
Washington State and Local Tax System Dysfunction & Reform

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Richard S. Conway, Jr.

Dick Conway & Associates
2323 Eastlake Avenue East
Seattle, Washington 98102
(206) 324-0700

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RICHARD S. CONWAY, JR. is principal of Dick Conway & Associates, a research and consulting firm engaged in regional economic forecasting and analysis, and co-publisher of *The Puget Sound Economic Forecaster*, a forecast and commentary on the regional economy (www.economicforecaster.com).

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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.”



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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 forty 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 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 the 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 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 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 4.6 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 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 the 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 in the nation, 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.



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.



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. 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. Illustrating this finding, 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 opacity—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 also 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 system 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 U.S. 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.”



In FY 2011, Washington state and local revenue amounted to \$56.0 billion. As a percent of personal income, Washington garnered significantly less state and local revenue than other states (19.0 percent compared to 20.4 percent). Washington also spent relatively less for state and local government goods and services (19.6 percent compared to 20.1 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.

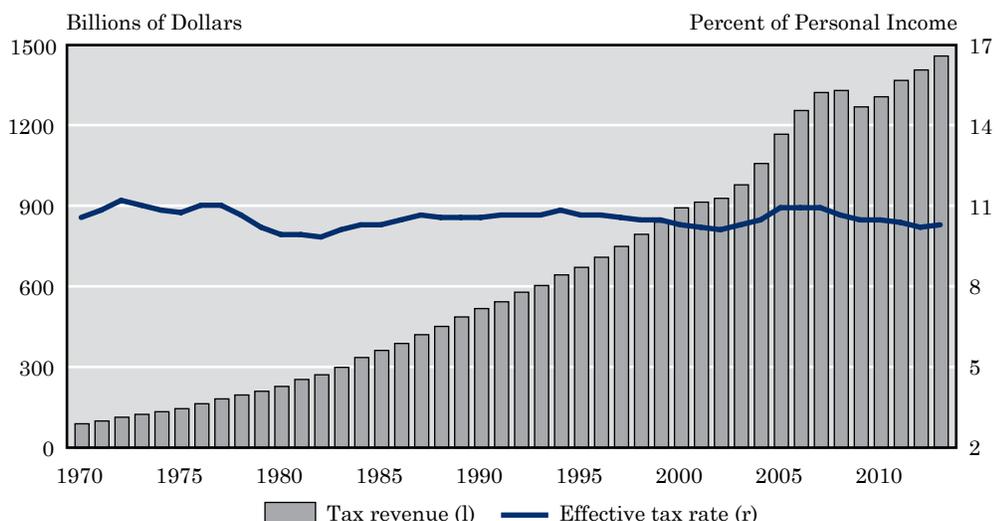
When businesses challenged the legality of the income tax, the Washington Supreme Court ruled in a narrow 5-4 decision that the graduated income tax was an “unconstitutionally non-uniform property tax.” At the same time, the court upheld the legality of the business and occupation tax, which had been 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.

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

FIGURE 1 U.S. STATE AND LOCAL TAX REVENUE



Source: U.S. 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	---	---

¹All 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	---	---

¹Includes business and occupation taxes.

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



Washington state and local tax revenue totaled \$28.4 billion in FY 2011. Without an individual or corporate income tax, 61.6 percent of the tax revenue originated from sales and gross receipts taxes. The national dependency on these taxes was only 34.4 percent.



PER STUDENT OR PER \$1,000 OF INCOME?

In FY 2011, Washington ranked thirtieth among states in current spending per student in public elementary and secondary schools but only forty-sixth in spending per \$1,000 of personal income, according to the U.S. Census Bureau. For purposes of comparison, which of these is the preferred indicator? Both measures are deficient because they do not take into account cost of living differences across states. Nevertheless, the edge should go to “\$1,000 of personal income.”

Cost of living differences distort educational spending comparisons based on dollars per student. For example, studies by ACCRA and Sperling’s Best Places indicate that the cost of living is about 5 percent higher in Washington than the United States. This implies that the state must spend 5 percent more than the nation in order to provide the same educational services (teachers, classrooms, and materials).

Since the per capita income of a state tends to reflect its cost of living, it should not be surprising that Washington’s per capita income exceeds the U.S. average by 5 percent. If Washington were to spend the same number of dollars per \$1,000 of income on education as the nation, the state’s expenditures in dollars per student would be 5 percent greater. But that is exactly what is needed to cover Washington’s 5 percent higher costs of education. Because per capita income and the cost of living tend to go hand in hand, dollars per \$1,000 of personal income is judged to be the superior measure for comparing educational spending.

There is a more fundamental reason for using spending per \$1,000 of personal income for purposes of comparing educational and other public expenditures across states. Over time state and local government expenditures (and the tax revenue to pay for them) and personal income have risen at about the same rate. This reflects the fact that public goods and services, like private goods and services, are “normal goods.” The demand for them increases right along with income.

Their differences notwithstanding, the two measures of educational spending convey the same message: compared to other states, Washington state and local spending for public elementary and secondary education has sunk to a low level.

tuitions, hospital stays, and other services (20.7 percent), and \$3.6 billion from miscellaneous sources (6.4 percent).

As a percent of personal income, Washington garnered significantly less state and local revenue than other states, 19.0 percent compared to 20.4 percent. The difference amounted to \$4.0 billion. Washington was notably deficient in tax revenue in FY 2011, as collections totaled only 9.6 percent of personal income, compared to 10.4 percent for the rest of the nation.

The one characteristic of the tax system that distinguishes Washington from most other states is the absence of an individual or corporate income tax, which accounted for 24.9 percent of total U.S. state and local

government tax revenue in FY 2011 (Table 3). Only six other states (Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming) do not levy an individual income tax.

Instead, Washington relies heavily on general and selective sales taxes. Including the business and occupation tax, sales and gross receipt taxes amounted to \$17.5 billion or 61.6 percent of total state and local tax revenue. Nationally, the dependence on general and selective sales taxes was only 34.4 percent. As a share of total tax revenue, Washington property taxes (30.6 percent) and other taxes (7.8 percent) were more or less in line with other states.

In FY 2011, Washington state and local government expenditures totaled \$57.8 billion (Table 2). While this exceeded total revenue by \$1.8 billion, as a percent of personal income it was still less (19.6 percent) than spending by state and local governments nationally (20.1 percent). The major spending categories included education (\$19.2 billion), social services (\$16.1 billion), transportation (\$5.0 billion), and public safety (\$4.7 billion).

One critical public function that has been harmed by the shortfall in Washington state and local revenue is elementary and secondary school education (Table 4). Whereas U.S. state and local governments spent \$41.92 per \$1,000 of personal income in FY 2011, Washington expended only \$34.90, one-sixth less. Among the fifty states and the District of Columbia, Washington ranked forty-sixth in elementary and secondary school expenditures relative to personal income.

3. EVALUATION OF THE WASHINGTON STATE AND LOCAL TAX SYSTEM

Characteristics of tax systems. The objective of this study is to compare the Washington state and local tax system with tax systems in other states, focusing on five principal characteristics:

1. **FAIRNESS.** Fairness refers to the tax burden placed on households and businesses. There are two guiding principles: the benefit principle, where individuals and businesses are taxed based on the benefits they receive from government; and the ability-to-pay principle, where they are taxed based on their income or wealth.
2. **ADEQUACY.** Adequacy is the ability of a tax system to generate sufficient tax revenue to meet the public needs, such as education and transportation, of a growing economy. An inadequate tax system requires periodic enhancements to tax rates or the tax base in order to yield the desired revenue. Of the five characteristics analyzed in this study, adequacy and fairness are the two most important ones.
3. **STABILITY.** A stable tax system produces a relatively even and predictable flow of tax revenue. A volatile tax system creates problems for the planning and operation of state and local governments.
4. **TRANSPARENCY.** In a perfectly transparent tax system, every individual and business knows exactly how much they pay in taxes.
5. **ECONOMIC VITALITY.** This refers to the ability of the state and



One-third of the state and local expenditures went to education in FY 2011. Nevertheless, Washington ranked forty-sixth among the states in elementary and secondary school expenditures per \$1,000 of personal income.



TABLE 4 PUBLIC ELEMENTARY AND SECONDARY SCHOOL CURRENT SPENDING PER \$1000 OF PERSONAL INCOME, FY 2011

Dollars

Rank	State	Spending
	United States	41.92
1	Alaska	70.29
2	Vermont	57.73
3	West Virginia	56.67
4	New York	55.98
5	Wyoming	54.58
46	Washington	34.90
47	Colorado	34.30
48	South Dakota	34.28
49	Arizona	33.50
50	Florida	32.43
51	District of Columbia	22.09

Source: U.S. Bureau of the Census

local tax system to favorably affect economic growth and welfare. Because fostering economic vitality involves striking a balance between the need for public goods and services on the one hand and taxes on the other, this is a contentious issue.

Fairness. In most tax studies fairness generally refers to the tax burdens placed on households. Two tax systems are broadly considered fair: the proportional tax system, which taxes the income of all households at the same rate; and the progressive tax system, which taxes the income of high-income households at relatively high rates. Economically advanced countries tend to rely on progressive income taxes. The U.S. federal income tax is a progressive tax.

A regressive tax system taxes the income of low-income households at relatively high rates. While a regressive tax system is unfair, the Institute on Taxation & Economic Policy points out that every state and local tax system in the nation is fundamentally regressive.

State and local governments adopt a mix of progressive and regressive taxes. Individual income taxes are typically progressive, but property taxes, sales taxes, and other excise taxes are regressive. Sales taxes are often very regressive because low-income households spend a disproportionately large share of their income on goods subject to the sales tax. The overall regressivity of state and local tax systems is due to the fact that the individual income tax, the only progressive tax, accounts for just one-fifth of total state and local tax revenue.

Absent an income tax, Washington relies heavily on sales taxes. One would therefore expect that Washington would have a relatively regressive tax system. Two independent studies arrive at a much stronger conclusion:

1. WASHINGTON TAX STRUCTURE STUDY. In 2002, the Washington State Tax Structure Study Committee reported its findings on the

household incidence of retail sales taxes, other excise taxes, and property taxes (Table 5). The analysis was conducted with the Washington Excise and Property Tax Microsimulation Model, which was designed to estimate tax burdens by level of household income. The study did not attempt to compare Washington with other states.

In an understatement, the committee concluded that “Washington’s tax structure is regressive.” The analysis estimated that 15.7 percent of the income of the lowest-income households (incomes up to \$20,000 with an average of \$11,689) went to pay excise and property taxes in 1999. The effective tax rate for the highest-income households (incomes over \$130,000 with an average of \$206,840) was only 4.4 percent. This disparity in effective



Most economically advanced countries have progressive tax systems. A progressive tax system taxes the income of high-income households at relatively high rates.



The Washington State Tax Structure Study Committee found that in 1999 the Washington state and local tax burden was 15.7 percent of income for the lowest-income households but only 4.4 percent for the highest-income households.



TABLE 5 WASHINGTON STATE AND LOCAL EXCISE AND PROPERTY TAX BURDEN ON HOUSEHOLDS, 1999

Percent of Household Income

Household Income	Retail Sales Tax	Other Excise Tax ¹	Property Tax	Total Tax
\$20000 and under	6.7	3.2	5.8	15.7
\$20000-30000	4.4	1.9	3.5	9.8
\$30000-40000	4.0	1.6	3.9	9.4
\$40000-50000	3.7	1.4	3.2	8.3
\$50000-60000	3.7	1.3	3.2	8.2
\$60000-70000	3.5	1.2	3.1	7.7
\$70000-80000	3.3	1.0	3.1	7.4
\$80000-100000	3.2	0.9	2.7	6.8
\$100000-130000	2.9	0.7	2.5	6.0
\$130000 and over	2.2	0.4	1.8	4.4

¹Other excise taxes include taxes on alcohol, cigarettes, and gasoline.

Source: Washington State Tax Structure Study Committee

tax rates violates both the proportional and progressive principles of tax fairness.

In dollars, high-income households pay more taxes. In 1999, the highest-income households in Washington paid on average \$9,198 in state and local taxes, while the lowest-income households paid \$1,837. Despite paying five times more in taxes, the after-tax income of the highest-income households was still twenty times greater.

Another perspective on fairness based on the committee's findings was the effort it took to pay taxes. 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.

2. WHO PAYS? Using similar methodology, the Institute on Taxation & Economic Policy estimated the state and local tax burden on households by level of income for each of the fifty states and the

The lowest-income households had to work 8.2 weeks to pay their annual state and local taxes, while the highest-income households had to work only 2.3 weeks.

TABLE 6 **REGRESSIVE STATE AND LOCAL TAX SYSTEMS, 2013**

Taxes as Percent of Non-Elderly Resident Income

Rank ¹	State	20 Percent of Households with Lowest Incomes	60 Percent of Households with Middle Incomes	One Percent of Households with Highest Incomes	Ratio of Lowest to Highest
	United States	11.1	9.4	5.6	2.0
1	Washington	16.9	10.5	2.8	6.1
2	Illinois	13.8	11.1	4.9	2.8
3	Florida	13.2	8.3	2.3	5.7
4	Hawaii	13.0	11.3	8.0	1.6
5	Arizona	12.9	9.7	4.7	2.7
6	Texas	12.6	8.8	3.2	3.9
7	Indiana	12.3	10.7	5.4	2.3
8	Rhode Island	12.1	10.0	6.4	1.9
9	Pennsylvania	12.0	9.8	4.4	2.7
10	Arkansas	11.9	11.2	6.0	2.0
42	Virginia	8.6	8.1	4.9	1.8
43	New Hampshire	8.6	6.7	2.4	3.6
44	Oregon	8.3	7.7	7.0	1.2
45	Wyoming	8.2	6.0	1.6	5.1
46	Idaho	8.2	7.9	6.4	1.3
47	South Carolina	7.1	7.2	5.0	1.4
48	Alaska	7.0	4.4	2.4	2.9
49	District of Columbia	6.6	10.1	6.3	1.0
50	Montana	6.4	6.1	4.7	1.4
51	Delaware	5.7	5.3	4.2	1.4

¹Rank based on tax burdens for the 20 percent of households with the lowest incomes.

Source: Institute on Taxation & Economic Policy, 2013

District of Columbia in 2013 (Table 6). States were then ranked according to the regressivity of their tax systems.

The institute reported two measures of regressivity: (1) taxes as a percent of income for the twenty percent of households with the lowest incomes; and (2) the ratio of the tax burden for the twenty percent of households with the lowest incomes to the tax burden for the one percent of households with the highest incomes.



The Institute on Taxation & Economic Policy determined that in 2013 Washington possessed the nation's most regressive state and local tax system.



The tax burden for the lowest-income households was 16.9 percent of income, greatly exceeding the 13.8 percent tax burden in Illinois, the second most regressive state.



Acknowledging that all state and local tax systems are regressive, the institute called attention to the “Terrible Ten,” the ten most regressive states. These states rely heavily on sales and excise taxes because they either do not utilize an individual income tax or they employ a flat-rate individual income tax.

With no income tax and three-fifths of its tax revenue derived from sales and excise taxes, Washington held the distinction of possessing the nation's most regressive state and local tax system. In an earlier study, the institute concluded that “lacking an income tax... Washington has the most unfair tax system in the nation.”

In fact, based on both measures of regressivity, Washington has by far the most unfair tax system. For example, its tax burden for the lowest-income households in the state was 16.9 percent of income. Illinois ranked a distant second with a 13.8 percent tax burden.

Critics of regressivity studies voice several objections. The progressivity of federal income taxes compensates for the regressivity of state and local taxes. Welfare benefits, such as food stamps, should be counted as income. Low-income households include unemployed workers who are temporarily poor. Tax burdens tend to even out over a person's lifetime.

These comments, though not necessarily wrong, are off point. For example, incorporating federal taxes and food stamps into the analysis would tend to reduce the measures of regressivity for all states by the same relative amount. This would not appreciably alter the rank order of regressive states nor would it likely knock Washington out of first place.

The comments about the temporarily poor, whether they pertain to unemployed workers or young college students, suggest that we should not classify them as impoverished. The counter argument is that, notwithstanding their prospects, people who have lost their source of income or are struggling to pay tuition should not be saddled with large tax burdens.

Adequacy. Adequacy is arguably the most critical characteristic of the Washington state and local tax system. If tax revenue fails to keep up with the demand for public goods and services, it eventually 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 question at the core of the debate over taxes: how much of our income should be devoted to state and local taxes?

1. STATE AND LOCAL TAX BURDEN. How much state and local governments should tax is obviously a value-laden issue, as conservatives and liberals would offer different opinions. It is therefore better to

address the matter by rephrasing the question: how much *do* state and local governments tax? Statistically speaking, the answer to this question is very interesting. Furthermore, it has important tax policy implications (Figure 1 and Table 7).

Since 1970 total tax revenue for all state and local governments in the United States has averaged 10.6 percent of personal income (\$106 per \$1,000 of income). Moreover, the ratio has been very stable over time, ranging from a low of 9.8 percent in 1982 to a high of 11.3 percent in 1972. During the Great Recession and its aftermath, the effective tax rate never dropped below 10.2 percent.

The 10.6 percent average effective tax rate is not necessarily the optimal tax rate. Rather, it is simply the norm, that is, the effective tax rate that state and local governments have tended to maintain for more than forty years. However, if a state adopts a significantly higher effective tax rate than the norm, it needs to ask itself whether it is unduly burdening taxpayers. On the other hand, if a state adopts a significantly lower effective tax rate than the norm, it needs to ask itself whether it is underfunding the public goods and services needed to make the state a good place to live and locate a business.

The stable long-term norm for the U.S. state and local effective tax rate implies that the Washington effective tax rate should be about 10.6 percent.

2. TAX POLICY IMPLICATIONS. The existence of a stable long-term norm for the 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 along 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.

TABLE 7 U.S. STATE AND LOCAL TAX REVENUE, 1970-2013

Billions of Dollars

	Tax Revenue	Personal Income	Effective Tax Rate (%) ¹
1970	91.3	864.6	10.6
1980	230.0	2316.8	9.9
1990	519.1	4904.5	10.6
2000	893.2	8632.8	10.3
2010	1305.6	12435.2	10.5
2013	1457.0	14134.7	10.3
Average (1970-13)	---	---	10.6
Low (1982)	273.2	2778.8	9.8
High (1972)	115.6	1023.6	11.3

¹The state and local effective tax rate is tax revenue as a percent of personal income. The calendar-year estimates for 2000 and 2010 differ from the fiscal-year estimates in Table 8.

Source: U.S. Bureau of the Economic Analysis

IMPLICATIONS FOR TAX POLICY

- ✎ The state and local effective tax rate should be about 10.6 percent of personal income.
- ✎ 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.
- ✎ Any tax reform proposal should include an explicit estimate of the impact on the effective tax rate.

The debate over government taxes—and by implication government spending—typically degenerates into a “taxes are too high, taxes are too low” argument. One way to resolve this disagreement would be to adopt at the outset an effective tax rate—10.6 percent of personal income or some other explicit rate chosen by the people—as a lid on state and local tax revenue.

The concept of a tax lid is nothing new in Washington. In 2009, Initiative 1033 proposed a severe limit on government revenue growth (see “I-1033 lid”). But, whatever the lid, settling the question of how much to tax would free up voters and politicians to address other difficult tax questions, such as who should pay the taxes and how the tax revenue should be spent.

3. AN INADEQUATE TAX SYSTEM. How does the Washington state and local effective tax rate compare to the average effective tax rate for state and local governments in the United States? The following analysis reveals that Washington has one of the most inadequate tax systems in the nation.

Since FY 1999 Washington’s state and local effective tax rate has fallen well below the national norm of 10.6 percent due to its inadequate tax system.

TABLE 8 WASHINGTON AND U.S. STATE AND LOCAL TAX REVENUE, FY 1992-FY 2011

Billions of Dollars

	Washington Tax Revenue	Washington Personal Income	Washington Effective Tax Rate (%) ¹	Rank ²	U.S. Tax Revenue	U.S. Personal Income	U.S. Effective Tax Rate (%)
FY 1992	11.9	109.9	10.9	17	558.2	5220.0	10.7
FY 1993	12.8	117.5	10.9	18	594.3	5527.5	10.8
FY 1994	13.9	122.9	11.3	15	625.5	5767.7	10.8
FY 1995	14.8	129.8	11.4	12	660.6	6106.1	10.8
FY 1996	15.5	138.2	11.2	11	689.0	6454.9	10.7
FY 1997	16.4	149.2	11.0	14	728.6	6853.5	10.6
FY 1998	17.3	162.0	10.7	24	774.0	7326.6	10.6
FY 1999	18.1	175.2	10.3	26	815.3	7781.2	10.5
FY 2000	18.7	189.6	9.9	38	872.4	8301.0	10.5
FY 2001	na ³	197.2	na	na	914.1	8863.6	10.3
FY 2002	19.5	199.8	9.8	29	905.1	9043.2	10.0
FY 2003	na	206.8	na	na	939.0	9276.5	10.1
FY 2004	21.4	216.2	9.9	33	1010.5	9743.8	10.4
FY 2005	23.0	233.4	9.8	38	1098.5	10318.7	10.6
FY 2006	25.1	245.8	10.2	34	1205.7	11017.2	10.9
FY 2007	27.5	265.3	10.4	30	1283.3	11686.8	11.0
FY 2008	28.6	285.7	10.0	34	1329.6	12271.9	10.8
FY 2009	26.9	286.1	9.4	38	1277.6	12240.1	10.4
FY 2010	26.7	281.7	9.5	37	1270.9	12180.2	10.4
FY 2011	28.4	294.9	9.6	38	1338.4	12826.9	10.4

¹The state and local effective tax rate is tax revenue as a percent of personal income. The fiscal-year estimates for the United States differ slightly from the calendar-year estimates in Table 1. ²Rank among states based on the highest effective tax rate. ³The U.S. Bureau of the Census did not report state and local tax revenue by state for FY 2001 and FY 2003.

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

I-1033 LID.

Proposed in 2009, Initiative 1033 was designed as a lid to protect taxpayers. The measure stipulated that state and local general fund revenue could not rise faster than the previous year's population growth plus inflation.

The initial popularity of I-1033 was no surprise, since Washington was in the throes of the Great Recession. The proposal was also founded on the seemingly reasonable premise that state and local government budgets need only keep pace with a growing population and the rising cost of goods and services.

Opponents portrayed the measure as a financial disaster for the public sector, eroding the ability of government to provide high-quality education, a safe place to live, adequate healthcare, and much needed infrastructure.

At the heart of the debate was the age-old question: how much should we tax? Based on the historical record at the time, the norm for state and local government taxes nationally was approximately 11 percent of personal income.

It is not difficult to show how I-1033 would have worked in practice. Imagine that the initiative had been implemented in FY 1996. To what extent would it have constrained the growth of state and local taxes over the next ten years?

Between FY 1996 and FY 2006, Washington state and local taxes increased at a 5.0 percent annual rate, climbing from \$15.5 billion to \$25.1 billion. Because personal income grew faster, expanding at a 5.9 percent rate from \$138.2 billion to \$245.8 billion, the tax burden (the state and local effective tax rate) declined from 11.2 percent of personal income to 10.2 percent.

If tax revenue had grown in accordance to the 11 percent lid (the norm), it would have risen at a 5.7 percent annual rate and reached \$27.0 billion in FY 2006.

If the I-1033 lid had been in effect, the fiscal situation for state and local governments would have been radically altered. Between FY 1996 and FY 2006, tax revenue would have grown at a 3.3 percent annual rate, the sum of the population growth rate (1.4 percent) and the inflation rate as measured by the consumer expenditures deflator (1.9 percent) between FY 1995 and FY 2005. As a result, state and local tax revenue would have amounted to only \$21.5 billion in FY 2006, 14.3 percent less than the actual revenue (\$25.1 billion) and 20.4 percent below the norm (\$27.0 billion).

In FY 2006, the Washington state and local tax burden under I-1033 would have dropped to 8.7 percent of personal income, well below the national norm. Among the fifty states, Washington would have ranked forty-eighth in tax burden and the ability to pay for public goods and services, sharing company with South Dakota (8.5 percent) and New Hampshire (8.6 percent).

Due to the inadequacy of the I-1033 tax lid—the inability to generate sufficient tax revenue in the long run—the initiative was defeated.

Source: Richard S. Conway, Jr., "Initiative 1033: Lid or Hammer?", 2009.



As tax revenue failed to keep pace with personal income, 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.



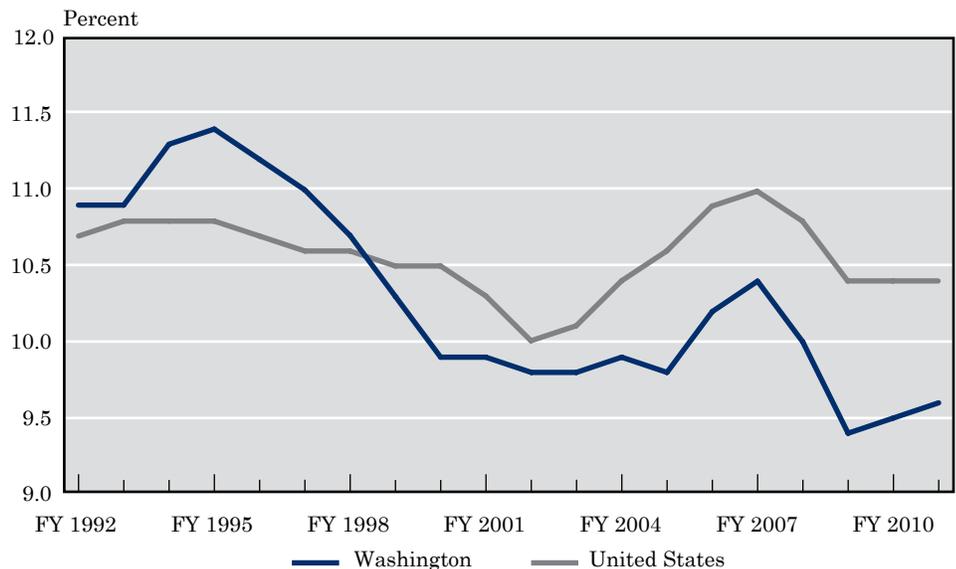
*From FY 2005 to FY 2011,
Washington state and local
governments forfeited \$14.4
billion in tax revenue—enough to
pay for the 520 bridge, the Alaska
Way Viaduct replacement, and
the Supreme Court-ordered basic
education funding requirement—
because of the inadequate tax
system.*

Table 8 and Figure 2 show the Washington and U.S. effective tax rates. The latest Census Bureau estimates extend only to FY 2011. However, Washington state government tax revenue reported by the Washington State Economic and Revenue Forecast Council suggests that the state and local effective tax rate was likely 9.4 percent in FY 2012 and 9.5 percent in FY 2013 (see Table 11). The U.S. Bureau of Economic Analysis estimates that the U.S. state and local effective tax rate was 10.3 percent in each of those fiscal years.

In FY 1995, the Washington state and local effective tax rate rose to 11.4 percent. It was well above both the 10.6 percent historical norm and the 10.8 percent average for all states in that year. The Washington effective tax rate was the twelfth highest in the nation.

By FY 2000, however, the effective tax rate had fallen to 9.9 percent, well below the 10.6 percent norm and the 10.5 percent nationwide average. The effective tax rate was the thirty-eighth highest—the fourteenth lowest—in the nation, a drop of twenty-six places in just five years.

FIGURE 2 WASHINGTON AND U.S. STATE AND LOCAL EFFECTIVE TAX RATES



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

Since FY 2000 Washington’s effective tax rate has stayed well below the norm and the average for all states. Between FY 2002 and FY 2007, the period of economic recovery from the Dot-Com/911 Recession, the Washington effective tax rate increased from 9.8 percent to 10.4 percent. But even at its highest point in FY 2007 it fell short of the norm (0.2 percentage points) and the U.S. average (0.6 percentage points).

In FY 2011, two years after the end of the Great Recession, the Washington state and local effective tax rate was down to 9.6 percent, 0.8 percentage points below the U.S. average. Once again Washington had the fourteenth lowest effective tax rate in the nation.

Between FY 1995 and FY 2011, the U.S. state and local effective tax rate decreased from 10.8 percent to 10.4 percent (0.4 percentage points), while the Washington tax rate fell from 11.4 percent to 9.6 percent (1.8 percentage points). Except for South Dakota, no other state experienced a bigger fall-off in its state and local effective tax rate.

4. **FISCAL IMPACT OF INADEQUACY.** Some people argue that low taxes are good for the economy. Others contend that if taxes are too low, government will be incapable of providing the kind of education and infrastructure required for a strong economy.

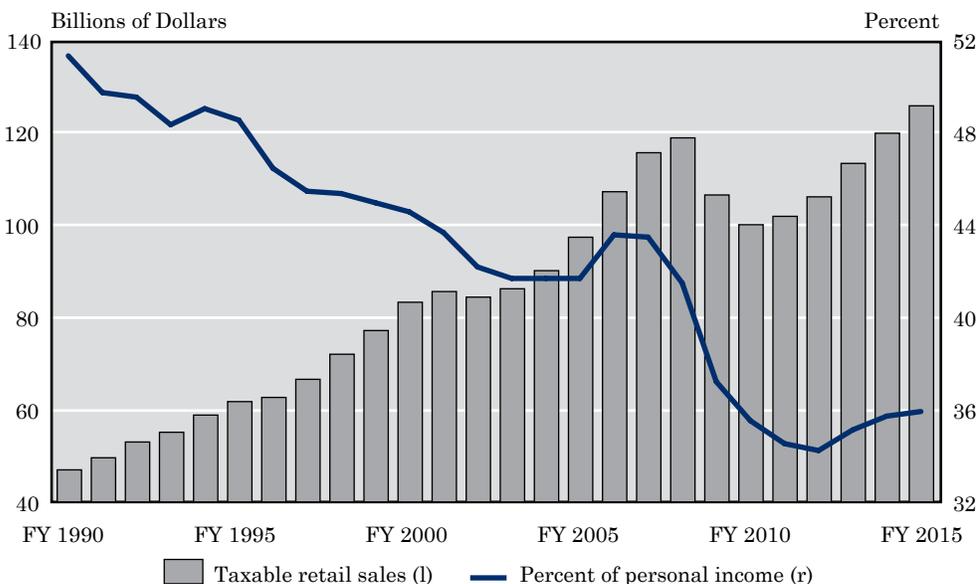
What is not arguable is the amount of state and local tax revenue that Washington has forfeited because of its inadequate tax system. From FY 2005 to FY 2011, for example, Washington state and local governments collected \$186.2 billion in taxes. If the effective tax rate in each year had equaled the norm (10.6 percent of personal income), they would have collected an additional \$14.4 billion. If the effective tax rate had equaled the U.S. average in each year, the extra revenue would have totaled \$15.1 billion.

This is hardly “loose change.” With an additional \$14.4 billion, Washington could have paid outright for the 520 bridge (\$4.1 billion), the Alaska Way Viaduct replacement (\$3.1 billion), Washington’s share of the new Columbia River Bridge (\$0.5 billion), and still had \$6.7 billion left over to meet the Supreme Court-ordered basic education funding requirement. As noted previously, Washington ranked forty-sixth among the fifty states and District of Columbia in current spending for elementary and secondary education per \$1,000 of personal income in FY 2011.

5. **A PERMANENT FIXTURE.** Inadequacy is not an intermittent problem of the Washington state and local tax system. Rather, it is a permanent fixture, as illustrated in the chart on taxable retail sales, the state’s biggest source of tax revenue (Figure 3). Taxable retail sales more than doubled between FY 1990 and FY 2012,

Inadequacy is a permanent fixture of the sales-based Washington state and local tax system, as evident by the fact that taxable retail sales, the state’s biggest tax base, plunged from 51.4 percent of personal income in FY 1990 to 34.2 percent in FY 2012.

FIGURE 3 WASHINGTON TAXABLE RETAIL SALES



Source: Washington Economic and Revenue Forecast Council

increasing from \$47.2 billion to \$106.0 billion. As a percent of Washington personal income, however, taxable retail sales plunged from 51.4 percent to 34.2 percent. If taxable retail sales had been an adequate tax base—had remained at 51.4 percent of personal income—it would have totaled \$159.3 billion in FY 2012 and would have yielded an additional \$3.5 billion in sales taxes for state government alone in that year.



Reflecting the inadequacy of the Washington state and local tax system, the estimated income elasticity of the state and local tax base is 0.71. This means that a 10.0 percent gain in personal income, all else being equal, yields only a 7.1 percent increase in the state and local tax base.

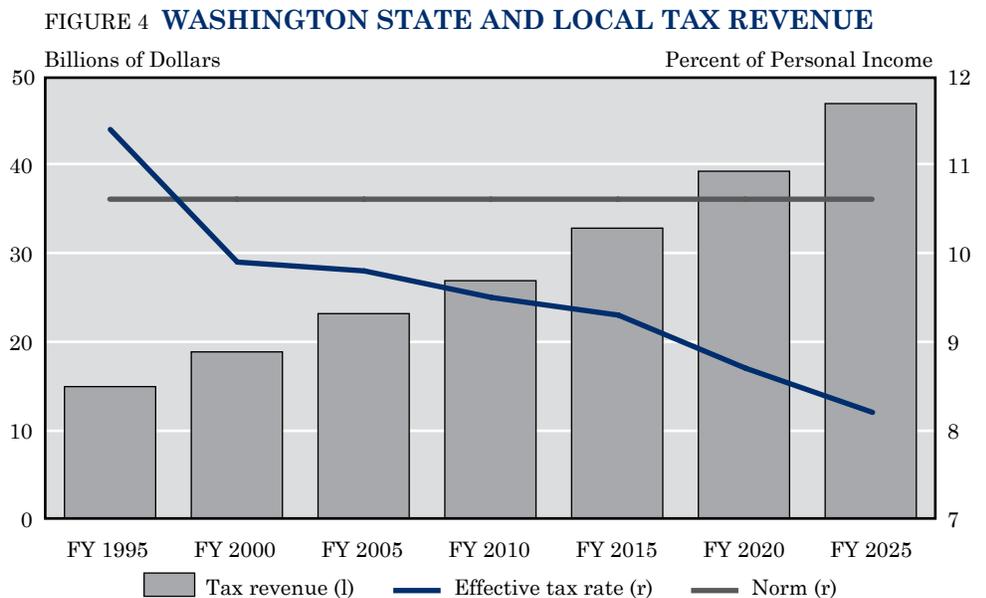


Due to the economic recovery from the Great Recession, the sales tax base is experiencing a temporary period of adequacy. After hitting bottom in FY 2012, taxable retail sales as a percent of personal income is expected to remain above 35 percent through FY 2015, according to forecasts made by the Washington State Economic and Revenue Forecast Council. While the stabilization of the effective sales tax rate is welcome news, there is no prospect that the rate will climb back to its previous levels, at least not without legislative intervention. Moreover, in FY 2015, taxable retail sales as a percent of personal income is expected to resume its downward path.

6. FUTURE TAX REVENUE GROWTH. Without legislated changes to the tax system, Washington tax collections face a bleak future. This can be shown with a few calculations.

With constant tax rates, the long-run growth of state and local tax revenue depends on how fast the Washington economy, as measured by the growth of personal income, expands the tax base (see “An ill-behaved tax base”). The responsiveness of the tax base to changes in income is measured by the so-called income elasticity. The estimated income elasticity for the state and local tax base is approximately 0.71. This means that a 10.0 percent gain in personal income yields a 7.1 percent increase in the state and local total tax base. Note that an adequate tax base has an elasticity of 1.00, whereas an inadequate tax base has an elasticity of less than 1.00.

The income elasticity for the state and local government tax base



Source: Richard S. Conway, Jr.

AN ILL-BEHAVED TAX BASE.

On a technical note, state and local tax bases, such as taxable retail sales, are forecast using econometric models. Tax revenue is determined by multiplying the tax base by its corresponding tax rate. The current state government sales tax rate is 6.5 percent.

The tax base models are formulated in accordance with economic theory and calibrated with forty years of historical data. Following is the equation that predicts Washington taxable retail sales:

$$\Delta \text{taxable retail sales} = 0.8017 \Delta \text{personal income} - 0.1189 \Delta \text{unemployment rate} + 0.0264 \Delta \text{housing permits}$$

The “ Δ ” signifies the percentage change in each variable. The estimated regression coefficients, called elasticities, show the responsiveness of taxable retail sales to changes in the explanatory variables. For example, a 10.0 percent gain in personal income is expected to elicit an 8.0 ($=10.0 \times 0.8017$) percent increase in taxable retail sales, all else being equal.

Since personal income is the only explanatory variable that increases over time, it determines the long-term growth of taxable retail sales. The unemployment rate and housing permits, which fluctuate in the short run but remain relatively constant in the long run, predict the cyclical changes in taxable retail sales.

The taxable retail sales equation embodies both the inadequacy and volatility of the Washington tax system. The income elasticity of 0.80 indicates that the retail sales tax base is grossly inadequate. Without raising the sales tax rate or broadening the tax base, retail sales taxes as a percent of personal income (the retail sales effective tax rate) will continue to decline in the long run.

It is possible to observe in reality the income elasticity of taxable retail sales. All that is required are two distantly separated years over which there has been little change in the unemployment rate or housing permits. In both 1990 and 2007, the Washington unemployment rate was close to 5 percent, while housing permits numbered around 48,000. Over the seventeen-year period, taxable retail sales increased 143.1 percent (from \$48.9 billion to \$118.9 billion), while personal income increased 180.2 percent (from \$98.8 billion to \$276.8 billion). The implied income elasticity for this observation period was 0.79 ($=143.1/180.2$), almost identical to the estimate above.

As a percent of personal income, taxable retail sales declined from 49.5 percent in 1990 to 43.0 percent in 2007. With a constant 6.5 percent sales tax rate for state government, the retail sales effective tax rate fell from 3.2 ($=6.5 \times 48.9/98.8$) percent to 2.8 ($6.5 \times 118.9/276.8$) percent of income.

The Great Recession further weakened the retail sales tax base. Between 2007 and 2010, the unemployment rate jumped from 4.6 percent to 9.6 percent (a 108.7 percent increase) and housing permits plummeted from 47,400 to 20,200 (a 57.4 percent decrease). According to the model, the cyclical forces represented by these two variables caused a 14.4 ($= -0.1189 \times 108.7 + 0.0264 \times -57.4$) percent decrease in taxable retail sales, very close to the 15.6 percent actual drop.

Source: Richard S. Conway, Jr., “Revenue Forecast,” 2013.



Forecasts indicate that without legislated changes to the tax rates or tax base, the Washington state and local effective tax rate will decline from 9.5 percent in FY 2010 to 8.2 percent in FY 2025. In FY 2025, Washington could have the lowest state and local effective tax rate in the nation.



The inadequacy of the Washington tax system has been a major source of its long-term instability.

is estimated as the weighted average of four individual tax base elasticities, the weights being their respective shares of total taxes: taxable retail sales 0.80 (33.7 percent); business and occupation tax base 1.01 (11.7 percent); property tax base 0.50 (30.6 percent); and the other excise tax base 0.70 (24.0 percent). Arithmetically, $0.71 = 0.80 \times 0.337 + 1.01 \times 0.117 + 0.50 \times 0.306 + 0.70 \times 0.240$, where, for example, 0.80 is the income elasticity for taxable retail sales and 0.337 (33.7 percent) is the retail sales tax share of total state and local tax revenue.

The income elasticities for taxable retail sales (0.80) and the business and occupation tax base (1.01) are estimated with econometric models. Note that the business and occupation tax base is Washington's only adequate tax base. The estimated property tax elasticity (0.50) is artificially low because of a restriction limiting the annual increase in property taxes to one percent plus taxes on new property. The estimate of the other excise tax base elasticity (0.70) is based on forecasts made by the Washington State Economic and Revenue Forecast Council.

After falling from 11.4 percent in FY 1995 to 9.5 percent in FY 2010, the state and local effective tax rate has stabilized but only temporarily, as previously noted. When the economic recovery

has run its course, the cyclical lift from increased housing activity and falling unemployment will dissipate and the effective tax rate will begin to fall again (Table 9). Assuming no legislated changes to the tax rates or the tax base and a 5.0 percent annual growth rate for current-dollar personal income, the effective tax rate is predicted to decline to an estimated 9.3 percent (12.3 percent below the 10.6 percent national norm) in FY 2015, 8.7 percent (17.9 percent below the norm) in FY 2020, 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.

TABLE 9 WASHINGTON STATE AND LOCAL TAX REVENUE, FY 1995-FY 2025

Billions of Dollars

	Tax Revenue	Personal Income	Effective Tax Rate (%) ¹
FY 1995	14.8	129.8	11.4
FY 2000	18.7	189.6	9.9
FY 2005	23.0	233.4	9.8
FY 2010	26.7	281.7	9.5
FY 2015	32.6	350.3	9.3
FY 2020	39.0	447.1	8.7
FY 2025	46.6	570.6	8.2

¹The state and local effective tax rate is tax revenue as a percent of personal income. Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Richard S. Conway, Jr.

The analysis of adequacy leads to two inescapable conclusions. First, the fact that Washington's state and local effective tax rate is low and falling rapidly relative to other states indicates a clear need for additional tax revenue. This should not, however, be interpreted as a call for "high taxes." Tax revenue should be increased but only until it reaches an agreed upon adequate level.

During the Great Recession, the Washington federal, state, and local

¹Because of a smaller reliance on property taxes, the estimated income elasticity for the state government tax base is somewhat higher: $0.79 = 0.80 \times 0.499 + 1.01 \times 0.216 + 0.50 \times 0.130 + 0.70 \times 0.156$. This estimate is reasonably consistent with the forecasts made in February 2014 by the Washington State Economic and Revenue Forecast Council. Between FY 2015 and FY 2019, when the economy is expected to be fully recovered from the Great Recession—that is, there are no lingering cyclical effects—state government tax revenue is expected to increase at a 4.1 percent annual rate, while current-dollar personal income will rise at a 5.1 percent rate. The implied elasticity is 0.81 ($=4.1/5.1$), close to the independent estimate made for this study.

effective tax rate dropped to a sixty-year low. Nevertheless, an often heard contention was that, given the economic hardships caused by the downturn, taxes were too high. Now that the recession is behind us, it is time to address a different issue. Will Washington have sufficient state and local tax revenue to sustain a healthy economy and a high quality of life in the long run?

Second, considering the enormity of the inadequacy problem, it cannot be solved without major changes to the Washington state and local tax structure. Working around the edges, such as closing tax loopholes and legalizing marijuana, will help, but it will not halt the growing tax revenue shortfall. If this study's long-term projections of the Washington state and local effective tax rates are anywhere close to being on target, major tax reform in Washington is not just imperative but probably inevitable.

Stability. As evident by the widespread damage caused by the Great Recession, no state is impervious to national economic cycles. Thus, no state has a perfectly stable state and local tax system. Even if its effective tax rate remains constant throughout the course of an economic cycle, tax revenue will rise and fall with personal income.

Some state and local tax systems, however, are more unstable than others due to the sensitivity of their effective tax rates to economic fluctuations. The variability of an effective tax rate depends on the composition of the state and local tax base. If a state draws significant revenues from consumer durable sales and new construction, as does Washington, its effective tax rate will tend to be relatively volatile. Similarly, a state that relies heavily on capital gains taxes, as does California, will also experience periods of significant instability. In general, states with a personal income tax but a low capital gains tax will tend to have a more stable state and local tax system.

Given that states have no control over economic cycles, the test of the stability of state and local tax systems should focus on the variability of the effective tax rate:

1. **TWO DECADES OF INSTABILITY.** The test involves measuring the state and local effective tax rates for the fifty states and the District of Columbia at four points in time: FY 1995, FY 2002, FY 2007, and FY 2011 (Table 10). These years correspond with the high and low values of the Washington and U.S. state and local effective tax rates over the course of two economic cycles.

Four periods are analyzed: FY 1995-02 includes the end of the Dot-Com boom and the subsequent Dot-Com/911 recession; FY 2002-07 covers the short-lived recovery from that recession; FY 2007-11 encompasses the Great Recession and its aftermath; and FY 1995-2011 includes the entire sixteen-year period.

Despite a strong economy in the late 1990s, the U.S. state and local effective tax rate fell steadily from 10.8 percent in FY 1995 to 10.0 percent in FY 2002. After rebounding to 11.0 percent in FY 2007, the Great Recession knocked it back down to 10.4 percent in FY 2011.

For purposes of comparison, a stability index is developed for each state. Specifically, the index is the ratio of the absolute change



Measured by the relative change in its state and local effective tax rate, Washington had the forty-seventh most stable state and local tax system in the nation between FY 1995 and FY 2011.





During the Great Recession, the sensitivity of the Washington tax base to economic cycles caused an unprecedented loss of state government tax revenue. The state government effective tax rate declined from 5.3 percent in FY 2007 to 4.5 percent in FY 2009.



in the state and local effective tax rate of the given state to the absolute change in the average effective tax rate for all states (i.e., the U.S. rate). Since this is strictly a test of stability, there is no consideration given to the direction of change in the effective tax rate. However, it should be pointed that with the exception of states with large severance taxes, such as Alaska, the effective tax rates of all states tend to rise and fall together.

If the change in a state's effective tax rate equals the national change, the state's stability index is 1.00. If the state experiences no change in its effective tax rate—the rate is perfectly stable—its stability index is 0.00. During the four test periods, the value of the index ranged from 0.00 for Ohio from FY 1995 to FY 2002, when its effective tax rate remained at 10.74 percent, to 8.51 for Alaska from FY 2002 to FY 2007, when its effective tax rate soared from 9.72 percent to 17.99 percent. Note that the analysis is carried out to two decimal places.

Between FY 1995 and FY 2002, the Washington state and local effective tax rate fell from 11.41 percent to 9.77 percent, while the U.S. rate declined from 10.82 percent to 10.01 percent. The changes in the state and national effective tax rates were -1.64 and -0.81, respectively. Disregarding the direction of change, the stability index for Washington was 2.03 (=1.64/0.81). This meant that the

Washington state and local effective tax rate was twice as unstable—changed twice as much—as the national rate. Washington had the forty-seventh most stable—the fifth most unstable—tax system in the nation.

In terms of stability, the Washington tax system fared better during the economic recovery between FY 2002 and FY 2007. With a stability index of 0.63, the state had the twentieth most stable tax system in the nation. But a stability index of less than one when most state and local effective tax rates were rising due to the economic upturn meant that the Washington effective tax rate dropped further below the national rate. The gap between

the Washington effective tax rate (9.77 percent) and the U.S. rate (10.01 percent) was only -0.24 percentage points in FY 2002. By FY 2007, however, the gap between the state rate (10.38 percent) and the national rate (10.98 percent) widened to -0.60 percentage points. In FY 2011, due to the Great Recession, another time of instability, the gap further increased to -0.81 percentage points, as the Washington and the U.S. effective tax rates decreased to 9.63 percent and 10.43 percent, respectively.

Between FY 1995 and FY 2011, the Washington state and local effective tax rate declined from 11.41 percent to 9.63 percent, while the U.S. rate decreased from 10.82 percent to 10.44 percent. With a stability index of 4.64, Washington had the nation's forty-seventh

TABLE 10 **STABILITY OF WASHINGTON STATE AND LOCAL TAX SYSTEM, FY 1995-FY 2011**

	FY 1995-02	FY 2002-07	FY 2007-11	FY 1995-11
Economic phase	Boom-Bust	Recovery	Recession	Trend
First-year effective tax rate (%)	11.41	9.77	10.38	11.41
Last-year effective tax rate (%)	9.77	10.38	9.63	9.63
Change in effective tax rate (%)	-1.64	0.61	-0.75	-1.78
U.S. change in effective tax rate (%)	-0.81	0.97	-0.55	-0.38
Stability index¹	2.03	0.63	1.36	4.64
Rank²	47	20	31	47

¹The stability index for each state is the ratio of the absolute change in its state and local effective tax rate to the absolute change in the U.S. effective tax rate. ²Rank among states based on the lowest stability index.

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Richard S. Conway, Jr.

most stable state and local tax system over the sixteen-year period. Even that dubious distinction needs qualification, since three of the four states with more unstable tax systems—Alaska (11.24), North Dakota (10.94), and Wyoming (7.12)—experienced sizeable long-run gains in their effective tax rates due to a surge in severance taxes from natural resource extraction.

The California state and local tax system is purported to be unstable due to erratic capital gains taxes. With a trend stability index of 1.58, California had the twenty-fifth most stable tax system in the nation between FY 1995 and FY 2011. Among the three shorter periods, the California stability index reached a high of 1.56 between FY 2002 and FY 2007, but that was a time when its effective tax rate was rising. In the other two periods, California had a more stable tax system than most other states. With a trend stability index of 1.36, Oregon had the twenty-first most stable tax system. Unlike Washington, Oregon has an income tax but no sales tax.

It should be pointed out that the inadequacy of the Washington tax system has been a major source of its instability. The long-term decline in the state and local effective tax rate caused by the inadequate tax system is primarily responsible for the high value of Washington's trend stability index. At the same time, by hindering growth of tax revenue during the economic recovery between FY 2002 and FY 2007, the inadequate tax system resulted in an unwanted period of stability. To the extent that inadequacy precludes tax revenue from growing with personal income, it is a major problem in its own right. But inadequacy can also indirectly affect the stability as well as the fairness of a state and local tax system. This is why adequacy is considered a critical characteristic of the Washington tax system.

2. TAX REVENUE IMPACT OF THE GREAT RECESSION. The instability of the Washington state and local tax system stems not only from the inadequacy of its tax base but also from the sensitivity of its effective tax rate to economic cycles.

During the Great Recession, caused by the crash of the housing and financial markets, Washington state and local budget imbalances were often blamed on “runaway spending.” But data show that in no single year from FY 2007 to FY 2011 did Washington outspend the rest of the nation relative to personal income. In FY 2007, state and local general expenditures amounted to 18.7 percent of income, compared to 19.3 percent nationally. With increased federal transfers during the recession, the state's rate of spending rate rose to 19.6 percent in FY 2011, but it was still less than the 20.1 percent national rate. Over the five-years Washington and U.S. state and local general expenditures averaged 19.4 percent and 20.1 percent of personal income, respectively.

Rather than over-spending, the budget difficulties of Washington state and local governments stemmed from an unprecedented loss of revenue caused by the Great Recession and an unstable tax system. The fiscal problems of state government, which can be documented through FY 2013, illustrate this point. Between FY 2007 and FY 2009, while current-dollar personal income increased 7.8 percent, state government tax revenue fell 8.8 percent (Table 11). This low-



Despite enhancements to state government revenue, such as a temporary increase in the business and occupation tax for services, real per capita state tax revenue measured in 2009 dollars plunged from \$2,376 in FY 2007 to \$2,056 in FY 2013, a drop of 13.5 percent. This meant that the purchasing power of state government tax revenue—the ability to provide public goods and services—declined by one-seventh over the six-year period.



TABLE 11 WASHINGTON STATE GOVERNMENT GENERAL FUND TAX REVENUE, FY 2007-FY 2013

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2007-13 Percent Change
State tax revenue (bils. \$)	14.2	14.3	12.9	13.2	14.3	14.5	15.4	8.3
Personal income (bils. \$)	265.3	285.7	286.1	281.7	294.9	310.1	322.6	21.6
Effective tax rate (%)	5.3	5.0	4.5	4.7	4.9	4.7	4.8	-10.9
State tax revenue (bils. \$)	14.2	14.3	12.9	13.2	14.3	14.5	15.4	8.3
State and local price deflator (09=1.000)	0.930	0.980	1.004	1.012	1.043	1.067	1.076	15.7
Population (thous.)	6416.2	6511.9	6614.8	6705.5	6783.5	6867.9	6943.0	8.2
Real per capita state tax revenue (\$09)	2376	2242	1947	1950	2022	1977	2056	-13.5
Personal income (bils. \$)	265.3	285.7	286.1	281.7	294.9	310.1	322.6	21.6
Personal consumption deflator (09=1.000)	0.958	0.987	0.999	1.010	1.027	1.052	1.067	11.3
Population (thous.)	6416.2	6511.9	6614.8	6705.5	6783.5	6867.9	6943.0	8.2
Real per capita income (\$09)	43161	44438	43279	41607	42326	42941	43567	0.9

Source: Washington State Economic and Revenue Forecast Council, U.S. Bureau of Economic Analysis, and U.S. Bureau of the Census

ered the state government effective tax rate from 5.3 percent to 4.5 percent (-0.8 percentage points). By comparison, the U.S. state and local effective tax rate declined from 11.0 percent to 10.4 percent (-0.6 percentage points). Because of a 7.9 percent rise in the cost of government goods and services due to inflation and a 3.1 percent increase in population, real per capita state tax revenue fell from \$2,376 measured in 2009 dollars to \$1,947, an 18.1 percent loss over the two-year period.

Washington state government tax revenue and its effective tax rate began to rebound in FY 2010. Tax revenue climbed from \$12.9 billion in FY 2009 to \$15.4 billion in FY 2013, causing the effective tax rate to increase from 4.5 percent to 4.8 percent. But much of the gain was due to non-economic changes, principally a consolidation of accounts, a tax amnesty program, and a temporary increase in the business and occupation tax rate for services. The non-economic changes added an estimated \$1.5 billion to tax revenue in FY 2013. Thus, without these non-economic changes, state tax revenue in FY 2013 would have amounted to only \$13.9 billion, implying an effective tax rate of 4.3 percent.

Even with the enhancements to revenue, real per capita state government tax revenue hardly improved, inching up from \$1,947 in FY 2009 to \$2,056 in FY 2013. This was not enough to recoup the earlier loss. Thus, on net, state tax revenue measured in 2009 dollars plunged from \$2,376 in FY 2007 to \$2,056 in FY 2013, a drop of 13.5 percent. In other words, the purchasing power of state government tax revenue—the ability to provide public goods and services (education, safety, healthcare, and infrastructure) for Washington’s people and businesses—declined by one-seventh over the six-year period.

A commonly used tactic to counteract an unstable tax system is a rainy

day fund. Proposed by the Washington State Tax Structure Study Committee, voters in 2007 approved a constitutional amendment to create a rainy day fund. Although designed to cushion the ups and downs of tax revenue, rainy day funds seldom have sufficient resources to adequately deal with the fiscal problems caused by a recession.

At the beginning of FY 2009, almost one year into the Great Recession, the Washington state government rainy day fund had a balance of less than \$1 billion. It was no match for the tax revenue shortfall, which would total \$10 billion over the next five years.² Some fiscal experts recommend a fund balance equal to 15 percent of the annual general fund expenditures. For Washington state government that would mean a rainy day fund balance of \$2.5 billion. At the present rate of funding, it would take fourteen years to replenish the nearly depleted rainy day fund to that level.

Transparency. The real error of our ways during the housing bubble was that we allowed a major part of our economy to become opaque. We neglected a basic tenet of a market economy: both buyers and sellers should have “perfect information.” That is, all of our economic transactions should be transparent. When we lack transparency, we expose ourselves to Ponzi schemes and the financial shenanigans associated with subprime lending and mortgage-backed securities. More importantly, as we have witnessed, we place our economy in jeopardy.

INPUT-OUTPUT TABLE.

The 2007 Washington input-output table is the eighth estimate of the state’s interindustry structure since 1963. The first input-output table was constructed by Professor Philip Bourque of the University of Washington and Professor Eldon Weeks of Washington State University. The latest table was built under the direction of William Beyers of the University of Washington and Marc Baldwin and Ta-Win Lin of the Washington Office of Financial Management.

An input-output table serves three purposes. First, it is a comprehensive set of accounts on the purchases (input) and sales (output) of goods and services among Washington industries, households, and government. Second, the input-output data provide the factual basis for estimating output, employment, and income multipliers used in impact analysis. Third, enhanced input-output models, such as the Washington Projection and Simulation Model, have proven to be effective economic and demographic forecasting methods.

Identifying 52 industries, the latest input-output table also helps answer an important question about tax incidence: who ultimately pays the business and occupation tax (see discussion of transparency)? Extracted from the larger input-output table, Table 12 shows interindustry sales and purchases for five aggregated industries in 2007.

Source: Washington State Office of Financial Management, *The 2007 Washington Input-Output Model*, 2012.



*The Washington State Tax
Structure Study Committee
concluded that “a significant part
of the Washington state tax system
is not transparent to households.”*



²The tax revenue shortfall is the difference between the actual revenue and the forecast revenue over a period of time.

Taxes should also be transparent. In the words of the Washington State Tax Structure Study Committee, “Households should be able to determine their overall annual state tax burden, including any taxes embodied in the prices of goods and services that they buy...The finding (of the study) is that a significant part of the Washington state tax system is not transparent to households. To the extent that (business) taxes are passed on to consumers in the form of higher prices, the taxes are not transparent. In addition, most households are unaware of their annual sales tax burden even though sales tax paid on consumer purchases is explicitly stated on receipts and invoices.”

The business and occupation tax is not totally transparent, since up to three-fifths can be passed on to customers in the form of higher prices.

1. **PASSING ON THE TAX BILL.** The business and occupation tax is ostensibly paid by businesses. However, the tax can sometimes be passed on to customers in the form of higher prices. This is likely to occur when competing local businesses are selling their goods and services in local markets. Even without collusion, they soon realize that it is mutually advantageous to increase their prices to cover the tax. Oftentimes, in the process of maximizing profits, businesses pass on the tax without any conscious effort.

The potential for tax-shifting is great, according to the Washington input-output table (Table 12). In 2007, output of Washington in-

TABLE 12 **WASHINGTON INDUSTRY SALES, 2007**

Billions of Dollars

	Industries	Consumers	Investment	Government	Exports ¹	Total
Resources	3.8	0.6	0.1	0.4	8.1	13.1
Construction	18.9	2.5	30.9	7.0	7.5	66.8
Manufacturing	26.7	8.1	1.5	3.1	120.4	159.8
Trade	18.9	28.4	1.1	2.9	17.1	68.4
Services and utilities	88.2	103.4	0.6	9.8	93.6	295.6
Total	156.4	143.0	34.2	23.3	246.7	603.7
Percent						
Resources	29.2	4.6	0.8	3.1	62.3	100.0
Construction	28.3	3.7	46.3	10.5	11.2	100.0
Manufacturing	16.7	5.1	0.9	1.9	75.3	100.0
Trade	27.6	41.5	1.6	4.2	25.0	100.0
Services and utilities	29.8	35.0	0.2	3.3	31.7	100.0
Total	25.9	23.7	5.7	3.9	40.9	100.0

¹Includes federal government expenditures.

Source: Washington State Office of Financial Management

dustries totaled \$603.7 billion. Of that amount, \$357.0 billion (59.1 percent) were local sales to industries, consumers, investment, and government and \$246.7 billion (40.9 percent) were exports. This implied that up to three-fifths of the business and occupation tax base was subject to local tax-shifting.

The ability to pass on the business and occupation tax to customers has two undesirable effects. It reduces the transparency of the tax system, since it is unclear how much of the business and occupation

tax burden ultimately falls on Washington businesses, households, and government.

Tax-shifting also results in pyramiding, which is the multiple payment of the business and occupation tax on a product as it moves from one firm to another up the production chain. To the extent that pyramiding raises the cost of producing exports, the key driver of the Washington economy, it hinders economic growth.

2. **THE BUSINESS AND OCCUPATION TAX.** Being unique to Washington, the business and occupation tax warrants further discussion. The tax has a number of features that are popular with government officials. It has an adequate tax base (the estimated income elasticity is 1.01) because of its broad coverage of the economy. Unlike the sales tax base, which consists of goods and new construction, the business and occupation tax also encompasses services. Due to its extensive coverage, business and occupation tax revenue also tends to be more stable than sales tax revenue. Furthermore, because of the ability of businesses to pass on the tax, there are relatively few complaints when the governor and legislature raise the business and occupation tax rate, typically on services, during recessions.

In addition to opaqueness and pyramiding, there are other drawbacks to the business and occupation tax. As a gross receipts tax, it is not levied on business income. Thus, a business is obligated to pay the tax even if it earns no profit. In this way, the gross receipts tax can retard the formation of start-ups.

The direct burden of the business and occupation tax is also very high. In FY 2011, business and occupation tax revenue for city and state governments amounted to \$3.3 billion. The effective tax rate was 1.1 percent of personal income, nearly three times the corporate income effective tax rate (0.4 percent) for all state and local governments in the United States.

Recognizing that the business and occupation tax can put exporting companies at a competitive disadvantage, Washington offers selective preferential tax rates. For example, manufacturing pays a lower tax rate (0.004840) than services (0.015000). Boeing, facing strong competition from Airbus and being constantly courted by other states, pays an even lower tax rate (0.002904). The Washington Department of Revenue specifies thirteen different tax rates for thirty-five categories of business activities. The rationale for each specific rate is not always clear. Moreover, the preferential tax rates raise questions about the potentially unfair application of the tax.

3. **TEST OF TRANSPARENCY.** Comparing the transparency of state and local tax systems across states is a somewhat subjective exercise, requiring a “quantitative” estimate of the transparency of each type of tax.

A state’s rank is determined by a total transparency index, which is defined as the weighted average of the transparency of five types of taxes: individual income tax, business tax (business and occupation or corporate income tax), sales tax, property tax, and other excise tax. The weights are equal to each tax’s share of total state and local tax revenue.



The business and occupation tax has an adequate and relatively stable tax base. However, the tax also has several drawbacks: opaqueness, tax pyramiding, regressivity, high tax burden, and numerous tax rates.



Individual income taxes are totally transparent, as there is always a record of payment. Sales taxes are partially transparent since most households are unaware of their annual sales tax burden.





Due to the lack of an income tax and a heavy reliance on the sales tax and the business and occupation tax, Washington edged out only Alaska in having the least transparent tax system in the nation.



A transparent tax system is a prerequisite for rational tax policy.



TABLE 13 STATE AND LOCAL GOVERNMENT TAX SYSTEM TRANSPARENCY INDEX, FY 2011

Rank ¹	State	Index ²
	United States	0.669
1	Oregon	0.763
2	Maryland	0.738
3	Massachusetts	0.731
4	Connecticut	0.720
5	Virginia	0.715
47	Wyoming	0.567
48	Nevada	0.559
49	Tennessee	0.553
50	Washington	0.549
51	Alaska	0.531

¹Rank among states based on highest transparency index. ²Index=1.000 indicates totally transparent tax system.

Source: Richard S. Conway, Jr.

For example, suppose a state collects one-half of its tax revenue from personal income taxes and one-half from sales taxes. If income taxes are totally transparent (that is, have a transparency index of 1.000) but sales taxes are only 50 percent transparent (have an index of 0.500), the state's total transparency index is 0.750 ($=0.50 \times 1.000 + 0.50 \times 0.500$).

Individual income taxes are totally transparent, as there is always a record of payment. Since "most households are unaware of their annual sales tax burden," as noted by the Washington State Tax Structure Study Committee, the transparency index for sales taxes is assigned a value of 0.500. Based on the input-output analysis, which suggests that businesses can pass on up to 60 percent of their taxes, the business and occupation tax and the corporate income tax transparency indexes are each given a value of 0.400. The property tax transparency index, which is assumed to be 0.700, presumes that residential and nonresidential property owners are aware of the property taxes they pay but renters are not. Finally, the transparency index for excise taxes is assumed to have the same value as the sales tax transparency index.

With a total transparency index of 0.763, Oregon had the nation's most transparent tax system in FY 2011 (Table 13). Its top ranking is due to a high dependency on the personal income tax coupled and the absence of a sales tax. Also heading the list are four east coast states: Maryland, Massachusetts, Connecticut, and Virginia.

In contrast, Washington edged out only Alaska for having the least transparent tax system among the fifty states and the District of Columbia. The total transparency index was 0.549. In this case, the opaqueness of the Washington state and local tax system is attributable to the lack of an income tax and a heavy reliance on the sales tax and the business and occupation tax.

Note that the total transparency index is sensitive to the assumption regarding the transparency of sales and other excise taxes. If the indexes of these two taxes are increased from 0.500 to 0.750, Washington's total transparency index rises to 0.694. But the state's ranking—second to the bottom—remains unchanged.

Transparency is not just an issue of knowing how much each of us pays in taxes. It is also having a good sense of how much everybody else pays. What are the actual tax burdens of households and businesses? What are the actual tax burdens of low-income and high-income households? The lack of transparency in the Washington state and local tax system makes it difficult to address one of the fundamental tax policy questions: is everyone paying his or her fair share of taxes? In other words, a transparent tax system is a prerequisite for making rational tax policy.

Economic vitality. The literature regarding the relationship between taxes and economic vitality is inconclusive. Some economists argue that low taxes are the best way to promote job and income growth, while others contend that high-quality education and good roads are necessary for a strong economy. From the standpoint of tax policy, the issue reduces down to two questions: how much should state and local governments tax households and businesses and what kinds of taxes should be utilized?

As a preface to the following discussion, there are three relevant facts to keep in mind. The first fact is that for four decades the effective tax rate for U.S. state and local governments has averaged 10.6 percent of personal income with relatively little variation. The second fact is that forty-four states and the District of Columbia employ an individual income tax. The third fact is that neither of the first two facts currently applies to Washington.

BUSINESS TAX CLIMATE SPREADSHEET ANALYSIS.

Here is a business tax climate analysis that you can do at home. Calculate the change in wage and salary jobs between 1970 and 2012 for each state, according to U.S. Bureau of Economic Analysis data (the national change is 60,632,000). Enter the changes in state employment down a column in an Excel spreadsheet. In the next column, enter the corresponding Tax Foundation’s business tax climate ranking (Wyoming is 1 and Washington is 6). Finally, calculate the correlation (correl) between employment change and the business tax climate ranking. There is virtually no correlation (0.001).

The literature regarding the effect of taxes on economic vitality is inconclusive, which makes the issue contentious.

There are business people and policy analysts who insist that the lack of an income tax gives the Washington economy a competitive advantage. A widely cited study conducted by the Tax Foundation in 2012 concludes that Washington has the sixth best business tax climate in the nation.

1. **BEST BUSINESS TAX CLIMATE.** In its latest study, the Tax Foundation concludes that, among the fifty states and the District of Columbia, Wyoming has the best business tax climate.

The overall rank for each state is based on a weighted average of scores—the weights are shown in parentheses—for five types of taxes: individual income tax (33.1 percent), corporate tax (20.1 percent), sales tax (21.5 percent), property tax (14.0 percent), and the unemployment insurance tax (11.4 percent). The score for each tax is determined by its tax rate and tax base.

The Tax Foundation 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 that these states have in common is the absence of a major tax (individual income tax, corporate tax, or sales tax). The Tax Foundation concludes that “the lesson is simple: a state that raises sufficient revenue without one of the major taxes will, all things being equal, have an advantage over those states that levy every tax in the state collector’s arsenal.”

But a closer look reveals that the lesson is not so

TABLE 14 BEST BUSINESS TAX CLIMATE AND EMPLOYMENT CHANGE

Rank ¹	State	1970-12 Employment Change (thous.) ²	Percent of U.S. Employment Change
	United States	60632.0	100.0
1	Wyoming	168.7	0.3
2	South Dakota	221.3	0.4
3	Nevada	954.5	1.6
4	Alaska	230.6	0.4
5	Florida	5219.2	8.6
6	Washington	1807.6	3.0
47	Rhode Island	79.5	0.1
48	Vermont	143.8	0.2
49	California	7550.4	12.5
50	New Jersey	1150.6	1.9
51	New York	1382.0	2.3

¹Rank among states based on best business tax climate in 2013.
²Wage and salary employment.
 Source: Tax Foundation, 2013 and U.S. Bureau of Economic Analysis.



The Tax Foundation rates Washington as having the sixth best business tax climate in the nation because it does not have an income tax. But four of the top states (Wyoming, Alaska, Nevada, and Florida) do not need an income tax since they receive a major portion of their state and local revenue from severance or tourist-related taxes. Washington instead has to rely heavily on regressive and inadequate sales taxes to generate the necessary tax revenue



BUSINESS OR PERSONAL?

Published in 1987, *Washington Works Worldwide* was an economic development strategy for the state. It was conceived during the 1981-82 recession but died during the 1984-90 economic boom.

As a consultant, this author wrote one of the study's two volumes: "The Washington State Economy: An Assessment of Its Strengths and Weaknesses."

When the subject of an income tax came up for discussion among the members of the Economic Development Board, the representative of a company that had recently located in Seattle said that he did not want to talk about it. Another board member immediately concurred.

I asked the newly arrived representative why he would not consider an income tax, since the business and occupation tax could be a greater financial burden on a firm than a corporate income tax. He responded that his business had moved to Seattle not because Washington did not have a corporate income tax but because it did not have a personal income tax.

In the final report, the Economic Development Board recommended that Washington "broaden and stabilize the tax system by reducing the sales tax rate and instituting a flat-rate personal income tax."

Source: Washington State Economic Development Board, "Washington Works Worldwide," 1987.

clear. While the top six states do not have a major tax, 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). Since Wyoming earns about one-fourth of its general fund revenue from severance taxes on coal, oil, and gas extraction, it does not require an income tax. In contrast, Washington, which does not have an alternative tax source, has to rely heavily on regressive and inadequate sales taxes to generate the necessary state and local tax revenue.

The Tax Foundation presumes that states with the lowest taxes have the best business tax climate. But Wyoming is in fact a high-tax state. Including severance taxes, Wyoming's state and local effective tax rate was 13.7 percent of personal income in FY 2011. In contrast, Washington and the U.S. effective tax rates were only 9.6 percent and 10.4 percent, respectively.

Severance taxes make it possible for Wyoming not only to get by without an income tax but also to generously fund education. In FY 2011, Wyoming ranked sixth nationally in educational expenditures per student. Wyoming spent \$15,849 per pupil, \$5,289 more than the U.S. average and \$6,366 more than Washington.

2. NO CORRELATION WITH JOB GROWTH. Despite having the best business tax climate, there is no evidence that it has done the Wyoming

economy much good. Between 1970 and 2012, Wyoming grew faster than the nation but added only 168,700 wage and salary jobs, just 0.3 percent of the total gain nationally. Moreover, back-of-the-envelope calculations indicate that one-half to two-thirds of the new jobs were directly or indirectly related to mining activity. The only other basic industry exhibiting growth was tourism.

There is in fact no correlation between a state's business tax climate and its ability to generate jobs, as a simple statistical test reveals (see "Business tax climate spreadsheet analysis"). Illustrating this lack of correlation, with the third worst business tax climate, California created on net 7,550,400 payroll jobs—one out of every eight new jobs in the nation—between 1970 and 2012 (Table 14).

3. ANOTHER ISSUE OF FAIRNESS. It is argued that a Washington income tax would make it more difficult—that is, more costly—for high-tech firms to attract talented workers. As a general proposition, that is probably true. But new workers and their families place demands on the public sector for schools, roads, and safety. If the costs of these public goods and services were to fall disproportionately on low and middle-income households, as they do under Washington's current tax system, those households would in effect be subsidizing the high-tech companies and their employees.

4. WASHINGTON AND OREGON. Opponents to an income tax argue that it would hamper economic growth in Washington. But a comparison of the Washington and Oregon economies strongly contradicts that contention. Washington and Oregon are a curiosity in the tax world, as there is no other pair of geographically adjacent states that have more different tax systems. Washington has no income tax, while Oregon has an income tax but no sales tax or business and occupation tax.

Despite fundamentally different tax structures, the Washington and Oregon economies have performed equally well over time

Wyoming has the best business tax climate, but it has not done its economy much good. Between 1970 and 2012, the state created only 168,700 wage and salary jobs, mostly related to mining. With the third worst business tax climate, California added 7,550,400 jobs.

A statistical test reveals that there is in fact no correlation between a state's business tax climate ranking and its ability to generate jobs.

TABLE 15 WASHINGTON AND OREGON ECONOMIC GROWTH, 1970-2010

	1970	1990	2010	Average Annual Percent Change		
				1970-90	1990-10	1970-10
Washington						
Employment (thous.)	1282.1	2350.1	2998.3	3.1	1.2	2.1
Personal income (bils. \$)	14.3	96.3	286.7	10.0	5.6	7.8
Per capita income (\$)	4189	19637	42521	8.0	3.9	6.0
Population (thous.)	3417.4	4903.0	6743.6	1.8	1.6	1.7
Oregon						
Employment (thous.)	767.7	1315.2	1677.9	2.7	1.2	2.0
Personal income (bils. \$)	8.2	51.2	137.7	9.6	5.1	7.3
Per capita income (\$)	3927	17895	35869	7.9	3.5	5.7
Population (thous.)	2100.4	2860.4	3838.2	1.6	1.5	1.5

Source: U.S. Bureau of Economic Analysis



The contention that the lack of an income tax gives the Washington economy a competitive edge is contradicted by local history. Despite fundamentally different tax structures—Oregon has an income tax but no sales tax or business and occupation tax—the Washington and Oregon economies have performed equally well over time.



(Table 15). Both states have grown more rapidly than the nation since 1970. In terms of jobs, Washington has advanced a bit faster than Oregon (2.1 percent annually versus 2.0 percent).

Washington has also experienced faster per capita income growth (6.0 percent per year versus 5.7 percent), but that difference is largely due to the emergence of high-paying jobs at Microsoft and Washington's generally higher inflation rate. When adjusted for these two factors—using data from a Microsoft impact study and estimates of the Seattle and Portland consumer price indexes—the Washington per capita income growth rate from 1970 to 2010 decreases from 6.0 percent to 5.8 percent, just 0.1 percentage point higher than the Oregon rate.

A common shortcoming of tax policy studies, like that of the Tax Foundation, is a strict focus on taxes and the presumption that states with the lowest taxes will generate the most jobs. They fail to recognize that reduced tax revenue means a diminished ability to provide the kind and level of public goods and services needed to make a state a good place to live and operate a business. As indicated by the zero correlation between the business tax climate and job creation, there is much more to economic growth and welfare than taxes.

4. TAX REFORM

Study findings. The principal objective of this study is to compare the Washington state and local tax system with the tax systems of other states and the District of Columbia. Based on an analysis of the fairness, adequacy, stability, transparency, and economic vitality, it is hard not to conclude that Washington has the worst state and local tax system in the nation.

1. **FAIRNESS.** Due to a reliance on regressive sales taxes, the Washington State Tax Structure Study Committee found that the lowest-income households paid 15.7 percent of their income on state and local taxes, while the highest-income households paid just 4.4 percent. This meant that low-income households had to work 8.2 weeks out of a year to pay their state and local tax bill, while high-income households had to work only 2.3 weeks. In 2013, the Institute on Taxation & Economic Policy characterized Washington's regressive tax system as the "most unfair" in the nation.
2. **ADEQUACY.** Washington's dependence on sales taxes has also created one of the most inadequate tax systems in the nation. Since 1970 the national norm for state and local tax revenue as a percent of personal income has been a relatively stable 10.6 percent. But the Washington state and local effective tax rate fell from 11.4 percent (the eleventh highest in the nation) in FY 1995 to 9.6 percent (the fourteenth lowest) in FY 2011. As a result of dropping well below the 10.6 percent norm, Washington state and local governments forfeited \$14.4 billion in tax revenue from FY 2005 to FY 2011. Without further increases in tax rates or the tax base, the Washington state and local effective tax rate is forecast to drop to 8.2 percent in FY 2025. That could make it the lowest effective tax rate in the nation.
3. **STABILITY.** The instability of the Washington state and local tax

MIXED MESSAGES.

The Great Recession has revealed the contradictions in our society with regard to government fiscal policy. Here are a few anecdotes courtesy of *The Seattle Times*.

No, no, no to increased taxes...At a time like this, you don't raise taxes because raising taxes is demanding more, and there isn't any more. There is less...Government should not add to people's economic hurt (April 17, 2009).

Almost every state is experiencing hard-core, near cataclysmic budget woes. States like Oregon that rely heavily on income tax. States like Washington that rely just as heavily on sales tax. States like California that rely on both. So it is hard not to chuckle at Oregon's leading newspaper: "Oregon's state finances desperately need stability, and a sales tax would provide that."...The money is always green on the other side (May 20, 2009).

\$1 billion in new taxes will cost Washington state residents jobs... These tax hikes will...depress the economy. The damage will be greater than it would have been had lawmakers shown more restraint and cut spending deeper (March 8, 2010).

A study by the Institute on Taxation & Economic Policy released just a few months ago again ranked Washington state's tax code dead last—50th out of the 50 states—in basic fairness. Yet for years we have lacked the political will to fix this problem (April 30, 2010).

The Seattle Times editorial board opposes Initiative 1098, the state income tax...(It) runs counter to the idea of government adjusting its appetite downward...I-1098 also takes away the most important tax-based advantage that Washington has in attracting businesses and jobs here: our lack of a state income tax. (June 18, 2010).

I am appalled that you want middle-class workers and the working poor, who are the hardest hit by this recession, to continue to bear the heaviest state taxes in the country (June 27, 2010).

A new report from the National Research Council finds that 15 doctoral programs at the University of Washington are tops among their peers at major universities across the country (October 5, 2010).

The University of Washington raised tuition and fees by the largest dollar amount in the school's history...At the same time, the school announced it will be doing "significant layoffs" to try to blunt the impact of a \$106 million cut in state funding this year (June 30, 2011).

Fully funding education in Washington will require more tax revenue. The Joint Task Force on Education Funding estimates that we will need \$1.4 billion in 2013-15 just to meet the true costs of basic education for all children...(and) \$4.5 billion by 2017 (March 4, 2013).

In an unscientific poll conducted by *The Seattle Times* on the question of how to close a \$1.3 billion state budget shortfall and fund education, on-line readers said: enhance revenue 57.4%, cut spending 17.6%, enhance revenue and cut spending 13.3%, prioritize spending putting education first 7.3%, and other 4.5% (March 21, 2013).

Source: *The Seattle Times*.



It is hard not to conclude that Washington has the worst state and local tax system in the nation. Among the tax systems, Washington ranks at or near the bottom in fairness, adequacy, stability, and transparency.





Given the enormity of the problems with the Washington tax system, major tax reform, including instituting a personal income tax, is the only solution.



system stems from the inadequacy of its tax base as well as the sensitivity of its effective tax rate to economic cycles. Because of the long-term decline in the Washington state and local effective tax rate, Washington had the forty-seventh most stable (the fifth most unstable) tax system between FY 1995 and FY 2011. In recent years, the Great Recession has taken a heavy toll on state government tax revenue. Measured in 2009 dollars, real per capita state government tax revenue fell from \$2,376 in FY 2007 to \$2,056 in FY 2013, a 13.5 percent decline. In FY 2011, due to lagging tax revenue, Washington ranked forty-sixth among states in current spending for elementary and secondary education per \$1,000 of personal income.

4. **TRANSPARENCY.** Without an income tax, the only totally transparent tax, the Washington state and local tax system ranked fiftieth in transparency in FY 2011. The Oregon tax system, featuring an income tax but no sales or business and occupation tax, was the most transparent.
5. **ECONOMIC VITALITY.** There is no evidence that the economic vitality of a state is affected one way or the other by its business tax climate, specifically, whether or not it has an income tax. The Tax Foundation rates Washington as having the sixth best business tax climate in the nation because of the absence of an income tax. But a statistical test of the fifty states and the District of Columbia reveals that there is virtually no correlation between the Tax Foundation business tax climate ranking and employment growth. The assertion that an income tax would hinder economic growth in Washington is also contradicted by local history. Despite fundamentally different tax structures—Washington has no income tax, while Oregon has an income tax but no sales tax or business and occupation tax—the Washington and Oregon economies have performed equally well since 1970.

Tax policy options. Fixing the dysfunctional Washington tax system is no easy task. Given the enormity of the problems, many remedies, such as closing tax loopholes and legalizing marijuana, will help but only on the margin.

Doing nothing is not an option, particularly given the inadequacy of the Washington state and local tax base. If the state and local effective tax rate is allowed to continue on its downward path, Washington will increasingly fall behind other states in its ability to provide high-quality

TAX POLICY OPTIONS

-  Maintain the current tax base and tax rates, causing a further decline in the adequacy of state and local tax revenue.
-  Raise the tax rates and broaden the tax base, exacerbating the unfairness of the tax system.
-  Institute an income tax, reduce the sales tax, and eliminate the business and occupation tax, all of which would increase the fairness, adequacy, stability, and transparency of the Washington tax system.

education, a safe place to live, adequate healthcare, and much needed infrastructure.

Working within the framework of the current tax system, however, creates a dilemma. If in the course of combating inadequacy Washington chooses to raise tax rates and broaden the tax base, it will exacerbate the regressivity of the tax system, which is already considered the most unfair in the nation.

Major tax reform, including instituting a personal income tax, is the only way out of this tax policy bind. Ironically, tax reform would not be an issue today if eighty years ago just one more justice of the Washington Supreme Court had acknowledged the wishes of voters and declared their proposed graduated income tax constitutional.

The intent of this study is not to design in detail an alternative tax system. Instead, the following discussion outlines two variants of the tax system that highlight the beneficial role of an income tax.

1. **ALTERNATIVE 1: INDIVIDUAL INCOME TAX SYSTEM.** The design of the first tax system is admittedly extreme, but it is far from unreasonable (Table 16). The tax system is a single-rate personal income tax. It is based on the presumption that, no matter what tax system is chosen, it is the people of Washington who ultimately pay the taxes.

Personal income, which is the total receipts or cash earned by people, is the tax base. The major components of personal income are labor income (wages and salaries, including benefits, and proprietors' income), property income (dividend, interest, and rent payments), and government transfer payments (old-age and disability income, medical benefits, income maintenance, and unemployment compensation). Washington personal income is estimated and reported quarterly by the U.S. Bureau of Economic Analysis.

The preferred single tax rate is 10.6 percent of personal income, equal to the average U.S. state and local effective tax rate since 1970. Of course, there is no reason why Washington citizens could not select a different rate.

A single-rate personal income tax has several attractive features. It is the simplest tax structure possible, making it easy to understand and apply. It is also a universal tax. No matter the source of income, every resident earning personal income would pay taxes. More importantly, with a tax rate of around 10.6 percent, 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.

In terms of fairness, adequacy, stability, and transparency, a single-rate personal income tax would be vastly superior to the current tax system. A flat-rate tax might be less desirable than a progressive tax, but it would nevertheless greatly reduce the unfairness of the present tax system. The state and local tax burden of the lowest-income households would be reduced by about one-third. The single-rate personal income tax would be perfectly adequate. There would no need to raise the tax rate or enhance the tax base to meet future revenue needs. Except for the ups and downs in tax revenue caused by fluctuations in personal income, the single-rate



One alternative tax system is a single-rate personal income tax with a preferred tax rate of 10.6 percent. The alternative tax system would be simple and universal. It would also be more fair than the current system, perfectly adequate and stable, and totally transparent. With a 10.6 percent tax rate, there would be no need for a sales tax, a business and occupation tax, a property tax, or any other excise tax.



Based on the findings of this study, if Washington were to adopt a single-rate personal income tax, it would have the best—not the worst—tax system in the nation.



tax system would also be perfectly stable. Finally, since the individual income tax is the only truly transparent tax, the single-rate personal income tax system would be totally transparent. In short, if Washington were to adopt a single-rate personal income tax, it would have the best—not the worst—tax system in the nation.

No doubt critics would still object to an income-based tax system,

TABLE 16 **ALTERNATIVE WASHINGTON TAX SYSTEMS, FY 2011**

Billions of Dollars

	State and Local Tax Revenue	Percent of Total	Effective Tax Rate (%) ¹
Current Tax System			
Tax revenue	28.4	100.0	9.6
Income	0.0	0.0	0.0
Individual	0.0	0.0	0.0
Corporate	0.0	0.0	0.0
Sales and gross receipts	19.7	69.4	6.6
General sales	9.6	33.7	3.2
Business and occupation	3.3	11.7	1.1
Other excise	6.8	24.0	2.3
Property taxes	8.7	30.6	3.0
Alternative 1: Individual Income Tax System			
Tax revenue	31.3	100.0	10.6
Income	31.3	100.0	10.6
Individual	31.3	100.0	10.6
Corporate	0.0	0.0	0.0
Sales and gross receipts	0.0	0.0	0.0
General sales	0.0	0.0	0.0
Business and occupation	0.0	0.0	0.0
Other excise	0.0	0.0	0.0
Property taxes	0.0	0.0	0.0
Alternative 2: U.S. Multi-Tax System²			
Tax revenue	31.6	100.0	10.7
Income	9.2	29.1	3.1
Individual	7.9	25.1	2.7
Corporate	1.3	4.0	0.4
Sales and gross receipts	12.3	38.9	4.2
General sales	6.7	21.2	2.3
Business and occupation	0.0	0.0	0.0
Other excise	5.6	17.7	1.9
Property taxes	10.1	32.0	3.4

¹The state and local effective tax rate is tax revenue as a percent of personal income. ²The multi-tax system is based on the tax distributions of the thirty-nine states and the District of Columbia that make use of all major taxes.

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Richard S. Conway, Jr.

arguing that it would hinder economic growth, despite evidence to the contrary. But the findings of this study suggest that the concern over an income tax is not only unfounded but also misdirected. Since 2000 the chief threat to the economy has been the inadequacy of the current sales-based tax system.³ Without major tax reform or substantial increases in taxes, the latter aggravating the regressivity of the tax system, Washington's schools, highways, public transportation, parks, police and fire departments, public health operations, and environment face a dark future. A deteriorating public sector is hardly conducive to long-run economic growth and welfare.

2. **ALTERNATIVE 2: U.S. MULTI-TAX SYSTEM.** The second tax system might best be described as "one like most others." Seven states do not have an individual income tax (Washington, Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming), while four states do not have a sales tax (Oregon, Delaware, Montana, and New Hampshire). The remaining thirty-nine states and the District of Columbia make use of all major taxes.

In FY 2011, the state and local effective tax rate for the thirty-nine states and the District of Columbia with a full complement of taxes was 10.7 percent of personal income, slightly above the 10.6 percent norm. If Washington had adopted their tax structure, its total state and local tax revenue would have amounted to \$31.6 billion. This would have been \$3.2 billion (11.3 percent) more than the \$28.4 billion actually collected.

The breakdown of Washington state and local taxes would have been \$9.2 billion in personal and corporate income taxes (29.1 percent of the total), \$6.7 billion in sales taxes (21.2 percent), \$5.6 billion in other excise taxes (17.7 percent), and \$10.1 billion in property taxes (32.0 percent). The effective tax rates would be 10.7 percent for total state and local taxes, 3.1 percent for income taxes, 2.3 percent for sales taxes, 1.9 percent for other excise taxes, and 3.4 percent for property taxes.

The multi-tax system would also be superior to the current tax system. As evident in the analysis of the single-rate personal income tax, any presence of an income tax would enhance the fairness, adequacy, stability, and transparency of the Washington tax system. The most important improvement with the multi-tax system would be the increased adequacy of tax collections. Washington would have collected not only \$3.2 billion more in taxes in FY 2011 but also approximately \$10 billion more over the preceding five years.

With an income tax it would be possible to eliminate the business and occupation tax, much of which is passed on to consumers in the form of higher prices. Removal of this unfair high-rate gross receipts tax would send a message that Washington is a business-friendly state. Indeed, since the corporate income tax accounts for only 3.6 percent of total state and local tax revenue nationally, it might be beneficial from the standpoint of economic vitality to eliminate business taxes altogether in Washington.



A second alternative tax system might best be described as "one like most others." It would utilize all taxes, including the individual and corporate income tax, in accordance to the distribution of state and local taxes nationally.



The inclusion of an individual income tax would enhance the fairness, adequacy, stability, and transparency of the Washington tax system. An income tax would eliminate the need for a business and occupation tax and would reduce the retail sales tax rate from about 9 percent to 6 percent.



³In recent years, the statutory limit on property taxes has significantly aggravated the problem of adequacy, especially for local governments. The restriction on the annual increase in property taxes—one percent plus the taxes on new property—is currently so tight that eventually it will have to be loosened whether or not there is major tax reform.

An income tax would also generate sufficient revenue to significantly reduce the retail sales tax rate. In FY 2011, excluding business and occupation taxes, Washington collected \$9.6 billion in general sales taxes, implying a 3.3 percent effective tax rate. In the multi-tax system sales taxes would have summed to only \$6.7 billion, yielding an effective tax rate of 2.3 percent. A decline in the effective tax rate from 3.3 percent to 2.3 percent would correspond to a drop in the Washington state and local retail sales tax rate from approximately 9 percent to 6 percent.



Considering the increasingly dysfunctional Washington state and local tax system, especially with regard to fairness and adequacy, tax reform is almost certainly inevitable.



Tax reform is a highly contentious issue and is unlikely to be on the ballot anytime soon. The resistance to change is widespread. An income tax is commonly viewed as the “third rail” of politics. Some citizens prefer the current system because it is beneficial to them. Others fear that tax reform is just another way to get into their wallets. But the overriding fact of the matter is that the Washington state and local tax system has become—and will continue to become—increasingly dysfunctional over the years, especially with regard to fairness and adequacy. In light of that, tax reform is almost certainly inevitable.

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