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# Taxes and Economic Growth

The system of major state general fund taxes (excluding cigarette and alcohol taxes) being proposed by the governor would have grown at about the same rate as growth in the economy (as measured by personal income) over the last 11 years. The current tax system, without changes in tax rates or bases, would have grown at a rate of about 90 percent of economic growth.

The elasticity of the system is the issue. Tax elasticities measure the relationship between economic growth (personal income) and tax revenue growth. An elasticity of 1.00 means that the rate of change in tax revenue equalled the rate of change in the economy. An elasticity of 0.90 means that the rate of change in tax revenue was 90 percent of the change in the economy. A 1.10 elasticity means tax revenue growth was 110 percent that of the economy, or 10 percent more.

The elasticity figures most commonly discussed are hypothetical figures — they assume no changes were made in tax rates or tax bases over the years considered. For example, the Research Council figures assumes that the tax rates and bases in effect in 1987 applied for the entire 1976–87 period. (This report relies on data provided by the Department of Revenue (DOR).)

Our calculation of a state tax elasticity of 0.90 differs from the 0.85 state tax elasticity figure cited by the DOR because we exclude cigarette and alcohol taxes. Those taxes are based on quantities purchased rather than purchase price, and therefore are not expected to keep pace with inflation. They are inelastic taxes, and account for only a small share of general fund revenues. We similarly exclude cigarette and alcohol taxes from our presentation of actual tax collections and from the Gardner reform proposal.

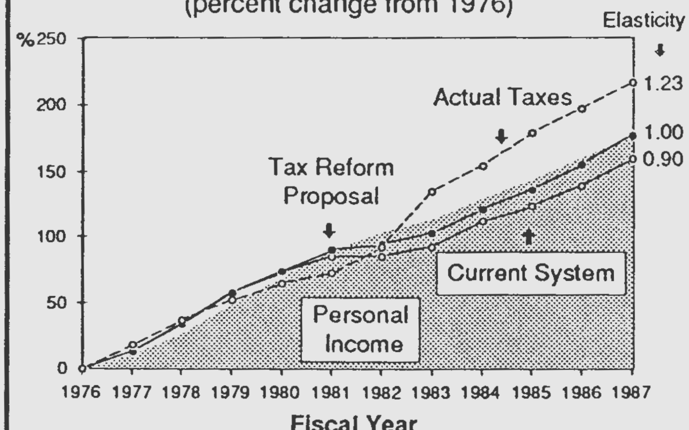
Over the entire period from 1976 to 1987, as shown in the graph on the right, the current tax system without adjustment increased at a rate of 90 percent of the economy, the tax reform proposal increased at the same rate as the economy, and actual tax collections grew at about 123 percent of economic growth.

But elasticities are variable — they change over time — and do not express a constant relationship between the tax system and the economy. So it's not enough to say that "the present tax structure grows at a rate of 90 percent of the economy," which implies a fixed relationship.

The elasticity characteristics of the governor's proposal are similar to our current system — both would have grown slower than the economy during the 1980–83 recession and both would have grown faster than the economy during periods of economic expansion. As the table below shows, hypothetical elasticities, assuming constant rates and bases,

(over)

**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).

*Source: Tax Alternative Model, DOR, 1988*

**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 |
| Gardner's Reform Proposal | 1.07 | 0.64 | 1.22 | 1.00 |
| Actual Tax Collections | 0.93 | 1.68 | 1.17 | 1.23 |

*Source: Tax Alternatives Model, DOR*

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of both the tax reform proposal and the current system, grew faster than the economy from 1976 to 1980 and from 1983 to 1987, and slower than the economy during the 1980–83 recession. The reform proposal grows faster than the current system in all three sub–periods. Actual taxes grew faster than the economy during and after the recession, but lagged from 1976 to 1980.

DOR director Bill Wilkerson told the House Revenue Committee, "no tax performs well in the 1981–83 situation." Support for that observation can be found in a National Conference of State Legislatures (NCSL) study of state tax systems in the early 1980s. NCSL reports the following: in 1981, five states raised sales taxes (three of them, including Washington, in special sessions); in 1982, nine states raised major taxes (five increased the sales tax and four raised the income tax); and, in 1983, 38 states increased at least one tax (16 raised personal income taxes, 11 raised sales taxes, and 12 raised major business taxes — some raised more than one tax).

State tax systems are not recession–proof. And, even under the reform proposal, tax rates would have had to increase during the recession to achieve the same level of spending. As the graph shows, both the current system and the reform proposal lead actual tax collections until 1982, when the lines cross, reflecting the rate increases adopted by the legislature. During and after the recession, the current system lags the growth of the reform proposal. Actual collections, however, have been well ahead of the hypothetical receipts.

Both the current system and the reform proposal grow generally with the economy. The 11–year elasticity (covering the years from 1976 to 1987) of the reform proposal more closely approximated economic growth than did the current tax structure for two reasons: it did not drop as low during the recession, and it grows faster than the economy during non–recessionary periods.

Until the state experiences a measurable recession, tax collections under both the current and proposed tax systems should exceed economic growth, with the proposed system growing somewhat faster.

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*For more information on the state tax system, call or write the Research Council to order your copy of our report,* ***Understanding Washington's Taxes****.*