Washington Research Council

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Higher Business Taxes Would Make Washington Less Competitive

BRIEFLY

As the legislature struggles to balance the state budget, legislators should avoid increasing business's tax burden. Higher taxes on business would make the state's economy less competitive. That would mean fewer jobs, lower wages, and higher prices for the goods and services state consumers buy.

Introduction

Governor Gary Locke's 2003-2005 budget maintains essential state services without raising taxes (see "Governor's Budget Sets Priorities, Lives Within Means," PB 02-16, December 20, 2002). In preparing his budget, the governor used one of the nation's most innovative and thoughtful budget reviews, which he calls the Priorities of Government process.

The results have been predictably controversial, as he has recommended substantial program reductions, amending or suspending three popular citizen initiatives, and holding the line on employee compensation. Various interest groups are calling for tax and fee hikes to boost state spending. Similar conversations are being conducted across the country, as most states confront budget shortfalls.

How this state handles the budget problem directly affects our long-term economic competitiveness, as we noted in a report published earlier this fall (see "Closing the Budget Gap is Now a Major Competitiveness Challenge," September 17, 2002). In that report, we recommended that the legislature implement long-term expenditure controls, avoid recovery-killing tax increases, and restore the integrity of the general fund by reducing the effects of ballot initiatives.

In the budget he released December 17, Governor Locke successfully addressed many of these concerns.

Our state will doubtless lag the nation in recovering from recession. Recovery here is both elusive and fragile. State revenues are projected to increase about seven percent from the 2001-2003 biennium to the next, reflecting a slow return to slow growth

Washington businesses pay nearly half of all state and local taxes, so the public sector depends to an extraordinary extent on the health of the state's private employers (see Figure 1). The business share of the tax burden in Oregon is 27 percent; in Idaho, about 31 percent. Recently, the Washington State Tax Structure Study Committee (Tax Study Committee) wrote: "Our proportion of state taxes collected from businesses compared to households is dramatically different from norms: 46 percent from business in Washington compared to a western states average of 30 percent."

The high initial incidence on business taxes has frequently been cited as a serious competitive disadvantage our state faces in recruiting and retaining jobs and investment. Both the Washington Competitiveness Council (WCC) and the Washington Alliance for a Competitive

Washington Research Council
108 S Washington St., Suite 406
Seattle WA 98104-3408
206-467-7088
fax: 206-467-6957
www.researchcouncil.org

Economy (WashACE) have suggested approaches to reducing the business tax liability, including retention and expansion of existing tax exemptions and deferrals.

The Tax Study Committee "agrees that high business tax burdens reduce the economic vitality of the state, discourage firms from locating their operations here, and invite firms already located in Washington to consider other locations."

Despite the admittedly difficult challenges associated with balancing the state budget within existing revenues, tax increases would jeopardize and delay recovery, adding to future budget problems.

The major taxes paid by businesses are the retail sales and use taxes, the business and occupation tax, public utility taxes, property taxes, and real estate excise taxes.

Retail Sales and Use Taxes

The retail sales tax is imposed on purchasers of tangible personal property and certain services. Sellers collect the sales tax for state and local government and itemize the tax on the receipt provided to the buyer. The use tax complements the sales tax and is imposed on the use of items when sales tax has not been collected.

The state's sales tax rate is currently 6.5 percent. This is the third highest state rate in the country. Local rates range from 0.5 percent to 2.4 percent. (The 2.4 percent rate applies in parts of Snohomish County.) In fiscal year (FY) 2001 the state received $5,920 million in sales and use taxes. In calendar year (CY) 2001, local governments received $1,732 million in sales and use taxes.

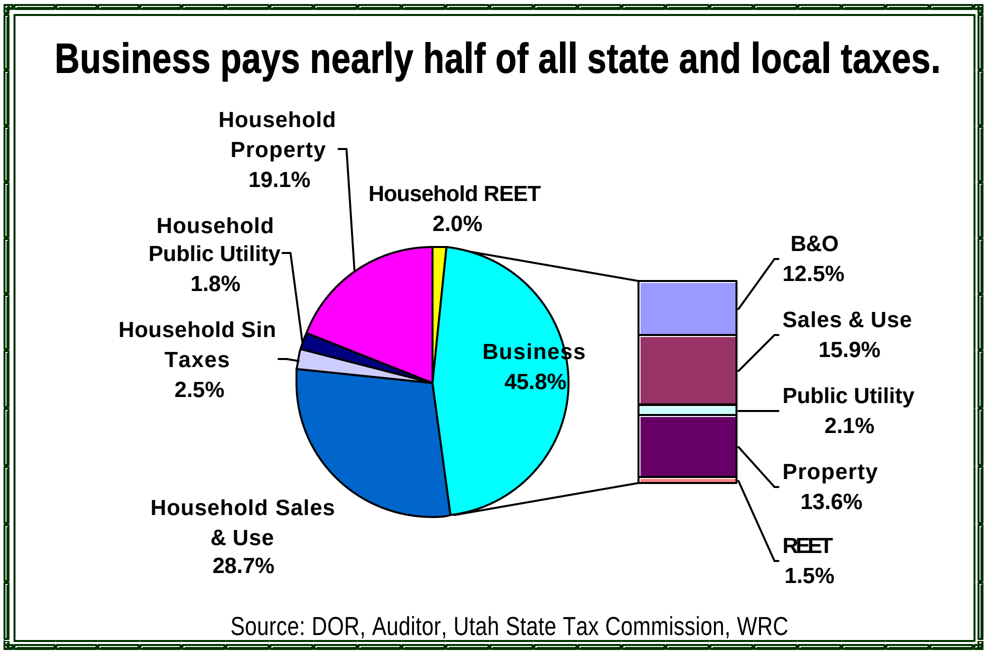
By Department of Revenue calculations, businesses pay 36 percent of state and local retail sales taxes. These taxes represent about 34 percent of the business tax burden in the state.

Ideally, the retail sales tax should be a comprehensive tax on personal consumption expenditures. In practice, Washington's sales and use taxes fall far short of this ideal. The tax applies to many business purchases, while many consumer purchases, particularly purchases of services, are not taxed.

Applying the retail sales tax to business purchases violates the principle that government should only "tax things once." The sales taxes pyramid one on top of another as businesses sell to businesses. As the late John Due, who was the nation's foremost expert on sales taxation, explained, "Inclusion of purchases for production purposes is contrary to the philosophy of the [sales] tax, results in haphazard and uncertain distribution of the tax burden, affects choice of production process, and, from a state's standpoint, may adversely affect economic development."

Reflecting the tax-things-once ideal, Washington does exempt from retail sales tax goods that are purchased for resale and manufactures' purchases of ingredients that are physically incorporated in their products. But this falls far short of exempting all business purchases.

During the 1993 fiscal crisis, Governor Mike Lowry proposed broadening the base of the sales tax by extending it to services purchased by businesses. As the Research Council noted then, such a change would move the retail sales tax further away from the ideal as a



tax on consumer expenditures and "widen the gap in business tax burdens between Washington and other states." Fortunately, the legislature did not adopt the Lowry proposal. The Tax Study Committee has recommended that the state consider extending the sales tax to a select set of purely consumer services, including beauty shops, amusement, recreation, and cable TV. The Committee specifically does not advocate greater taxation of those services purchased by businesses.

Business and Occupation Tax

The state business and occupations (B&O) tax applies to the gross income of a business, without any deduction for expenses. The B&O is what economists call a multi-stage gross receipts tax or a turnover tax. In effect the tax is a very broad sales tax. However, unlike the retail sales tax, the B&O is imposed on the sellers of goods and services, not the buyers, and it applies to all sales and not just final sales.

There are six separate rate categories:

- Manufacturing, wholesaling and selected other activities, 0.484 %
- Retailing and environmental cleanup, 0.471%
- Travel agents, stevedoring, freight brokerage, and international investment management services, 0.275%
- Various food-processing and manufacturing activities, and warehousing or reselling of prescription drugs, 0.138%
- Low-level radioactive waste disposal, 3.3%
- Services, hospitals, and all other activities, 1.5%

Cities can tax businesses based on their gross receipts, based on the type of activity, based on the number of employees, or based on the floor space occupied. The maximum rate for a city gross receipts tax is 0.2 percent, unless voters explicitly approve a higher rate. A survey conducted by the Association of Washington Cities found that 37 cities imposed gross receipts taxes. Average rates were:

- Retail, 0.17%
- Wholesale, 0.15%
- Manufacturing, 0.15%
- Service, 0.21%

In FY 2001, the state collected $2,012 million in business and occupation taxes. In addition, in CY 2000 cities collected $206 million in municipal business taxes. Together the state and city business taxes account for 27 percent of businesses' tax burden.

The B&O tax has a much broader base than the state's retail sales tax: In CY 2001 the retail sales tax applied $84.9 billion in transactions, while the B&O applied to $322.0 billion.

The broad B&O base does have virtues; it makes the tax relatively stable and elastic. But with this broad base, much more pyramiding occurs with the B&O than with the sales tax. The damage from pyramiding is moderated by the fact that B&O rates are considerably lower than the sales tax rate. Increasing B&O rates or further expanding the base would magnify the damage.

Most other states tax businesses based on their profits. Washington's B&O tax, in contrast, is levied on gross receipts without regard to profitability. As a result, the Tax Study Committee concluded, "low profit margin firms and firms that are new or expanding may suffer a competitive disadvantage compared to their competitors in other states." Raising B&O rates would further disadvantage these businesses at a time when expanding employment is the state's highest priority.

Public Utility Tax

Sales by public utilities are generally exempt from the retail sales and B&O taxes. Instead, they are covered by separate state and city public utility taxes.

The state public utility tax is a gross receipts tax, much like the B&O. Although it is formally imposed on the seller, since the utilities are regulated and allowed to pass the tax on to their customers, the tax is effectively imposed on the buyer.

- Distribution of water, 5.029%
- Distribution/generation of electric power, 3.873%
- Telegraph, natural gas, and sewerage, 3.852%
- Urban transportation, water transportation via vessels under 65 feet in length, 0.642%
- Railroads, motor transportation, and other public service businesses, 1.926%

Cities are allowed to levy gross receipts taxes on utilities. For electricity, natural gas, steam energy, and telephone utilities local voters must approve rates higher than 6 percent. There is no voter approval requirement for taxes on other utilities. The Association of Washington Cities survey found that more than 172 cities tax electric utilities, and 169 cities taxed telephone service. Natural gas, cellular phone, garbage, water, sewer, and cable television were each taxed in more than 110 cities. Average rates range from 5.4 to 7.5 percent, depending on the type of utility.

- Natural gas, 5.47%
- Electric, 5.54%
- Telephone, 5.64%
- Cellular telephone, 5.73%
- Garbage, 6.95%
- Water, 7.23%
- Sewer, 7.44%
- Storm drainage, 7.22%
- Cable television, 5.58%

The state collected $268 million in public utility taxes in FY 2001. Cities collected $420 million in public utility taxes in CY 2000. The Department of Revenue estimates that businesses pay 53 percent of public utility taxes. These taxes represent 5 percent of business's tax burden.

Public utility taxes are imposed instead of the retail sales and B&O taxes. Combined state and city public utility tax rates are often higher than the retail sales tax. The same logic that holds that business purchases should be exempt from retail sales and B&O taxes applies equally to public utility taxes.

Property Tax

All property is subject to the property tax, unless explicitly exempted by law. The tax is primarily applied to real property, that is land and everything that is permanently affixed to it. For 2002 taxes, property with assessed value totaling $478.7 billion was subject to the tax. Real property accounted for 93 percent of the assessed value. The average tax was $12.52 per $1,000 of assessed value. The total levy was $5,978 million, of this $1,442 million, 24 percent, was for the state, while the remainder was for local governments.

The Department of Revenue estimates that businesses pay about 42 percent of property taxes. Property taxes represent roughly 30 percent of the business tax burden.

Property taxes are subject to three main restrictions; two of these restrictions are constitutional, while the third is statutory:

Uniformity: The state constitution requires that "all taxes shall be uniform on the same class of property," and "all real estate shall constitute one class."

Tax rates greater than one percent require voter approval. The constitution requires that the "aggregate of all tax levies upon real and personal property by the state and all taxing districts [other than ports or public utility districts] now existing or hereafter created, shall not in any year exceed one percent of the true and fair value of such property in money." Property taxes with this 1 percent limit are termed "regular" levies. The constitution also allows tax rates greater than 1 percent if approved by a 60 percent majority of a district's voters.

One percent limit on revenue growth: Under the terms of Initiative 747, the total revenue that a taxing district may raise can increase by no more than 1 percent from one year to the next (with an allowance for additional taxes on new construction) unless voters approve a larger increase.

While all three of the restrictions protect business taxpayers, the uniformity requirement is particularly important. In states that lack a uniformity requirement, business property is frequently taxed at a higher rate than household property and at a higher rate overall. Homeowners believe they get a deal by shifting the property tax burden onto businesses, but this is an illusion.

The property tax rate directly affects the state's competitiveness. Modern economic theory recognizes that the property tax is a tax on capital investment. Higher tax rates on business property would discourage business investment in the state, and reduced investment would translate into fewer jobs and lower wage rates.

Real Estate Excise Tax

Transfers of real property are subject to state and local real estate excise taxes (REET). Washington's REET is one of the highest real estate transfer taxes in the nation.

The state imposes a 1.28 percent tax on sales and other transfers of real property. Cities and counties are authorized four separate local option REETs. Were a jurisdiction to exercise all of these options, the local REET would be 2.00 percent and the combined state and local rate would be 3.28 percent. The highest combined rate actually imposed is 2.78 percent (in Friday Harbor). Most jurisdictions impose a combined rate of either 1.53 percent or 1.78 percent.

The REET is a volatile tax, and the local REET is particularly volatile.

In FY 2001, the state collected $434 million in REET. In CY 2000, cities and counties collected $157 million. The state REET and three of the four local option REETs are formally imposed on the seller of the property. One local option REET, the conservation REET, which must be used to acquire and maintain conservation areas and which is only levied in San Juan County, is imposed on the buyer of the property.

The Department of Revenue estimates that 43 percent of REET is paid by business. REET represents 3 percent of business's tax burden.

In addition to its direct effect on the business tax burden, REET reduces the state's competitiveness by adding to the cost of housing. The greatest impact is on the first-time homebuyer, whose biggest barrier to purchasing a home is covering the down payment and closing costs.

Discussion

As the legislature struggles to balance the state budget, legislators should remember that the citizens of this state already shoulder a heavy burden of taxes. The Tax Foundation calculates that in 2002 Washington ranked 11th in state and local taxes per capita and 20th in state and local taxes per $1,000 of personal income.

Governor Locke has proposed a budget that lives within these means. His budget is the end result of an innovative and thoughtful process that laid out specific priorities for state government and asked how each state program stacked up against these priorities.

Some legislators will be tempted to avoid hard spending choices by increasing business's tax burden. As economist John Mikesell has noted, "many state lawmakers prefer taxes that conceal the burden on individuals and generate high yield without a high advertised rate. … State lawmakers play the 'tax on business v. tax on individuals' myth." But it would be foolish to raise business taxes at the depth of a recession.

The old saw cuts to the heart of the matter: People ultimately bear the burden of the taxes government levies on businesses. Higher taxes on business would make the state's economy less competitive. That would mean fewer jobs, lower wages, and higher prices for the goods and services state consumers buy.

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