

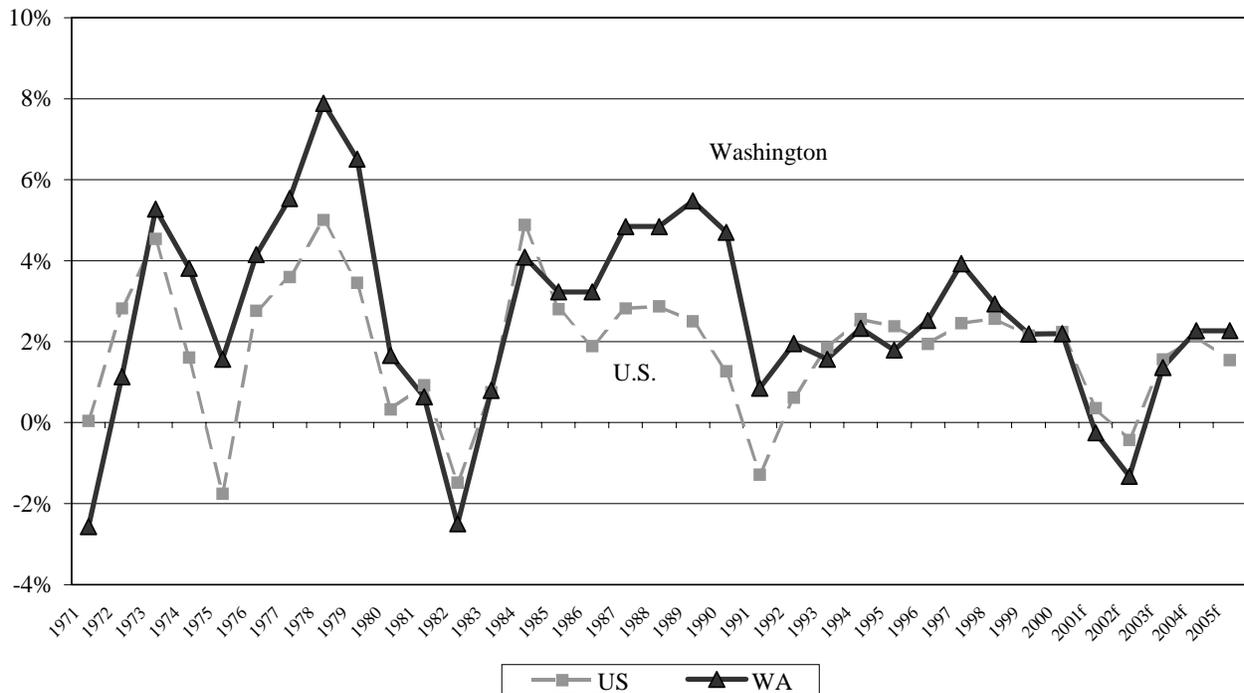
Washington State Tax Structure Study Research Findings

1. Stability/Volatility

Business Cycles

- Revenue volatility is a function of business cycles and our tax structure's response to those cycles.
- Business cycles contribute to revenue instability in Washington and in all states.
- States go through business cycles at different times. However, Washington's economy tends to follow the timing and magnitude of change in the U.S. economy more closely than most other states.
- Washington's business cycles are less volatile than they used to be. Over the two decades from 1971 to 1990, Washington's business cycle, as measured by the annual change in non-agricultural employment, varied more than twice as much as the U.S. business cycle. However, in the last decade, Washington's business cycle has been less volatile than the U.S. business cycle. The situation is expected to be reversed in the forecast period from 2001 through 2005 when Washington's year-to-year change in employment is expected to be more volatile than the U.S. average change in employment.

Annual Non-agricultural Employment Growth, WA and US



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Tax Structure Response to Economic Cycles

- All of Washington's taxes are volatile. Some of Washington's taxes are more volatile than others. Sales & use tax and business and occupation taxes are more volatile than personal income. Property tax and public utility tax are less volatile. All four taxes, combined and weighted to represent their relative mix, are more volatile than personal income because of the heavy reliance on sales, use and business and occupation taxes.

Sales & use tax	More volatile
Business & occupation tax	More volatile
Property tax	Less volatile
Public utility tax	Less volatile
All taxes combined	More volatile

- When taxes are volatile, excess revenues are generated in peak economic periods and the reverse is true in economic downturns. This is magnified when volatility is greater than the volatility of the business cycle.
- Volatile taxes would be less of a problem to the extent a state is able and/or willing to:
 1. Save excess revenues to spend during downturns.
 2. Raise taxes during bad times and lower them during good times.
 3. Lower spending during bad times.
- With respect to spending during good and bad times, Washington State's expenditures over the last 20 years have been very stable despite economic fluctuations, which means they don't seem to adjust to changes in the business cycle.
- Excess revenues create the impression that citizens have been overcharged for government services. Periods of excess revenues, even of a short-term duration, have historically enabled tax cuts to be made, often of a permanent nature. Permanent tax cuts exacerbate the problem of a volatile tax structure when the economy is in a downturn.
- The following are possible policy choices to increase the overall stability of our tax structure:
 1. Emergency reserve funds or budget stabilization accounts that can more effectively save revenues during good times and more easily use them during downturns;
 2. Tax reductions during good times that don't permanently reduce the stability of the tax system;
 3. Broader-based taxes;
 4. A more "diversified portfolio" of taxes.

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2. Adequacy of State and Local Revenue

State Government

Revenue Growth Compared with Economic Growth

- With 8.3 percent per year revenue growth versus 8.8 percent personal income growth, General Fund revenue, in the absence of legislation, has historically grown about 10 percent slower than personal income.
- Since revenue (without changes in rates or the tax base) has tended to grow more slowly than personal income, taxes and fees have been raised periodically to keep pace.
- Taken together, historical revenue growth, trends in consumer spending habits, and the effects of recent voter approved tax reduction measures suggest that General Fund revenue under Washington's present tax system is likely to grow fifteen percent slower than personal income (or the general economy) in the long run. (4.7 percent per year revenue growth versus 5.5 percent personal income growth)

Growth in Demand for Public Services Compared with Economic Growth

- Using actual public expenditures as a proxy for public demand for government services, state and local government expenditure growth, and Washington spending growth in particular, has moved in tandem with personal income growth.
- Washington government spending and personal income have grown at about the same rate (8.9 percent expenditure growth versus 8.8 percent personal income growth for the 1971-2001 period). The only exceptions to the tandem growth of spending and income were in the early to mid-1990s when revenue was raised to maintain existing state government programs during an economic slowdown and the late 1990s when spending slowed in response to Initiative 601,
- Recently, as the state economy fell into recession, spending outpaced the sluggish income growth that resulted from a slumping economy.
- State government spending through most of the 1980s and 1990s exceeded the rate of inflation and population growth by about 30 percent. This pushed spending growth to equal and even exceed the rate of personal income growth.
- The main reasons that state spending growth equals or exceed personal income growth are:
 1. Policy decisions to impose longer prison sentences for serious crimes.
 2. Increased access to health care for poor and low income families.
 3. Measures to address the special education needs of handicapped and bilingual children
- Increased utilization of health care and special education services also contributed significantly to expenditure growth.

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Expenditure Outlook and Revenue Adequacy

- Due in large part to rapidly rising health care costs, which will affect government spending in the foreseeable future, total state government expenditures will have a tendency to continue growing in tandem with, or even slightly exceeding, personal income growth
- Since revenues, in turn, are likely to grow about 10 to 15 percent more slowly than personal income, budget pressures will likely exceed the capacity of the current tax system, forcing budget cuts or revenue increases, or a combination of both.
- A deficit of about \$1 billion (or over 4 percent) is projected for the 2003-05 Biennium, rising to nearly \$3 billion (or about 12 percent) in the 2005-07 budget period.
- One way that expenditures could rise at or below the rate of revenues under the current tax system – and result in much smaller deficits -- would be if all expenses increased only by population related caseload growth and general inflation. This would likely require per capita health care costs and state government employee, vendor, higher education and K-12 wage growth to increase at or close to the rate of general inflation.
- However, limiting growth in wages paid by state government to employees, educators, and vendors to the rate of general inflation would, in the long run, cause these wage levels to fall behind private sector wages. In the private sector, employee compensation tends to capture productivity gains in the economy, enabling wage growth to stay ahead of inflation.
- Reserves have not been allowed to grow very large during good economic times. They have been depleted due to increased spending or permanent tax cuts.

Local Government

- There is very little unused taxing capacity remaining for county government.
- There is some unused taxing capacity for city government, mainly in the areas of B&O and utility taxes. However, these sources have been unpopular and essentially unused by cities east of the Cascades.
- Legislatively imposed reductions in the sales tax (exemptions, credit programs) have reduced local revenues by about \$600 million per biennium.
- City, county, and transportation district losses due to the repeal of the state MVET total nearly \$800 million per biennium.
- Expected local regular levy property tax losses due to the passage of Initiative 47 will total more than \$200 million per biennium.
- Local taxes have grown faster than personal income in the last decade.
- Current charges (tuition, garbage and sewer service, public hospitals, ports) by state and local government have doubled in the last decade.

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Earmarked Funds

- Housing impact fee revenue is increasing rapidly for both cities and counties.
- State taxes dedicated to specific programs have remained somewhat stable at about 26% of state revenues.

3. Economic Vitality

Competitive Position of Washington Firms

- Washington's B&O tax burden is higher than most states' income taxes.
- Washington's unemployment insurance tax is among the highest of any state for many firms.
- Washington's industrial insurance tax is among the lowest in the nation for all firms.
- Washington's property tax burden is in the middle compared to other states.
- Washington's sales tax burden on manufacturers is not high compared to other states.
- Firms with low profit margins have the highest tax burden in Washington compared to competing states.
- Factors other than taxes have larger impacts on profitability.
- It is unclear whether Washington's relative competitive position changes during periods of economic upturn or downturn.

Taxes and Firm Location

- Taxes are not one of the most important factors influencing business location decisions.
- The most important consideration influencing business location decisions are general market factors (location of potential customers, availability of raw materials, basic inputs, and supplies).
- A good transportation infrastructure is a significant driver in location decisions, a more important factor than taxes.
- Other factors more important than taxes are the presence of a skilled work force and quality higher education institutions.
- If other factors are equal, then the relative tax burden does matter and may be the deciding factor.

Tax Incentives and Economic Vitality

- The sales tax exemption for manufacturing machinery and equipment and the state sales tax rebate on construction of large warehouses and distribution facilities has improved Washington's competitive position in attracting and retaining these industries.
- There is broad disagreement about whether tax incentives create jobs. Studies that examine the effectiveness of tax incentives in promoting job growth either conflict or have

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inconclusive results. Academic studies show small, if any impact on employment growth. There are studies involving interviews or surveys showing that for individual firms tax incentives are working to create jobs in the communities in which they locate.

Washington Taxes and New Businesses

- New manufacturers do not face an inordinate tax burden in Washington compared to other states (the high B&O tax burden is offset by the low industrial insurance burden).
- Taxes do not seem to impede the ability to start new businesses. Washington has the highest rate of new business start-up. It also has the highest rate of new business closures.

4. Economic Neutrality

- Businesses are increasingly engaged in a variety of strategies to legally minimize their tax obligations in Washington. One contributing factor may be the reduced level of federal corporate income tax, making the Washington tax payment (primarily B&O) relatively more important.
- Most of these strategies are designed to reduce the level of taxable income, rather than to avoid tax altogether.
- Strategies to minimize taxes are often inefficient and can be costly to implement. They also increase the complexity and level of effort necessary to review and fairly enforce Washington's tax.
- Business strategies to reduce their Washington tax levels include: creating wholly owned subsidiaries to receive a portion of the income in another state, conducting a portion of the manufacturing operation in another state, creating holding companies, and creating a purchasing agent relationship with customers.
- Individuals illegally avoid use tax by making purchases through the Internet, via catalogs of businesses with no taxable nexus in Washington, and making purchases in states with a lower or no (Oregon) sales tax.

5. Equity

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).

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- 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.

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.
- We have measured effective tax rates as all taxes (sales, use, B&O, public utility and property taxes) as a percent of gross income. Our preliminary results yield the following:
 - Effective tax rates for all taxes vary by industry. Average effective rates range from less than 1% to a high of 1.5% across sectors. Agriculture, forestry and mining and wholesalers pay lower effective rates for all taxes. Construction, manufacturing and the service sectors pay higher effective rates. Finance, insurance and real estate and retail industries pay in the middle of the range.
 - There are no discernable differences in effective tax rates between new and established and between small and large firms with the one exception of property tax. Small construction firms pay higher effective property tax rates than do large construction firms. The opposite appears to be true for services. (Note: these results are measured as a percent of gross income and not profit margins.)
- 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

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- Intangible Assets
- Rental of Real Property
- Agricultural Production
- Investment Income of Non-financial 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.

6. Transparency (Hidden Taxes)

- Taxes legally imposed on businesses, and not purchasers or customers, are hidden.
- Many of Washington's taxes are legally imposed on businesses and, therefore, are not visible to purchasers or customers.
- Business taxes are not taxes on purchasers or customers but are considered part of business operating overhead.
- Business taxes may, to varying degrees, be passed on to purchasers and customers as a hidden component of the price of the good or service.
- The taxes that are imposed on purchasers and customers, and are visible, include state/local retail sales taxes, state/local public utility taxes, state/local property taxes, the car rental tax, the convention center tax, the solid waste collection tax, the 911 taxes, and the wood stove fee.
- The only truly pyramiding tax is the state/local gross receipts business and occupation tax.

7. Timing of Tax Payments

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- Taxes are considered to be "lumpy" if the timing of the tax payment and/or the amount of the payment are burdensome to taxpayers.
- Property taxes, real estate excise taxes, and watercraft excise tax are the lumpiest taxes. These tax payments are considered by taxpayers to be burdensome both by nature of their timing and their large dollar amounts (in the case of large purchases or high property values).
- Most other taxes are not considered to be lumpy since they are paid more frequently and in smaller amounts.
- Taxes that are paid exclusively by businesses (B&O, PUT, etc.) are less lumpy than the taxes that are also paid by consumers (property taxes, REET, etc.). This is because business tax payments are generally more frequent and most businesses receive regular income throughout the course of a year.

8. Administrative Simplicity

Department of Revenue Costs

- The cost to the Department of Revenue to administer the state and local taxes has averaged 0.75% of collections, or 75 cents per \$100 of tax collected.
- Relative collection costs have been declining in recent years, due to lower staffing levels and technological enhancements. Costs in Fiscal Year 2001 were 69 cents per \$100.
- Tax sources that are dedicated to fund specific programs are generally more complex and more costly to administer. Examples are the hazardous substance tax (\$4.26 per \$100) and the litter tax (\$12.94 per \$100).
- Taxes that are costly for the Department to collect are also generally difficult and costly for taxpayers to comply with.

Costs to Retailers to Collect and Remit State and Local Sales Taxes

- Retailers are unpaid agents of state and local government in the collection and remittance of the sales tax. More than one-half of the sales tax states compensate retailers for collection costs.
- Costs of collection for state and local sales taxes range from \$6.47 per \$100 for small retailers to \$0.97 per \$100 for large retailers.
- Costs for local sales tax only range from \$3.30 per \$100 for small retailers to \$0.31 per \$100 for large retailers.

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Record Keeping Obligations for Taxpayers

- The majority of taxpayers use much of the information gathered to file the state portion of their state tax return for other purposes as well.
- Most taxpayers collect and organize data required to file the local portion of their state tax return only for this purpose.
- The lack of uniform definitions of activities between cities, and between the cities and the state system, adds to taxpayer costs to comply with city-imposed B&O taxes based on gross receipts. Rules for allocation of income between entities are inconsistent, and apportionment of income rarely occurs.

9. Home Ownership

The impact of taxes on the ability to purchase and retain a home

- Taxes (sales and/or real estate excise) as a percent of the purchase price of a home range between 1.8% and 7.1% depending on whether the home is existing, spec- or custom-built.
- Development impact fees range from zero to about 2.7% of the purchase price of each home in a new housing development.
- Property taxes average about 1.3% of the market value.
- Property taxes do not play a large role in determining whether a prospective buyer can qualify for a home loan.
- About 70% of homeowners pay less than 4% of their income in property taxes; almost 50% pay less than 3%.
- Almost 6% of homeowners pay over 8% of their income in property taxes.

The impact of taxes on the ability to purchase or retain a home by low-income persons

- Mortgage interest and principal payments, rather than property taxes, determine the ability of below-median income households to qualify for home loans. The typical first-time homebuyers in 16 counties are not able to afford the median-priced home.
- Property taxes can impact the ability of homeowners to retain their homes, especially in circumstances where home values rise and income remains fixed (retired) or drops dramatically (job loss, disability, etc.).
- Washington has two programs that provide property tax relief to disabled and senior citizens. One program, for persons 61 and over, provides substantial relief for households with incomes under \$30,000. The other, for persons 60 and over with household incomes under \$34,000, allows participants to be relieved of any remaining property tax for the rest of their lives.
- Some homeowners have high property taxes as a percent of income but do not qualify for either program, either because of age or income.