Washington Research Council

Policy Brief

May 22, 2019 PB 19-12

Despite Substantial Recent Revenue Growth, Legislature Increases Taxes by Over $1 Billion

Briefly

The March revenue forecast estimated that 2019–21 revenues will be $50.555 billion, an increase of 9.6 percent over 2017–19 (also as estimated in the March forecast). Nevertheless, the Legislature passed several tax bills that will increase total revenues by a net of $1.101 billion in 2019–21 (based on the most recent fiscal estimates). Of that, about $908.0 million will go to funds subject to the outlook and the new workforce education investment account. With the new revenue bills, 2019–21 revenues are projected to increase by 11.4 percent over 2017–19.

Among the enacted tax bills are a workforce education investment business and occupation (B&O) tax surcharge on certain sectors in the "other business or service activities" category, an additional B&O tax on large financial institutions, and a graduated real estate excise tax. Notably, the Legislature did not pass a capital gains tax.

Some of the tax changes will worsen budget sustainability by increasing revenue volatility and directing revenues to dedicated funds (thereby avoiding transfers to the rainy day fund, which helps manage volatility, and, in some cases, avoiding the four-year balanced budget requirement). There are also some questions about constitutionality and transparency and concerns about increasing business tax burden.

The Economic and Revenue Forecast Council (ERFC) estimated in the March forecast that 2019–21 revenues will be $50.555 billion. This is $5.6 billion higher than the revenue forecast on which the 2018 supplemental to the 2017–19 budget was based. That level of revenues is more than enough to fund the $50.485 billion maintenance level for 2019–21. (And, along with other existing state resources, it would allow for new policy spending as well.)

Nevertheless, legislators passed several bills this year (many in the last few days of the legislative session) that significantly increase taxes. (Despite being proposed in both the House and Senate, a capital gains tax was not enacted.) Although the governor has now signed the bills, fiscal notes are still being finalized for some of them. Based on the most recent publicly-available information, the Legislature increased 2019–21 revenues from funds subject to the outlook (NGFO) and the new workforce education investment account (WEIA) by a net of $908.0 million. Including impacts to other accounts, the Legislature increased revenues by a net of $1.101 billion. (These figures include the impact of SSB 5581, which is also accounted for in the March revenue forecast. See Table 1 on page 2.)

The March revenue forecast estimated that NGFO revenues for 2017–19 will be 18.1 percent higher than in 2015–17. With the revenue legislation passed this year, revenues are projected to increase by 11.4 percent in 2019–21. (Without the new legislation, they were estimated to increase by 9.6 percent.)

(For an overview of the 2019–21 budget

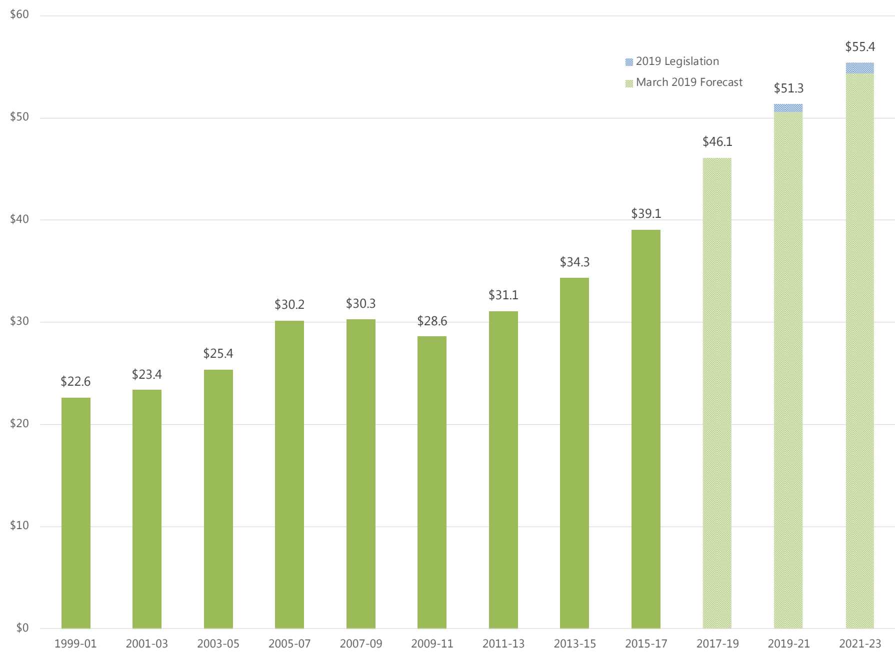
NGFO Plus WEIA

In recent years, legislative fiscal committee staffs have based budget presentations on a synthetic "account" that rolls up the general fund–state (the state's primary budget account) with the education legacy trust account and the opportunity pathways account, because they believe that it better reflects the entire budget situation. Previously called the near general fund–state plus opportunity pathways (NGFS+), it is now more simply called "funds subject to the outlook" or the near general fund–outlook (NGFO). (Under the four-year balanced budget requirement, a positive ending balance is required in both the current and following biennium on an NGFO basis.)

In 2019, the Legislature created the workforce education investment account (WEIA) to fund higher education programs. As these programs would typically be funded through the NGFO, it is appropriate for budget transparency purposes to roll up the WEIA with the NGFO (though the WEIA is not included in the four-year balanced budget requirement).

deal and details on appropriations, see our earlier reports: "Legislature Adopts New Taxes to Increase 2019–21 Spending by 18.3 Percent" and "State Operating Appropriations for 2019–21 Increase by 18.3 Percent, Topping $50 Billion.")

Chart 1: Revenues in Funds Subject to the Outlook Plus WEIA (Dollars in Billions)



Business and Occupation (B&O) Tax Changes

Workforce Education Investment Surcharge. E2SHB 2158 imposes a surcharge of 20 percent on top of current B&O taxes for businesses in certain sectors in the "other business or service activities" category beginning Jan. 1, 2020. Their B&O tax rate will increase from 1.5 percent to 1.8 percent.

Table 2 (on page 3) lists the 43 types of businesses subject to the 20 percent surcharge under the bill. The bill states that these are "professions that depend on higher education," but there is no public information about the basis on which these industries were chosen.

Additionally, advanced computing businesses are subject to higher surcharges under the bill. The surcharge is 33.3 percent for affiliated groups of advanced computing businesses with worldwide gross revenue of more than $25 billion up to $100 billion (their B&O tax rate will increase from 1.5 percent to 2.0 percent). The surcharge is 66.7 percent for affiliated groups of advanced computing businesses with worldwide gross revenue of more than $100 billion (their B&O tax rate will increase from 1.5 percent to 2.5 percent). Affiliated groups will have to

Table 1: Revenue Impacts of 2019 Legislation (Dollars in Millions)

		NGFO + WEIA			Other Accounts			Total Revenue Effect		
		2019-21	2021-23	Four-year Total	2019-21	2021-23	Four-year Total	2019-21	2021-23	Four-year Total
Major Revenue Increases										
E2SHB 2158	Workforce Education Investment (B&O)	$380.0	$393.1	$773.1	$0.1	$0.1	$0.2	$380.1	$393.2	$773.3
ESSB 5998	Graduated REET	$243.5	$354.8	$598.3	$1.0	$1.4	$2.4	$244.5	$356.2	$600.7
SHB 2167	Financial Institutions (B&O)	$133.2	$205.6	$338.8	–	–	–	$133.2	$205.6	$338.8
SSB 5581*	Wayfair (Sales, B&O)	$114.9	$190.0	$304.9	$1.0	$1.6	$2.6	$115.9	$191.6	$307.5
ESB 6016	International Investment Management (B&O)	$59.4	$66.1	$125.5	$0.003	$0.0	$0.003	$59.4	$66.1	$125.5
ESSB 5997	Refund Program for Nonresidents (Sales)	$53.8	$58.9	$112.8	$0.1	$0.1	$0.2	$53.9	$59.0	$112.9
ESSB 6004	Travel Agents and Tour Operators (B&O)	$4.7	$5.3	$10.0	–	–	–	$4.7	$5.3	$10.0
E2SHB 1873**	Vapor Products Tax									
2SHB 1087	Long-term Care Payroll Tax	–	–	–	$0.1	$1,298.8	$1,298.9	$0.1	$1,298.8	$1,298.9
ESSB 5993	Model Toxics Control (Hazardous Substance)	–	–	–	$172.5	$201.9	$374.4	$172.5	$201.9	$374.4
ESSB 5313**	Local Levy Lid Lift (Property)	–	–	–						
Subtotal		**$989.5**	**$1,273.9**	**$2,263.4**	**$174.9**	**$1,503.9**	**$1,678.7**	**$1,164.4**	**$2,777.7**	**$3,942.1**
Other Revenue Legislation		**-$81.5**	**-$27.4**	**-$108.9**	**$18.5**	**$26.8**	**$45.3**	**-$63.1**	**-$0.6**	**-$63.6**
Net Total		**$908.0**	**$1,246.5**	**$2,154.4**	**$193.3**	**$1,530.7**	**$1,724.0**	**$1,101.3**	**$2,777.2**	**$3,878.4**

* The revenue impact of SSB 5581 is accounted for in the March revenue forecast.

** A fiscal note based on the bill as passed is not yet available.

pay combined advanced computing surcharges of at least $4 million but not more than $7 million a year.

A partial fiscal note estimates that the bill will impact 82,000 businesses and increase total revenues by $380.1 million in 2019–21 and $393.2 million in 2021–23. All revenues will be deposited in the new workforce education investment account to be used for higher education purposes. (This means that the revenues from the surcharges will not be subject to constitutionally-required transfers to the rainy day fund or the four-year balanced budget requirement, as we discuss below.)

Table 2: Sectors Subject to 20 Percent Workforce Education Investment Surcharge (NAICS Code)

5112	Software Publishers
5417	Scientific Research and Development Services
5231	Securities and Commodity Contracts Intermediation and Brokerage
54151	Computer Systems Design and Related Services
5211	Monetary Authorities-Central Bank
51791	Other Telecommunications
5239	Other Financial Investment Activities
5191	Other Information Services
5413	Architectural, Engineering, and Related Services
454	Nonstore Retailers
5416	Management, Scientific, and Technical Consulting Services
5182	Data Processing, Hosting, and Related Services
5223	Activities Related to Credit Intermediation
5411	Legal Services
517311	Wired Telecommunications Carriers
5174	Satellite Telecommunications
517312	Wireless Telecommunications Carriers (except Satellite)
5222	Nondepository Credit Intermediation
5241	Insurance Carriers
4234	Professional and Commercial Equipment and Supplies Merchant Wholesalers
5152	Cable and Other Subscription Programming
5111	Newspaper, Periodical, Book, and Directory Publishers
2211	Electric Power Generation, Transmission and Distribution
5414	Specialized Design Services
5331	Lessors of Nonfinancial Intangible Assets (except Copyrighted Works)
5242	Agencies, Brokerages, and Other Insurance Related Activities
4251	Wholesale Electronic Markets and Agents and Brokers
5221	Depository Credit Intermediation
33641	Aerospace Product Parts Manufacturing
5418	Advertising, Public Relations, and Related Services
54121	Accounting, Tax Preparation, Bookkeeping, and Payroll Services
62111	Offices of Physicians
6214	Outpatient Care Centers
5259	Other Investment Pools and Funds
8139	Business, Professional, Labor, Political, and Similar Organizations
55111	Management of Companies and Enterprises
62151	Medical and Diagnostic Laboratories
9211	Executive, Legislative, and Other General Government Support
5611	Office Administrative Services
5419	Other Professional, Scientific, and Technical Services
6212	Offices of Dentists
6213	Offices of Other Health Practitioners
6219	Other Ambulatory Health Care Services

The bill includes language that any ambiguity or question about whether the provisions apply to a particular business "should be construed in favor of application of the surcharges" through Dec. 31, 2021. This is an unusual standard not applied to other general tax sources. Consequently, the fiscal note states, "There is reduced compliance and the possibility of refunds starting in Fiscal Year 2022, as a result of the expiration date of the evidentiary standard." Also, the Department of Revenue (DOR) "anticipates that a significant number of taxpayers will contest letter rulings, assessments and determinations."

Additional Tax on Large Financial Institutions. Financial institutions are currently subject to a 1.5 percent B&O tax rate (under the "other business or service activities" category). SHB 2167 imposes an additional tax of 1.2 percent for financial institutions with annual net income of at least $1.0 billion.

The combination of this additional tax and the workforce education investment surcharge means that there will be seven potential B&O tax rates on businesses in the "other business or service activities" category, ranging from 1.5 percent to 3.7 percent (Mahon and Barton 2019). Large financial institutions will pay rates of 3.0 percent, 3.2 percent, or 3.7 percent, depending on whether they are members of affiliated groups subject to the advanced computing surcharges under E2SHB 2158.

A partial fiscal note estimates that SHB 2167 will increase general fund–state (GFS) revenues by $133.2 million in 2019–21 and $205.6 million in 2021–23. According to the fiscal note, the bill will affect about 20 taxpayers (none of whom are headquartered in Washington). There is some concern that the bill's treatment of out-of-state banks may violate the interstate commerce clause of the U.S. Constitution.

The text of this bill was first made public on April 26 (two days before the scheduled end of the 105-day legislative session. The bill was passed on that same day by the House and on April 28 by the Senate. According to Crosscut, House Finance Committee Chair Gael Tarleton "said the last-minute bank-tax bill was needed after Senate leaders once again rejected the House's proposal to enact a capital-gains tax" (Santos 2019).

International Investment Management Tax Rate. ESB 6016 narrows eligibility for the preferential B&O tax rate (0.275 percent) for international investment management services to companies with more than 25 percent of their employees located in Washington and that are members of affiliated groups with 10 or more offices in at least eight other countries, have at least 500 employees worldwide, have worldwide gross revenues of more than $400 million, and have average assets under management of more than $200 billion. International investment management services companies that no longer qualify for the preferential rate will be subject to a rate of 1.5 percent (unless they are subject to the surcharge under E2SHB 2158). (The bill also extends a sales and use tax exemption for sales of standard financial information by 10 years.) The fiscal note estimates the bill will increase revenues by $59.4 million in 2019–21 and $66.1 million in 2021–23.

Travel Agents and Tour Operators Tax Rate. ESSB 6004 increases the B&O tax rate on travel agents and tour operators that have annual taxable amounts of more than $250,000 from 0.275 percent to 0.9 percent beginning July 1, 2019. (This is still a preferential rate; typically, these businesses would be subject to a rate of 1.5 percent.) The tax rate for travel agents and tour operators with annual taxable amounts of $250,000 or less will remain 0.275 percent. The fiscal note estimates that the bill will increase GFS revenues by $4.7 million in 2019–21 and $5.3 million in 2021–23.

Real Estate Excise Tax Changes

Under current law, the real estate excise tax (REET) rate is a flat 1.28 percent of the sales price of real property. ESSB 5998 graduates the rate to reduce the tax for some taxpayers and increase it for others. Beginning Jan. 1, 2020, the rate will be 1.1 percent on the portion of the selling price that is $500,000 or less; 1.28 percent on the portion that is between $500,000 and $1.5 million; 2.75 percent on the portion between $1.5 million and $3.0 million; and 3.0 percent on the portion that is more than $3.0 million. (Every four years, the selling price thresholds will be adjusted to the lesser of the growth in the consumer price index for shelter or 5 percent.)

The 1.28 percent flat rate will still apply to sales of timberland and agricultural land. The bill also expands the time period over which the transfer or acquisition of a "controlling interest in any entity with an interest in real property located in the state" is deemed to be a taxable sale for purposes of the REET from 12 months to 36 months.

The bill is expected to increase total revenues by $244.5 million in 2019–21 and $356.2 million in 2021–23. The bill will also increase the portion of REET revenues that are dedicated to the education legacy trust account, thereby avoiding contributions to the rainy day fund (see Table 3).

(Of the increased revenues under the bill, just $23.0 million in 2019–21 and $32.5

Table 3: REET Revenue Distribution

	Current Law		ESSB 5998	
	Through 6/30/2023	Beginning July 1, 2023	1/1/2020 - 6/30/2023	Beginning July 1, 2023
General Fund-State	92.3%	92.3%	79.4%	79.4%
Public Works Assistance Account	2.0%	6.1%	1.7%	5.2%
City-County Assistance Account	1.6%	1.6%	1.4%	1.4%
Education Legacy Trust Account	4.1%	--	17.5%	14.0%

Chart 2: State Real Estate Excise Tax Due

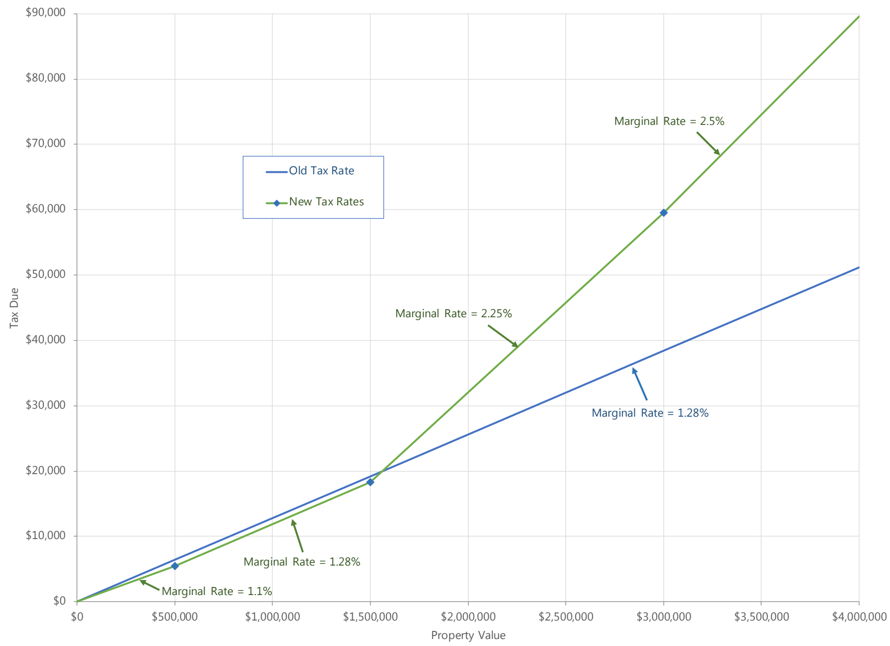
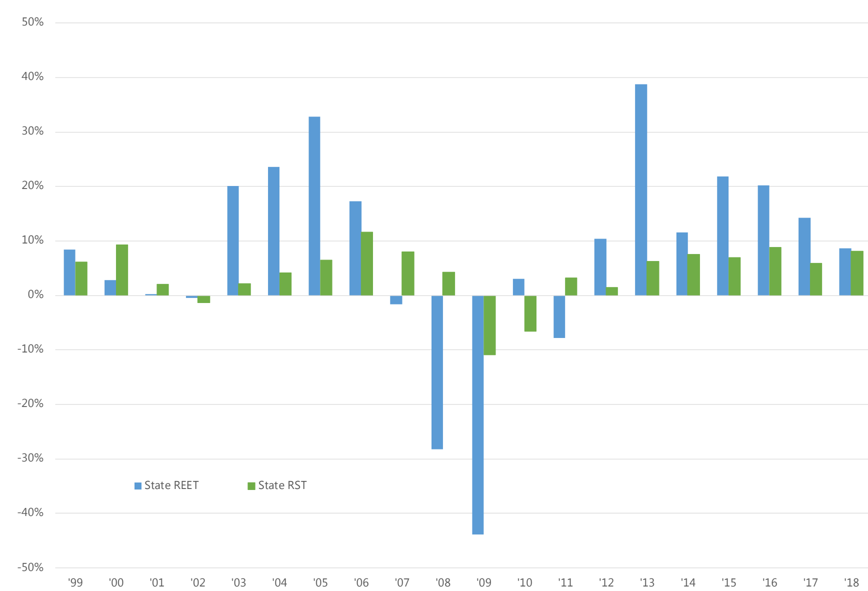


Chart 3: Volatility of State Real Estate Excise Tax Compared to that of State Retail Sales Tax (Percent Change In Revenue from Preceding Fiscal Year)



million in 2021–23 go to the GFS.)

Under the new rates, properties sold for up to $1.56 million will be taxed less than under the current flat rate and properties sold for more than $1.56 million will be taxed more. (See Chart 2.) Effectively, the new graduated rate will reduce taxes on much of the single-family housing market, while dramatically increasing taxes on multifamily residential and commercial property transactions.

By graduating the REET, the Legislature is making a volatile tax even more volatile. Chart 3 shows the volatile nature of collections from the current flat rate REET. This volatility will increase when the rate is graduated, because the average REET rate will rise as the average sales price rises (and fall as the average sales price falls).

Sales Tax Changes

Wayfair. In 2017, the Legislature enacted EHB 2163, which requires remote sellers and others to either collect and remit sales taxes or notify Washington customers that they owe taxes and report Washington customer information to the Department of Revenue. Subsequently, in June 2018, the U.S. Supreme Court held that states can require out-of-state sellers to collect and remit sales taxes sold to their residents (South Dakota v. Wayfair Inc). Early in the 2019 session, the Legislature passed SSB 5581. The bill makes changes to state sales tax law to conform with the Supreme Court's decision, and it makes changes to other tax areas (including the B&O tax) for consistency. These changes are expected to increase total revenues by $115.9 million in 2019–21 and $191.6 million in 2021–23. Because the bill became law on March 14, its revenue effects are included in March revenue forecast.

Refund Program for Nonresidents. ESSB 5997 changes the current sales tax exemption for nonresidents to a refund program. Under the bill, nonresidents making purchases in Washington will pay state and local sales taxes to the seller. The following calendar year, these buyers may request a refund of sales taxes paid from the Department of Revenue. Only one request may be made per year, and the total amount to be refunded must be at least $25. The fiscal note assumes "a small decrease in purchases" because applying the sales tax to purchases will increase their cost to buyers. Still, the fiscal note expects that nonresidents will continue to shop in Washington and that 100,000 of them will make refund claims annually. (Opponents of the bill, primarily from southwest Washington, disagree with that conclusion.) The fiscal note estimates that the refund program will increase state revenues by $53.9 million in 2019–21 and $59.0 million in 2021–23.

Property Tax Changes

ESSB 5313 increases school district levy limits. In calendar year 2018, school districts could levy up to 28 percent of their state and federal revenues. As part of the state's response to the McCleary decision on school funding, the Legislature further limited levies so that in CY 2019, districts may levy the lesser of $1.50 per $1,000 of assessed value or $2,500 per pupil (RCW 84.52.0531). (The reduction in local levies was paired with an increase in the state property tax to $2.70 per $1,000 of assessed value for CY 2018 through 2021. Legislation in 2018 reduced the state property tax to $2.40 per $1,000 of assessed value for CY 2019 only. In CY 2020, the rate will go back to $2.70 per $1,000 of assessed value as originally planned.)

Under ESSB 5313, beginning in CY 2020, districts with fewer than 40,000 students may levy the lesser of $2.50 per $1,000 of assessed value or $2,500 per pupil. Districts with 40,000 or more students (i.e., Seattle Public Schools) may levy the lesser of $2.50 per $1,000 of assessed value or $3,000 per pupil. (This increase in the levy limit creates a potential twofold property tax increase in CY 2020, depending on the location of property and decisions by local school boards and voters.)

There is no fiscal note for the bill as passed, but Senate Committee Services estimates that the bill will increase the revenue generated from local levies by $419.3 million and tax rates by $0.32 statewide in CY 2020, compared to what they would have been in CY 2020 if ESSB 5313 were not enacted (SCS 2019). The actual change in levy collections will depend on local voter approval and will vary by district.

Other Tax Changes

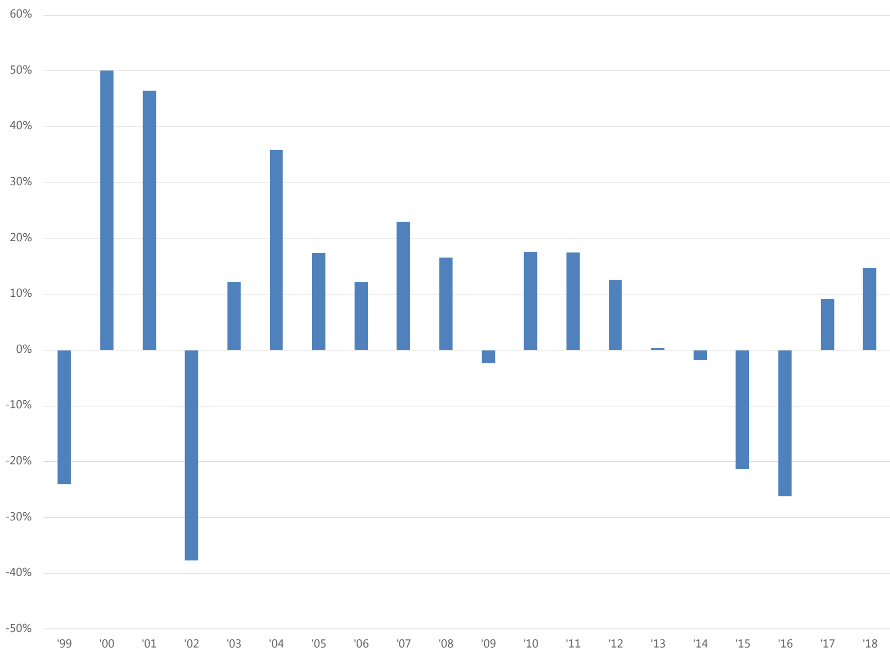
Vapor Products Tax. E2SHB 1873 imposes a tax on vapor products of $0.09 per milliliter of solution for accessible containers of solution that are larger than five milliliters and $0.27 per milliliter of solution for all other vapor products. Revenues are to be split equally between the Andy Hill cancer research endowment fund match transfer account and a new foundational public health services account. There is not yet a fiscal note on the bill as passed by the Legislature.

Long-Term Care Payroll Tax. Beginning Jan. 1, 2022, 2SHB 1087 imposes a payroll tax of 0.58 percent of wages to fund a new long-term care benefit. The premiums will be deposited in the new long-term services and supports trust account. Non-NGFO revenues are estimated to increase by $1.299 billion in 2021–23.

Hazardous Substance Tax (HST). Currently, hazardous substances are taxed at a rate of 0.7 percent of wholesale value. Under ESSB 5993, beginning July 1, 2019, the rate will be $1.09 per barrel for petroleum products. Every year, the per-barrel rate will be adjusted by the implicit price deflator for nonresidential structures. (The hazardous substance tax rate for non-petroleum products is unchanged; these products account for about 4.8 percent of HST collections under current law, according to the fiscal note.)

The primary policy objective of the bill is

Chart 4: Volatility of the Current Hazardous Substance Tax (Percent Change In Revenue from Preceding Fiscal Year)



Budget Sustainability Requirements

The state constitution requires that 1 percent of general state revenues be transferred to the budget stabilization account (BSA, or rainy day fund) each year. "General state revenues" include most state money for the general fund, but not dedicated funds (like the education legacy trust account, or the new workforce education investment account).

Additionally, the constitution requires that three-quarters of any extraordinary revenue growth be transferred to the BSA at the end of each biennium. "Extraordinary revenue growth" is defined as "the amount by which the growth in general state revenues for that fiscal biennium exceeds by one-third the average biennial percentage growth in general state revenues over the prior five fiscal biennia." Washington experienced extraordinary revenue growth in 2013–15, 2015–17, and (as currently estimated) 2017–19.

Another budget sustainability tool is the four-year balanced budget requirement. The Legislature must pass budgets that leave positive ending fund balances in the general fund and related funds (RCW 43.88.055). "Related funds" are defined as the opportunity pathways account and the education legacy trust account. These accounts are both dedicated to education.

"to achieve the financial stability, transparency, and long-term protection of revenues." Indeed, the new tax structure is expected to generate considerably more revenue. The fiscal note estimates that it will increase non-NGFO revenues by $172.5 million in 2019–21 and $201.9 million in 2021–23. (The bill increases revenues by 55.7 percent in 2019–21 and by 61.3 percent in 2021–23 over projected revenue for the respective biennia under current law.)

This tax is ultimately borne by retail customers. We estimate that ESSB 5993 will increase the price of gasoline by about 1 cent per gallon.

In addition to increasing revenues, the bill states that it "[e]liminates the year-to-year volatility of hazardous substance tax revenues by moving to a volumetric rate for petroleum products." Indeed, HST revenue has been volatile, as the wholesale prices of most petroleum products move up and down with the price of crude oil (see Chart 4). The changes made by the bill will make the HST less volatile. However, the choice to index the tax to the implicit price deflator for nonresidential structures—rather than to the more commonly used and less volatile personal consumption expenditure implicit price deflator—means that the HST will be less stable than it otherwise could be.

Comment

In 2019, the Legislature increased total taxes by a net of about $1.101 billion in 2019–21 and $2.777 billion in 2021–23 (the substantial increase in the second biennium occurs because the long-term care payroll tax isn't imposed until 2021–23). Excluding revenues from the long-term care payroll tax and the hazardous substance tax (which are not intended to fund general programs), total revenues increase by about $928.7 million in 2019–21 and $1.277 billion in 2021–23. Of these revenues, just $307.5 million in 2019–21 and $531.1 million in 2021–23 are directed to the general fund.

From a budget sustainability perspective, the tax changes with the largest revenue impacts raise some flags. First, there are potential constitutional issues with some of them. If any of the tax bills are challenged and found to be unconstitutional, the 2019–21 budget could be put out of balance or planned spending programs could go unfunded.

Second, most of the new revenues are directed to accounts other than the general fund, even when they will fund general programs. This means that they will bypass the rainy day fund, an important tool for managing revenue volatility (which will increase under the graduated REET, for example) and maintaining spending programs during economic downturns. (See the box on page 7.) Dedicated accounts also reduce the transparency of the budget. To help improve transparency, the WEIA, which is dedicated to education, should at least be included in the four-year balanced budget requirement.

Third, transparency was also lacking in the process by which some of these bills were passed. The workforce education investment B&O tax surcharge is specifically targeted at certain industries, but the criteria by which those industries were chosen is not clear. Also, the additional B&O tax on financial institutions was introduced and passed during the last few days of the session with hardly any vetting.

The tax increases were passed despite the anticipated 9.6 percent increase in revenues in 2019–21 from economic growth. Those revenues would have been more than enough to fund maintenance level spending (including the McCleary response). Further, this level of revenue growth is on top of revenue increases of 18.1 percent in 2017–19 and 13.8 percent in 2015–17, adding to concerns about whether the 2019–21 budget can be sustained in the future—particularly when the inevitable economic downturn arrives.

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