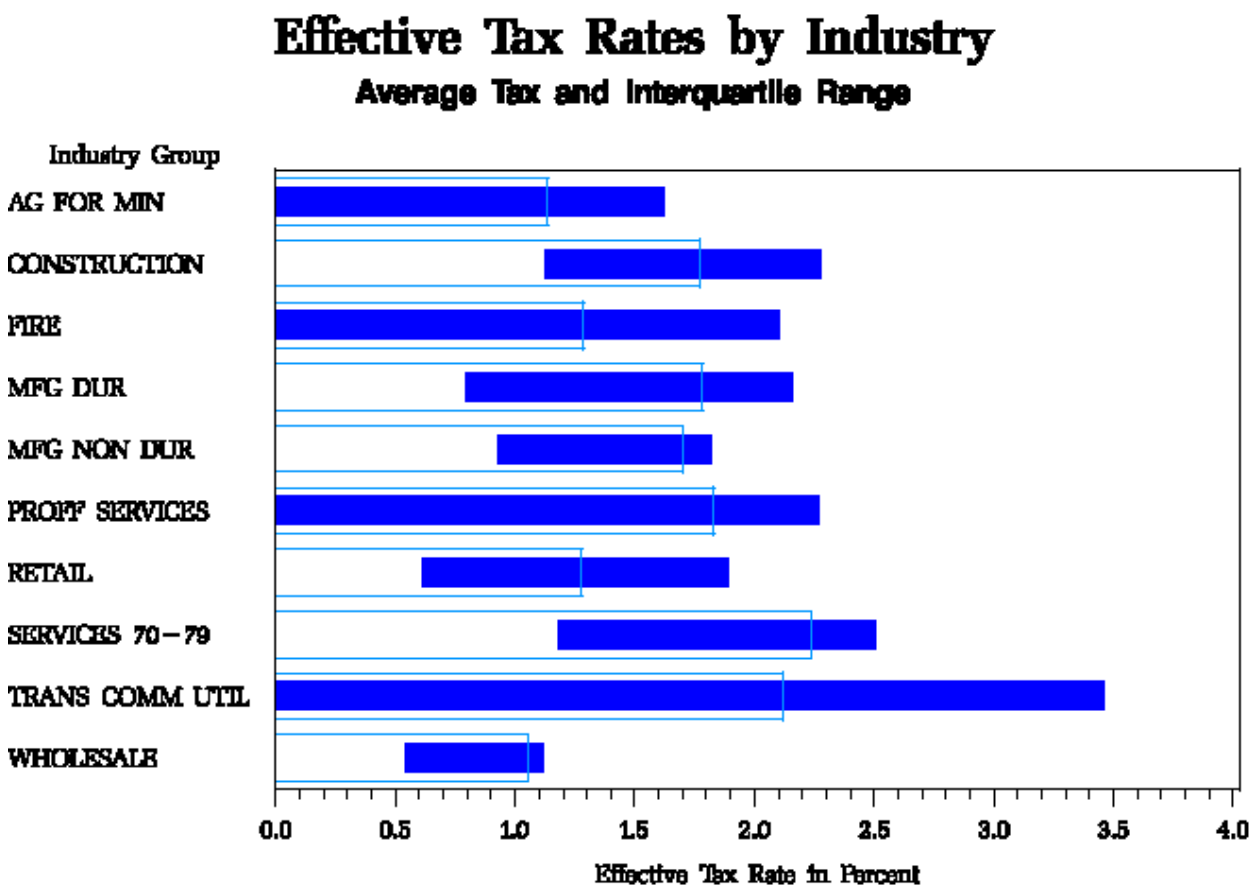
Source: Washington Excise and Property Tax Microsimulation Model

Horizontal Equity for Business

The following chart 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, because taxpayers' holdings of property relative to their gross income varies tremendously. Firms with gross income less than $28,000 pay no B&O because of the small business credit. These data are too preliminary to be used for relative comparisons.

Information displayed in Chart 6 and Tables 9-12 are from a merged database including B&O/public utility, property tax, sales tax paid on purchases, and data from the Employment Security Department on employees and wages at the firm level.

Chart 6



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 DOR/CTED study *Tax Incentive Comparison of Six States and One Province* we have estimated that a high tech call center's tax payments can 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 may be as much

as 23 percent lower in low tax locations. Semiconductor manufacturers, software, and biotech firms fell between these two ranges.

In terms of the after tax profit margin, holding all other factors constant, low tax locations can raise a high tech call center's after-tax profits by two percentage points. Both biotech and general manufacturing see their after-tax profits rise by some six-percentage points. Semiconductor manufacturers and software firms fell between these two ranges. Note that this analysis includes all statewide tax incentives and exemptions but does not include tax incentive programs that are based on location.

Table 7
GEOGRAPHIC VARIATION IN TAX RATES -- IMPACT ON AFTER TAX PROFITS[1]

Taxes	Highest Tax Rates Seattle Area	Lowest Tax Rates Various Rural	Alternate Low Rate Various Rural Areas
Sales Tax Rate[2]	8.8%	7.5%	7.5%
Property Tax	Pierce Co.	San Juan Co.	Wahkiakum Co.
Tax Rate	15.97	8.35	10.25
Assessment Ratio	0.934	0.843	0.873

Firm Profit Margin (%)	Profit @ High Rate	Profit @ Low Rate	Profit @ Alternative Rate
Firm Type			
Semiconductor Manufacturer	8.4%	9.1%	8.9%
General Manufacturing	3.8%	4.5%	4.4%
Biotech Integrated	12.4%	13.2%	13.0%
Software Originators	6.5%	7.0%	6.9%
Call Center, High Tech	7.6%	7.8%	7.8%

Table 8
GEOGRAPHIC VARIATION IN TAX RATES--IMPACT OF TOTAL STATE & LOCAL TAXES[3]

Total Taxes	Taxes @ High Rate	Taxes @ Low Rate	Percent Savings High	Taxes @ Alternate Low Rate	Percent Savings Low
Firm Type					
Semiconductor Manufacturer	6.339	4.586	27.7%	4.963	21.7%
General Manufacturing	1.242	0.871	29.9%	0.952	23.4%
Biotech Integrated	4.534	3.252	28.3%	3.507	22.6%
Software Originators	0.136	0.106	22.0%	0.112	17.9%
Call Center, High Tech	0.467	0.414	11.4%	0.423	9.5%

1. Profits as a percent of firm revenues after state and local taxes.
2. Includes all statewide tax incentives but not local tax incentive programs.
3. B&O, sales/use, property, unemployment and industrial insurance taxes.

Different Taxation of Similar Items/Activities

Washington's tax system inherently relies on distinctions between various business activities and types of taxpayers. The Business and Occupation (B&O) tax is not imposed at a single uniform rate but relies on various classifications of business activities and provides separate tax rates for each. However, each taxpayer is 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 certain anomalies. There are certain circumstances where similar activities are treated differently under the tax system, generally by specific legislative action to fulfil a certain purpose. For example, the disparate treatment of food products depending on the purchase location and type of food fulfils the intent of the voters to exempt food for home consumption from the retail sales tax.

In other instances the tax difference is due to the classification of the activity. For example, a customer may regard the provision of movie entertainment in various forms as similar activities, but these activities may be taxed differently depending on whether they are classified as a retailing or service activity.

The property tax system also contains certain anomalies where similar taxpayers or types of property have different tax liabilities. Again, many of these circumstances are due to specific legislative action to exempt or partially exempt a certain class of property or taxpayer.

There are additional circumstances where similarly situated taxpayers receive different treatment by virtue of targeted exemptions. These exemptions are too numerous to mention in this paper, except to point out this additional category of dissimilar treatment.

For detail on the above-mentioned anomalies, see Appendix 3.

Intersectoral/Vertical Equity

Business/Household

The following table shows the percentage of state and local taxes paid by households, business and government. Households pay 51 percent of the total state and local tax burden; business pays 45 percent and government 4 percent. See Table 9 for shares by tax type.

Table 9
TAX INCIDENCE OF HOUSEHOLD V. BUSINESS - STATE & LOCAL GOVT.
FY 2000 State Taxes/$Millions

	HH	Bus.	Govt.	Household	Business	State & Local Govt.	Total
Retail Sales/Use	60%	32%	8%	$3,474	$ 1,859	$457	$5,789
B&O Tax	0%	100%	0%		1,855		1,855
Property Tax	58%	42%	0%	776	553		1,329
Motor Fuels Tax	67%	33%	0%	506	250		755
Real Estate Excise	57%	43%	0%	248	187		435
Cigarette/Tobacco	100%	0%	0%	274			274
Public Utility Tax	45%	52%	3%	111	128	7	246
Beer, Wine, Liquor	86%	14%	0%	140	23		163
Total	51%	45%	4%	$5,529	$4,854	$464	$ 10,847

Differences in Tax Rates across Industries

Table 10 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 1.1 percent of gross income for agriculture, forestry and mining industries to 2.2 percent of gross income for the services industry. The data in the following three tables are preliminary to be used for relative comparisons.

Table 10
AVERAGE TAX RATES ACROSS INDUSTRIES
Calendar 2000

SICS	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, 90's	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

The following table 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 business pays a smaller share of sales tax as a percentage of gross income than large business. B&O taxes are fairly consistent between large and small. For the overall tax rates there are differences between large, medium and small business. However, the differences are not consistently higher or lower. (See Appendix 4 for details by tax type.)

Table 11
AVERAGE TAX RATES BY SIZE OF FIRM
Calendar 2000

SICS	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, 90's	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

The following table shows average tax rates for new and established firms. New businesses pay a higher percentage of gross income in taxes than established businesses. This is mainly caused by higher property taxes as a percentage of gross income. (See Appendix 5 for details by tax type.)

Table 12
AVERAGE TAX RATES FOR NEW AND ESTABLISHED FIRMS
Calendar Year 2000

SIC	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, 90's	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%

How Exemptions Shift the Tax Burden to Other Taxpayers

Excise Tax Exemptions
Enactment of excise tax exemptions results in a decreased tax burden for the taxpayers that engage in the activities subject to the exemption or purchase the goods and services that are no longer subject to tax. When such exemptions are enacted through a statute or initiative, they rarely include a companion tax increase on other taxpayers as replacement revenue. However, a tax increase in some future period has the effect of shifting taxes onto existing sources. Previously enacted tax exemptions are rarely repealed as a means to generate revenue. As a consequence, over an extended period of time, there is a shift of tax burden away from activities, goods, and services that have been the recipients of preferential treatment onto the activities, goods, and services that remain a part of the tax structure.

Property Tax Exemptions
Property tax exemptions result in tax savings for the owners of the property that is the subject of the exemption. However, unlike excise tax exemptions, enactment of property tax exemptions generally results in a direct and immediate increase in the tax burden of the remaining taxable property. Exemption legislation has almost always resulted in the tax savings for the owners of the exempt property being made up by increased taxes on the remaining property. It occurs for both regular levies and voter approved excess or special levies. The cause of these shifts is inherent in the structure of the property tax itself. Regular levy amounts, without voter approval, are constrained to 1 percent growth a year. If property is exempted, the district value declines and the levy is made up by higher rates for taxable properties until rates hit statutory rate maximums. Special levies are voted in dollar amounts. When value is exempted from the rolls, higher special levy rates apply to remaining taxable property. (For detail, see Appendix 6.)

Administrative Equity--Equity and Noncompliance

Noncompliance contributes to inequity because the greater the noncompliance the greater the tax burden 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. Tax administration affects equity in that noncompliance is tied to tax administration efforts.

Noncompliance varies by industry, size of firm and age of firm, as can be seen in the following tables. Tables are from the Department's 1999 Noncompliance Study.

Table 13
Total Noncompliance by Industry

	Estimated Annual Noncompliance	Unreported Percentage of Taxable Income	Unreported Percentage of Tax Liability
Construction	$24,526,945	0.225%	3.6%
Manufacturing	16,742,878	0.033	3.5
Transport/Utility	2,500,376	0.026	0.8
Wholesale	10,075,328	0.047	3.4
Retail	29,787,124	0.091	1.5
Finance/Real	7,612,625	0.081	4.8
Service 7000	33,802,776	0.276	5.3
Service 8000	9,590,462	0.089	4.5
Other	1,087,360	0.060	3.5
Total	$145,725,874	0.081%	2.8%

As can be seen from Tables 14 and 15, new firms have a higher noncompliance rate than established firms. One reason for this is that ignorance of the law is the greatest reason for noncompliance, occurring 34 percent of the time. Computing errors accounted for another 26 percent of compliance errors. New firms are more likely to make these types of mistakes.

Table 14
Noncompliance by Age of Firm

	Estimated Annual Noncompliance	Unreported Percentage of Taxable Income	Unreported Percentage of Tax Liability
Newer Firms	$30,391,738	0.255%	6.4%
Older Firms	115,334,137	0.050	1.9
Total	$145,725,874	0.081%	2.8%

Small firms are much less compliant than large firms. One reason for this is that the department administrative efforts such as audit and collection are less cost effective applied to small firms compared to large firms.

Table 15
Total Noncompliance by Size of Firm

Annual Gross Income $ Thousands	Estimated Annual Noncompliance	Unreported Percentage of Taxable Income	Unreported Percentage of Tax Liability	Average Noncompliance Per Firm
$100 <	$27,805,014	1.750%	19.9%	$199
$100-500	18,067,570	0.265	4.9	331
$500-$1,000	27,402,879	0.363	8.8	1,340
$1,000-5,000	23,060,282	0.098	2.3	1,059
$5,000-10,000	6,785,258	0.036	1.3	1,200
$10,000-50,000	13,879,921	0.036	1.3	4,027
> $50,000	28,724,950	0.034	1.7	60,273
Total	$145,725,874	0.081%	2.8%	$591

Significant Activities Taxed and Not Subject to Taxation in Washington

The three major areas of taxation are taxes on income, assets and consumption. Washington relies most heavily on consumption taxes (sales, use and selective business sales taxes) for 60 percent of its tax revenues and currently imposes one of the highest sales tax rates in the nation at 8.9 percent in certain areas. Taxes on gross income of business (including B&O, public utility and insurance premiums) are about 20 percent of tax revenues. However, Washington along with six other states does not tax the income of individuals. Property and "in lieu of property" taxes are about 12 percent of revenues. Washington imposes taxes on all real property and on the personal property of businesses but does not tax business inventories or intangible assets.

Following is a list of other significant activities that are not taxed in Washington either as a tax policy choice made by the Legislature or the voters, or because of state constitutional prohibitions. A more detailed description of the activities and reasons they are not taxed is included in Appendix 7.

- Rental of Real Property
- Agricultural Production
- Investment Income of Non-financial Business
- Food for Home Consumption

Perceived Equity

Washington Tax System

The Department conducts a periodic survey of business taxpayers on 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.

Taxpayer Surveys

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 8.

Taxation of Externalities

Development Impact Fees

The Growth Management Act of 1990 authorized cities and counties in Washington State to impose fees on developers of property to mitigate the impact of new development on public infrastructure. Impact fees are most often used for such facilities as roads, water and sewer systems, and schools. The purpose and size of the fees must be reasonably related to the new development and must be used for public facilities where the benefits are reasonably related to the new development.

Development impact fees appear to be the most prevalent and the highest in King County where school fees can be as high as $4,186 per dwelling and transportation mitigation fees can be as high as $7,535 per dwelling in a residential development.

Environmental Taxes

Washington State has several taxes that are imposed on activities perceived to be harmful to the environment. Revenues from these taxes are dedicated to programs designed to reduce these

externalities. The following table shows Washington's taxes on externalities, the incidence of the tax and purpose for which the funds are dedicated. More detail about each of the taxes is included in Appendix 9.

Table 16

Type of Tax	Incidence of the Tax	Dedicated Purpose of Tax
Petroleum Products tax	Possession of petroleum products	Pollution Control Liability Fund and Fund Insurance related to leakage of underground storage tanks
Oil Spill Tax	Reception of crude oil or petroleum products at a marine terminal from a waterborne vessel	Oil spill response programs and oil spill clean up
Hazardous Substance Tax	First possession of certain "hazardous" items within the state	State and local hazardous waste management projects
Solid Waste Collection Tax	Use of services of a solid waste collection business	Local government public works projects.
Litter Tax	Sale of targeted items deemed most likely to contribute to litter, such as food and beverage products, and paper products	Youth litter patrol programs and education programs relating to litter control and recycling
Wood Stove Fee	Sale of a wood stove	Education about effects of wood stove smoke on air quality

Washington is not alone in the imposition of taxes on externalities. As of 2001, forty states imposed one or more taxes specifically designed to generate revenue from activities that are perceived harmful to the environment. Taxes that are imposed by other states but not imposed by Washington state include: hazardous waste taxes, taxes on underground storage tanks, nuclear facility and waste fees, sewerage, and tire taxes. Appendix 9 has more detail on these taxes and states that impose them.

Answers to the Questions

Ability to Pay

1) *How regressive is our tax system (on both an income and wealth basis)?*
   Washington's overall tax system is regressive, especially at the high and low ends of the income scale. Taxes as a percent of income ranges from 16.1 percent at the low-income end to 4.6 percent at the high-income end. Sales tax is the biggest contributor to regressivity. Tobacco taxes are the most regressive.

2) *How do business taxes affect regressivity when passed through to households?*
   Data are not currently available.

3) *Is our system regressive when looking at lifetime equity?*
National studies show that when looking at lifetime income, taxes are somewhat less regressive. Sales tax is lifetime regressive. Property tax is lifetime progressive for homeowners and lifetime regressive for renters.

4) *To what extent can households shift or export taxes (to business, the federal government, etc.)?*
Homeowners that itemize on the federal income tax return can export a portion of their property tax to the federal government. Less than one-third of Washington taxpayers itemize deductions.

5) *What taxes are on income, assets, and consumption?*
Washington relies on consumption taxes for over half its tax revenues. While businesses are taxed on their gross receipts, individuals are not taxed on their income. Property taxes exempt the taxation of inventories and intangible assets.

Benefits Received

6) *Do people/entities that receive benefits from the state pay a corresponding amount of tax for the benefits ?*
Information is not available.

7) *Which of our taxes are tied to benefits received? What percentage are these taxes compared to the tax system? How does that percentage compare with the percentage of these taxes in other states?*
In Washington, the state school levy, the gas tax and the cigarette tax are the largest sources of dedicated taxes tied to benefits received. Washington's dedicated taxes make up 26 percent of all tax collections, which is above the national average of 22 percent. Our dedicated tax share of collections has been stable over the last 50 years while nationally, the dedicated tax share has declined by half.

8) *Regionally, where are taxes generated and where are they spent*
Information was not available in time for this paper.

9) *To what extent are taxes targeted and earmarked?*
See response to question 7.

Horizontal Equity (Equity among similarly situated taxpayers)

10) *Do similar households (with similar income/household size) pay similar amounts of tax?*
There is significant variation in total tax paid as a percentage of income within income groups. Sales tax has the most variation. Households in the lowest income group have the most variation because for many of the households, permanent income is higher than annual income. This causes disproportionate spending.

11) Do taxpayers engaged in similar activities pay similar amounts of tax?

There is significant variation in effective tax rates amongst individual taxpayers within industry groups. Property tax causes the most variation, because taxpayers holdings of property relative to their gross income varies tremendously.

Although the majority of different tax treatments are directed by specific legislative action (i.e., targeted exemptions), there are certain anomalies of structural differences in treatment dictated by the tax system.

12) Do similar taxpayers in different locations pay significantly different taxes because of local taxes?

In examples using hypothetical firms, taxes in high local tax areas can be 9 percent higher than taxes in low local tax areas. Profit margins of the hypothetical firms are up to 6 percent higher in low local tax areas compared to high local tax areas.

Intersectoral/Vertical Equity

13) What percentage of tax is paid by business? By households?

Households pay 51 percent of the total state and local tax burden, business pays 45 percent and government 4 percent.

14) Do businesses in different industries have similar tax burdens?

The mean effective business tax rate by industry varies from 1.1 percent of gross income for the agriculture, forestry and mining industry to 2.2 percent of gross income for the services industry.

15) Do big and small businesses within the same industry have similar tax burdens?

Large businesses pay a smaller share of property tax as a percentage of gross income than small businesses. For some industries, small business pays a smaller share of sales tax as a percentage of gross income than large business. B&O taxes are fairly consistent between large and small. For overall tax rates there are differences between large, medium and small business. However, the differences are not consistently higher or lower.

16) Do new businesses and established businesses have similar tax burdens?

New businesses pay a higher percentage of gross income in taxes than established businesses. This is mainly caused by higher property taxes as a percentage of gross income.

17) When new exemptions are created, do tax increases shift to other taxpayers?

Excise tax exemptions do not directly cause a shift of tax burden to other taxpayers. However, since tax exemptions are rarely repealed, taxes can be shifted to other taxpayers over a period of time as taxes are increased. Property tax exemptions result in an immediate shift.

18) Are our taxes administered equitably?

The overall noncompliance rate was estimated to be 3.4 percent in 1999. New firms and small firms have higher noncompliance rates.

19) Are there any sectors or groups that don't pay a proportionate share of tax?

See answers to questions 1-4 and 13-18.

20) Are there significant activities that are not subject to taxation?

The following is a list of significant activities that are not taxed in Washington. A more detailed description of the activities and reasons they are not taxed is included in Appendix 7.

- Income of Individuals
- Business Inventories
- Intangible Assets
- Rental of Real Property
- Agricultural Production
- Investment Income of Nonfinancial Business
- Food for Home Consumption

Perceived Equity

21) Do taxpayers think our tax system is fair?

Washington business taxpayers are neutral with respect to the effect of our tax system on their ability to conduct business.

22) Which taxes do taxpayers think are fair?

In surveys conducted in four states, taxpayers regarded taxes as fair where everyone pays the same rate. Taxpayers regarded the sales tax as the most fair and preferred the flat-rate income tax over the graduated-rate income tax. Property tax ranked as the least fair.

Externalities

23) Do activities that create negative impacts pay a proportionate tax?

Cities and counties in Washington State can impose fees on developers of property to mitigate the impact of new development on public infrastructure.

Washington has several environmental taxes that are imposed on activities that are perceived to be harmful to the environment. Some environmental externalities not taxed in Washington but taxed in other states are: hazardous waste, underground storage tanks, nuclear facilities and nuclear waste, tires, and sewerage.