

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:

| <u><i>Goal</i></u> | <u><i>Option</i></u> | <u><i>Fiscal Impact</i></u> |
|---|--|--|
| 1. Be taxpayer friendly to businesses and households | <ul style="list-style-type: none"> • 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 | <ul style="list-style-type: none"> • Have growth management impact fees paid at the time of closing by the buyer. | Revenue neutral |
| 3. Support education | <ul style="list-style-type: none"> • 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 | <ul style="list-style-type: none"> • 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. <p>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.</p> | To be determined |
| 5. Rainy day fund | <ul style="list-style-type: none"> • 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.