

Introduction and Summary

No one likes paying taxes. However, raising money to pay for a community's government and services has been a fixture of organized human existence for thousands of years. The challenge is (as it has always been) how to best structure the tax system so it is considered fair by community members, does not interfere with productivity, and provides sufficient resources for the services that the public demands.

The Washington State Tax Structure Study Committee was created by statute to report to the Legislature on how well Washington's current tax system works and how it might be changed to better serve the citizens of the state in the twenty-first century. This committee is different in composition from the prior tax reform commissions. Rather than being composed of interest group representatives, the majority of the Committee members were professors specializing in public finance, tax economics, accounting, and tax law. Legislators from both houses and both political parties were also members of the Committee.

The Committee evaluated Washington's tax system based on principles outlined in the legislation. Those principles include, among others, fairness, stability, adequacy and the effect of the tax system on Washington's economic vitality.

The Committee concludes that our current system is fundamentally inequitable to low- and middle-income people, unfair to many businesses, and subject to sharp fluctuations in revenue. The Committee also finds that while our tax structure, which was put in place in 1935, might have worked well for a mid-twentieth century manufacturing economy, it doesn't work well in today's economy with its greater dependence on the service sector. If this current trend continues, our tax structure will be even less adequate in the future. Furthermore, the rapidly expanding "Internet economy" is eroding our retail sales tax base. This impedes Washington's ability to collect its fair share from economic activities occurring over the Internet.

In this report, the Committee outlines a number of major and minor alternatives that the Legislature could implement to bring Washington's tax system into the twenty-first century. Serious and fundamental changes are warranted. Rather than providing a single "best" solution, the Committee provides the Legislature and the Governor with a variety of choices. In several instances, the Committee recommends particular alternatives among the various choices because these alternatives will be more effective in solving targeted defects in our tax system. The alternatives outlined in this report can be "mixed and matched" to provide significant improvements in the overall system. However, it must be emphasized that by implementing a change meant to resolve one defect, the Legislature may aggravate other problems within our tax system.

Any tax system in a modern industrialized society is bound to be complicated. Change is likewise complicated and time consuming. Solutions are not simple—nor is this report. We encourage interested parties to read the entire report carefully. The Committee has attempted to write an understandable document, but a state's tax structure is not reducible to short sound bites.

The major alternatives and other adjustments described in this report can be used to restructure a tax system. The benefits would be a tax system that is:

- Substantially fairer to low- and middle-income people.
- More equitable in its treatment of businesses.
- More effective in supporting the state's economy.
- Considerably more compatible with the federal tax system and consistent with the taxing systems used by most other states.

The Committee feels that the broad array of choices and the recommendations in this report provide plausible alternatives to Washington's tax system. This report lays a foundation for our elected leaders and our citizens to make informed choices that will help Washington grapple with the problems of our existing tax structure and turn it into a system that is truly effective in the twenty-first century.

Recommendations

In developing replacement and incremental alternatives, the Committee focused on the following problem areas: regressivity, adequacy, volatility, neutrality, economic vitality, and simplicity. This section provides a summary of the recommendations the Committee includes in its final report. Although the report contains many other alternatives deemed worthy of discussion and consideration, the Committee believes that the following alternatives deserve special attention. It should be noted that the Committee proposes alternatives and recommendations with an eye to revenue neutrality, consistent with the charge it received from the Legislature.

Replacement Alternatives

If the Legislature chooses to replace major taxes in the current tax system, the Committee recommends:

- 1. A subtraction method business value added tax to replace the business and occupation (B&O) tax.**

Replacing the B&O tax with a value added tax eliminates the "pyramiding" effect as goods move through the production chain, thereby addressing the Committee's concerns with economic neutrality and competitiveness. A majority of the Committee members recommend this alternative.

- 2. A flat rate personal income tax to reduce the state sales tax rate and eliminate the state property tax. Share all or part of the state property tax relief with local governments and/or local schools.**

The Committee developed the personal income tax alternative in response to a number of concerns about the existing tax system.

Regressivity: Low-income households pay a larger proportion of their income in taxes than do higher income households. This option would address these concerns by imposing a tax on income earned in Washington, thus redistributing the tax burden across income groups.

Federal Tax Burdens: Changing to a personal income tax would allow households to export a portion of their state tax burden to the federal government because state income taxes are deductible in the federal income tax computation. This will significantly reduce the federal income tax burden on Washington taxpayers.

Vitality: Since businesses pay a significant percentage of the retail sales tax, reduction of this tax will cause a shift of overall tax burden from businesses to households. A reduction in the relative business tax burden would improve Washington's competitive position with other states.

Adequacy: Decreasing the state sales tax rate should reduce the impact of revenue loss from cross-border and remote shopping. Diminishing the incentive for cross-border and remote shopping also improves the competitive position of Washington retailers.

The Committee recommends both a flat rate and a graduated rate income tax. However, a greater number of Committee members supported a flat rate income tax versus a graduated rate income tax.

The Committee recommends the elimination of the state portion of the property tax because the property tax is unpopular, yet the public appears more accepting of local property taxes for local purposes. Accordingly, the Committee suggests that the Legislature consider replacing the state property tax levy and granting local school districts or other local governments additional levy authority.

Incremental Alternatives

The following incremental changes are recommended for adoption except where inconsistent with replacement recommendations. The Committee realizes that some of these alternatives will increase revenue and others will decrease revenue. To maintain revenue neutrality, it would be necessary to either generate additional revenue from another source to offset the effects of those alternatives that reduce revenues or reduce revenue from another source to offset the effects of those alternatives that increase revenues. The Committee recommends the following incremental alternatives.

1. Address adequacy.

- *Extend the sales tax to consumer services.*

To broaden the sales tax base, this alternative recommends including certain personal services such as beauty and barber services. The Committee developed this alternative in

response to research showing significant erosion of the tax base due to a shift in consumption from tangible personal property to services.

- *Extend the 0.5 percent excise tax currently applied to watercraft to motor homes and travel trailers as well. Consider increasing the rate from 0.5 percent to 1 percent on all three types of property.*

Research shows that motor homes, travel trailers, and boats are another source of leakage from the tax base. Many are used as substitutes for vacation homes, which are subject to the property tax. This alternative would expand the Washington tax base.

- *Review tax exemptions every ten years to make sure economic and social goals are achieved.*

This alternative is in response to concerns that the state economy and business practices are changing so rapidly that exemptions may outlive their usefulness. This alternative helps ensure fair application of tax incentive programs by requiring a periodic review of whether the programs are meeting established policy goals.

- *Avoid dedicated taxes.*

The Committee recommends avoiding dedicated taxes that bear no clear relationship between taxpayers and those who receive benefits. Research indicates these taxes are costly for businesses to comply with and government to administer.

2. Address volatility of the current tax system and also the volatility in any replacement tax system that may be enacted.

- *Create a constitutionally mandated "rainy day fund."*

This alternative supports creation of a rainy day fund to address the volatility of the existing tax system and the volatility in any replacement system that may be enacted. Research demonstrates that constant rate, constant base tax revenues grow faster than the economy in good economic times and contract more than the economy in poor economic times. The proposal is to create a constitutionally mandated rainy day fund with automatic triggers for saving and spending the reserve funds.

3. Simplify tax administration.

- *Streamline the sales tax.*

The Committee supports the efforts of the Streamlined Sales Tax Project to enact uniform sales tax definitions and other measures of tax simplification. These efforts will facilitate the possibility of subjecting remote sales (such as e-commerce) to state tax requirements. The ability to tax remote sales would also help stem erosion of the retail sales tax base. This would also help the competitive position of Washington retailers.

- *Simplify local B&O taxes.*

The Committee also supports the ongoing efforts of local governments, business representatives, and legislators to develop a simplified municipal B&O tax structure that satisfies the goals and concerns of its stakeholders.

4. Improve economic vitality.

A number of alternatives mentioned earlier address economic vitality. The flat rate personal income tax shifts the relative tax burden from businesses to households. The streamlined sales tax project also diminishes the sales tax collection burden on Washington retailers.

- *Increase the small business B&O tax credit from \$35 to \$70 a month and index the credit to adjust with inflation.*

Research reveals that new businesses pay a relatively high tax burden. Increasing the B&O credit decreases the state tax burden on small new businesses.

- *Exempt construction labor from sales tax.*

This alternative addresses economic vitality and harmony with other states. Washington State is one of the few states that imposes sales tax on construction labor. Exempting the labor portion of construction would make our treatment of these costs consistent with other states, including Oregon. Implementing this significant exemption would require a corresponding increase in another tax in order to maintain revenue neutrality.

5. Address regressivity.

- *Continue to impose an estate tax in the amounts of the state credit allowed under prior federal law.*

This alternative addresses regressivity by maintaining a current tax on high net worth households. Washington State did not conform its estate tax system to the changes made in 2001 to the federal estate and generation skipping transfer tax programs. This proposal would continue to impose Washington's existing estate tax in the amounts of the state credit allowed under federal law prior to the reductions and eventual repeal authorized in the federal Economic Growth and Tax Reform and Reconciliation Act.

Chapter 3: Current Washington State Tax Structure

Possible Ways to Tax

There are three general types of taxes common to most state and local governments. One type of taxation is imposed on the assessed valuation of asset ownership including real, personal, and intangible property. A second type, common to most states, is imposed on personal and corporate net income. The final type is imposed on transactions and measured by the gross proceeds of each sale. Of these three methods for imposing taxes—property, income, and excise taxes—Washington state and local governments rely on property and excise taxes. Washington does not impose taxes on net income.

Property taxes are applied annually to the value of taxable real and personal property. They are collected semi-annually. Real property includes land and structures, while personal property comprises items that are generally movable. The major type of taxable personal property in Washington is business machinery and equipment. Household items, business inventories, and intangibles like stocks and bonds are exempt. Property taxes have traditionally been the major source of revenue for local governments, and local jurisdictions in all states levy this type of tax. Washington is one of nine states that also has a significant property tax levy at the state level.

The state portion of the property tax constitutes a quarter of all property taxes. The state levy is for the support of common schools, however, this levy comprises less than 30 percent of the state's funding of public K-12 education. County treasurers collect the tax on behalf of the state based on a county's market value of property in relation to the statewide market value of all property.

Income taxes for persons and corporations are measured by the net income received by individuals, households, and business entities. Typically, these taxes are computed on an annual basis. Through withholding and estimated payments the actual payments may be made more frequently than annually. The federal income tax, including a tax on individuals, estates, trusts, and corporations, is the most visible income tax. Income taxes are also levied by most states: 45 states impose a corporate net income tax and 43 states levy a personal income tax (41 are broad-based taxes and two are restricted to interest and dividends). Only Washington, Nevada, South Dakota, and Wyoming do not impose any form of income tax.

