

# Special Topic: Washington Tax Structure

## Dysfunctional.

Taxpayers dodged a bullet in the last Washington legislative session but school children and university students got hit. A record deficit in the state's budget turned the gathering into a politician's nightmare. Should we raise taxes in the middle of a recession or cut funding to vital programs? After briefly considering various tax hikes, the governor and legislature decided to increase class size and raise college tuition.

It is tempting to dismiss the state's financial predicament as a one-time event caused by an extreme economic downturn. But in fact there is a more systemic problem: the Washington tax structure is dysfunctional. This is the second time in ten years that it has broken down.

Its fundamental weakness is an extraordinary reliance on sales taxes. In FY 2005-06, general sales taxes (retail sales and business gross receipts taxes) accounted for 61.1 percent of total state and local taxes collected in Washington, compared to only 34.5 percent nationally. Washington is one of only four states without either a corporate or personal income tax.

In 2002, the Washington State Tax Structure Study Committee evaluated the retail sales tax, the largest source of state and local

revenue, along three principles—fairness, adequacy, and stability—and found it wanting.

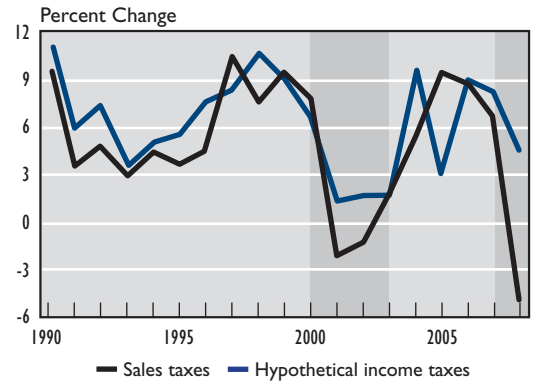
One way to judge the retail sales tax is to compare it with a hypothetical flat-rate tax on personal income. The sales tax base is taxable retail sales (including new construction), while the income tax base is personal income (excluding capital gains). Washington's effective combined state and local sales tax rate is about 8.5 percent. To generate the same amount of revenue for state and local governments, the income tax rate would have to be 3.5 percent.

Based on the three principles, how do these two taxes stack up?

1. *Fairness.* Washington's sales-based tax structure is highly regressive. The Institute on Taxation and Economic Policy has concluded that, lacking an income tax, "Washington has the most unfair tax system in the nation." It is likely that the tax structure becomes even more regressive during recessions, since low income households tend to bear the brunt of the job losses.

2. *Adequacy.* This refers to the ability of a tax base to keep up with the demand for public services, which grows about as fast as personal income. We estimate that the long-run elasticity of taxable retail sales with respect to person-

**Puget Sound Retail Sales Taxes and Hypothetical Personal Income Taxes**



al income is 0.9. This means that a 10 percent rise in income, for example, elicits only a 9 percent increase in taxable retail sales. Largely because of two severe recessions, Puget Sound taxable retail sales growth between 1990 and 2008 (4.7 percent per year) significantly trailed personal income growth (6.1 percent). One implication of an inadequate tax base is the need to periodically raise tax rates. The retail sales tax rate in King County recently jumped to 10.0 percent.

3. *Stability.* It is the volatility of sales taxes that is now thumping state and local governments, much like it did during the 2001-03 recession. After increasing 7.2 percent in 2007, Puget Sound taxable retail sales fell 5.2 percent in 2008. And taxable sales could plummet another 10 percent or so in 2009. There is no doubt that a flat-rate income tax would have outperformed the sales tax over the past two decades. As evident in the chart, income tax collections would have grown more stably and would have never declined.

Given Washington voters' distain for an income tax, the likelihood of changing the tax system—even for the better—is small. But two recessions may have upped the odds.

## Washington and U.S. State and Local Taxes, FY 2005-06

Percent of Total Taxes	Washington	United States
Property	27.4	30.0
Sales and gross receipts	61.1	34.5
Income	0.0	26.9
Other	11.5	8.6
<b>Total taxes</b>	<b>100.0</b>	<b>100.0</b>
Taxes per capita* (\$)	3948 (18)	4001
Taxes per \$1000 of income* (\$)	112 (28)	116

\*Including rank among states.

# Special Topic: Washington Tax Structure (2)

**Time for change.**

The tax structures of Washington, Oregon, and California could not be more different. Washington has a sales tax, a unique business gross receipts tax, but no income tax; Oregon has a flat-rate income tax but no sales tax; and California has a progressive income tax and a sales tax. About the only thing these tax systems have in common has been an inability to generate anything close to sufficient revenue during the current recession.

The big cuts in state and local spending necessitated by falling tax revenues have prompted a few calls for tax reform. But most voters continue to resist the idea of tax change. They fear that tax reform is just another way for government to get into their pockets.

Which raises a critical but seldom asked question: how much should state and local government tax? If we could answer that question, we could then rationally discuss how best to collect taxes.

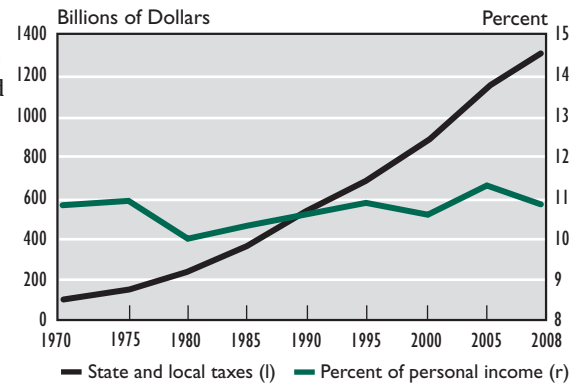
Based on the behavior of state and local governments over the past forty years, the answer to this potentially thorny question is pretty clear: state and local governments should tax households

and businesses an amount equal to 11 percent of personal income. Between 1970 and 2008, U.S. state and local tax collections averaged 10.8 percent of personal income (\$108 per \$1,000 of income). The ratio was 10.9 percent in both 1970 and 2008. Economic cycles have caused minor variations in the ratio over time; it hit a low of 9.8 percent in the recession year of 1982 and a high of 11.6 percent in the boom year of 1972. In FY 2005-06, the latest year for which individual state data are available, Washington state and local tax revenues amounted to 11.2 percent of personal income, down from 12.0 percent ten years earlier.

If Washington were to adopt this 11 percent norm, it would in effect put a lid on the growth of state and local taxes. But the lid would be considered “adequate,” since taxes would be allowed to increase at the same rate as personal income (see the June special topic).

The concept of a lid is nothing new. On the fall ballot is Initiative 1033, which proposes to limit tax growth to a rate determined by population change and inflation. While this restriction may sound reasonable, it would result in a grossly inadequate tax system. Consider what would have happened between 2000 and 2008, when Washington personal income expanded at a 5.0 percent annual rate, population increased at a 1.3 percent rate, and the inflation rate averaged 2.5 percent. Under the “11 percent lid” taxes would have grown at a 5.0 percent rate, thereby keeping taxes at \$108 per \$1,000 of income, close to the national norm. Under the “1033 lid” taxes would have risen at only a

**U.S. State and Local Taxes**



3.8 (=1.3+2.5) percent rate. In that case, tax revenue to fund schools, infrastructure, and other public needs would have dropped to \$98 per \$1,000 of income in 2008, well below the national norm. Since the population/inflation growth rate almost always falls short of the income growth rate, Initiative 1033 would result in a slow dismantling of the Washington public sector.

Based on two essays, it may seem presumptuous to propose a new tax system. But there is a better way to collect state and local taxes in Washington. Moreover, it is important to give serious thought to our state’s tax structure before we say yes to Initiative 1033 and opt for something much worse.

What would a reformed tax structure look like? Total tax collections would be limited to 11 percent of personal income. A flat-rate personal income tax would partially replace the sales tax, thereby improving the fairness, adequacy, and stability of tax collections. A corporate income tax would replace the business and occupation tax, thereby enhancing the competitiveness of Washington businesses. Ultimately, the new tax system, incorporating many of the recommendations made by the Washington State Tax Structure Committee, would look a lot like everyone else’s.

**U.S. State and Local Taxes**

Billions of Dollars	1970	1990	2008
Personal income	10.9	109.6	305.9
Corporate income	3.5	22.5	47.6
Sales	31.6	184.3	436.3
Property	36.7	161.5	404.6
Other	8.3	41.3	124.1
Total taxes	91.3	519.1	1318.6
<b>Percent of personal income</b>			
Personal income	1.3	2.2	2.5
Corporate income	0.4	0.5	0.4
Sales	3.8	3.8	3.6
Property	4.4	3.3	3.3
Other	1.0	0.9	1.0
Total taxes	10.9	10.6	10.9