Washington Research Council

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Corporate, Personal Income Taxes Proposed Higher Property Taxes Allowed

Embraced now by the governor, the tax reform package proposed by Rep. Art Wang (D–Tacoma), referred to as Governor II or Gov. II, is substantially different from the governor's original proposal. Rather than a single constitutional amendment and accompanying implementing bill, the proposal is now in several separate bills and constitutional amendments. The main pieces of legislation, SHB 1195 and SHJR 4205, refer primarily to the state general fund tax system. A transportation proposal is taking a separate course through the transportation committees and would not require a constitutional amendment. The local proposals are also in separate legislation, SHB 2124, HJR 4207 and HJR 4219, and would appear as separate constitutional amendments if they reach the November ballot. The following summarizes the major components of the tax proposal:

- A corporate income tax is proposed and a flat–rate personal income tax, which includes a surtax of 2.4 percent on family adjusted gross income exceeding $100,000 annually. Both are earmarked for K-12 and higher education purposes.
- Business and occupations (B&O) tax rates are reduced by 20 percent and exemptions are proposed for small businesses.
- Labor used in construction of new buildings for manufacturers and research and development businesses is exempted from the sales tax.
- The state sales tax rate is reduced to 4.1 percent, rather than the 3.9 percent originally proposed. With the local sales tax authority of 1.6 percent, the total combined state and local maximum rate would be reduced from the current 8.1 percent to 5.7 percent.
- The menu of local–option taxes included in the original proposal is replaced with changes in property taxes at both the state and local level. The full package — contained in a number of bills and constitutional amendments, which can be acted on separately by the voters — includes reduction in the state levy authority, earmarking a portion of the state levy for school construction, movement of library districts outside the 1 percent constitutional, and designation of emergency medical service district levies as special levies and therefore, outside the 1 percent limit. The various property tax elements are being proposed as a package which, (if all passed the voters successfully) would result in a net increase in state and local property taxing authorities of $0.35 per $1,000 of assessed valuation (AV).
- Finally, the transportation revenue options in the governor's original proposal have been replaced with a separate proposal to increase the state motor fuels tax, the motor vehicle excise tax and truck weight fees, and to allow local–option transportation taxes.

The revenue limit and other fiscal controls are also different from the original proposal:

- Gov. II includes a constitutional requirement that growth in taxes cannot exceed the growth in state personal income. Revenues collected in excess of the limit or remaining at the end of the biennium go into a reserve account, or rainy day fund, and a 60 percent majority vote of the legislature would be required to use money in the reserve. If the reserve fund exceeds 3 percent of general fund appropriations, the excess would go into the common school construction fund.
- The formula for the limit is set in statute and would be re–indexed every six years to actual revenues.
- Both proposals require that the legislature act to assure that taxing rates are adjusted to keep revenues received within the revenue limit. This provision, together with no language requiring appropriation to the rainy day account, reduce the potential for a rainy day account being developed.

Faster Revenue Growth Proposed

As shown in the graph on the next page, Gov. II tax system would have grown at about 109 percent of economic growth, compared with the current system's elasticity over that period of 90 percent the growth of the economy. The differences would have been largely in the periods from 1976 to 1980, when the proposed system's unindexed personal income taxes would have grown more rapidly due to inflationary growth, and in the recessionary period from 1980 to 1983, when personal income taxes would have produced state revenues at a faster rate. The current system's consumption–based tax revenues contracted dramatically during the recession (see table at top of page 2).

Actual taxes over the period grew at 123 percent of economic growth as the result of legislative action during the recession to raise tax rates and expand tax bases. What the

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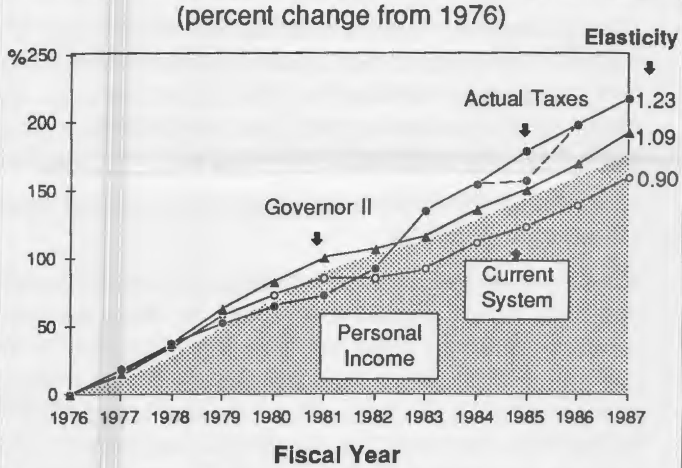
Elasticity of Major State Tax Revenues

	Expansion 1976 to 1980	Recession 1980 to 1983	Expansion 1983 to 1987	Entire Period 1976 to 1987
Current Tax System*	1.04	0.45	1.17	0.90
Governor II*	1.19	0.73	1.16	1.09
Actual Tax Collections	0.93	1.68	1.17	1.23

* Constant rate and base

Source: Tax Alternatives Model, DOR, 1989

Growth Comparison
State Tax Revenue and Personal Income
(percent change from 1976)



Note: Major tax sources shown. Excludes cigarette and alcohol taxes, and beer and wine surtax (quantity–based taxes). Figures for current system and Governor II are constant rate and base estimates.

Source: Tax Alternatives Model, DOR, 1989

elasticity is, or will be in some future time period, is dependent on the state's economic climate. If a major recession is on the near–term horizon, we can expect both the current and proposed tax systems to slow down in their production of tax revenues.

If a recession does not occur, taxes produced by both the current and proposed systems will grow at a similar pace — about 16 percent ahead of economic growth. Gov. II would have been more elastic — that is, proposed state taxes would have grown faster than growth in the economy — than the current system when adjusted to estimate constant rates and bases for the period from 1976 to 1987.

Gov. II is discussed in more detail below:

Personal Income Tax

With a favorable popular vote to change the state constitution, Gov. II would allow taxation of income, both personal and corporate, for the first time in the state's history.

The standard deductions and personal exemptions to federal adjusted gross income adopted in the initial legislation are protected in the amending constitutional language. They would constitute a floor, so that taxes could not be increased by future legislatures by lowering or eliminating deductions and exemptions.

However, the standard exemptions and deductions in Gov. II are not indexed for inflation and as a result, the personal income tax in this proposal would have grown at about 158 percent of the economy as the real value of the deductions and exemptions declined over the period from 1976 to 1987.

Under the proposed constitutional amendment, these new taxes, together with those raised from the corporate net income tax, would be dedicated to fund educational purposes — both K–12 and higher education. The significance of this, however, is unclear, since anticipated revenues from the proposed income taxes in fiscal year 1991 would account for only about 20 percent of the monies proposed to go to K–12 and higher education in 1989–91, or about 40 percent if they were collected for the entire biennium.

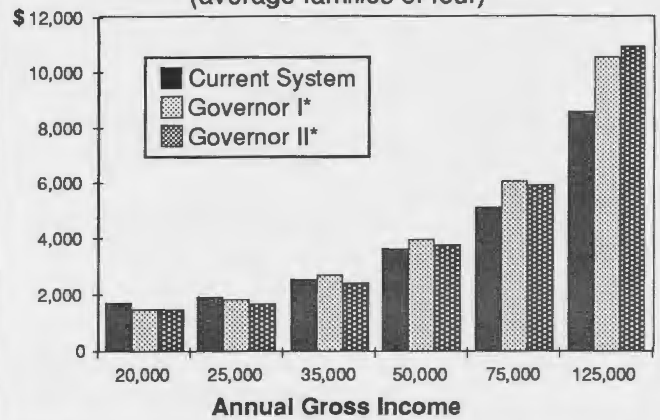
The break–even income level for a family of four (i.e., that income level where the current tax burden would equal the proposed tax burden) is about $40,000, $10,000 higher than in the governor's original reform proposal. That assumes that taxable purchases are about 42 percent of gross income. The effect of this shift in tax burden is compared to the current tax system and the governor's proposal in the graph at the top of the next page.

According to the fiscal note on SHB 1195, the cost of administering the personal income tax would be about $21 million a year and would require 395 additional full–time equivalent (FTE) staff.

Personal Income Tax

Rate:	4.1% on taxable income	
Standard Deductions: (not indexed)	Single	$ 9,000
	Married	15,000
	Separate	7,500
	Head of House	13,200
Personal Exemption: (not indexed)	$3,750 for each individual for whom an exemption is allowed for federal income tax purposes.	
Surtax:	2.4% on Adjusted Gross Income in excess of $100,000	

State and Local Household Tax Burden
Comparison of Distribution
(average families of four)



* Excludes impact of additional local–option and transportation taxes.

Source: Tax Alternatives Model, DOR 1989

Corporate Income Tax

Corporate income taxes represent an additional new tax for the Department of Revenue (DOR) to administer. The fiscal note on SHB 1195 indicates the added cost of administering this new tax in combination with the personal income tax is about $3 million a year and would require 54 additional FTEs, primarily for additional auditors.

Corporate Income Tax

Rate:	4.1% on federal taxable income
	2.4% alternative minimum tax

The issues surrounding the corporate income tax are more complicated than those of the personal income tax. Important considerations expand to include such issues as the following:

- Adjustments for pre–enactment appreciation, where property purchased prior to tax reform has appreciated in value and the appreciated value will be subject to taxation for both corporations and individuals.
- Apportionment provisions, where Washington State receives tax on whatever hypothetical income remains after other states have applied a three–factor, multi–state tax compact formula.
- Authorities to combine or consolidate corporate returns, which are left solely to the DOR.
- Definitions of "waters–edge" corporations, which "err on the side of inclusion" of foreign corporations.
- Potential for taxing installment transactions twice during the transition to a new tax structure by collecting B&O taxes on gross sales originally and corporate income tax on the net profit of installment collections received into the future.
- Alternative minimum tax (AMT), which may yield different results than federal AMT, due to potentially different definitions of "combined group" which could be used by Washington State.

B&O and Public Utility Taxes

Through a combination of proposed B&O tax rate reductions, surtax elimination, exemptions and deductions, Gov. II provides some tax relief for small businesses. The level of exemption varies for manufacturing, retailing and service sole proprietors.

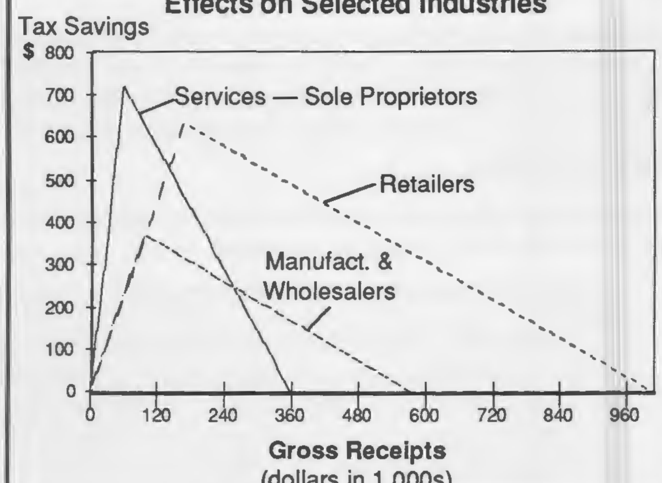
B&O and Public Utility Taxes

Rates: (effectively reduced by 20%)	Manufacturing	0.387%
	Retailing	0.377
	Services	1.200
	Power, gas	3.082
	Water	4.023
	Urban transp.	0.514
	Trucking, other	1.541
Exemptions:	Retailing	$168,000
	Services*	60,000
	All other	96,000
Deductions:		Phased out between:
	Retailing	$168,000 and $1,008,000
	Services*	60,000 and 360,000
	All other	96,000 and 576,000

* sole proprietors

The bottom line tax effects for different sectors range from $0 to $720 per year for service sole proprietors. The graph below demonstrates how the proposal would work for selected industries at varying levels of gross receipts. It shows the amount of the proposed deduction or exemption.

Proposed B&O Exemptions and Rate Reductions
Effects on Selected Industries



Retail Sales and Use Tax

Gov. II would reduce the state sales and use tax rate by 2.4 percentage points, to 4.1 percent. When combined with the local sales and use tax authorities, the maximum rate would be 5.7 percent. If Initiative–102, the children's initiative, passes, the combined rate would increase 0.9 percentage points, to 6.6 percent, and the additional tax collections for the initiative would fall outside the revenue limit.

Retail Sales and Use Tax

Rate:	State rate reduced to:	4.1%
	New combined state and local maximum rate:	5.7%
Exemptions:	Labor on construction of new manufacturing and R&D facilities.	

Property Tax

The proposed ballot title for the constitutional amendment on the state tax reform proposal asks: "shall state finances be reformed by limiting revenues, providing a reserve fund, authorizing income taxes, and providing property tax relief?" Under the state tax proposal, SHB 1195, the state property tax levy is reduced by 40 cents. However, other measures included in the package, HJR 4207, HJR 4219 and SHB 2124, allocate additional taxing authority to local governments and remove library and EMS districts from the 1 percent constitutional property tax limitation. If all portions of the proposed package receive their necessary approvals (either from the legislature or the voters) property taxes would effectively be increased by $0.35 per $1,000 AV. This is equivalent to an additional $35 in property taxes a year on a $100,000 house.

Other property tax legislation would allow taxing districts, including state government, to impose special property tax levies with voter approval for up to six years for any purpose. Currently, local governments can pass one–year special levies and school districts can pass one– or two–year special levies for operations and six–year special levies for capital purposes.

In addition, on bond levies, the proposal alters the requirement for writing ballot titles. Under the new language, the title would not need to state the proposed levy rate or the dollar amount of the levies, only the value of the general obligation bonds to be retired.

Finally, the constitutional amendment on the state portion of the plan authorizes property tax relief, which, if implemented by the legislature, would result in transfer payments to low–income families in the form of negative income taxes.

Property Tax

Rate:
- Reduces state levy by $0.40 to $3.20 per $1,000 AV.
- Dedicates $0.15 of state levy to school construction.
- Makes emergency medical service (EMS) districts special levies of $0.25 per $1,000 AV, and therefore outside the 1 percent constitutional limit.
- Removes library districts ($0.50 per $1,000 AV) from the 1 percent limit.
- Results in net increase in property taxing authority of $0.35 per $1,000 AV.

Exemptions: Creates new constitutional authority for tax relief to low–income homeowners and renters.

Revenue Limit

Growth in general fund tax revenue and some dedicated revenues, such as state property taxes and income taxes earmarked for education, would be limited to a six–year average of the growth in state personal income under Gov. II. (I-102 funds would fall outside of the limit under this proposal, however.)

The base for the revenue limit would be redefined every six years and revenue over the limit (which is used following declaration of an emergency) would not increase the revenue ceiling unless it was the result of a court order. The legislature is directed to adjust tax rates so that revenue does not exceed the anticipated limit.

Rainy Day Fund

If revenue collections exceed the revenue limit and if unobligated funds remain in the general fund at the end of the biennium, revenue in excess of the limit would be transferred to a reserve, or rainy day, account.

A 60 percent majority vote of each house of the legislature would be required to appropriate money from this account. If the balance in the account reaches 3 percent of appropriations, the excess would be transferred to the common school construction account.

It is unlikely, given the provision requiring the legislature to adjust rates to stay within the limit and no requirement for an appropriation to a rainy day fund, that a "rainy day" reserve will be developed.

While final action on the proposals did not take place during the regular session, the issue won't go away and we feel that it is important to keep informed about the proposals. At this time, it appears a bipartisan committee will be formed to work tax reform, with the committee to dissolve on July 1 of this year. If you have questions, contact Elaine Ramel or Barbara Cellarius at the Research Council office, (206) 357–6643.