Special Report

Washington Research Council February 1, 2000

Preserve Property Tax Uniformity to Maintain Washington's Economic Competitiveness

Briefly

Early in this short election-year legislative session the Senate passed a split-roll property tax measure aimed at giving homeowners an ever-larger credit against their state property-tax bills. Because the proposal breaks with Washington's constitutional principle of taxing all real property uniformly, the state constitution would have to be amended, an action requiring voter approval after passing both houses of the legislature by supermajority votes.

The Washington Research Council and most tax authorities believe uniformity is the foundation of good property tax systems. In addition, the Research Council found that states with uniformity have experienced more rapid economic growth in recent years. Moreover, experience in other states has shown that when uniformity is scrapped, businessowners tend to pay higher property taxes, but the tax burden on homeowners remains about the same as that on homeowners in states retaining uniformity.

From a business cost standpoint, Washington faces significant challenges: high housing prices, traffic congestion, heavy business regulation and one of the nation's heaviest business tax burdens. Preserving uniformity in property taxation maintains one of the few competitive advantages offered by our tax structure.

Early in the 2000 legislative session, in a bipartisan vote the Senate overwhelmingly adopted a Democratic proposal to amend Washington's Constitution to create a classified, or "split roll," property tax system.

As it now stands, the Constitution requires "uniformity." This entails treating all real property in Washington as a single class of property that is assessed and taxed equally.

The Senate amendment would break uniformity by giving homeowners a credit against the state portion of the property tax, beginning with a $200 credit in 2001. In time, sponsors intend for the legislature to increase the credit to eliminate effectively the state property tax on homeowners.

While this change would provide some relief to homeowners, it would do nothing for the thousands of businessowners who already shoulder one of the nation's heaviest business tax loads. Indeed, over time it will shift the property-tax burden to business owners of real property.

The overall tax burden shifted more onto business in the fall. With passage of Initiative 695, the business tax burden has increased as a share of all taxes.

Theory suggests that states with classified property-tax systems will be less attractive places to do business. The data support the theory. States with uniform property-tax systems have experienced significantly greater economic growth over the last fifteen years.

The Washington Research Council examined the growth in gross state products over the 15-year period 1982-1997. In states with a classified real property tax, gross state product increased by 59 percent. In states with uniformity, gross state product grew by 69 percent.

Once again, then, the issue of property tax uniformity confronts lawmakers and, indeed, all Washingtonians. It is time to remember the significant protection provided to all taxpayers, homeowners and business alike, by the state Constitution.

Breaking uniformity would hurt business and impede economic growth. A Washington Research Council review of property tax systems in the fifty states finds that classified systems typically result in increasing business property tax burdens.

Less apparent, but of equal significance, is how a split roll would hurt homeowners by obscuring the cost of government. Shifting some of the property tax burden onto businessowners would mislead the public into underestimating the added tax burden on homeowners and workers. To the extent that businesses can pass tax increases forward on to those who buy their goods and backward on to employees, all members of the community incur higher costs. These costs ultimately include higher prices, lower wages, less community economic development, and fewer jobs, goods and services.

Five desirable characteristics for a state and local tax system

In our publication *Understanding Washington State Taxes,* the Research Council identified five criteria for evaluating state and local tax systems: economic neutrality, transparency, fairness, administrative simplicity, and stability:

- **Economic neutrality:** A tax system should minimize distortions in economic decision-making.
- **Transparency:** A tax system's design should make clear who bears the costs of government.
- **Fairness:** The burden of taxation should spread equitably among citizens.
- **Administrative simplicity:** A tax system should neither cost too much to administer nor should it impose undue record-keeping and reporting requirements on taxpayers.
- **Stability:** The revenue of a tax system should not fluctuate wildly, with changing economic conditions.

Weakening the constitutional requirement for uniformity in the taxation of real property would violate the first four criteria. Investment decisions would be affected, the costs of government concealed, the tax burden shifted unfairly, and by requiring application and approval, the credit provision would diminish administrative simplicity.

The Senate bill

The Senate property tax bill, SJR 8212, faces an uncertain reception in the House. Constitutional amendments require two-thirds majorities in each chamber and an affirmative vote of the people in the November election.

The pivotal section of the bill states: "Notwithstanding any other provision of this Constitution, there shall be a credit against property taxes levied for state purposes on owner-occupied residential property. The amount of the credit shall be two hundred dollars for taxes payable in 2001. The credit shall increase each year thereafter by the change in the state personal income for the previous year."

Parenthetically, it should be noted that this indexing provision, by total personal income growth, is extraordinary. Ordinarily, such a provision would adjust for growth by using change in per capita income. The extra increment, the growth in state population, that the proposed index includes has averaged 1.3 percent annually between 1994 and 1999. Personal income grew by 5.8 percent annually over the period; per capita personal income by 4.5 percent.

In any event, growth in the amount of the credit would not be limited to the growth in personal income, because the measure says, “The legislature may, by statute, increase the amount of the credit.”

Property tax in Washington

Property is divided into two types. Real property generally constitutes land and everything permanently affixed to it. All else is personal property.

The constitution requires that real property constitutes a single class. By statute, however, business and household personal properties are separate classes. And household personal property is exempt from taxation.

In 1999, 5 percent of the assessed property value subject to the property tax was personal property. The remaining 95 percent was real property. Virtually all of the taxable personal property belonged to businesses, mostly in the form of machinery and equipment. Single-family homes represented about 63.5 percent of the assessed value of real property. Multi-family homes represented 9.6 percent; commercial and manufacturing uses, 18.9 percent; all else, 8.0 percent.

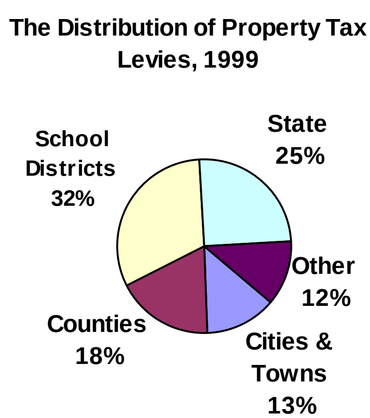
(The assessment data do not distinguish whether housing units are owner or renter occupied. According to the 1990 census, 37.4 percent of the occupied housing units in the state were rentals.)

Who levies the property tax?

Washington has more than 1,700 separate districts that, besides the state itself, hold the power to levy property taxes. In 1998 these included 39 counties, 277 cities and towns, 296 school districts, 406 fire districts, 16 library districts, 77 ports and 135 emergency medical service (EMS) districts.

In 1999, property tax levies totaled nearly $5.1 billion. Figure 1 breaks down the property taxes collected in 1999 by types of taxing district.

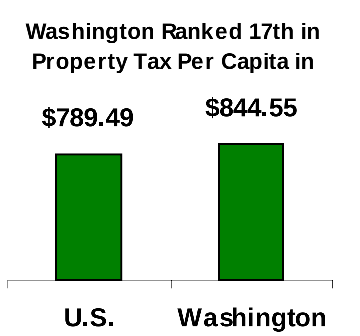
FIGURE 1



Nearly one third was collected directly by school districts; another one quarter was collected by the state for support of public schools. Counties collected 18 percent, cities and towns 13 percent, and all other districts 12 percent.

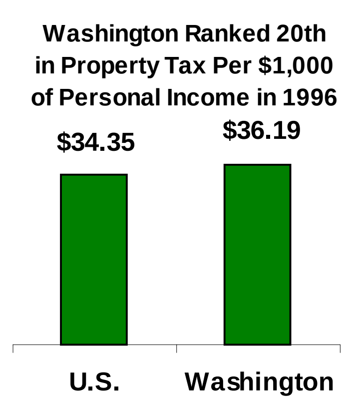
Figure 2 and 3 compare Washington’s property taxes with like taxes in the other 49 states and the District of Columbia for the 1996 fiscal year. In taxes per $1,000 of personal income, Washington ranked 20th. In taxes per capita, Washington ranked 17th. In property taxes as a share of total taxes, Washington ranked 24th.

FIGURE 2



Source: Washington Research Council

FIGURE 3



This year, the legislature threatens to break real property into two classifications. Allowing differential taxation of business and household real property most likely will lead to higher taxes on business property in the future.

That will negatively affect local investment decisions, violating the principle of economic neutrality. Also, because the costs of property taxes levied on businessowners are ultimately borne in large part by customers and workers, the transparency of the state's tax system will decrease.

The benefit to homeowners may be temporary

Supporters of the Senate Democrat's proposal hope that breaking uniformity will mean a lower rate of taxes for homeowners. But a 1999 interstate comparison of property tax rates by the Minnesota Taxpayers Association (MTA) suggests that this is not likely to occur.

The MTA comparison shows that average property tax rates on owner-occupied housing in states lacking uniformity roughly equal the average rates for states with uniformity – even though average tax rates on business property are higher in non-uniform states than in uniform states.

Split-rolls, then, generally result in higher taxes on business, not in lower taxes on homeowners, according to these statistics.

FIGURE 4

Washington effective tax rates compared with the U.S.

	Real Property		Personal Property				
	Land and Building	Fixtures	Machinery and Equipment	Inventories	National Average ETR	Washington ETR	Washington Rank
Homestead	$70,000	$10,000			1.28%	0.96%	32
Homestead	$150,000	$50,000			1.16%	0.82%	35
Commercial	$100,000	$20,000			2.23%	1.12%	46
Commercial	$1,000,000	$200,000			2.27%	1.12%	46
Commercial	$25,000,000	$5,000,000			2.28%	1.12%	46
Industrial	$100,000	$10,000	$50,000	$40,000	1.71%	0.91%	46
Industrial	$1,000,000	$100,000	$500,000	$400,000	1.75%	0.91%	46
Industrial	$25,000,000	$2,500,000	$12,500,000	$10,000,000	1.75%	0.91%	46
Apartment	$600,000	$30,000			1.97%	1.11%	41

MTA pegged the effective tax rate on real property in Seattle at 1.009 percent. The rates shown for homesteads were lower because personal property is included in the base when the effective tax rate is calculated, and household personal property is exempt in Washington. Also, the effective tax rate on the higher valued homestead is less than that for the lower-valued because the former includes relatively more personal property.

The effective tax rate on the commercial properties in Seattle is higher than the ETRs on homesteads because of the taxation of business personal property in Washington.

The ETRs calculated for industrial properties in Seattle are roughly equal to the rates for homesteads because of the exemption of inventories from the property tax in Washington.

For the largest cities in each state and in the District of Columbia, the MTA study calculated effective tax rates for nine hypothetical properties—two owner-occupied homes, three commercial establishments, three industrial plants and an apartment building. (Effective tax rates relate taxes that would be actually paid to the market value of the properties. They differ from statutory rates to the extent that assessed property values differ from market values.)

In each case, the property for which taxes were calculated comprised both real and personal property.

As seen in Figure 4, the MTA comparison shows that property-tax rates in Washington were low relative to the national averages.

The effective tax rate on homesteads calculated for Washington averaged 0.893 percent, compared to a national average of 1.217 percent; for commercial property Washington averaged 1.119 percent, compared to 2.256 percent nationally; for industrial 0.914, compared to 1.736 percent; for apartments, 1.105 percent, compared to 1.971 percent.

(Effective tax rates calculated by MTA for Washington are not completely uniform because the state exempts certain classes of personal property. The MTA developed a measure to indicate the degree to which the states classify real property. By this measure, Washington is one of 13 states without classification of real property.)

Although classification is sold as a means of holding down the rate of tax for homeowners, the national evidence suggests that it is more a means for raising the taxes on business.

Figure 5 compares average effective tax rates for states with classified systems of real property taxation to those without. The average effective tax rates on households differ only slightly between states with uniformity and those without. For lower valued homesteads the rate is 1.36 percent for states with uniformity versus 1.37 percent for states without; for higher-valued homesteads the average is 1.16 percent with uniformity and 1.15 percent without. By contrast, the average effective tax rates for business properties are significantly higher in states without uniformity than in states with: for the large industrial property 1.93 percent versus 1.24 percent; for the large commercial property, 2.55 percent versus 1.54 percent; for apartments, 2.12 percent versus 1.57 percent.

FIGURE 5

Classification associated with higher business taxes

	Lower Homestead	Higher Homestead	Large Industrial	Large Commercial	Apartment
Classification States	1.37%	1.15%	1.93%	2.55%	2.12%
Uniform States	1.36%	1.16%	1.24%	1.54%	1.57%

History of uniformity

Alexander Hamilton once warned, “Whenever a discretionary power is lodged in any set of men over the property of their neighbors, they will abuse it.” A later exponent of the uniformity principle, J.R. McCulloch, in 1865 declared that “the moment you abandon, in the framing of such taxes, the cardinal principle of exacting from all individuals the same proportion of their income of their property, you are at sea without rudder or compass, and there is no amount of injustice and folly you may commit.”

Washington has held to the principle of uniformity from the outset. When the 1853 Organic Act established the government of Washington Territory, Congress imposed a strong requirement for equality in taxation through this provision: “And all taxes shall be equal and uniform; and no distinctions shall be made in the assessments between different kinds of property, but the assessments shall be according to the value thereof.”

Congress also worried that the Territory’s residents would try to shift the burden on taxation onto nonresidents, and acted to prevent that from happening with a provision stating, “Nor shall the lands and other property of nonresidents be taxed higher than the lands and other property of residents . . ..”

Upon reaching statehood, Washington in 1889 created a constitution that required strict uniformity in taxation.

Uniformity

As the Washington Research Council, along with most tax policy authorities, has noted, uniformity stands as one of the great strengths of Washington’s tax system. Tinkering with the constitution’s provision requiring uniform taxation of all real property is a conspicuously bad idea.

The principle of uniformity is rooted in the founding of our nation. It is based on the ideal of treating people equally. And it evolved into a strong income and property tax principle during the 19th century.

Uniformity appeals to our idea of fairness: taxpayers in essentially the same circumstances should pay essentially the same taxes. It also provides protection against the majority unfairly attempting to pass the cost of government onto a minority.

Those who support breaking the uniformity of the property tax often appeal to fairness as the reason for doing so. But once the effects of property taxes are taken into account, their argument falters. Renters, nearly 40 percent of households, do not share in the tax break given to homeowners. And the increased taxes on business will hold down the wages paid to low-skilled workers.

New York University Professor Dick Netzer, one of the nation’s foremost authorities on the property tax, makes this observation: “Increases in non-uniformity are likely to be perverse in equity terms . . . the lower taxes on residential property will most benefit . . . relatively well-off homeowners. The higher taxes on business property will most hurt the owners of non-residential land, most likely to be relatively high income, but also immobile labor, likely to be low-income unskilled workers.”

In 1930, the 14th Amendment to Washington’s constitution enabled the legislature to define separate classes of property, distinct from real estate. But within a property class, uniformity still prevailed: “All taxes shall be uniform on the same class of property within the territorial limits of the authority levying the tax . . . . All real estate shall constitute one class . . ..”

With some special exceptions, (see box) Washington holds strongly to uniformity today. These exceptions not withstanding, a study by the Minnesota Taxpayers Association indicates Washington’s property tax system is one of the nation’s most uniform.

Washington's limited exceptions

The constitution does provide three relatively minor exceptions where the legislature, if it chooses, may depart from strict uniformity. First, the legislature may "tax mines and mineral resources and lands devoted to reforestation by either a yield tax or an ad valorem tax at such rate as it may fix, or by both,"

This provision entered the constitution in 1930 through the 14th amendment to allow the legislature to remove impediments to the development of mineral resources and the reforestation of logged or burned over lands. Presently, forestland is subject to the property tax based on the estimated value of bare timber land. The timber itself is subject to the timber excise tax at the time that it is harvested. By matching the timing of tax liability more closely with the realization of revenue, the substitution of the timber excise tax for the property tax on timber, this system discourages the premature harvesting of trees and encourages reforestation.

Second, the legislature may provide "that the true and fair value in money of farms, agricultural lands, standing timber and timberlands, and of other open space lands . . . shall be based on the use to which such property is currently applied."

The 53rd amendment, approved in 1968, allowed open space to be valued according to its current use. The purpose is to encourage the maintenance of lands in agriculture, forestry and open space near urban areas, by removing the pressure to develop land created by the need to pay property taxes levied against the value the land would be worth if developed.

Finally, the legislature may "grant to retired property owners relief from the property tax on the real property occupied as a residence by those owners. . . . Restrictions and conditions may include . . . the limiting of the relief to those property owners below a specific level of income."

This provision entered the constitution 1966 through the 47th amendment. The legislature has used this power to grant tax relief to retired and disabled homeowners of modest means. The Department of Revenue reports that 1999 129,000 applicants were granted relief averaging $884.

The states that diverge significantly from uniformity follow one of several different approaches in the taxation of real property. In some cases, different tax rates are applied to separate classes of property. In other cases, the ratio between assessed value and market value differs by property class. In still other cases, owners of particular classes of property (often homeowners) are exempted from paying a set dollar amount of taxes or from paying tax on a set increment of assessed value. These split-roll systems result in systematic differences in the effective tax rates on different classes of property.

Business competitiveness

Breaking away from uniformity will inevitably increase the tax burden on businesses. This burden is heavy as it is, and making it heavier still would militate against businesses locating, expanding and creating more jobs (and therefore paying more taxes) in Washington.

Even without breaking uniformity, there's "serious concern" about the state's business climate, about how competitive Washington is right now, and about whether it will remain competitive in the future, says Mark Turner, director of the Spokane Economic Development Council and president of the Washington Association of Economic Development Councils.

Anything that would shift more taxes onto businesses would be "of grave concern," he says.

Who ultimately pays the taxes on business property?

In many cases, the party from whom a tax is formally collected can shift the cost onto others. Economists recognize this and distinguish between the initial and ultimate burden of the tax.

In the modern view, the property tax is a tax on the value of land and on income from capital. Land is fixed in place. Capital, on the other hand, is mobile; it flows to seek the highest return. When the property tax varies by location and by the type of property, the tax will affect decisions on how and where capital is used.

When a local jurisdiction raises the tax on business property, capital will tend to flow out to other areas where investment is more attractive. The outflow only stops when something else has changed to equalize the attractiveness of the local jurisdiction compared with the outside alternatives.

The outflow of capital may reduce the supply of goods to the local markets and increase the prices paid by businesses' customers. Or it may reduce the demand for labor in the local market, resulting in a decrease in local wages. In any event, in the long run the increase in local property taxes will not be borne by the owners of mobile capital. Rather, the tax will fall on land and on immobile local customers and workers.

Customers and workers often do not recognize the business taxes they bear. And as a result, they underestimate their portion of the cost of government services.

Legislators may like that, since this way it is easier to raise taxes. Joseph Stiglitz, former chairman of President Clinton's Council of Economic Advisors, has suggested, "In some cases there is an almost deliberate attempt to persuade individuals that the cost of government is less than it is. Just as businesses find that they can sell cars more easily if the describe the cost as 'only $340 per month for a short 40 months' than if they describe it as $13,600 paid over 3 and ½ years, so, too, government sometimes show a preference for tax systems in which individuals never fully reckon the cost of government."

Addressing a Greater Seattle Chamber of Commerce conference in October, Boeing's chief financial officer, Debby Hopkins, said, "We recently examined the cost of doing business in all the places we currently operate," she said. "We looked at items such as labor costs, property taxes, energy costs and transportation infrastructure. I hate to say it, but out of the 27 locations where Boeing has plants and employees, Washington came out 16th.

Washington only managed to rank as high as that because of low energy rates, Hopkins noted. "This is not a pretty picture. Compared to everywhere else we do business, Washington is below average."

"Right now," she declared, Boeing is looking at where we should locate any future e-commerce subsidiaries. And Washington state isn't even among the top 10 choices."

State and local governments in Washington collect a relatively high share of their tax revenue from business. A 1997 study by the Institute on Taxation and Economic Policy showed that the Washington business share of total state tax revenue amounted to the fourth highest among states across the nation. By contrast, the household share was the seventh lowest.

The Institute found that 50.6 percent of Washington taxes were collected from business, 45.6 percent from households, and the remainder from out of state payers.

A 1999 study, by the Utah State Tax Commission, shows that for fiscal year 1997-98, Washington had the highest business-tax burden of the seven Western states examined. Moreover, Washington was one of only two states where the business tax burden had increased from the 1995-96 level. (For more on the Utah study, see the Research Council policy brief *"Washington's Business Taxes Highest in the West."*)

The effect of tax decreases enacted since 1993 on tax payments in fiscal year 2001: Households benefit more.

Session	General Fund Taxes	Total	Household	Business
1994 Session	Hi Tech tax incentives	(44)		(44)
	Distressed Area exemption	(21)		(21)
	Small Business Tax Reduction	(24)		(24)
	Other Reductions	(3)		(3)
1995 Session	Manufacturing Tax Exemption	(99)		(99)
	Misc. Sales Tax Exemptions	(8)		(8)
	Misc. B&O reductions	(10)		(10)
1996 Session	B&O Rate Decrease on Services	(119)		(119)
	Repair and Replacement	(24)		(24)
	R&D Equipment	(15)		(15)
	Other Reductions	(13)		(13)
1997 Session	Property Tax Reduction (Ref. 47)	(238)	(138)	(100)
	B&O Rollback	(124)		(124)
	Other Reductions	(23)		(23)
1998 Session	MVET tax cut only (Ref. 49)	(131)	(106)	(25)
	Other Reductions	(36)		(36)
1999 Session	Rural County Incentives	(12)		(12)
	Other Changes	(6)		(6)
I 695	MVET Elimination	(765)	(620)	(145)
	Total	(1,716)	(864)	(852)

Notes on calculations:

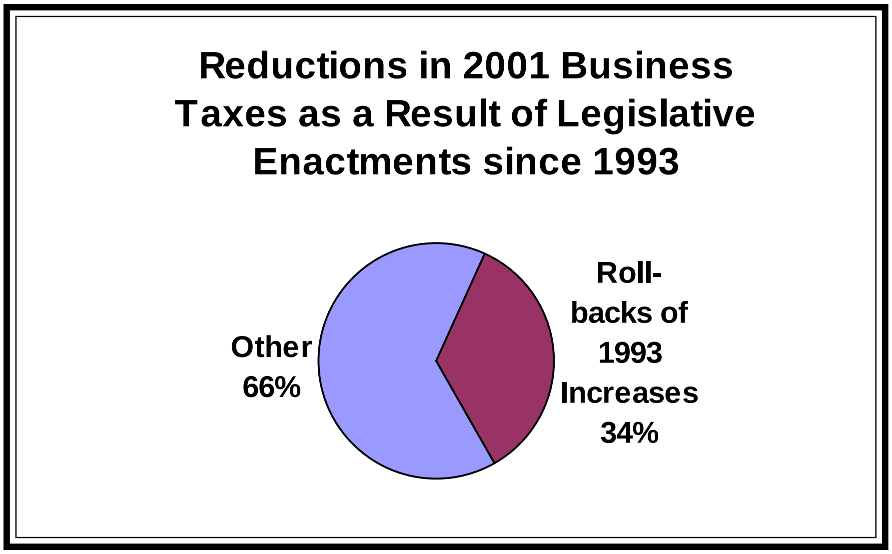
Data on Legislative tax cuts from House Finance Committee; Estimate of FY 2001 value of I 695 calculated as the average of OFM estimates for CY2000 and 2001; 81% estimate for share of MVET paid by households from House Finance Committee Staff; 58% estimate of property tax on single family households from DOR spreadsheet LEVY99.xls; all other tax decreases allocated to business.

FIGURE 6

Figure 6 shows the effects on taxes, to be paid in the 2001 fiscal year, of the major tax changes enacted since 1993. The largest tax reduction since 1993 is in the MVET, which was first reduced by R-49 and then eliminated by I-695. More than 80 percent of this benefits households. The second largest reduction is the property tax cut approved by voters is R-47. Nearly 60 percent of this benefits the owners of single-family residential property. On balance, the tax reductions enacted since 1993 provide a greater benefit to households in the coming fiscal year than to business owners.

Those who argue that households have gotten the short end on tax cuts focus on legislative actions, ignoring the elimination of the MVET by I-695. But more than one third of the cuts enjoyed by business were roll-backs of tax increases enacted in 1993. (See Figure 7.)

FIGURE 7



Preserve uniformity to retain competitiveness

The Washington Research Council has documented significant competitiveness challenges facing the state, including high labor costs, heavy business regulation, extraordinarily high taxes on businesses, lack of affordable housing and terrible traffic congestion. Without question, uniformity in property taxation maintains one of the few competitive advantages offered by our tax structure.

This Report is also available in a shorter version in the e-Brief: *"Uniformity in Property Taxation Should be Retained."*

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