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Policy Brief

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Tax Relief Prospects for 1997

In 1997, the Legislature will have a rare opportunity to provide tax relief. Revenues available to the general fund for the 1997-99 biennium exceed the Initiative 601 spending limit by more than $750 million, the carry-forward budget is running below the I-601 cap and, according to the state Forecast Council, economic indicators "suggest a more robust Washington economy in the coming years."

The Washington Research Council's recent evaluation of the state tax structure found that the tax system performs well on the general criteria of economic neutrality, fairness, administrative simplicity, transparency and stability.[1] Consider the following strengths:

- Tax revenues increase with economic growth;
- Property taxes are uniform and assessed at 100 percent of market value;
- The retail sales tax is broad-based;
- The state avoids the revenue instability of income taxes; and
- For most individual taxpayers, the tax burden over their lifetimes is distributed proportionately.

However, there are significant weaknesses:

- The general level of taxes is too high;
- The burden on business, particularly the service industry, is disproportionate; and
- There is excessive tax earmarking and "off-budget" spending.

In this *Policy Brief*, after reviewing and consolidating the findings of our earlier analyses, we suggest approaches to tax relief which are consistent with those findings. Specific recommendations include:

- Completing the repeal of the tax increases imposed by the 1993 Legislature;
- Providing general property tax relief while preserving uniformity and market-value assessment; and
- Reducing the reliance on earmarked taxes and limiting the growth in dedicated accounts.

Background

The major taxes supporting the state general fund grow at about the rate of the state economy. That is, over time, the combined elasticity (the percentage change in tax revenues associated with a one percent change in personal income) of these taxes is 1.0. This feature of the tax system means generally that when state lawmakers want to increase or decrease the state tax burden — the share of the economy claimed by state taxes — an explicit change in tax rates or tax bases will be required.

Overall tax levels. About $118 of every $1,000 of personal income in the state is claimed by state and local taxes, ranking the state 17th highest in the nation, according to 1993 statistics presented by the U.S. Department of Commerce, Bureau of the Census. We expect the 1994 data to show a higher ranking as the impact of the 1993 tax increases (which have not yet been fully repealed) is reflected.

Business tax burden. About 43 percent of the state and local tax burden falls initially on businesses, compared with a national business share of about one-third. Several factors account for this high statutory incidence on business — the absence of a personal income tax, the broad-based retail sales tax (the recent repeal of the sales tax on machinery and equipment eased the business burden somewhat), and the gross receipts tax.

Family tax burden. Estimates of the tax burden on individuals and families in Washington vary. However, our analysis supports the conclusion that the lifetime tax burden is nearly proportional. The lifetime analysis is important because as expenditures and earnings vary predictably over time, so will the share of income claimed by taxes. While state and local taxes here have a regressive statutory incidence (taxes as a share of household income drop from 11 percent for a family of four earning $25,000 to 6 percent for a family with income of $100,000), when federal taxes and transfer payments are considered, the overall system appears progressive. The most regressive features of the state tax system are the gas tax, the public utility tax, and tobacco taxes.

Business and Occupation Tax

The state B&O tax is unique. Critics say the tax discourages small business development, representing a particular hardship during the unprofitable start-up phase. The evidence is mixed. A 1989 Washington Research Council study[2] concluded that so long as the rates remained low, the tax was manageable for most concerns, especially those whose competition was in-state. In addition, the B&O has the virtues of administrative simplicity, and it is not subject to the revenue volatility associated with the corporate income tax.

However, the 1993 tax increases imposed on service businesses were excessive. Adopted as a last-minute substitute for an equally ill-advised attempt by the governor and some legislators to extend the state sales tax to services, the increase unfairly singled out a fast-growing sector of the economy to fund an even faster growing state general fund.

B&O taxes represent considerable revenue for state government. Collections are estimated to be $3.6 billion in the coming biennium, of which about $250 million is attributable to the remaining share of the 1993 rate hike.

Recommendation: The repeal of the 1993 tax increase should be completed. Given the availability of surplus revenues under Initiative 601, relief should be provided to those business taxpayers representing the source of the higher revenues. The 1993 tax increases were passed to bridge the budget gap between desired spending and anticipated revenues. The condition no longer exists and the measures taken at that time are no longer required.

Property Taxes

The Washington Research Council's review of property taxes evaluated property tax levels in 15 Washington cities and compared Washington's property tax burdens with those of 11 states and the U.S. average. On balance, the Washington property tax system conforms with good tax policy. In particular, the state's adherence to the principles of uniformity and 100 percent fair market value assessment represents a significant strength. Taxes on all classes of property in Washington remain below the national average and below those of states with which Washington competes for economic development. Evidence from other states strongly suggests that classification systems lead to higher business taxes with no corresponding reduction in the taxes paid by homeowners.

About $2.7 billion in property taxes will be collected by the state in the 1997-99 biennium. The state property tax, uniformly applied to the market value of real property, is limited to $3.60 per $1,000 of true and fair value. In 1995, it was reduced by 4.7 percent for taxes due and payable in 1996.

Recommendation: Any property tax relief granted must be adopted without compromising uniformity or market value assessment principles. The state could proceed by 1) reducing the state property tax rate, or 2) lowering the 106 percent limitation (perhaps to the lower of 106 percent or the rate of inflation).

Miscellaneous Taxes, Earmarking

In recent years, the Legislature has increased its reliance on taxes earmarked for specific purposes, a trend which confuses and misleads taxpayers and violates good fiscal practice. The Washington Research Council has previously pointed out the problems inherent with the taxes supporting the Health Services Account (HSA) and the Violence Reduction and Drug Enforcement Accounts (VRDEA) (primarily tobacco, alcohol, and syrup taxes)[3] and the real estate excise tax.[4] Too often, earmarking violates the benefit principle (those who benefit should pay) or represents a mismatch between expenditure requirements and available revenues. In addition, as noted above, several of these minor taxes represent the more regressive components of the state tax system.

Recommendation: The Legislature should act immediately to reduce the state's use of dedicated accounts and earmarked taxes. Ideally, these revenues and programs should be transferred to the general fund. Alternately, the I-601 growth factor should be applied to the major dedicated accounts, like HSA and VRDEA. This would eliminate the current incentive to create and expand such accounts outside the 601-limited general fund.

Endnotes

[1] See *Understanding Washington State Taxes*, August 19, 1996, for a more complete discussion of these principles.

[2] *New Business Locations in the Northwest*, July, 1989.

[3] *Too Much Earmarking, Dedicating Funds*, July 31, 1996.

[4] *Real Estate Excise Taxes in Washington State*, February 1, 1993.