



## Taxing Business

State and local governments in Washington raise an extraordinarily high share of their revenue through taxes on business. This fact has long been a focal point in discussions of the state's business climate and has received new attention as tax reform has become an issue in the gubernatorial campaign.

The state's two major taxes, the sales tax and the business and occupations tax, fall heavily on business (Washington Research Council, 2003). The sales tax is popularly viewed as a tax on consumers, but in fact the department of revenue calculates that 36 percent of the revenue generated by the sales tax (and its companion use tax) derives from purchases made by businesses (Washington State Tax Structure Study, page 105). As the late John Due, who was the nation's foremost expert on sales taxation, put it, "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" (Mikesell, page 558).

The business and occupation tax (B&O) is similar to a sales tax, although the number of transactions subject to the B&O is far greater than the number subject to the sales tax (for 2003, \$318.9 billion versus \$87.7 billion). With this broad base, the B&O is a turnover tax which economists recognize to be the least desirable form of sales tax (Musgrave and Musgrave, page 397).

To explore the impacts of the sales and business and occupations taxes on economic activity in the state we have simulated their removal using the WRC-REMI model of the state economy.

Simply removing one tax without an offsetting decrease in government spending or increase in another tax can be misleading. Therefore we present balanced simulations, where the revenues from the sales and B&O taxes are replaced by a rudimentary personal income tax.

In principle an income tax should affect the state economy through three channels. First, the tax will reduce the money that households have to spend on goods and services. Second, the tax reduces the after-tax wage in this state relative to those in other states and thus decreases the rate at which people migrate to the state. Third, the personal income tax is also a tax on the profits of non corporate businesses, which are taxed through the personal income tax rather than the corporate income tax. Only the first two of these channels are captured by the income tax we employ in the simulations.

Moreover, at the present time we are unable to model an income tax with an average rate that varies across households. Therefore the tax we use is a flat-rate tax on household personal income. It is

highly unlikely that an actual state income tax would be absolutely flat, and in fact, many advocates want a tax that is aggressively progressive. A progressive tax will impact consumption and migration differently than a flat-rate tax.

Thus, our simulations do not accurately represent any particular income tax proposal. This caveat notwithstanding, we believe the simulations do provide useful, preliminary information on the relative impacts of the sales and B&O taxes.

### Simulations

We report six simulations with the WRC-REMI model. (For a description of the model see Washington Research Council, 2004.) In each of the simulations we make a change to the state tax structure beginning in the year 2001 and compare the result for 2010 to a baseline simulation that preserves the existing tax structure. We focus on two economic indicators: employment and real disposable personal income per capita (personal income per capita adjusted for changes in consumer prices and reduced by income taxes paid).

#### *Simulation #1: Eliminate the B&O*

The business and occupations tax applies to most business revenues at rates that range from 0.138 percent to 3.3 percent. The tax generated \$1.9 billion in revenue for the state during fiscal year 2003.

When we replace the B&O tax with a flat-rate income tax, employment in 2010 is 22,500 greater than the baseline scenario. (Our measure of employment includes self-employed proprietors as well as wage and salary workers, and totals 3,962,500 for 2010 in the baseline simulation.) Real disposable personal income per capita is 0.02 percent lower in 2010 with the B&O eliminated, compared to the baseline simulation.

To get a sense of the impact of the B&O tax relative to the sales tax, we next simulate a sales tax rate reduction with revenue loss equivalent to B&O elimination. Identical revenue losses assure that the differences we see reflect the structural impacts of the taxes rather than differences in the level of taxation.

### Six Simulations: Differences from Baseline in 2010

	Employment	Real Disposable Personal Income Per Capita
#1: Replace B&O with Flat-Rate Income Tax	22,500	-0.02%
#2: Reduce Sales Tax with Flat-Rate Income Tax	5,400	-0.08%
#3: Reduce Consumption Sales Tax with Flat-Rate Income Tax	-7,000	-0.16%
#4: Reduce Business Sales Tax with Flat-Rate Income Tax	28,400	0.07%
#5: Replace Sales Tax with Flat-Rate Income Tax	14,600	-0.26%
#6: Replace Sales & B&O Taxes with Flat-Rate Income Tax	36,100	-0.28%

### *Simulation #2: Reduce the sales tax*

The state levies sales and use taxes at the rate of 6.5 percent. (In addition various local governments levy sales taxes so that the highest rate in the state is as high as 8.9 percent.) The state tax raised \$5.9 billion in fiscal year 2003. Since 36 percent of the sale tax is paid by business, its direct burden on business is actually a bit greater than that of the B&O.

In this scenario we reduce the sales tax rate in each year level that results in a revenue loss just equal to the B&O's revenue. Again the revenue is replaced with a flat-rate tax on personal income.

In this case employment in 2010 is boosted by 5,400 compared to the baseline, while real disposable personal income per capita is reduced by 0.08 percent.

Eliminating the B&O adds 17,000 more jobs than a revenue-equivalent reduction in the sales tax. Thus it appears that per dollar raised, the B&O tax is more destructive to business activity in the state than the sales tax is.

To provide a more complete understanding of the impact of the sales tax, we next decompose it into separate taxes on consumer and business purchases.

### *Simulation #3: Reduce the sales tax on consumer purchases*

In this case we reduce the sales tax on consumer purchases by an amount equivalent to the revenue from the B&O tax, while leaving the sales tax on business purchases unchanged. The revenue is replaced by a flat-rate tax on personal income.

This change reduces employment in 2010 by 7,000, compared to the baseline simulation, and reduces real disposable personal income per capita by 0.16 percent.

### *Simulation #4: Reduce the sales tax on business purchases*

In this case we reduce the sales tax on business purchases in an amount that is revenue-equivalent to the elimination of the B&O. The tax on consumer purchases is unchanged, and the revenue is replaced with a flat-rate income tax.

This change increases employment by 28,400 in 2010 compared to the baseline scenario and increases real disposable personal income by 0.07 percent.

Simulations 3 and 4 show that economic activity is hurt much more by the sales tax on business purchases than by the sales tax on consumer purchases. With the business sales tax reduction the state has 35,400 more jobs than with the consumer sales tax reduction. Similarly the business sales tax reduction adds 0.23 percent to real disposable personal income compared to the consumer sales tax reduction.

It is also instructive to compare elimination of the B&O tax with an equivalent business tax reduction through a reduction in business sales tax payments. Comparing simulations 1 and 4, reducing the



sales tax on business purchases provided 6,000 more jobs than eliminating the B&O and results in 0.10 percent higher real disposable personal income. Dollar for dollar, the sales tax on business purchases provides a greater drag on the economy than does the B&O.

*Simulation #5: Eliminate the sales tax*

This simulation totally eliminates the state sales tax and replaces the revenue with a flat-rate income tax. In this case 2010 employment rises by 14,600, compared with the baseline, and real disposable personal income falls by 0.26 percent.

*Simulation #6: Eliminate both the sales tax and the B&O tax*

Finally, when we simultaneously eliminate the B&O and sales taxes, employment in 2010 exceeds the baseline by 36,100. Real disposable personal income per capita falls by 0.28 percent. These effects are roughly equal to the sums of the effects found for the separate eliminations of the two taxes.

**Discussion**

The results reported in this Policy Brief are a set of approximations intended to shine a light on the effects of the state's current system of business taxation. They are not intended to be evaluations of any specific tax reform proposals.

The personal income tax we use to replace revenue when we cut B&O and sales taxes has a flat-rate with no exemptions. A graduated income tax (or even a flat tax with personal exemptions) will have a larger effect on economic activity than does this proportional tax. Further, we have not captured the impact of the personal income tax as a tax on non-corporate business.

The simulations reported here support the proposition that the way that the state currently taxes businesses does put a drag on economic development. Cutting the B&O tax gives a bigger boost than a revenue equivalent cut in the sales tax. Cutting the business portion of the sales tax gives a bigger boost than cutting B&O.

## References

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