Washington State and Local Tax System Dysfunction & Reform

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Fairness

The Institute on Taxation & Economic Policy has determined that "lacking an income tax... Washington has the most unfair tax system in the nation."

Preface

My great grandparents migrated to Seattle in the 1870s, but I did not arrive until 1969 when I entered the University of Washington business school. Prior to that, I had taught mathematics in a secondary school in Sierra Leone, West Africa. After meeting Professor Philip Bourque during a campus visit in 1968, he offered me a Research Assistantship to help him develop models of the Washington economy. That was the start of my career in applied regional economics.

I am principal of Dick Conway & Associates, a Seattle firm specializing in regional forecasting and analysis. I am also co-publisher of *The Puget Sound Economic Forecaster*, a newsletter and web site on the regional economy.

Over the past thirty-nine years, I have published 28 articles in economic journals and books, primarily on regional economic modeling and applications, and have produced more than 300 other publications and research reports. My latest research paper "The Process of Regional Economic Growth: A Case Study of Washington State" will be published this fall in a book entitled *Regional Science Matters* by Springer International.

I have taught courses in the University of Washington business school, geography department, and economics department and have served as Associate Editor of the *Journal of Regional Science* and the *International Regional Science Review*. I have also been a member of the Washington Governor's Council of Economic Advisors since 1985.

In 2001, I was appointed to the Washington State Tax Structure Study Committee, which was given the task of evaluating the state and local tax system. As a member of the committee, I conducted simulations of a proposed rainy day fund, addressed the issue of how much to tax, and analyzed the adequacy of the current tax system.

Since then the Washington tax system has become increasingly dysfunctional, particularly with regard to adequacy. The last recession resulted in large state and local budget deficits, which were widely blamed on overspending. In fact, the fiscal problem stemmed from a long-standing decline in tax revenue relative to personal income due to our inadequate sales-based tax system.

The principal objective of this paper is to evaluate the Washington state and local tax system, comparing it to the tax systems of the other states. Five characteristics of the tax system are analyzed: fairness, adequacy, stability, transparency, and economic vitality.

A related objective of this study is to provide sufficient documentation to enable the reader to verify the findings of the analysis. Most of the data are drawn from readily available sources (e.g., the U.S. Bureau of the Census and the U.S. Bureau of Economic Analysis). In addition, the various tests of the tax system characteristics are spelled out in detail.

Dick Conway, *November 1, 2014*

Adequacy

Reflecting the gross inadequacy of its tax system, the Washington state and local effective tax rate (state and local taxes as a percent of personal income) fell from 11.4 percent (the twelfth highest in the nation) in FY 1995 to 9.6 percent (the fourteenth lowest) in FY 2011. Only South Dakota experienced a greater fall-off.

Summary

Stability

Due to the inadequacy and volatility of its large sales tax base, Washington had the forty-seventh most stable—the fifth most unstable—tax system in the nation between FY 1995 and FY 2011.

This study compares the Washington state and local tax system with the tax systems of the other forty-nine states and the District of Columbia. It focuses on five characteristics: fairness, adequacy, stability, transparency, and economic vitality. The findings indicate that Washington probably has the worst state and local tax system in the nation.

Fairness. Fairness generally refers to the tax burden placed on households. Progressive tax systems have relatively high tax rates for high-income households, while regressive tax systems have relatively high tax rates for low-income households.

☞ The Washington State Tax Structure Study Committee concluded that “Washington’s tax structure is regressive.” Their analysis found that 15.7 percent of the income of the lowest-income households went to sales, property, and other excise taxes in 1999. In contrast, the tax burden on the highest-income households was only 4.4 percent.

☞ Bearing a 15.7 percent tax burden, the lowest-income households had to work 8.2 weeks out of the year to pay their annual state and local tax bill. With a 4.4 percent tax burden, the highest-income households had to work only 2.3 weeks.

☞ A 2013 study by the Institute on Taxation & Economic Policy determined that Washington had by far the most regressive state and local tax system among the fifty states. This echoed the finding from an earlier study by the institute: “lacking an income tax…Washington has the most unfair tax system in the nation.”

Adequacy. Adequacy is the ability of a tax system to generate sufficient revenue to meet the public needs, such as education and transportation, of a growing economy. If tax revenue fails to keep up with the demand for public goods and services, it becomes necessary to increase tax rates or broaden the tax base. In a sales-based tax system like Washington’s, this makes the tax system even more unfair.

☞ Adequacy raises a critical issue in taxation: how much should state and local governments tax? Since 1970 tax revenue for all state and local governments in the nation as a percent of U.S. personal income (the state and local effective tax rate) has averaged 10.6 percent. The effective tax rate has also been quite stable over time.

☞ The existence of a stable norm for the U.S. state and local effective tax rate has three implications for Washington tax policy: (1) The state and local effective tax rate should be about 10.6 percent of personal income. (2) The state and local tax structure should be designed such that tax revenue grows with personal income, thereby maintaining the desired effective tax rate without raising tax rates or broadening the tax base. (3) Any tax reform proposal should include an explicit estimate of the impact on the effective tax rate.

☞ Washington has one of the most inadequate tax systems in the nation. The Washington state and local effective tax rate fell from 11.4 percent (the twelfth highest in the nation) in FY 1995 to 9.6 percent (the fourteenth lowest) in FY 2011. Only South Dakota experienced a greater fall-off.

☞ Washington state and local governments have forfeited billions of dollars because of the inadequate tax system. If the Washington state and local effective tax rate had equaled the norm (10.6 percent) from FY 2005 to FY 2011, state and local governments would have collected an additional $14.4 billion. This would have been sufficient to pay for the new 520 bridge, the Alaska Way Viaduct replacement, Washington's share of the Columbia River Bridge, and the Washington Supreme Court-ordered basic education funding requirement.

☞ Inadequacy is a permanent fixture of the current Washington state and local tax system because of its reliance on sales taxes and the restriction limiting the annual increase in property taxes to one percent plus taxes on new property. Forecasts from a model of the Washington economy and tax system indicate that, without legislated changes to the tax rates or the tax base, the state and local effective tax rate will decline to 9.3 percent (12.3 percent below the 10.6 percent norm) in FY 2015 and 8.2 percent (22.6 percent below the norm) in FY 2025. In FY 2025, Washington could have the lowest state and local effective tax rate in the nation.

Stability. A stable tax system facilitates government operations. Since every state is subject to national economic cycles, no state has a perfectly stable state and local tax system. Some state and local tax systems, however, are more unstable than others due to the sensitivity of their effective tax rates to economic fluctuations. Given that states have no control over economic cycles, the test of stability focuses on the variability of the effective tax rate.

☞ Measured by a stability index constructed for this study, Washington has a highly unstable tax system due to the inadequacy and volatility of its sales tax base. The Washington state and local effective tax rate was nearly five times more unstable than the average effective tax rate for all states between FY 1995 and FY 2011. Among the fifty states and the District of Columbia, Washington had the forty-seventh most stable—the fifth most unstable—tax system.

☞ The Washington stability index and its ranking have varied over time. The economic recovery between FY 2002 and FY 2007 was a period of relative stability for the Washington state and local effective tax rate. The state had the twentieth most stable tax system in the nation. However, during the economic upturn, the state and local effective tax rate rose in Washington but not as much as it did in other states. The Washington state and local effective tax rate thus fell further behind the average state and local effective tax rate for all states in what turned out to be a period of "unwanted stability."

☞ Washington state government experienced an unprecedented loss of tax revenue between FY 2007 and FY 2013 because of the Great Recession and its volatile tax system. Despite enhancements to revenue, such as the increase in the business and occupation tax on services and a tax amnesty program, real per capita tax revenue measured in 2009 dollars plunged from $2,376 to $2,056, a 13.5 percent drop. This meant that the purchasing power of state government tax

Transparency

Without an individual income tax, which is the only totally transparent tax, Washington has the second least transparent tax system among the fifty states and the District of Columbia, edging out only Alaska.

revenue—the ability to provide public goods and services—declined by one-seventh over the six-year period.

Transparency. Like other transactions in the economy, taxes should be transparent. Every household and business should know how much it pays in taxes. Transparency is a prerequisite for rational tax policy.

☞ Washington's unique business and occupation tax, a gross receipts tax, is not transparent, as businesses can sometimes pass the tax on to customers in the form of higher prices. The Washington input-output table indicates that up to three-fifths of the business and occupation tax ostensibly paid by the business sector is subject to tax-shifting, much of it to local consumers.

☞ Due to its broad coverage, the business and occupation tax has an adequate and relatively stable tax base, making it popular with government officials. However, along with its opaqueness, the tax has several drawbacks. Tax-shifting results in pyramiding—the multiple payment of the tax on a product as it moves up the production chain—which can raise business costs. The tax is levied on receipts rather than income, which can retard the formation of start-ups. The tax burden is high, nearly three times the average business state and local effective tax rate nationally. Washington offers preferential business and occupation tax rates to selected industries, which raises questions about the potentially unfair application of the tax.

☞ Individual income taxes are totally transparent, since there is always a record of payment. Sales taxes are only partially transparent. Despite knowing the sales tax on each purchase, "most households are unaware of their annual sales tax burden," according to the Washington State Tax Structure Study Committee.

☞ A transparency test encompassing five types of taxes (individual income tax, business tax, sales tax, property tax, and other excise tax) shows that Washington has the second least transparent tax system in the nation, edging out only Alaska.

☞ In FY 2011, with a sales tax and a business and occupation tax but no income tax, the Washington state and local tax system had a transparency index of 0.549 (1.000 being totally transparent). With an income tax, the Oregon tax system had a transparency index of 0.763, making it the nation's most transparent tax system.

Economic vitality

There is virtually no correlation between the business tax climate of a state—namely, whether or not it has an income tax—and its ability to generate jobs. With fundamentally different tax systems, the Washington and Oregon economies have performed equally well since 1970.

Economic vitality. The literature on how taxes affect economic vitality is inconclusive. Thus, the issue is contentious. Some economists argue that low taxes are the best way to promote job and income growth. Others believe that high-quality education and good roads provide the foundation for a strong economy.

☞ A widely cited study by the Tax Foundation on the best business tax climates contends that "states with the best tax systems will be the most competitive in attracting new businesses and most effective at generating economic and employment growth." The top six states are Wyoming, South Dakota, Nevada, Alaska, Florida, and Washington. One thing these states have in common is the lack of a major tax (individual income tax, corporate tax, or sales tax).

☞ The top six states all have no income tax, but their tax systems, especially with regard to raising tax revenue, are not equally advantageous. Four states have major alternative sources of tax revenue: severance taxes from resource extraction (Wyoming and Alaska) and tourist-related taxes (Nevada and Florida). These states do not need an income tax. On the other hand, without a major alternative tax source, Washington must rely on a regressive and inadequate sales tax base to generate the needed state and local tax revenue.

☞ In spite of having the best business tax climate, there is no evidence that it has done the Wyoming economy much good. Between 1970 and 2012, it added only 168,700 wage and salary jobs, just 0.3 percent of the total gain nationally. Moreover, one-half to two-thirds of these jobs were related directly or indirectly to mining activity.

☞ A statistical test shows that there is in fact virtually no correlation (0.001) between the business tax climate of a state—specifically, whether or not it utilizes an income tax—and its ability to generate jobs. As an example, with the third worst business tax climate, California created 7,550,400 wage and salary jobs—one out of every eight jobs in the nation—between 1970 and 2012.

☞ The contention that the lack of an income tax gives the Washington economy a competitive advantage is contradicted by the long-term growth of the Washington and Oregon economies. The two states have fundamentally different tax systems. Washington has no income tax, while Oregon has an income tax but no sales tax or business and occupation tax. Nevertheless, the two economies have performed equally well over time. Since 1970 the Washington and Oregon annual employment growth rates have averaged 2.1 percent and 2.0 percent, respectively.

Tax policy options. It is hard not to conclude that Washington has the worst state and local tax system in the nation. Given the nature of its problems—unfairness, inadequacy, instability, and opaqueness—the only solution is a personal income tax. Two alternative tax systems are presented to highlight the beneficial role of an income tax.

☞ The first alternative tax system is a single-rate personal income tax with a preferred rate of 10.6 percent. This is the simplest tax structure possible. The tax is universal, as everyone earning personal income would pay it. With a 10.6 percent rate, there would be no need for a sales tax, a business and occupation tax (or corporate income tax), a property tax, or any other excise tax. The single-rate tax would be fair, adequate, stable, and transparent and would have no adverse effect on economic vitality. If Washington were to adopt a single-rate personal income tax, it could have the best –not the worst– tax system in the nation.

☞ The second tax system is "one like most others." If Washington had collected taxes like other states in FY 2011, the breakdown of revenue would have been: personal and corporate income taxes (29.1 percent), sales taxes (21.2 percent), property taxes (32.0 percent), and other excise taxes (17.7 percent). The introduction of an income tax would enhance the fairness, adequacy, stability, and transparency of the tax system. For example, in FY 2011, even though the second alternative tax system would have reduced the state and local retail tax rate from approximately 9 percent to 6 percent, state and local governments would have collected $3 billion more in taxes.

Tax policy

If Washington were to adopt a single-rate personal income tax, it could have the best—not the worst—tax system in the nation. The single-rate tax would be fair, adequate, stable, and transparent and would have no adverse effect on economic vitality.

Washington State and Local Tax System
Dysfunction and Reform

Few of us like taxes, but in 2013 we paid $3.2 trillion in taxes for the goods and services provided by government. Nearly $1.5 trillion went to state and local governments.

Despite claims to the contrary, federal, state, and local taxes relative to personal income are low today.

1. INTRODUCTION

In 1932, Washington citizens overwhelmingly passed an initiative to enact a graduated income tax, but it was ruled unconstitutional by the Washington Supreme Court. Eighty years later, Washington is one of only seven states without an income tax. The major components of the current state and local tax system include a retail sales tax, a business and occupation tax, and a property tax.

Throughout its existence the Washington tax system has been problematic. Its heavy reliance on retail sales taxes, whose tax base does not keep up with the growth of the economy, has made it necessary to raise the state government sales tax rate from 2.0 percent to 6.5 percent. This in turn has greatly increased the regressivity of the Washington tax system, which is broadly recognized as the most unfair in the nation.

Due to the volatility of the sales tax base, the Dot-Com/911 Recession and the Great Recession caused a 1.9 percent decrease in state government tax collections in FY 2002 and a 9.6 percent decline in FY 2009. By FY 2011, Washington ranked thirty-eighth among the fifty states and the District of Columbia in state and local tax collections and forty-sixth in public elementary and secondary school spending per $1,000 of personal income.

In 2001, the Washington state legislature established the Washington State Tax Structure Study Committee to evaluate “the elasticity, equity, and adequacy of the state’s tax system.” Notwithstanding the wide-ranging and thoughtful effort, the study brought about no fundamental change to the tax system.

Carrying on the work started by the tax structure committee, this study compares the Washington state and local tax system with the tax systems of the other forty-nine states and the District of Columbia. The analysis focuses on five characteristics of the tax systems: fairness, adequacy, stability, transparency, and economic vitality. Based on the findings of the study, it is hard not to conclude that Washington has the worst state and local tax system in the nation. Moreover, the evidence indicates that the most logical resolution to its various shortcomings is instituting an income tax

2. GOVERNMENT FINANCES

Federal, state, and local tax revenue. Few of us like taxes, but in 2013 U.S. households and businesses paid $3.2 trillion in taxes for the goods and services—national security, education, highways, police and fire protection, healthcare, parks and recreation—provided by federal, state, and local governments, according to the national income and product accounts (Table 1). Nearly $1.5 trillion went to state and local governments. The state and local effective tax rate (total state and local taxes as a percent of personal income) was 10.3 percent.

THE SOCIAL CONTRACT

"The organizer of industry who thinks that he has 'made' himself and his business has found a whole social system ready to his hand in skilled workers, machinery, a market, peace and order—a vast apparatus and a pervasive atmosphere, the joint creation of millions of men and scores of generations. Take away the social factor and we are but…savages living on roots, berries, and vermin."

L. T. Hobhouse, *The Elements of Social Justice*, 1922.

Despite claims to the contrary, taxes are relatively low today. Since President Bush's tax cuts in 2001 and 2003, the effective tax rate for federal, state, and local taxes has averaged 22.5 percent of personal income. From 1970 to 2000, it averaged 24.7 percent.

The effective tax rate is not only subject to changes in tax policy, but it is also sensitive to fluctuations in the economy, falling during recessions and rising during recoveries. Compared to the federal effective tax rate, the state and local effective tax rate has been quite stable over time. Since 1970 the federal effective tax rate has averaged 13.6 percent but has ranged from a low of 9.6 percent in 2009 to a high of 15.9 percent in 1970. The U.S. state and local effective tax rate, which has averaged 10.6 percent, has varied from 9.8 percent in 1982 to 11.3 percent in 1972 (Figure 1).

Since 1970 the state and local effective tax rate (state and local taxes as a percent of personal income) has averaged 10.6 percent. It has also been quite stable.

TABLE 1 **U.S. FEDERAL, STATE, AND LOCAL TAX REVENUE, 1970-2013**

Billions of Dollars

	1970	1985	2000	2007	2008	2009	2010	2011	2012	2013
Tax revenue	229.2	823.9	2202.8	2958.4	2777.0	2431.9	2610.6	2862.4	3041.2	3209.3
Federal	137.9	460.2	1309.6	1637.1	1448.1	1163.7	1305.0	1496.1	1636.0	1752.3
State and local	91.3	363.7	893.2	1321.3	1328.9	1268.1	1305.6	1366.3	1405.2	1457.0
State	48.1	220.9	540.1	759.7	763.6	688.2	720.0	773.2	804.9	847.1
Local	43.2	142.8	353.1	561.6	565.3	580.0	585.7	593.1	600.3	609.9
Personal income	864.6	3515.9	8632.8	11995.7	12430.6	12082.1	12435.2	13191.3	13743.8	14134.7
Effective tax rate (% of income)	**26.5**	**23.4**	**25.5**	**24.7**	**22.3**	**20.1**	**21.0**	**21.7**	**22.1**	**22.7**
Federal	15.9	13.1	15.2	13.6	11.6	9.6	10.5	11.3	11.9	12.4
State and local	**10.6**	**10.3**	**10.3**	**11.0**	**10.7**	**10.5**	**10.5**	**10.4**	**10.2**	**10.3**
State	5.6	6.3	6.3	6.3	6.1	5.7	5.8	5.9	5.9	6.0
Local	5.0	4.1	4.1	4.7	4.5	4.8	4.7	4.5	4.4	4.3

Source: U.S. Bureau of Economic Analysis

Washington and U.S. state and local revenue and expenditures. States differ in how they divide the responsibility of governing—raising revenue and providing public services—between state government and local governments. When comparing fiscal policies, it is therefore necessary to consider state and local governments in each state as a "single government."

According to the latest data, Washington state and local government revenue amounted to $56.0 billion in FY 2011 (Table 2). This included $28.4 billion from taxes (50.7 percent of total revenue), $12.4 billion from federal transfer payments for social programs and infrastructure projects (22.1 percent), $11.6 billion from direct charges for university tuitions, hospital stays, and other services (20.7 percent), and $3.6 bil-

In FY 2011, Washington state and local revenue amounted to $56.0 billion. Without an individual or corporate income tax, 61.6 percent of the total state and local tax revenue originated from sales and gross receipts taxes. The national dependency on these taxes was only 34.4 percent.

SHORT HISTORY OF WASHINGTON TAXES.

Until 1900 most Washington residents lived and worked on farms. Since farm sales were unpredictable, lawmakers thought that excise taxes would be unreliable. Consequently, Washington initially depended on property taxes to finance government.

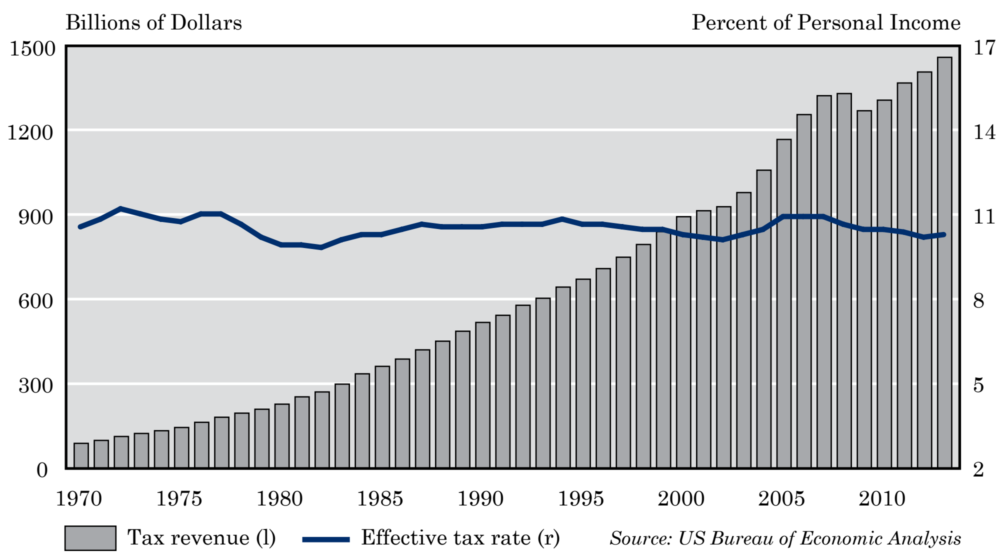
As Washington grew, the demand for government goods and services increased, causing property taxes to escalate in the farm community. In 1932, in an attempt to broaden the tax base, 70 percent of the voters passed an initiative to cut property taxes in half and establish a graduated income tax.

When businesses challenged the legality of the income tax, the Washington Supreme Court ruled in a narrow 5-4 decision that the graduated income tax was an “unconstitutionally non-uniform property tax.” At the same time, the court upheld the legality of the business and occupation tax, which had been adopted during the litigation period. Shortly thereafter, economic suffering during the Great Depression gave rise to an unprecedented need for social services and public works projects. Thus, in 1935, the legislature passed the Revenue Act, which added a retail sales tax, the last major piece of today’s state and local tax system.

Since the adoption of the Revenue Act the state retail sales tax rate has risen from 2.0 percent to 6.5 percent. Adding in local sales taxes, the combined sales tax rate currently ranges from 7.0 percent in unincorporated Klickitat County to 9.6 percent in Mill Creek, Snohomish County.

Washington State Tax Structure Study Committee, *Tax Alternatives for Washington State*, 2002.

FIGURE 1 **U.S. STATE AND LOCAL TAX REVENUE**



Source: US Bureau of Economic Analysis

TABLE 2 **WASHINGTON AND U.S. STATE AND LOCAL REVENUE AND EXPENDITURES, FY 2011**

Billions of Dollars

	Washington	Percent of Total	Percent of Income	United States[1]	Percent of Total	Percent of Income
General revenue	**56.0**	**100.0**	**19.0**	**2612.8**	**100.0**	**20.4**
Federal transfers	12.4	22.1	4.2	646.0	24.7	5.0
Tax revenue	**28.4**	**50.7**	**9.6**	**1338.4**	**51.2**	**10.4**
Current charges	11.6	20.7	3.9	428.9	16.4	3.3
Education	3.0	5.4	1.0	129.9	5.0	1.0
Hospitals	3.2	5.7	1.1	116.7	4.5	0.9
Other charges	**5.4**	**9.6**	**1.8**	**182.2**	**7.0**	**1.4**
Miscellaneous revenue	3.6	6.4	1.2	199.5	7.6	1.6
General expenditures	**57.8**	**100.0**	**19.6**	**2583.1**	**100.0**	**20.1**
Education	19.2	33.2	6.5	872.7	33.8	6.8
Social services	16.1	27.9	5.5	728.7	28.2	5.7
Transportation	5.0	8.7	1.7	182.5	7.1	1.4
Public safety	4.7	8.1	1.6	225.6	8.7	1.8
Other expenditures	10.3	17.8	3.5	464.9	18.0	3.6
Interest on debt	2.5	4.3	0.8	108.7	4.2	0.8
Personal income	294.9	---	---	12826.9	---	---

[1]All state and local governments in the United States.

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis

TABLE 3 **WASHINGTON AND U.S. STATE AND LOCAL TAX REVENUE, FY 2011**

Billions of Dollars

	Washington	Percent of Total	Percent of Income	United States	Percent of Total	Percent of Income
Tax revenue	28.4	100.0	9.6	1338.4	100.0	10.4
Individual income	**0**	**0**	**0**	**284.9**	**21.3**	**2.2**
Corporate income	0	0	0	48.5	3.6	0.4
Sales and gross receipts	**17.5**	**61.6**	**5.9**	**460.8**	**34.4**	**3.6**
General sales[1]	12.9	45.4	4.4	301.4	22.5	2.4
Selective sales	4.6	16.2	1.6	159.5	11.9	1.2
Motor fuel	1.2	4.2	0.4	41.2	3.1	0.3
Alcoholic beverage	0.3	1.1	0.1	6.2	0.5	0.0
Tobacco products	0.5	1.8	0.2	17.7	1.3	0.1
Public utilities	1.1	3.9	0.4	28.7	2.1	0.2
Other selective sales	1.5	5.3	0.5	65.6	4.9	0.5
Property	8.7	30.6	3.0	443.3	33.1	3.5
Motor vehicle excise license	0.5	1.8	0.2	23.2	1.7	0.2
Other taxes	1.7	6.0	0.6	77.7	5.8	0.6
Personal income	294.9	---	---	12826.9	---	---

[1]Includes business and occupation taxes.

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis