Economic Opportunity Institute
Policy Memo

Reforming Washington's Tax System: *Where Do We Go From Here?*

By
Marilyn P. Watkins, Ph.D.
Policy Director

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Introduction

State government services are essential to the health and well-being of all state residents. The public schools, institutions of higher education, transportation infrastructure, justice system, regulation of workplace safety, protection of the environment, social safety nets, and other public services establish the framework which enables individual freedom and opportunity to flourish. State services that are adequately financed and well run allow opportunity and prosperity to be broadly shared and available to all. On the other hand, inadequate and overburdened state services constrict opportunity and prosperity for the whole community.

Unfortunately, Washington's seventy-year-old tax structure is no longer able to produce sufficient revenues to keep Washington among the best states to live and do business. Most states rely on a four-part mix of personal income tax, sales tax, property tax, and corporate income tax to finance the bulk of state services, enhanced by an array of specialty taxes on alcohol, tobacco, gambling and the like. However, Washington has historically rejected both personal and corporate income taxes. Instead, Washington collects a higher rate of sales tax than most states and a business and occupation (B&O) tax on gross business receipts. Because of its unusual tax structure, Washington has:

- ***The most regressive tax system in the United States.***
  People in the lowest income quintile of the state's population pay 18% of their income directly and indirectly in state and local taxes, the middle class pays 11%, while the richest 1% pay just 3%.[1]
- ***A shrinking tax base.***
  State revenues are growing at only 85% the rate of the state's economy, and therefore will perpetually fall below the level needed to maintain services, even when the state is fully recovered from recession.[2]
- ***Unfair business taxes.***
  Washington's business taxes are widely considered to be unfair, particularly to start-up companies and those with slim profit margins.

During the 1990s, Washington's revenue problems were compounded by a series of tax reduction initiatives. These measures effectively eliminated the motor vehicle excise tax as a source of state revenue and limited increases in property tax collections to less than the rate of inflation,

Economic Opportunity Institute
1900 N. Northlake Way
Suite 237
Seattle, WA 98103
www. eoionline.org

particularly hurting local governments. Initiative 601 also limited the growth in state spending by a population growth plus inflation formula despite the fact that demand for state services has historically risen at a faster rate, one more closely tied to growth in personal income and the state economy. I-601 has squeezed the state budget even more.[3] Since the majority of state residents do pay relatively high rates of state and local taxes, it is not surprising that voters have backed lowering the most visible of their taxes, even while they have clamored for higher quality schools and expanded transportation options.

State revenues have been further eroded by numerous tax exemptions granted by the legislature both during the economic boom of the 1990s and the recession that followed. Of the more than 500 tax exemptions on the books in 2003, 213 were for businesses (including agriculture), and over half of these were adopted after 1990.[4]

Reduced revenues have undermined the state's ability to deliver quality services. Among the states, Washington fell from 11th place in 1995, to 17th in 1998, to 32nd in 2002 in collection of state and local taxes per $1,000 of personal income. During that seven-year-period, the amount collected fell by 18%, from $123 to $100.90 per $1,000 of personal income. The 2002 level is the second lowest for Washington since the U.S. Census Bureau began compiling the data in 1960.[5] According to the latest figures, in 2002 Washington ranked 45th on K-12 public school funding per $1,000 in personal income and 30th in total per pupil spending.[6] In higher education, Washington ranked 29th in spending per $1,000 and 33rd in the number of bachelor's degrees earned per 1,000 residents.[7]

The state of Washington can coast on past investments for only so long. In order to assure a high quality of life and broadly shared opportunity for state residents in the coming decades, Washington needs to be able to invest more in education – from pre-school through research universities – and more in transportation, health care, and other important services. In the long run, making these investments will require major reforms in the state's tax structure so that it:

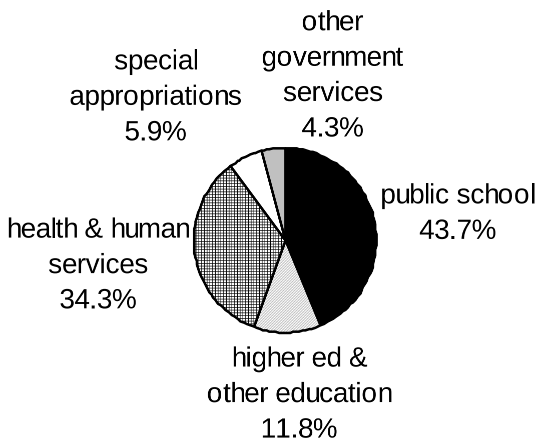
- distributes taxes more fairly across income levels, capturing a higher percentage of the incomes of the state's highest income residents, and lowering rates for moderate and low income residents;
- produces revenues that grow with the state's economy and demand for services;
- makes business taxes more fair and accountable;
- provides a mechanism for stabilizing revenues; and
- establishes procedures for government accountability and realistic limits in spending that give Washington residents confidence that tax money is being well spent.

This brief does not attempt to recommend specific details of a new tax structure for Washington state. Rather, it describes general elements that should be included in a balanced and fair system, along with issues to consider in deciding among alternatives.

I. Washington's Current Tax Structure

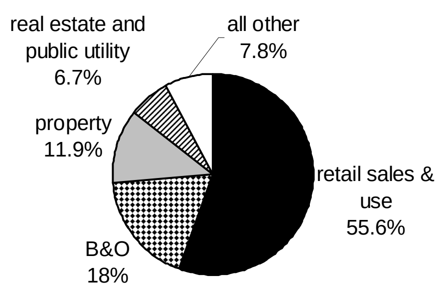
Washington's 2003-05 general fund budget totals about $23 billion. Public schools are the largest item in the general fund budget, accounting for 43.7% of spending. Another 11.8% is devoted to higher education and other educational services. Health and human services account for just over one-third of spending. Other state services, including courts, the legislature, natural resources, and governmental operations together make up the other 10% of general fund spending.[8]

Washington State General Fund Spending, 2003-05



Source: Legislative Evaluation and Accountability Program Committee, 2004 Budget Notes.

Washington State General Fund Revenues, 2003-05



Source: Legislative Evaluation and Accountability Program Committee, 2004 Budget Notes.

Washington's general fund has three major sources of revenue. The sales and use tax provides 55.6%, the B&O tax contributes 18%, and the state's share of property taxes adds 12%. Other more specialized taxes make up the remaining 15% of the budget, including real estate, public utility, tobacco, alcohol, and estate taxes.

The Washington Tax Structure Study Committee

In 2001, the Washington Legislature established a Tax Structure Study Committee to evaluate the state's tax system and recommend alternatives. Bill Gates, Sr. chaired the committee which included legislators from both parties, economists, and others with expertise in public finance.

The committee presented its final report in November 2002. It identified regressivity, unfair business taxes, volatility, and the declining tax base as serious problems with the state's tax structure. The committee recommended a number of significant reforms, including:[9]

1. Replacing the gross receipts B&O tax with a value added tax that would allow businesses to deduct costs of goods and services purchased from other companies, making the system fairer. The committee also proposed lowering the total amount of taxes directly paid by businesses.
2. Reducing the state sales tax rate, which is now 6.5% (local governments collect an additional 0.5% to 2.4%), and extending the sales tax base by adding consumer services.
3. Eliminating the state portion of the property tax (about 25% of total property tax collections). Local governments and school districts might be allowed to pick up some or all of that authority.
4. Adopting a personal income tax to replace revenues lost to lower business, sales, and property taxes.
5. Evaluating tax exemptions alongside policy goals every ten years.

6. Creating a constitutionally mandated rainy day fund to reduce the effects of volatility.

Despite the high profile of the Tax Structure Committee and a significant state budget deficit that might have been eased by adopting some or all of the recommendations, the committee's report was almost immediately shelved by the legislature and governor. Because its legislative mandate required the committee's recommendations to be revenue neutral, the committee did not directly address the adequacy of funding for state services. However, the committee did produce a wealth of data and analysis that provides a solid starting point for current discussions of Washington's tax system.

II. Elements of a 21st Century Tax Structure for Washington State

Achieving a tax system that is fair, stable, and accountable and that produces adequate revenue to lay the foundations of broadly shared health, opportunity, and prosperity will be most easily achieved by:

1. Lowering the sales tax and extending it to cover more transactions
2. Adopting a personal income tax
3. Reforming business taxes
4. Keeping property taxes in the mix
5. Retaining a range of specialty and use taxes
6. Adopting highly visible measures to assure accountability and build trust in government.

Specific alternatives within each of the above six elements need to be balanced against other choices for the tax system as a whole to best serve the needs of the people of the state. For example, choosing to limit an income tax to very high-income households would increase its popularity, but also limit revenues, meaning that little reduction in sales or other taxes would be possible unless other new sources of revenue were tapped. Ideally the overall system should be broad and balanced, covering all parts of the economy. That will allow rates to remain low and will keep the tax system from distorting decision-making by individuals, businesses, and local governments, while allowing revenues to remain more stable and grow as the economy changes.[10]

Incremental reform may be more achievable politically than a complete overhaul of the state tax structure. Both incremental measures and broader reform alternatives are discussed below for each of the six elements of a balanced tax system.

A. Retail Sales Tax Issues and Alternatives

Washington's heavy reliance on sales tax is the prime culprit in both regressivity and the shrinking tax base. People with lower incomes spend most or all of their income. People with high incomes tend to save more, spend more on services that are mostly not subject to sales tax, and spend more out of state, so spend a much lower percentage of their income on sales tax.

The retail sales tax applies to tangible goods, construction, repair, and a handful of other activities. Most services, such as those provided by lawyers, accountants, and hair dressers, are excluded from the sales tax. In the current system, consumers who purchase tax preparation software pay sales tax, while those who go to a tax preparation service do not; those who purchase hair care products pay sales tax, while those who go to a hair stylist do not. Since 1960, services have increased from 40% of personal expenditures to nearly 60%, while the percentage of income spent on goods has declined.[11] Internet and catalog sales are reducing sales tax revenues further.[12]

Washington state collects sales tax at a rate of 6.5%. Local governments collect an additional 0.5% to 2.4%. Nine other states had higher combined allowable state and local sales tax rates in 2004.[13]

Despite its regressivity and the selective way it is applied, many people consider the sales tax to be "fair," since everyone pays the same rate for the same purchase. The tax is also paid in small amounts over numerous purchases, so few people ever know their total annual bill. For both of these reasons, there has been less voter resistance to the sales tax than to property or income taxes. However, the defeat of Initiative 884 in November 2004, which would have increased the state portion of the sales tax from 6.5% to 7.5%, suggests that Washington residents are opposed to further increases in the sales tax rate. The $1 billion in new annual revenue that I-884 would have raised would have been devoted to education, from preschool through college.[14]

Although it is regressive, the sales tax is an important part of a balanced tax system. Consumer spending constitutes a major part of the United States economy. Even in the worst recessions, sales taxes still generate significant public revenue. A state revenue system without a sales tax component would be more volatile and would require significantly higher rates on other taxes.

Major options for reforming the sales tax include:

- ***Reducing the state rate*.**

Lowering the state sales tax rate is one of the keys to making Washington's tax system less regressive. It would also have the benefit of spurring consumer spending and economic growth and making it easier for Washington merchants to compete with out-of-state sales. Every 1% reduction in the sales tax would reduce state revenues by about $1 billion annually. The lost revenue could be made up by extending the sales tax base to additional goods and services and/or some form of income tax.

- ***Extending retail sales tax to consumer goods now exempt.***

The current exemptions of sales tax on food and prescription drugs are extremely popular, reduce the regressivity of the sales tax, and promote social welfare. There are a few items that could be added to the sales tax base without undermining these benefits, such as candy and bakery goods. Another category to consider is the exemption for residents of low/non-sales tax states. However, this exemption has strong support, particularly among businesses with Oregon customers.

- ***Extending retail sales tax to consumer services.***

Extending the current sales tax to consumer services, such as veterinarians, cable TV, barbers, and entertainment, would raise an estimated $280 million in new state revenue for the 2005-07 biennium. Local governments, which have been particularly hard hit by initiatives limiting property tax, would gain $81.8 million in new revenue.[15] The B&O tax rate for businesses providing those services would fall from 1.5% to 0.471%. (The effects of lost B&O revenue are included in the revenue estimates.) Extending the sales tax to consumer services would broaden the tax base and would be somewhat less regressive than the sales tax on goods. The Tax Structure Study Committee recommended this action. Most states with sales tax apply it to at least some services, though how many and which ones vary considerably. Connecticut, Hawaii, Iowa, Nebraska, New

Net New Revenues from Extending Sales Tax to Selected Consumer Goods
2005-07 estimate, in millions

	State	Local
Candy & gum	$27.6	$8.1
Bakery goods	$54	$15.8
Repeal exemption for non-residents	$70.9	$20.7
Subotal Consumer Goods	**$152.5**	**$44.6**

Source: Washington Department of Revenue

Net New Revenues from Extending Sales Tax to Consumer Services
2005-07 estimate, in millions

	State	Local
Veterinarians	$37.1	$10.8
Cable TV	$57.8	$16.9
Beauty and barber shops	$51.9	$15.2
Tax preperation	$2.9	$.8
Movies, theaters, bands & orchestras	$30.3	$8.8
Pro sports, racing	$33.9	$9.9
Misc. personal services	$13.2	$3.9
Bowling, golf, other physical fitness and recreation	$45.1	$13.2
Funeral services	$8	$2.3
Subtotal Consumer Services	**$280.3**	**$81.8**

Source: Washington Department of Revenue

Mexico, South Dakota, Texas, and West Virginia are among the states that apply sales taxes to most consumer services.[16]

- ***Extending retail sales tax to business services.***

Applying sales tax to business services such as lawyers, architects, consultants, and security

Net New Revenues from Extending Sales Tax to Business Services
2005-07 estimate, in millions

	State	Local
Legal	$323.2	$94.4
Engineering/architectural	$136.7	$39.9
Accounting/auditing	$136.2	$39.8
Detective/security	$106.9	$31
Computer/data processing	$107.1	$31.3
Management services	$213.3	$62.3
Research & development	$57.1	$16.7
Advertising	$21.6	$6.3
Janitorial	$10.7	$3.1
Other business services	$104.2	$30.4
Subtotal Business	**$1,217**	**$355.2**

Source: Washington Department of Revenue services would generate an estimated $1.2 billion in new revenue for the state for the 2005-07 biennium, and $355 million for local governments.[17] Companies providing those services would also see a reduction of more than two thirds in their B&O rates. However, such a move without additional reform of the B&O tax could add to the inequities for smaller companies that purchase services rather than having lawyers, computer experts, accountants, and the like on staff. Hawaii, New Mexico, South Dakota, Texas, and West Virginia apply retail sales tax rates to many business services.[18]

B. Personal income tax issues and alternatives

Instituting a personal income tax would be the best way to make Washington's tax structure less regressive and raise enough new revenue to significantly improve the quality of Washington's education system and other services. Personal income also tends to grow, on average, at the same rate as overall economic growth and demand for state services.

Washington is one of only seven states with no form of personal income tax.[19] Each of the other six states has additional sources of revenue that are either unavailable in Washington or that Washington has not chosen to collect. In Nevada, gaming and casino entertainment produced 37% of state general revenues in 2003.[20] Oil revenues provide 70% to 80% of Alaska's unrestricted revenues and 7.5% of the Texas state general budget.[21] Texas also applies sales tax to a number of consumer and business services.[22] Wyoming relies heavily on oil and mineral production revenues.[23] South Dakota has extended sales tax to consumer, business, and professional services, including recreation, barbers, lawyers, and accountants.[24] Florida collects a tax on intangible personal property, such as stocks and bonds, at a rate of $1.00 per thousand dollars of value. Retirement accounts and the first $60,000 of assets are exempt, so the tax falls primarily on the wealthiest Floridians. This tax has contributed between 3.4% and 6% of Florida's general revenues in recent years.[25] Florida also has extended the sales tax to some consumer services.[26]

On average, states raise 42% of general revenues from income tax.[27] Levels of exemptions, numbers of brackets, and rates vary considerably. In January 2004, Montana had the highest top rate of 11% on incomes over $76,199.[28]

Major options for designing a new income tax system include:

- ***Type of income.***

Most state systems cover all forms of income and use federal income tax returns as a starting point for calculating state taxable income. New Hampshire and Tennessee tax *only* interest and dividend income, not earned income. Given the history of voter rejections of a general income tax in Washington, an interest and dividends tax might be a more viable alternative.

- ***Exemption level.***

Most states with a general income tax set the personal exemption level below $4,000, so that the vast majority of state residents pay some tax. Connecticut sets the highest personal exemption, at $12,500. However, Washington could set higher levels that would exempt low- or even middle-income residents. The higher the exemption level, the more politically acceptable an income tax is likely to be, and the less revenue it can generate at a given rate. A tax limited to households with incomes above $1 million would be paid by only 0.2% of the state's families.

- ***Flat or graduated system.***

Only six states have a flat system, which has the benefits of simplicity and less volatility. With a graduated system, the income tax would more fully offset the regressivity of sales and property taxes.

Additional issues to consider include:

- ***Constitutional and political questions.***

Washington voters approved a graduated income tax in 1932, but the State Supreme Court declared it unconstitutional. Since than, state voters have rejected constitutional amendments to allow a personal income tax six times, most recently in 1973. Some legal scholars and court observers believe that the court would likely uphold an income tax today if one were brought to it for review, because the precedents on which the earlier ruling was based have been overturned.[29] However, the history of voter rejection and the uncertain constitutionality are major hurdles.

Washington could institute a 1% tax on income over $3,000 without encountering constitutional questions. Such a tax could be imposed on all income or on interest and dividend income only.

- ***Administrative costs.***

The Department of Revenue (DOR) would have to set up a new collection system for an income tax, including a process for payroll deductions. DOR has estimated that administering a general income tax would cost $126 million per biennium, and administering a "millionaire tax" would cost $30 million.[30]

- ***Delay in revenue collections.***

Because a State Supreme Court review would surely be triggered and DOR would need time to set up the new system, revenues could not be collected immediately from a new personal income tax.

- ***Federal tax savings.***

State income taxes can be deducted from federal income taxes. If a new state income tax were adopted, Washington residents who itemize their federal returns would be able to reduce their federal taxes. Beginning in 2004, state sales taxes are also deductible for those who itemize, but that deduction may not be permanent, and Washington residents could still save more by deducting a state income tax rather than sales tax. In most states, the majority of households pay considerably more in state income taxes than in sales taxes, particularly among upper income families that are most likely to itemize.[31]

Estimated Revenues from Income Tax Alternatives

Description	Annual Revenue
Flat Tax: 3.8% with exemptions of $5,000 single, $7,000 head of household, $10,000 2-earner couples*	$4,490 million
Flat Tax: 5% on household incomes over $1 million**	$404 million
Graduated* 2.2% $0 to $49,900 3.5% $49,900 to $120,650 6% $120,650 +	$4,511 million
Graduated, exemptions of $15,000 per adult, $10,000 per child*** 4% under $25,000 6% $25,000 to $50,000 8% $50,000 to $100,000 10% $100,000 +	$6,847 million
Graduated** 0% $0 to $200,000 3% $200,000 to $500,000 5% $500,000 to $1 million 7% $1 million +	$944 million
Interest and Dividends tax, 1% with $3,000 exemption**	$43 million

Sources:
** Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State"*
*** Mark Gardner, "An Incremental Approach to Improve Washington State's Tax System," EOI.*
****Institute on Taxation and Economic Policy, "The Impact of the Ron Sims Tax Plan," 2004.*
***** Washington State Department of Revenue*

C. Business tax issues and alternatives

The B&O tax is the largest business tax, contributing $4.1 billion in the 2003-05 biennium (or 18% of Washington's general fund revenue).[32] Washington is the only state that calculates business taxes based on gross business receipts. Most other states have some form of corporate income tax. On average, corporate income taxes contributed 5% to state tax collections in 2003. New Hampshire has the highest reliance on corporate taxes, accounting for 20.2% of state tax revenue, followed closely by Alaska at 19.4%.[33]

The advantages of the B&O tax are that it produces large amounts of revenue for state services, is more stable than a profits-based tax during economic downturns, and is relatively simple to calculate. The B&O has several disadvantages. Because it is paid initially by businesses but largely passed on to consumers, the B&O tax contributes both to the business perception that taxes are too high and to the overall regressivity of Washington's tax structure.[34] It is particularly hard on new businesses that have not yet become profitable and those businesses that operate on low profit margins. And it pyramids, building up through the production process, therefore favoring vertically integrated companies over those that purchase goods and services.

The perceived problems with the B&O tax have led to a number of special exemptions. In 2003 there were 133 B&O exemptions in Washington's tax code.[35]

Options for replacing the B&O tax reform include:

- ***Replacing the B&O with a corporate income tax*.**

Corporate income taxes are well understood and related to ability to pay. Forty-four states use a corporate income tax. Most are graduated, with the top rates in each state ranging from 4.63% in Colorado to 12% in Iowa. In order to replace the revenue generated by the B&O tax, a Washington corporate income tax rate would have to be set at 16% or higher, considerably higher than in any other state.[36] If Washington replaced the B&O tax with a corporate income tax within the range used by other states, the state would have to gain new revenues from another source. Because profits are less stable than gross receipts, a secure rainy day fund would also be important.

- ***Replacing the B&O with a value-added tax (VAT)***

A VAT applies to a broader base of business income than a corporate income tax, but a smaller base than the gross receipts tax. It allows a company to subtract the value of purchased goods and services from taxable income. For example, a cider maker could deduct the cost of apples and other supplies, but not the cost of pressing and bottling the cider. This approach avoids the pyramiding that occurs in the B&O. New Hampshire and Michigan have forms of a VAT, as do Canada and many European countries.[37] The Tax Structure Study Committee recommended replacing the B&O tax with a VAT and reviewed several alternatives in detail. They concluded that a tax rate of 2.2% on a tax base of gross receipts minus the cost of intermediate goods would replace the revenues generated by the B&O tax (about $2 billion annually).[38]

- ***Combining a profits and VAT or gross receipts tax*.**

New Hampshire taxes corporate profits at a rate of 8.5%, and also applies a "business enterprise tax," or VAT, at a 0.75% rate to the sum of compensation, interest, and dividends paid or accrued by a company. This type of model provides more stability of revenues than a corporate income tax by itself.[39]

Options for reforming the B&O tax include:

- ***Raising the exemption level for small businesses.***

Firms with a tax liability of $35 or less per month pay no B&O tax. Currently, a retailer paying a rate of 0.471% and grossing $89,000 annually, a day care paying 0.484% and grossing $86,776, and a beautician paying 1.5% and grossing $28,000 are all exempt. Doubling the exemption level to $70 per month would double the amounts businesses could take in before they became liable for B&O taxes. This move would reduce state revenues by $28 million, according to the Tax Structure Study Report.[40]

- ***Establishing clear criteria for evaluating exemptions and balancing them against public priorities.***

Exemptions from the B&O tax were worth an estimated $5.5 billion during the 2003-05 biennium.[41] In recent years, the Legislature has established sunset dates and limited evaluation and public disclosure for some new exemptions. However, there are still no common standards, most exemptions are never reviewed, and exemptions are not routinely prioritized against each other or against other spending needs.[42] Evaluating and prioritizing exemptions would give legislators, the general public, and business owners greater confidence that the system is fair and working in the best interests of all the people of the state.

- ***Allowing more deductions and credits for inputs on which B&O tax has already been paid.***

This reform would reduce or eliminate pyramiding of the tax and some of the advantages of vertical integration and bigness. It would also reduce revenues.

D. Property tax issues and alternatives

Washington is just below the national average in the percentage of state and local tax revenue obtained from property tax. In 2002, property tax accounted for 29.7% of state and local tax revenue in Washington, compared to a national average of 30.8%.[43] Three-fourths of property taxes in Washington stay in local communities to support local school levies, city and county governments, fire, hospital and other services. About one-fourth of property tax collections go into the state general fund to support public education. Property tax accounted for $2.7 billion (or 11.9% of the state's 2003-05 general fund revenues). Public schools accounted for 44% of state spending.[44]

Most other states keep 95% or more of property taxes in local communities.[45] Washington's approach of sending a portion of property tax revenues to the state for redistribution has advantages. It assures more equity in school financing across wealthy and low-income districts. In addition, property taxes are more stable than other public revenues during economic recessions.

Despite these advantages, the Tax Structure Study Committee and others have suggested reducing or eliminating the state share of property tax. Property taxes are regressive and unpopular. Directly or indirectly, they fall more heavily on low- and middle-income families who spend a larger percentage of their incomes on rent or housing than high-income households. Property taxes are also highly visible. In contrast to retail sales taxes, most people know exactly what their annual property tax bill is. While economists tend to see this "transparency" as a plus, politically it is a liability. Many people view the assessment process as unfair and property taxes as too high. Washington residents repeatedly have supported local levies to raise their property tax to support local schools, libraries, parks, emergency and other services, but have also supported initiatives to slow the growth of general property taxes.

The state constitution requires that tax rates be uniform across classes of property. Real estate is considered a single class, making it difficult but not impossible to institute new exemptions or graduated rates. In most types of taxes, exempting or lowering taxes for a particular group, for example low-income seniors or expanding businesses, results in lower revenues. However, property taxes are currently structured so that lowering taxes for one group raises everyone else's taxes, thus not affecting revenues.[46]

Major options for property tax reform include:

- ***Lowering or eliminating the state levy.***

Substantially lowering or eliminating the state share of property taxes would be politically popular, but would require identifying new state revenues to support K-12 education. It would also increase volatility of state revenues, making establishing a strictly regulated rainy day fund more important. Reducing the state levy could be coupled with granting to local districts, whose revenues have been shrinking, the authority to raise additional property tax.

- ***Adding a homestead exemption.***

Many states exempt a certain amount of the value of a family's primary home from property taxes. This can lower taxes for low- and middle-income homeowners and lessen the regressivity of the property tax. However, without special provisions to protect renters, a homestead tax could increase the property taxes paid indirectly through higher rents paid by some of the state's lowest income residents.

- ***Expanding the low income senior/ disabled exemption.***

Senior and disabled homeowners with incomes under $30,000 have sliding scale exemptions on a portion of their property tax because of a constitutional amendment approved by voters in 1966. This exemption could be expanded to cover more seniors or to apply generally to low-income residents. However, expanding the exemption beyond retired homeowners would require a new constitutional amendment.

- ***Repealing or altering initiative limits.***

Since passage of Initiative 747 in 2001 (with 58% of the vote), the growth in property tax revenues from regular levies is limited to 1% per year without voter approval. With revenue growing more slowly than the rate of inflation, local governments and service districts are seeing their budgets squeezed. The Legislature could raise the growth limit to match the rate of inflation or the rate of income growth, or return it to the former 6% level.

E. Other taxes

Washington collects taxes on a host of other sales and activities, from carbonated beverage syrup, to hazardous substances, to rental cars. Together these other taxes amount to 14% of the general fund. They provide stability as well as needed revenue. These taxes also provide options for increasing revenues that are often less controversial than increases in general taxes.

Tobacco and alcohol taxes brought in over $530 million in 2003. These and other so-called "sin" taxes are even more regressive than general sales taxes. However, they also promote public health by discouraging smoking and drinking, particularly among teenagers. Voters tend to be more supportive of raising tobacco and alcohol taxes than other types of public revenue. The Washington Department of Revenue estimates that raising the cigarette tax by $0.50 a pack would net $50 million in additional revenue for the 2005-2007 biennium, and an increase in the liquor liter tax from $2.44 to $3.44 would gain $62.8 million.[47]

One of the few progressive taxes in Washington is the estate tax. It applies to the roughly 2% of estates over $850,000 (in 2004), or about 1,000 estates annually in Washington. The exemption level is scheduled to rise to $1 million in 2006. Small businesses and family farms have additional exemptions.[48] In 2003, the state collected $122 million from the estate tax. While the federal government and some states are phasing out the estate tax, Washington continues to collect it. One possibility for additional revenue for Washington would be to capture some or all of the former federal estate tax. Washington's estate tax has graduated rates. Bumping the estates subject to the estate tax up one bracket would raise an additional $185.8 million in the 2005-2007 biennium.[49]

The motor vehicle fuel tax of 23 cents per gallon goes into the transportation fund rather than the general fund. The state does not currently collect retail sales tax on gasoline. Sales tax on gasoline would bring in an additional $490 million for the 2004-05 biennium for the state, and $143 million for local governments.[50] Such an increase could have adverse impacts on low-income and rural residents and on businesses that depend on driving. At the same time, it could have positive environmental effects.

F. Public accountability and stewardship

State residents have a right to know how their tax dollars are being spent and to expect to pay their fair share. Two of the biggest obstacles to reforming Washington's tax structure are the current high level of distrust in government and the belief that wealthy individuals and companies will find a loophole to avoid paying taxes. An important element of reforming the state revenue structure is building in measures to assure both accountability and fairness, including spending limits, evaluations of government programs, evaluations of taxes and tax breaks, and a rainy day fund.

- ***Spending limits.***

Initiative 601, passed in 1993 and since amended by the Legislature, limits growth in the state general fund. Each year's spending can only increase by a fiscal growth factor calculated from population growth and inflation, averaged over three years. Spending in fiscal year 2005 can grow by up to 3.03% and in 2006 by up to 2.62%.[51]

A spending limit can be valuable if it encourages state government to set priorities and periodically evaluate programs and service delivery to maximize effectiveness. However, demand for state services grows at a faster rate than population plus inflation. Before I-601, state spending grew on average at about the same rate as personal income, which typically grows faster than inflation.[52] Among the factors currently pushing up costs for the state at a faster rate are disproportionate growth in the school age population, high medical inflation, tougher sentencing laws, and increased driving distances.[53] The current 601 limit is leading to the under-funding of critical education and health services. A spending limit based on a rolling average of state personal income growth and recalibrated to make up for lost capacity over the past decade would better serve the people of Washington.

- ***Evaluation of government programs.***

As conditions and needs change, government programs need to change, too. In any large structure, change is difficult. Establishing processes to periodically evaluate the effectiveness and efficiency of public services, prioritize programs, reorganize when necessary, and keep the public informed of progress could lead to better service delivery and greater public confidence that tax money was being well spent.

- ***Evaluation of taxes and tax breaks.***

Taxes and tax breaks will need to be regularly evaluated for fairness, balance, adequacy, effectiveness, and ease of administration. As the economy and conditions change, the balance among taxes and who is paying will inevitably shift. Public priorities will also change. Tax breaks that might have been important at one time may need to be replaced by higher priority needs. Washington's tax structure should provide a method for the Legislature and the public to evaluate the effectiveness of tax exemptions, require businesses to publicly report tax breaks, and require that tax exemptions be considered and prioritized as part of the budget process.

- ***Rainy day fund.***

No matter how balanced the tax system is, revenues will rise and fall with business cycles. However, during economic downturns the state often needs to spend more rather than less in order to shore up the social safety net and to help stimulate the economy. A rainy day fund is an important part of state fiscal policy.

Protecting the rainy day fund is equally important. Washington, along with most states, has a reserve fund. However, during the boom of the 1990s, the fact that the reserve fund was growing became a successful argument for tax cuts. As a result, during the economic downturn of the past several years, the state has had only limited reserves on which to draw, and has been forced to make steep cuts in spending on health care, child care, education, and other services.

To guard against such problems, the Tax Structure Study Committee recommended a constitutionally mandated reserve fund with automatic triggers for deposits and withdrawals.[54]

III. Conclusion

Washington's tax structure is no longer meeting the needs of the people of the state. Without additional revenue, we cannot provide high-quality education for all our children, a well-trained workforce for all businesses, the infrastructure to move people, goods, and information smoothly, or the social supports to keep our communities strong.

Billions of dollars have been cut from the state budget since 2002. In 2005, the state faces another deficit. The on-going fiscal crisis and the need to raise new funds present an opportunity. We can raise existing tax rates and leave the tax base and structure unchanged. Such an approach might lessen the pain of deeper cuts but will keep us mired in a cycle of revenues falling further and further behind public need. The better alternative is to raise revenues by extending the tax base and taking the first incremental steps to systemic reform.

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Notes

[1] The Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2002*, January, 2003, http://www.ctj.org/itep/whopays.htm. Somewhat different percentages but a similar pattern are reported by the Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Nov. 2002, Chap. 9, p. 97-102, http://dor.wa.gov/content/WAtaxstudy/Chapter_9.pdf.

[2] Washington Office of Financial Management, "Adequacy of State Revenues Presentation to the Washington State Tax Structure Committee*",* Feb. 8, 2002, http://www.ofm.wa.gov/fiscal/adequacy/ofm20020208.pdf. See also Marilyn P. Watkins and Jason Smith, "It's Not Just the Recession: The Budget Crisis and Washington State's Structural Deficit," Economic Opportunity Institute, July 2003, http://www.eoionline.org/Taxes/StructuralDeficit.pdf.

[3] For a full discussion of the state spending issue, see Watkins and Smith, "It's Not Just the Recession."

[4] Marilyn P. Watkins, "Lost Revenue, Lost Opportunities: Tax Exemption in Washington State," Economic Opportunity Institute, April 2004, http://www.eoionline.org/Taxes/TaxExemptionsInWashingtonState.pdf; Washington State Department of Revenue, *Study of Tax Exemptions, Exclusions, Deductions, Deferrals, Differential Rates and Credits for Major Washington State and Local Taxes*, January 2004, http://www.dor.wa.gov/content/statistics/2004/Tax_Exemptions_2004/default.aspx.

[5] Washington State Department of Revenue, *Comparative State and Local Taxes, 2002,* August 2004, Introduction, Tables 1 and 3, http://www.dor.wa.gov/content/statistics/2002/Compare02/default.aspx.

[6] U.S. Census Bureau, *Public Education Finances 2002*, September 2004, Tables 11 and 12, http://ftp2.census.gov/govs/school/02f33pub.pdf.

[7] Grapevine: An Annual Compilation of State Tax Appropriations for the General Operation of Higher Education, http://www.coe.ilstu.edu/grapevine/Tables_files/table%205.pdf; Washington Higher Education Coordinating Board, "2004 Strategic Master Plan for Higher Education," presented to Legislative Committee Assembly, September 2004.

[8] The state operating budget, which includes federal and other funds, totals $47. 4 billion. Legislative Evaluation and Accountability Program Committee, 2004 Washington Legislative Budget Notes, http://leap.leg.wa.gov/leap/budget/lbns/2004appdxa.pdf.

[9] State Tax Structure Study Committee, *Final Report,* Introduction and Summary, http://www.dor.wa.gov/content/statistics/WAtaxstudy/Intro&Summary.pdf.

[10] For discussion of general principles, see Hugh D. Spitzer, "Washington state's upside-down tax system," *Seattle Times*, June 6, 2004, http://archives.seattletimes.nwsource.com/cgi-bin/texis.cgi/web/vortex/display?slug=spitzer06&date=20040606&query=hugh+spitzer; and Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State," chap. 2.

[11] Bureau of Economic Analysis, Department of Commerce, Personal Consumption Expenditures, http://www.bea.doc.gov/.

[12] General Accounting Office, “Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain,” June, 2000, http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.21&filename=g600165.pdf&directory=/diskb/wais/data/gao; Forrester Research http://www.forrester.com/home/0,6092,1-0,FF.html; Donald Bruce and William F. Fox, *State and Local Tax Revenue Losses from E-Commerce: Updated Estimates,* Center for Business and Economic Research, The University of Tennessee, September, 2001, http://cber.bus.utk.edu/ecomm/ecom0901.pdf.

[13] Federation of Tax Administrators, “Comparison of State and Local Retail Sales Taxes,” February 2004, http://www.taxadmin.org/fta/rate/sl_sales.pdf.

[14] Washington Secretary of State, http://vote.wa.gov/general/measures.aspx.

[15] Washington State Department of Revenue, “Impact of Extending Retail Sales Tax to Selected Services,” November 15, 2004.

[16] Federation of Tax Administrators, “State Sales Taxation of Services,” 1997 with 2002 Update, http://www.taxadmin.org/fta/pub/services/rr147srv.pdf; http://www.taxadmin.org/fta/rate/tax_stru.html.

[17] Washington State Department of Revenue, “Impact of Extending Retail Sales Tax to Selected Services,” November 15, 2004. Some economists have argued that sales tax should also be applied to medical services, since health care is one of the fastest growing parts of the economy. While sales tax on medical services could be a step in addressing the shrinking tax base, the social costs likely outweigh the benefits. Health costs are already escalating rapidly, hurting individuals, employers, and governments. Some financial services might also be subjected to the sales tax, but the ability of state residents, including low income residents, to gain access to basic banking, would need to be protected.

[18] Federation of Tax Administrators, “State Sales Taxation of Services,” 1997 with 2002 Update, http://www.taxadmin.org/fta/pub/services/rr147srv.pdf; http://www.taxadmin.org/fta/rate/tax_stru.html.

[19] Overviews of state taxes can be found at Federation of Tax Administrators, “State Individual Income Taxes,” http://www.taxadmin.org/fta/rate/ind_inc.html; and Government of the District of Columbia, “Tax Rates and Tax Burdens In the District of Columbia – A Nationwide Comparison,” http://cfo.dc.gov/cfo/frames.asp?doc=/cfo/lib/cfo/tax_burden_nation_2003.pdf.

[20] Nevada State Budget 2003-2005, http://budget.state.nv.us/BIB_REVENUE.pdf.

[21] Alaska Department of Revenue, *Revenue Sources Book Spring 2004,* http://www.tax.state.ak.us/sourcesbook/2004/spr2004/S04_RSBFINAL2.pdf; Texas Comptroller of Public Accounts, *Sources of Revenue Growth*, May 2002, http://www.window.state.tx.us/taxbud/sources/96-571.pdf.

[22] Federation of Tax Administrators, “State Sales Taxation of Services,” 1997 with 2002 Update, http://www.taxadmin.org/fta/pub/services/rr147srv.pdf; http://www.taxadmin.org/fta/rate/tax_stru.html.

[23] Consensus Revenue Estimating Group, *Wyoming State Revenue Forecast*, Jan. 2004, http://eadiv.state.wy.us/creg/GreenCREG.pdf.

[24] South Dakota Department of Revenue & Regulation, *Sales and Use Tax Guide,* July 2004, http://www.state.sd.us/drr2/publications/cetandstguides/salestaxguide.pdf.

[25] Florida Department of Revenue, Florida Tax Information for New Residents, http://sun6.dms.state.fl.us/dor/taxes/new.html, Annual Report, 2003, http://sun6.dms.state.fl.us/dor/report/annual_report03.pdf.

[26] Florida Department of Revenue, Sales and Use Tax Guide for Business Owners, http://sun6.dms.state.fl.us/dor/forms/2003/gt300015.pdf.

[27] U.S. Census Bureau, “State and Local Government Finances,” http://www.census.gov/govs/www/estimate.html.

[28] Federation of Tax Administrators, “State Individual Income Taxes,” http://www.taxadmin.org/fta/rate/ind_inc.html.

[29] Hugh D. Spitzer, “A Washington State Income Tax – Again?” *University of Puget Sound Law Review*, vol. 16, no. 2, 1993.

[30] Washington Office of Financial Management, Fiscal Notes for Senate Bill 5902 (2003), http://www.ofm.wa.gov/fns/LegSearch.asp?BillNumber=5902&SessionNumber=58; and Senate Bill 6228 (2004), http://www.ofm.wa.gov/fns/LegSearch.asp?BillNumber=6228&SessionNumber=58.

[31] Government of the District of Columbia, “Tax Rates and Tax Burdens In the District of Columbia – A Nationwide Comparison 2002,” August 2003; *Seattle Post Intelligencer,* “IRS Releases Guidelines for State Sales Tax Deduction,” December 18, 2004, http://seattlepi.nwsource.com/money/204327_salestax18.html?searchpagefrom=1&searchdiff=4; Washington State Tax Structure Study Committee, “Tax Alternatives for Washington State,” p. 50, http://dor.wa.gov/content/WAtaxstudy/.

[32] Several other taxes that apply to certain types of businesses, including the public utility tax and insurance premiums tax, together account for about 7% of state revenue. LEAP Committee, 2004 Washington Legislative Budget Notes, http://leap.leg.wa.gov/leap/budget/lbns/2004appdxa.pdf; DOR, *Tax Reference Manual*, p. 7.

[33] Federation of Tax Administrators, “2003 State Tax Revenue,” http://www.taxadmin.org/fta/rate/03taxbur.html.

[34] Most analyses of state tax systems treat the B&O tax as a sales tax, ultimately borne by the consumer, while corporate income taxes are assumed to be borne by shareholders – a relatively high income group. In reality, probably some measure of B&O taxes reduce profits, and some portion of corporate income taxes are passed on to consumers. See Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2002*, January, 2003, http://www.ctj.org/itep/whopays.htm; Federation of Tax Administrators, “State Sales Taxation of Services,” 1997 with 2002 Update, http://www.taxadmin.org/fta/pub/services/rr147srv.pdf; U.S. Census Bureau, “State and Local Government Finances,” http://www.census.gov/govs/www/estimate.html.

[35] DOR, *Tax Exemptions, 2004.*

[36] The B&O replacement rate would be 16% if the business income tax applied to both C and S corporation, 22% if only C corporations were included. Washington Department of Revenue for the Tax Structure Study Committee, “Major Replacement Alternatives for Washington Taxes,” August 9, 2002, http://www.dor.wa.gov/content/statistics/WAtaxstudy/Major_Replacement_Alternatives_for_WA_Taxes.pdf.

[37] New Hampshire’s version, a “business enterprise tax,” applies a 0.75% rate to the sum of compensation, interest, and dividends paid or accrued by a company. New Hampshire Department of Revenue, “Overview of New Hampshire Taxes,” http://www.nh.gov/revenue/gti-rev.htm#Business%20Profits%20Tax. Michigan’s Single Business Tax is levied on labor, capital and profit. Michigan is phasing out the SBT over a 23 year period. In 1999 the rate was 2.3%, in 2002 1.9%. Michigan Department of the Treasury, Frequently Asked Questions, Business Tax, http://www.michigan.gov/treasury/0,1607,7-121-24326-7131—F,00.html.

[38] Washington State Tax Structure Study Committee, “Tax Alternatives for Washington State,” p. 35-47, http://dor.wa.gov/content/WAtaxstudy/.

[39] New Hampshire Department of Revenue, “Overview of New Hampshire Taxes,” http://www.nh.gov/revenue/gti-rev.htm#Business%20Profits%20Tax.

[40] Tax Structure Study Committee, *Final Report*, p. 91.

[41] DOR, *Tax Exemptions 2004*, p. 5.

[42] See Marilyn P. Watkins, *Lost Revenue, Lost Opportunities: Tax Exemptions in Washington State,* Economic Opportunity Institute, April 2004, www.eoionline.org.

[43] Federation of Tax Administrators, “2002 State & Local Tax Collection by Source,” http://www.taxadmin.org/fta/rate/slsource.html.

[44] Legislative Evaluation and Accountability Program Committee, 2004 Washington Legislative Budget Notes, http://leap.leg.wa.gov/leap/budget/lbns/2004appdxa.pdf.

[45] Federation of Tax Administrators, “2003 State Tax Revenue,” http://www.taxadmin.org/fta/rate/03taxbur.html.

[46] Property tax rates are not fixed. Levy rates are adjusted annually in each taxing district to reflect changes in assessed value, meet the budget needs of the districts, and remain within limits voters have imposed on increases in total property tax receipts. In Washington’s 39 counties, average levy rates in 2001 varied from a low of $8.35 per $1,000 of assessed value in San Juan County to $15.97 in Garfield County. Lowering the rates for seniors or some other group within a taxing district does not change the total that is needed and that can be legally collected, but rather raises the rates for other property owners. See DOR, *Tax Reference Manual*, p. 133-148.

[47] DOR, “Estimated Impact of Major Revenue Alternatives,” Nov. 2004.

[48] See EOI, “Issue Brief: Washington’s Estate Tax,” September 2002, http://www.eoionline.org/Taxes/WATaxPolicy-EstateSummary.pdf.

[49] DOR, “Estimated Impact of Major Revenue Alternatives,” November 2004.

[50] DOR, *Tax Exemptions 2004,* p. 236.

[51] OFM, “Initiative 601 and the State Spending Limit,” http://www.ofm.wa.gov/fiscal/i-601/index.htm.

[52] Tax Structure Study Committee, *Final Report*, p. 123-127.

[53] OFM, Adequacy of State Revenues, power point presentation, February 2002, http://www.ofm.wa.gov/fiscal/adequacy/ofm20020208.pdf. See also Marilyn P. Watkins, “It’s Not Just the Recession: The Budget Crisis and Washington State’s Structural Deficit,” July 2003, http://www.eoionline.org/Taxes/StructuralDeficit.pdf.

[54] Tax Structure Study Committee, *Final Report*, vol. 1, p. vii, vol. 2, p. 76-92.