

Washington State Tax Structure Study

Summaries for the Major Replacement Alternatives

Taxes on Goods and Services

1. *Conventional Value-added Tax (Multi-stage tax)*

Description: Taxes on gross receipts such as Washington's Business and Occupation Tax have a "pyramiding" effect; e.g., a supplier of materials pays tax on the value of these intermediate goods sold to a manufacturer. The manufacturer pays tax on the value of the final goods it produces, which includes the cost of the intermediate goods it has purchased. Thus, the value of intermediate goods is taxed multiple times. This multiple taxation would be avoided if the firm producing the final product produced the intermediate goods itself rather than purchasing them from an independent firm. These "pyramiding" taxes favor vertically integrated firms which produce their own inputs over smaller, non-vertically-integrated firms which purchase inputs from independent firms.

Taxing value added rather than gross receipts eliminates the pyramiding effect. This is one reason that many European countries have adopted value-added taxes (VATs). Gross value added is calculated as the difference between the value of goods and services sold and the cost of intermediate goods purchased, so the total tax on a product will be the same, regardless of whether or not the manufacturer is vertically integrated.

The "subtraction method" of calculating value added described in the preceding paragraph would be similar to the existing B&O tax, starting with gross receipts, but would allow deductions for intermediate goods purchased from other firms. This was the approach taken in a VAT proposed for Washington by Representative Dan Grimm in 1988.

European countries use the "invoice method" of calculating value-added taxes. The tax rate is applied to gross sales and businesses take a tax credit for the tax paid on purchased goods as shown on invoices. This is quite similar to the subtraction method but facilitates the implementation of non-uniform tax rates, e.g. a lower tax rate on food products.

Michigan's Single Business Tax uses the "addition method" for calculating value added. It starts with the measure of taxable profits on a firm's federal tax returns and adds interest paid, rent paid, employee compensation and depreciation to obtain gross value added. Although the subtraction method will result in the same measure of gross value added as the addition method, the subtraction method might be less vulnerable to a constitutional challenge in Washington than a VAT using the addition method because the former looks more like a sales tax while the latter looks like an income tax.

Value-added taxes may differ in the incentives they offer for capital investment. A net value-added tax allows a deduction for depreciation of capital equipment. The value-added taxes used

in Europe and Michigan's "Single Business Tax" are "consumption-type" VATs that allow firms to deduct capital expenditures when they are incurred.

Proposed Tax Base: Three possible tax bases: Gross value added, net value added or consumption-type

Proposed Tax Rate: Single rate at 1.1% for the broadest tax base, gross value added, or 1.9% on the narrower consumption-type tax base

Estimated Collections: \$2.0 billion

Advantages:

- Broad-based
- Approximates costs of government services to business
- Removes pyramiding

Disadvantages:

- Federal tax deduction in the year product sold
- Unique tax

Principles Most Advanced:

- Neutrality
- Equity
- Stability

Principles Most Eroded:

- Simplicity

2. Unified Goods and Services Tax (GST)

Description: A multi-stage value-added (sales) tax that replaces both the RST and B&O tax systems. All enterprises charge and remit tax on receipts from sales, whether sales are retail (business to consumer) or business to business. Taxes charged to the buyer are shown explicitly on sales invoices. In turn, all businesses receive credit for taxes paid on their purchases of materials and contractual services (but not employee compensation) as shown on their purchase invoices. Since the final value of a good or service is the sum of the contributed value added at each stage of the production chain, such a tax is equivalent to a single stage tax on the final value of all goods and services.

Proposed Tax Base: The value of goods and services produced in the state.

Proposed Tax Rate: Rate at 4%

Estimated Collections: \$7.9 billion*

Advantages:

- Broad-based
- Neutral
- No pyramiding
- Relatively stable source of revenue
- Tax transparent to businesses and households

Disadvantages:

- Whether tax is deductible from federal taxes in part or whole
- Unique tax (for a state—many countries have such a tax)
- Perhaps more regressive than a retail sales tax because food and services not exempted

Principles Most Advanced:

- Neutrality
- Efficiency
- Transparency

Principles Most Eroded:

- Equity, as measured by regressivity

3. Comprehensive Business and Occupation Tax (a.k.a. the Flat Tax)

Description: A value-added tax that isolates the component of value added by employees in order to provide a standard deduction and lower the effective tax rate on low income workers. Every enterprise pays tax on gross receipts from sales and receives a tax credit for taxes paid on purchases of materials and services as shown on purchase invoices. In addition, workers compute tax at the same rate on their earnings minus a standard deduction and receive a tax credit for imputed taxes paid on their total earnings by their enterprise employers. The difference is refunded to the employee if negative (as would be the case for persons with no self-employment earnings) or remitted by the employee if positive.

Proposed Tax Base: Value of goods and services produced in the state

Proposed Tax Rate: Single rate at 1%

Estimated Collections: \$1.1 billion from wages and salaries*
\$800 million from firms*

Advantages:

- Standard deduction relieves tax burdens on low income workers making it less regressive (more progressive)
- Everyone (owners and workers) pays the same tax rate on their contribution to value added
- No pyramiding
- Broad based and neutral
- Relatively stable source of revenue

Disadvantages:

- Could be perceived as an earned income tax
- Might be perceived as “anti-labor”
- Unique tax—no other model

Principles Most Advanced:

- Neutrality
- Stability
- Transparency
- Equity

Principles Most Eroded:

- Simplicity

Taxes on Business and Personal Income

4. Corporate Net Income Tax

Description: Washington is the only state that imposes a comprehensive business tax on all forms of business activities which is measured by gross receipts or gross sales. Most of the other states (46) tax businesses under a corporate tax based on profits as determined for federal tax purposes. This alternative would impose a mainstream net income tax on corporations which do business in Washington.

Proposed Tax Base: Net income (essentially corporate profits)

Proposed Tax Rate: 3.4%

Estimated Collections: \$500 million per year

Advantages:

- Most observers agree that it would be more equitable to tax on the basis of profits.
- The effective tax rate, in terms of net income, would be the same for all taxpayers (the existing B&O tax has a wide range of effective tax rates, depending upon the firms' profit margins).
- The tax is familiar to multistate corporations, since it is levied in 46 states.
- Use of federal taxable income, implicitly adopts the federal definitions and deductions, thereby simplifying administration of the state tax.

Disadvantages:

- The tax is significantly more complicated than gross receipts taxes, due to the determination of allowable deductions, as well as interstate apportionment. This increases the cost of administration for the state and the cost of compliance for the corporation.
- This tax would apply only to corporations. If used to replace the existing B&O tax, then noncorporate business (sole proprietors, partnerships, etc.) would have no state business tax liability, unless a companion personal income were also enacted.
- The tax is significantly more volatile than the existing gross receipts tax.
- The proposed rate would only replace less than one-third of the existing B&O tax. If the goal is total replacement of the B&O tax, then the tax rate would have to be approximately 20% - far higher than any other state corporate net income tax rate.
- Apportionment formulas would be necessary to determine the state's tax base, thus complicating the state for multistate firms, unless separate accounting is used for the establishment located in Washington.
- Other states have experienced a long-term decline in the revenues from this source.

- There is no correlation between a firm's profit and its dependence upon government services.

Principles Most Advanced:

- Economic neutrality
- Equity/fairness
- Interstate competitiveness

Principles Most Eroded:

- Administrative simplicity
- Revenue stability
- Transparency
- Long-term adequacy

5. Flat Rate Personal Income Tax

Description: Washington is one of seven states that does not levy some form of income tax upon individuals. Of the other 43 states, two impose a limited income tax on interest, capital gains or dividends only, and two states measure their tax by a percentage of federal income tax liability. Of the remaining 39 states, six states levy a flat rate state income tax, measured by either federal adjusted gross income (AGI) or federal taxable income. This leaves 33 states that levy a comprehensive personal income tax which features a graduated rate structure. Typically, these states start with federal AGI and allow some state-determined personal exemptions and/or deductions, and then apply their graduated rates to the resulting state-defined taxable income.

First, a decision would be needed whether to base such a tax upon federal AGI or federal taxable income (i.e., whether or not to incorporate the federal personal exemptions and standard/itemized deductions). Next, it would have to determine the amount of personal exemptions allowed if any, the type of deductions provided if any, and the flat income tax rate. Virtually any amount of state income tax revenue can be realized from such a tax, depending upon these variables.

Proposed Tax Base: Federal adjusted gross income (AGI)

Proposed Tax Rate: 1.0%

Estimated Collections: \$1.5 billion per year with no exemptions or deductions
\$1.3 billion per year with federal standard/itemized deductions
\$1.1 billion per year with federal personal exemptions and standard/itemized deductions

Advantages:

- Income taxes are generally progressive, especially those with larger personal exemptions and graduated rates, helping to reverse the regressive impact of most state excise taxes.
- Some degree of progressivity can be achieved by the use of personal exemptions, even with a flat rate income tax.
- Part of the tax can be exported to the federal government because, unlike sales taxes, state income taxes may be deducted by households that itemize their federal deductions.
- Utilizing federal definitions (e.g., to determine AGI) helps to minimize complexities.
- The tax is paid when income is earned (through withholding).
- Personal income taxes keep pace with economic growth, yet are often more stable than sales taxes during recessions.
- The tax applies to wealth which would otherwise not be subject to any state/local taxes (e.g., investments, savings, expenditures made outside the state, etc.).

Disadvantages:

- Administration would be significantly more complex (the state now has about 600,000 taxpayer accounts; under an income tax there would be an additional 2.3 million reporting entities).

- Gearing up to administer a major state income tax could take substantial time.
- Individuals currently have no direct reporting responsibility for state taxes (except property tax); under an income tax they would be faced with all the same reporting requirements as under the federal system.
- Under existing interpretations by the State Supreme Court an income tax would require amendment of the state constitution.
- Finally, there is the political consideration of the likelihood of Washington voters approving an income tax.

Principles Most Advanced:

- Equity/fairness
- Economic neutrality
- Long-term adequacy
- Revenue stability (maybe)

Principles Most Eroded:

- Administrative simplicity
- Transparency

6. Graduated Personal Income Tax

Description: Washington is one of seven states that does not levy some form of income tax upon individuals. Of the other 43 states, two impose a limited income tax on interest, capital gains or dividends only, and two states measure their tax by a percentage of federal income tax liability. Of the remaining 39 states, six states levy a flat rate state income tax, measured by either federal adjusted gross income (AGI) or federal taxable income. This leaves 33 states that levy a comprehensive personal income tax which features a graduated rate structure. Typically, these states start with federal AGI and allow some state-determined personal exemptions and/or deductions, and then apply their graduated rates to the resulting state-defined taxable income.

First, a decision would be needed whether to base such a tax upon federal AGI or federal taxable income (i.e., whether or not to incorporate the federal personal exemptions and standard/itemized deductions). Next, it would have to determine the amount of personal exemptions allowed if any, the type of deductions provided if any, the number and size of the income brackets, and the graduated income tax rates. Virtually any amount of state income tax revenue can be realized from such a tax, depending upon these variables.

Proposed Tax Base: Federal taxable income (AGI could also be considered)

Proposed Tax Rates: 3.0%, 4.5% and 5.5% based on first three federal brackets

Example for married couples filing jointly:

<u>Taxable income over</u>	<u>But not Over</u>	<u>Tax Rate</u>
\$ 0	\$ 42,000	3.0%
\$ 42,000	\$109,250	4.5
\$109,250	- - -	5.5

Estimated Collections: \$4.7 billion annually

Advantages:

- Income taxes are generally progressive, especially those with larger personal exemptions and graduated rates, helping to reverse the regressive impact of most state excise taxes.
- Any degree of progressivity can be achieved by the use of personal exemptions, income brackets, and graduated rates.
- Part of the tax can be exported to the federal government because, unlike sales taxes, state income taxes may be deducted by households that itemize their federal deductions.
- Utilizing federal definitions (e.g., to determine AGI) helps to minimize complexities.
- The tax is paid when income is earned (through withholding).
- Personal income taxes keep pace with economic growth, yet are often more stable than sales taxes during recessions.
- The tax applies to wealth which would otherwise not be subject to any state/local taxes (e.g., investments, savings, expenditures made outside the state, etc.).

Disadvantages:

- Administration would be significantly more complex (the state now has about 600,000 taxpayer accounts; under an income tax there would be an additional 2.3 million reporting entities).
- Gearing up to administer a major state income tax could take substantial time.
- Individuals currently have no direct reporting responsibility for state taxes (except property tax); under an income tax they would be faced with all the same reporting requirements as under the federal system.
- Under existing interpretations by the State Supreme Court an income tax would require amendment of the state constitution.
- Finally, there is the political consideration of the likelihood of Washington voters approving an income tax.

Principles Most Advanced:

- Equity/fairness
- Economic neutrality
- Long-term adequacy
- Revenue stability (maybe)

Principles Most Eroded:

- Administrative simplicity
- Transparency