

**Alternative Packages Suggested By Committee Members**  
**7/12**

A. The major package that I personally support would have:

- 1) a flat rate personal income tax with large exemptions (to make it somewhat progressive)
- 2) drastic reductions in the sales tax rate (Ideally I would abolish it, but at least to make the income tax politically palatable I would say the state sales tax rate should be limited to no more than 4% -- so the combined rate with local taxes shouldn't exceed 6% at most.)
- 3) a corporate income tax at the same rate as the personal income tax

I see the corporate tax as primarily to complement the personal income tax, preventing people from using corporation to shelter income from taxation. I would oppose a higher corporate tax to replace the B&O tax because it is a very volatile revenue source and it is not neutral with regard to forms of business organization and financing.

The (partial) replacement of the sales tax by the personal income tax would:

- 1) make the tax system less regressive,
- 2) make tax burdens more visible (which I think is a good thing),
- 3) make Washington business more competitive by reducing border tax problems, and
- 4) export part of the tax burden through the deductibility of income taxes on federal tax returns.

Some people probably want to have a more progressive income tax with graduated rates on the menu. I prefer the flat tax version because:

- 1) it is marriage neutral
- 2) a graduated tax may be more than adequate in the long run; i.e. revenues increase more than proportional to increases in personal income without any deliberate decision to increase tax rates
- 3) high marginal tax rates encourage more tax avoidance behavior, contrary to the neutrality objective
- 4) the public opinion polls favor the flat rate version (I'm being inconsistent here since I ignore public opinion on other issues when I think the public is poorly informed but I'll use it when they agree with me.)

Two other proposals can be considered independently of other changes:

B. Change the base of the B&O tax from gross receipts to value added

The primary advantage would be to enhance neutrality.

C. Broaden the base of the sales tax to include consumer services.

This would enhance:

- 1) neutrality and
- 2) long run adequacy

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### Three Revenue Neutral Packages

**1) Problems.** Washington has a highly non-neutral tax structure. The base of the RST is too narrow and growing more so because most services are not taxed. The B&O is a multiple tax on value added causing pyramiding. Pyramiding, and multiple B&O rates, cause non-neutralities and economic inefficiency. Constitutional and political restrictions make a personal income tax problematic.

#### **Alternative Package: *Replace RST and B&O with an Invoice Method VAT***

	<i>Approx. Revenue Impact</i>
Abolish existing B&O/PU and RST taxes	(\$7.8 billion)
Impose 6% invoice method VAT on a broad base (about \$130 billion)	\$7.8 billion

**Rationale:** The value added tax does not pyramid and since taxes on business to business services are removed, a major obstacle to extending sales taxes to services is removed. By unifying the two taxes, a simpler and more transparent tax structure is acquired. Modification of existing structure rather than replacement.

**2) Problems.** The RST is not deductible from Federal income taxes. As a result, Washingtonians pay nearly half a billion dollars more in Federal taxes than they need to. In addition, revenue from a destination-based tax like the RST does not grow sufficiently for government to provide for established programs, because the tax base excludes most services and is vulnerable to avoidance as internet commerce grows. The distribution of the RST tax burden is known to be very regressive with respect to income.

#### **Alternative Package: *RST replacement with a personal income tax***

	<i>Approx. Revenue Impact</i>
Abolish RST and use tax	(\$5.8 billion)
Impose 5% tax on federal AGI with a \$250 tax credit per person (sufficient to remove tax from family of 4 with \$20,000 AGI)	\$5.8 billion
Impose 5% corporation income tax creditable	

against existing B&O tax

\$0

**Rationale:** A state personal income tax is deductible from Federal taxable income by itemizing taxpayers. A personal income tax is paid by residents no matter where they shop. A flat rate personal income tax is made progressive because tax burdens on low income families are lowered by giving a fixed tax credit (or standard deduction). In addition, tax credits can be given to offset property tax burdens. Corporate income tax needed to backstop the personal income tax.

**3) Problems.** All of the problems in 1) and 2), plus the existing tax structure is a very unstable revenue source. Fluctuations in economic activity create fiscal crises. Heavy reliance on RST leads to high tax rates, exacerbating economic distortion and tax avoidance. In addition, local governments lack tax capacity, and the property tax is resisted by voters except where the benefits are clear. The state is required to fund schools, so lost state property tax revenue must be made up.

***Alternative Package: Abolish the state property tax and balance state revenue with a flat rate income and sales tax system***

	<b><i>Approx. Revenue Impact</i></b>
Abolish State property tax	(\$1.3 billion)
Reduce RST and use tax rate to 3.5%	(\$2.8 billion)
Impose 3.5% tax on AGI with \$150 tax credit Per person (sufficient to remove tax from family of 4 with \$20,000 AGI)	\$4.1 billion
Increase B&O tax rate to 1% for all industries and allow Enterprise to subtract costs of materials and services purchases	\$0
Impose 3.5% corporation income tax creditable Against reformed B&O tax	\$0

**Rationale:** Although vacating the state property tax removes a more stable revenue component, a combined income and sales tax provides a more stable revenue structure and permits lower rates, reducing distortions and incentives to avoid taxes. The traditional and best tax base for local government is the property tax, because real property is immobile. The income tax is deductible from Federal income taxes and is progressive, offsetting the regressive

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## **A. Individual Income Tax**

While difficult to achieve this is the only way to reverse the regressivity of our present structure. It should be based on graduated rates but if that is impossible to achieve then it should be designed with exemptions or credits that make it progressive. This can be achieved through personal exemption and by other means such as giving a credit on income tax liability for any property taxes paid on a principal residence up to some absolute number, say, \$300 or \$500. This would be a small but possibly effective inducement to home ownership but, more importantly, would tend to offset the advantage those with large incomes receive in the form of itemizing their payment of state income tax as a deduction from federal tax thereby in effect having the federal government pay in excess of 30% of the state income tax bill.

If there were such a tax then significant reductions can be made in the Sales Tax or the B&O tax.

## **B) Business tax:**

The issue of economic neutrality is that principally dealt with here. The current system is unacceptable on this principle. It is unclear to me whether this is best accomplished by a single rate business income tax (would it need to be limited to corporations?) or by a VAT type tax such as the Michigan single business tax. To be acceptable any such tax would have to eliminate the B & O tax. Also it seems unacceptably awkward to pay both a VAT type tax and a retail sales tax. This means any new business tax together with the impact of the income tax would have to supplant both the sales tax and the B & O.

## **C) Extend Sales Tax to Services:**

There seems to be accepted wisdom that the broader the base of activities being taxed the better. The problem of pyramiding and the problem of locus make imposing the sales tax on services unacceptably complex as applied to purchases by a business. It can, however, be designed as a tax on consumer services which appears to be practical. The existing sales tax rate could be significantly lowered if such a tax were imposed. It is not clear whether, in the absence of other new taxes, such an extension would permit any serious reduction of other taxes such as the B & O.

## **D) Estate Tax:**

Perhaps the worst thing about the current Federal legislation which will eliminate the State "pick up" tax is the fact that that tax involved virtually no administration. The answer would be to get the Congress to change its mind—highly unlikely now or in the near future.

This is the most progressive of all taxes and one that a state with a regressivity problem should not be without.

Notwithstanding the complexities of gearing up a new department to impose such a tax it should be done at a level which basically follows the Federal numbers for exemption and then is set a rate to retain the substantial revenue which it formerly produced and which will grow dramatically as the increased number of estates of our much much wealthier citizens begin to be subjected to the tax. Hopefully there is a way to do this which employs a great deal of the federal procedure, forms etc. to minimize state costs.

**E) Rainy Day Fund:**

Nothing seems more obvious than that every state should have a substantial rainy day fund. One of the worst features of our structure is its great volatility together with the fundamental fact that there is no way to install a tax structure which is not volatile.

**F) Packaging:** It is too early for me to design a “package” or “packages”. Such constructions absolutely require data about rates for projected tax structures. Clearly, the best system for Washington would be some combination of the above together with reduction or elimination of one or more existing tax.

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**IDEAS FOR ALTERNATIVE PACKAGES**

**State Income tax on Individuals, reduced sale and property taxes, VAT type tax on corporations only. VAT to cover all types of businesses of corporate entities. Other businesses (sole proprietorships & partnerships) taxed under individual income tax.**

Income tax to based on one of the following:

- A. Federal Adjusted Gross Income. WA set progressive tax rates.  
Simple to figure. Less manipulation by taxpayers.
- B. Federal Adjusted Gross Income plus or minus adjustments selected by the WA.  
WA set flat rate.  
Selected adjustments can reduce regressive nature of the flat rate.  
Allows WA to customize its taxes to its needs without requiring a completely separate system.  
More complex to compute. More administrative and taxpayer costs involved.
- C. Federal Taxable Income. WA set progressive tax rates.  
Simple to figure. Relying on all Federal tax laws. Changes at Federal level affect taxation at State level.
- D. Federal Income Tax. WA set flat rate.  
Simple to figure. Tax would be progressive because base is progressive.

This would help with long-term adequacy, pyramiding, regressivity and narrow tax base. If state income tax is withheld as the Federal tax is, the income tax would not be lumpy.

**B&O tax expanded to cover all service and rental businesses, reduce sales tax, increase licensing fees, expand property tax exemptions.**

Broaden base and reduce regressivity

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**1. REDUCE RST TO 4% BY IMPLEMENTING A "FLAT" 2% INCOME TAX.**

Reduce regressivity by dropping the RST from 6.5% to 4.0% but broaden base by adding sales tax on consumer services & phones. This by my reckoning causes an overall revenue reduction of (\$2.0437 billion).

Replace drop in RST by imposing a flat person income tax of 2% of AGI (with deductions & exemptions). This should yield about \$2.2 billion.

Handle "excess" of \$156.3 million by providing a credit to persons with AGI of less than \$20,000 (or increase that amount until the \$156.3 million is eaten up).

Retain local option RST's.

**2. REPLACE B&O/PUT WITH VAT; REDUCE STATE PROPERTY TAX**

Increase fairness by elimination of the (pyramiding) B&O tax and public utility tax. This causes a revenue reduction of (\$2.280 billion).

Increase perceived fairness by reduction of the State property tax by 31.5% (\$.44 billion).

Replace the drop in revenue from elimination of the B&O/PUT and reduction of property tax by imposing a conventional VAT at 1.5%, yielding \$2.72 billion.

Replace the city B&O with a local option VAT at a rate that would yield roughly the same amounts to participating cities as the local option B&O taxes do today. Extend the local option VAT to counties to provide revenue to replace recent drops in revenue from loss of State equalization payments.

**3. MAINTAIN THE ESTATE TAX DESPITE FEDERAL PHASE-OUT**

Maintain revenue neutrality and progressive taxation of large amounts of wealth by maintaining the State estate tax at the same rate despite the phase out of the federal estate tax.

**4. MAINTAIN MULTIPLE TAXES.**

The array of taxes described above increases the total number of major state taxes by one. This is good, because a broader array of taxes, at lower rates, should help stability and perceived fairness.

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**Reform proposals.**

- i. VAT, along with repeal of B&O and reduction in retail sales tax rate.
- ii. Personal and corporate income tax, along with reduction in retail sales tax rate and providing a relatively large exemption amount under real property tax.
- iii. A combination of "tweaks" to the current system, which might include expanding the sales tax base to include services; re-evaluating various exemptions; enacting a rainy day fund; incremental improvements to the B&O tax.