
Special Report



Washington Research Council

August 19, 1996

Understanding Washington State Taxes

In 1988, following a systematic review of the state's taxes, the Washington Research Council "found Washington's tax system to be fundamentally sound." While the conclusion remains valid, there have been a number of changes in tax rates and bases since the report was released. Therefore, we have produced this updated discussion of the state tax system.

Five Keys to Evaluating a Tax System

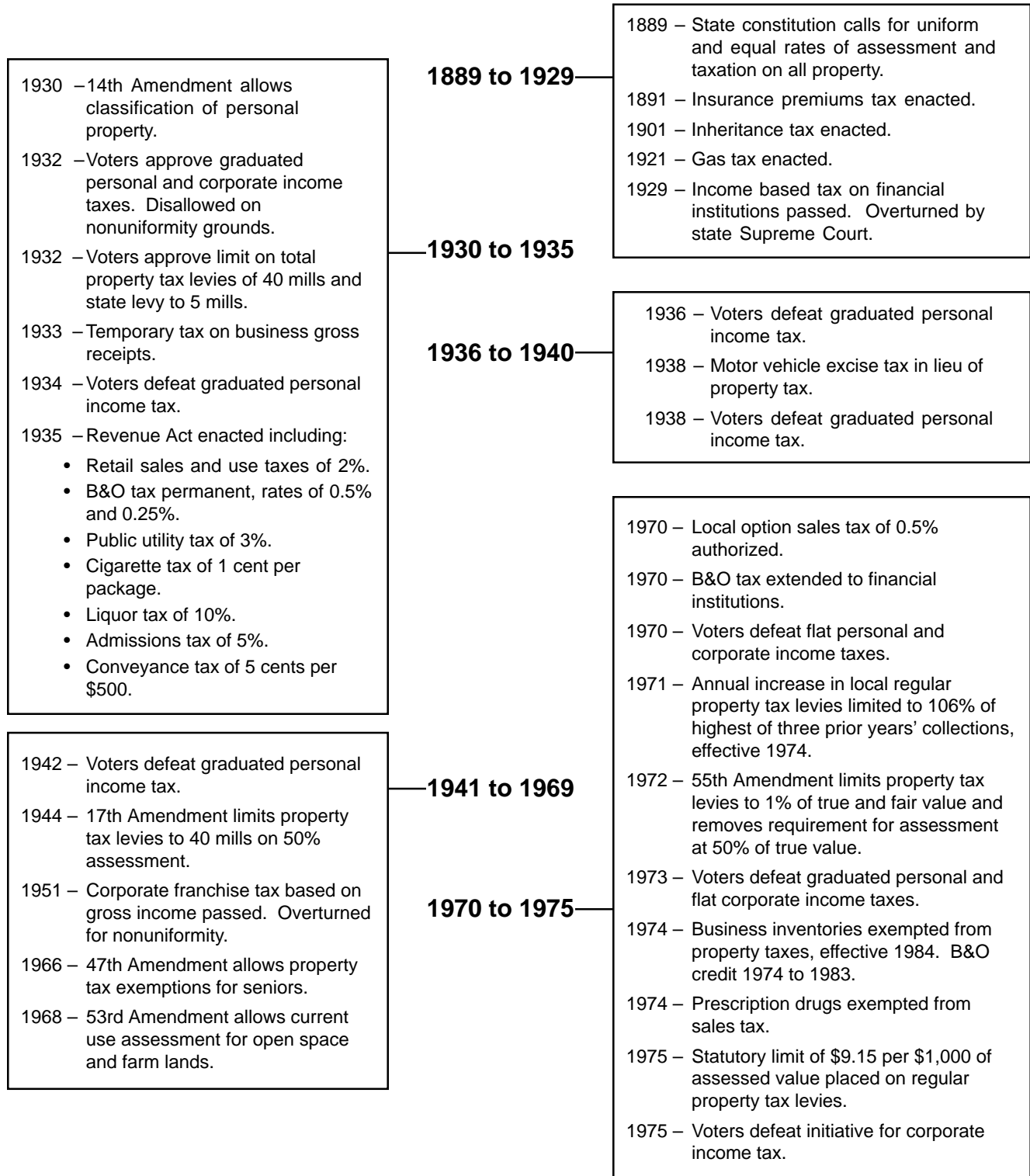
- ☑ **Economic neutrality:** A tax system should be designed to minimize distortions in economic decision making.
- ☑ **Fairness:** The burden of taxation should be equitably spread among the citizens.
- ☑ **Administrative simplicity:** A tax system should neither be excessively expensive for the state to administer nor impose undue record-keeping and reporting requirements on taxpayers.
- ☑ **Transparency:** A tax system should be designed so that the costs of government are clear to citizens.
- ☑ **Stability:** The revenue of a tax system should not fluctuate wildly with the condition of the economy.

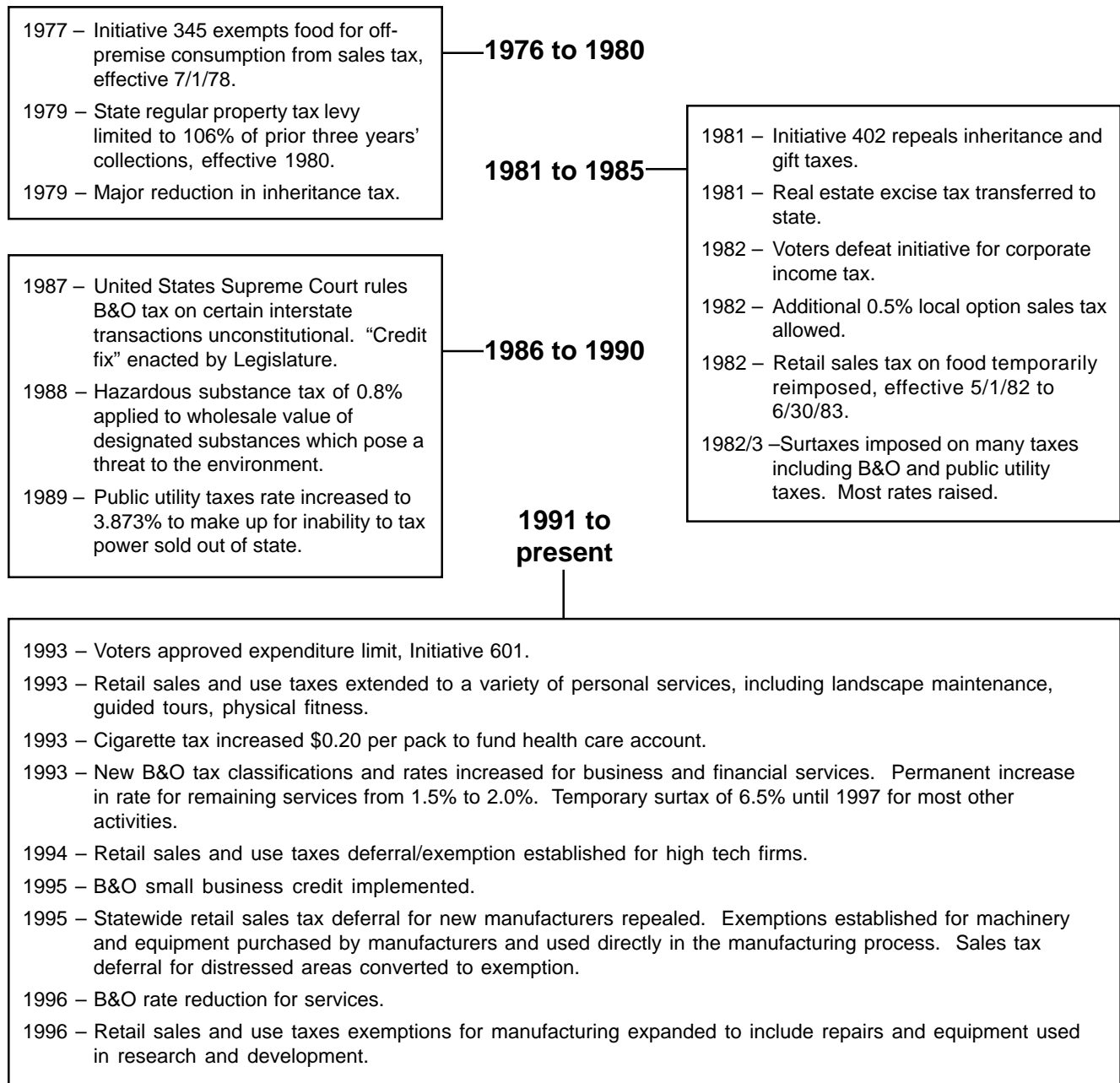
History of State Taxes

Like many other states, Washington adopted major taxes during the Great Depression to strengthen the tax system. The retail sales and use taxes, business and occupation tax and most other taxes that make up Washington's current tax structure were enacted between 1933 and 1937. Subsequently, Washingtonians have refrained from major structural changes, even in the late 1960s and early 1970s when many states were again adding major taxes. In fact, voters have defeated proposals to enact corporate and personal income taxes seven different times since 1935.

Until the 1930s most state and local government revenue came from taxes on property. In 1927, for example, property taxes accounted for more than 90 percent of state and local tax revenue. When the national economy failed after 1929, state personal income collapsed, falling more than 45 percent from \$1.14 billion in 1929 to \$625 million in 1932. Over that same period, property tax levies came down only slightly, from \$78 million to \$73 million. As a result, property taxes rose as a share of personal income from less than 7 percent in 1929 to nearly 12 percent in 1932. Property tax delinquencies soared, reaching 30 percent of the tax roll in 1932 and 1933. Citizens and legislators scrambled to relieve the property tax burden and to find new sources of tax revenue.

Figure 1
Major Tax Events in Washington





Efforts to institute personal and corporate income taxes were stymied because the state constitution required that all property be assessed and taxed uniformly. In 1929 the state Supreme Court overturned an income tax on financial institutions, declaring that it violated the equal protection provisions of the federal and state constitutions. The next year voters approved the 14th Amendment to the Washington State Constitution, which slightly relaxed the uniformity requirement. The amendment stated that "all taxes shall be uniform upon the same class of property. . . all real estate shall constitute one class." Many supporters of the amendment believed that the court would allow graduated tax rates if income was classified separately from tangible property.

In November 1932 Washington voters approved two initiatives. The first initiative limited property taxes to 40 mills, that is, four cents for each dollar of assessed value. This initiative also specified that property be

assessed at 50 percent of market value. The second initiative established personal and corporate graduated income taxes.

The constitutionality of the income taxes was immediately challenged, however, and the superior court ordered the state Tax Commission not to collect the taxes. As a result, the 1933 Legislature sought an alternate tax to replace the lost revenue, passing a temporary tax on business gross receipts. This tax survived legal challenges when the court ruled that it was a tax on the privilege of doing business rather than a tax on property. Eventually, the state Supreme Court struck down the income taxes, ruling that all income falls into a single class of property and must be taxed uniformly.

The 1935 Legislature passed the most sweeping tax measure in the state's history, the Revenue Act of 1935. The business gross receipts tax was made permanent and renamed the business and occupation (B&O) tax. The Revenue Act also initiated taxes on retail sales, public utilities, liquor, cigarettes, admissions, and other sources. The 1935 Legislature also continued the effort to adopt state income taxes. It enacted statutes establishing a flat-rate corporate income tax and a personal income tax with two rates. And it approved a constitutional amendment to allow graduated personal and corporate income taxes. The state Supreme Court overturned income tax statutes, while the voters rejected the constitutional amendment.

Voters again defeated amendments to allow graduated personal and corporate income taxes in 1938 and 1942.

With the establishment of the Motor Vehicle Excise Tax in 1937, nearly all components of the current tax structure were in place. Since that time there have been rate changes and additions to and subtractions from tax bases, and constitutional and statutory limitations have been placed on property tax levies. (See Figure 1 on pages 2 and 3, *Major Tax Events in Washington*.)

Tax advisory committees in 1966, 1968, 1971 and 1982 recommended various forms of income taxes. In 1989, the Governor's (Gardner) Committee on Washington's Financial Future endorsed a state personal income tax. Despite these urgings, Washington voters turned down proposed constitutional amendments that would have authorized corporate and personal income taxes in 1970 and 1973. And in 1975 and 1982, corporate income tax initiatives were defeated.

Most recently, voters in 1993 approved Initiative 601, requiring that any general fund tax increase — even if accompanied by an offsetting tax decrease — receive two-thirds majorities in both houses of the Legislature. Further, tax increases that will raise spending above the 601 limit must be submitted to the voters for approval.

Current Structure

Washington state government will collect nearly \$21 billion in taxes during the current biennium. By far, the largest share of state tax revenue is raised by the sales and use taxes, which will account for \$9 billion in 1995-97.

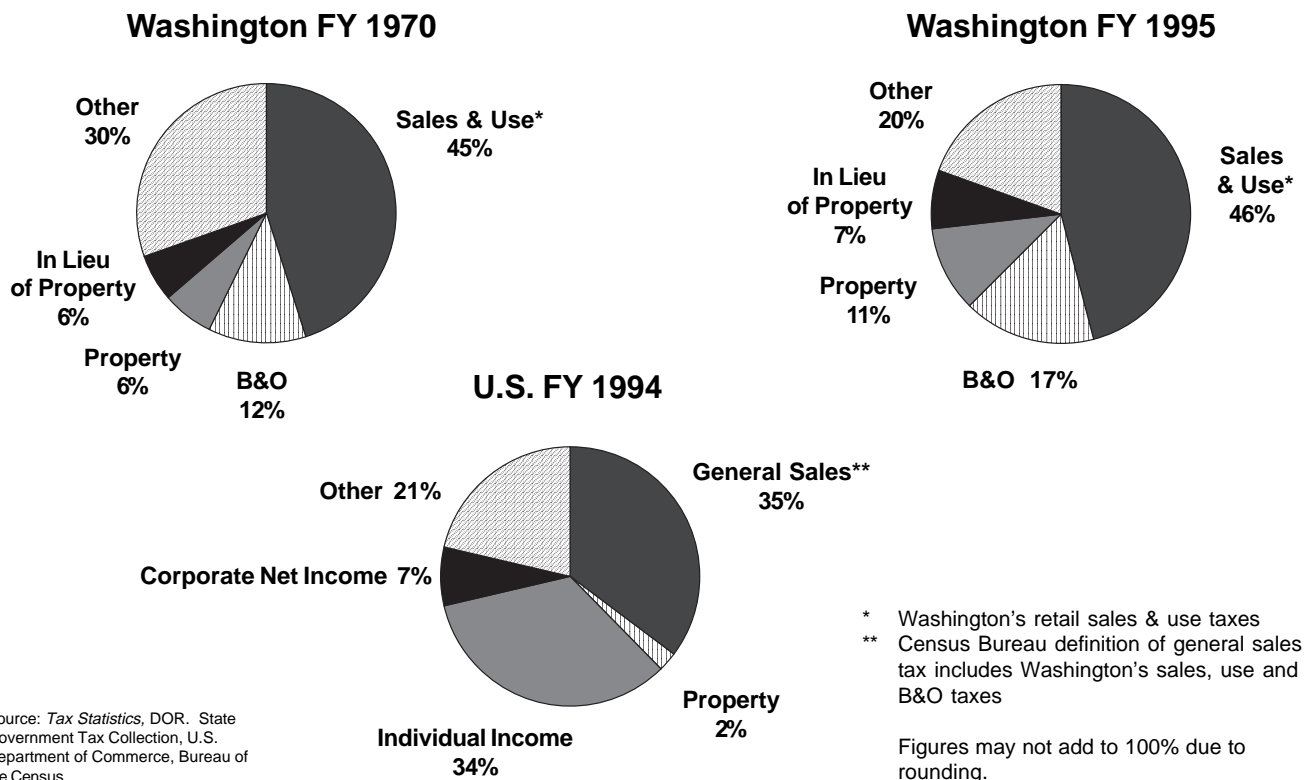
As shown in Figure 2 on page 5, the state's relative reliance on the retail sales and use taxes is about what it was 25 years ago. In FY 1970 these taxes equalled 45 percent of the total; in FY 1995, 46 percent. Between 1970 and 1995, the share of tax revenues represented by the B&O tax increased from 12 percent to nearly 17 percent. Over the same period, the share contributed by property taxes increased from 6 percent to

11 percent. The Other Taxes category dropped from 30 percent of revenue to 20 percent, primarily as a result of relatively slow growth in the gas tax, which amounted to 15 percent of state tax revenue in 1970, but only 7 percent in 1995.

Figure 2 also shows the breakdown of taxes for All States as reported by the U.S. Census Bureau. Nationally, governments rely heavily on two taxes, the individual and corporate income taxes. Washington, though, collects neither tax. Alternately, Washington is the only state to levy a B&O tax. The 17 percent of state taxes collected from the B&O is more than twice the 7 percent of state/local revenues generated nationally by the corporate income tax.

In some cases, the state exempts a class of property from the property tax but collects in its place an excise tax. This, for example, is the case with motor vehicles. The Census Bureau data on property taxes lump these "in lieu" excise taxes with the standard property taxes. Nationally, the property tax is the primary tax for local governments; most state governments collect little property tax. Washington state government's reliance on this tax is thus unusual. Washington is also unusual in the degree to which taxes overall are collected by the state government, rather than by local governments. Nationally, about 60 percent of combined state and local taxes were collected at the state level in FY 1993, while in Washington the figure was 70 percent. This difference is largely explained by the high share of Washington's public school spending that is state-funded.

Figure 2
Comparative State Taxes (percent of total state taxes)



Source: *Tax Statistics*, DOR. State Government Tax Collection, U.S. Department of Commerce, Bureau of the Census.

Regularly collected data do not reveal the share of overall state and local taxes collected from businesses as opposed to households. An analysis conducted in 1988 by James McIntire showed that Washington businesses paid about 44 percent of state and local taxes, compared to about 33 percent nationwide. There have been no major structural changes in Washington's state and local tax system since that time. B&O tax rates on some businesses were raised in 1993 and then partially rolled back in 1995. Also in 1995, the Legislature exempted manufacturing machinery and equipment from the sales tax; this exemption was expanded in 1996 to include repairs and research and development equipment.

Recently, the residential share of property taxes may have increased somewhat. On balance, though, the distribution of taxes between households and businesses has not changed greatly since 1988. The Washington Research Council estimates that 43 percent of taxes were collected from businesses in 1995, 53 percent from households, 3 percent from governments, and 1 percent from tourists.

The Economic Performance of Washington's Tax System: Elasticity

The (income) elasticity of a tax is defined to be the percentage change in tax revenues associated with a 1 percent change in personal income, holding constant the tax's base and rate. The overall elasticity is a significant property of a tax system as it measures the way government revenues grow as the economy grows.

Together, the sales and use taxes, the business and occupation tax, the property tax, and the motor vehicle excise tax represent over 80 percent of general fund state revenues. The Washington Research Council estimates that the combined elasticity of these taxes is one.

The remaining general fund state revenue sources are a mixed bag. Some, like the real estate excise tax, are based on the value of transactions and are well indexed to economic growth. Others, like the cigarette tax, are based on quantities purchased and thus are not well indexed. We place the combined elasticity of all of these taxes at 0.5.

Overall, then, the Washington Research Council estimates the long-run elasticity of general fund state revenues to be 0.9.

Retail Sales and Use Taxes

The retail sales tax is imposed on household and business purchases of tangible property. The tax is also imposed on some services (such as construction, cleaning, and repairs). The use tax is imposed on the use of an item in the state of Washington when the acquisition of the item has not been covered by a sales tax. The use tax applies, for example, to items purchased in other states by Washington residents or the purchase of a used car from a private individual. The simultaneous implementation of these two forms of taxation effectively constitutes a comprehensive tax on consumption. Washington's sales and use tax base is one of the broadest of any state in the country. Between them, these two revenue sources account for 46 percent of total state taxes and more than one-half of state general fund tax collections.

Figure 3
Retail Sales and Use Taxes

Enacted: 1935
 Forecast 1995-97 yield: \$9.1 billion*/State
 Fiscal 1995 yield: \$4.4 billion/State; \$983 million/Local
 Rate: State 6.5%
 Local 0.5-1.7%

Tax Savings due to Exemptions and Special Rates	1995-97* State (% of total)	1995-97* Local (% of total)
Total	\$10,782 m.	\$2,480 m.
Nonresident Property	47.0%	47.1%
Services	23.3%	23.4%
Food	9.3%	9.3%
Motor Fuel	3.3%	3.3%
Agricultural Products	2.4%	2.4%
Manufacturing Machinery	1.7%	1.7%
Prescription Drugs	1.6%	1.6%
Other	11.4%	11.2%

* Estimated

Source: DOR; Office of the Forecast Council.

Washington retail sales and use taxes enjoy a high degree of voluntary compliance. After a comprehensive analysis of compliance with state tax laws, the Washington Department of Revenue (DOR) in 1990 estimated compliance to be about 94 percent. Of the 6 percent noncompliance, only 1 percent was deemed willful. The remaining 5 percent was thought to involve ignorance of the tax law, differences of interpretation, or accounting errors.

The state retail sales tax rate is currently 6.5 percent. In addition to this rate, Washington statute imposes 0.5 percent for local government and allows cities and counties to charge an additional 0.5 percent as an "optional" tax. Local jurisdictions are authorized to further augment this rate by up to 1.7 percent — 0.1 percent to 0.6 percent for transit, 1.0 percent to fund high-capacity transportation,

and 0.1 percent for criminal justice, public facilities, and county correctional facilities. The highest current local sales tax rate in the State of Washington is 1.7 percent, levied in King County and much of Snohomish County.

The use tax is assessed at the same rate as the sales tax, since it acts as a direct substitute. DOR projects that revenue from sales and use taxes for 1995-97 will be \$9.1 billion. (See Figure 3 above.) Local sales and use taxes have become a significant revenue source for cities, counties, and transportation districts. They rank second only to property taxes for all local jurisdictions taken, and at the city level, they are nearly equal in rank.

Exemptions and Special Rates

Although sales and use taxes apply to a broad base of consumers, there are significant exemptions and special rates. Exempted purchases include food, pharmaceuticals, livestock, seed, agricultural products, and manufacturing machinery and equipment. DOR estimates that exemptions and special rates will save taxpayers \$10.8 billion in state taxes and \$2.5 billion in local taxes during the 1995-97 biennium.

Exemptions exist for many reasons. Some exemptions are court-mandated or required by either the federal or state constitutions. Some exemptions, like those for foods and drugs, reduce the burden on low-income consumers, while others promote certain industries, as with livestock and seed.

Gasoline and other highway fuels are not subject to sales or use taxes, but they are subject to a per-gallon excise tax, which is dedicated to highway purposes. Personal and professional services were exempt until 1993 when the tax base was extended to include landscape maintenance, guided tours, rental of equipment with operator, and selected other services.

Business and Occupation Tax

The B&O tax is a tax on the gross receipts of all firms doing business in Washington, including corporations, partnerships, sole proprietorships, and some nonprofit corporations. No deductions are allowed for the costs of doing business, like payments for raw materials and other inputs to production. DOR expects to collect about \$3.3 billion in B&O taxes during the 1995-97 biennium, about 17 percent of all state tax receipts.

The B&O tax has been found to be a stable source of revenue for the state. In addition, it is relatively easy for the state to administer.

Figure 4
Business & Occupation Tax

Enacted: 1935	Major Rates:	Current	After 6/30/97
Forecast 1995-97 yield: \$3,263 million*	Retailing	0.471%	0.471%
	Manuf., wholesaling, and other activities	0.506%	0.484%
	Service and other activities	1.82875%	1.750%
	Selected business services	2.000%	2.000%

<u>B&O Exemptions</u>	<u>1995-97* (% of total)</u>
Total	\$3,033 m.
Income of Employees	25.0%
B&O Deductions	21.2%
Insurance Premiums & HMOs	17.8%
Real Estate	13.4%
Differential Rates	5.6%
Nonprofit Organizations	5.5%
Agriculture	3.5%
Small Business Credit	1.5%
Public Activities	1.1%
R&D	0.8%
Credits	0.7%
Other	3.9%

* Estimated

Source: DOR; Office of the Forecast Council.

The Economic Performance of Washington's Tax System: Stability

The short-run stability of a tax system is defined here as the degree to which revenues change over the business cycle — small swings in revenue growth imply greater stability than large swings. Past studies have shown that this state has a relatively stable tax system.

Washington's major tax sources are relatively broad-based. For example, the B&O tax is paid by businesses on their total gross receipts, so that most businesses pay something. Similarly, the retail sales tax is paid by individuals and businesses on most retail items and some services. In contrast, the corporate income tax base fluctuates with corporate profits, and tax systems that rely on this type of tax are more volatile. While more stable than corporate income taxes, progressive personal income taxes have also been shown to be relatively volatile.

B&O Tax Rates

Currently, thirteen different B&O tax rates apply to various classifications of business activities. Firms are taxed according to the activities in which they engage, and depending on their activities, they may be subject to more than one rate. More than 90 percent of all B&O tax revenue in 1995 came from four major rate classifications: manufacturing, wholesaling and other activities; retailing; selected business services; and services and other activities.

B&O Exemptions

Although Washington's B&O tax represents the nation's most comprehensive gross receipts tax, many transactions are exempt. (See Figure 4.) Individuals are exempted from paying B&O taxes on the wages and salaries they receive, which represents about one quarter of the total \$3 billion in exemptions estimated by DOR for the current biennium. Other deductions are allowed for investments for nonfinancial firms, constitutional exemptions, and grants for nonprofit organizations. Real estate sales are taxed through the real estate excise tax and, therefore, exempted from the B&O tax. Most of the income of health maintenance organizations (HMOs) is subject to the tax on insurance premium income; this premium income is exempt from the B&O tax. Other exemptions include real estate rental proceeds, certain nonprofit and social service organizations, agricultural businesses, public agencies, interest on real estate loans, and other miscellaneous business deductions.

Recent Modifications to the B&O Tax

In 1987 the U.S. Supreme Court ruled that the Washington B&O tax presented the potential for double taxation of multistate businesses. In response, the state Legislature adopted provisions allowing manufacturers to take a credit against their Washington B&O tax bill for certain taxes paid elsewhere.

In 1993 the Legislature abandoned the uniform 1.5 percent rate applied to service activities, establishing three new service categories and increasing rates. For selected business services (including computer services, data processing, accounting, business consulting, business management, protective services, and public relations) the new rate was 2.5 percent; for financial services, 1.7 percent; and for other service activities, 2 percent.

In 1993 the Legislature also approved a surtax of 6.5 percent on many B&O classifications and expanded the B&O tax base to include public and nonprofit hospitals. The surtax was lowered to 4.5 percent on January 1, 1995. It will sunset on June 30, 1997.

A B&O credit for high-technology research and development was approved in 1994. This credit accounts for less than 1 percent of all B&O exemptions.

The 1996 Legislature approved a partial rollback of the 1993 B&O rate increases. The rollback lowered the selected business services rate from 2.5 percent to 2 percent; the financial services rate from 1.7 percent to 1.6 percent; and the "other" service activities rate from 2 percent to 1.75 percent (excluding the 4.5 percent surtax).

In 1994 very small businesses received special consideration. Previously, firms with gross revenue of less than \$1,000 per month were exempt from the B&O tax. This exemption was replaced with a \$35 credit per month (maximum) for the smallest firms with a declining credit for firms with up to \$70 per month in tax liability. At the 2 percent rate, the \$35 per month credit suggests monthly gross income of \$1,750. This credit amounts to 1.5 percent of all B&O exemptions.

Apportionment

An interstate business presents a particular problem for the application of state income or gross receipts taxes. A number of states may assert the right to tax the business. The issue is how states choose to coordinate these taxes. Recent years have seen two differing trends. On the one hand, states have introduced into their tax systems incentives to attract interstate businesses and jobs. On the other hand, states have been increasingly aggressive in asserting their right to tax out-of-state businesses with in-state customers.

The U.S. Constitution prohibits a state from taxing out-of-state businesses whose activities within the state fail to achieve a threshold, called nexus. In general, this requires that the activities within the state include something more than just the solicitation of orders. Washington generally targets only the businesses that have some physical presence within the state.

Ideally, a business's various activities should not be subject to double taxation at the state level. And a state's interests with regard to businesses headquartered there should be balanced against its competing interests regarding those businesses that only have customers within the state. Within the bounds established by the Constitution, each state adopts rules specifying how it will tax multistate businesses. Since 1967, the Multistate Tax Commission has provided a forum for coordinating these rules.

The U.S. Supreme Court requires that nonbusiness income generally be *allocated* for taxation by the state in which it is sourced. Business income, on the other hand, must be *apportioned* among the states. Under apportionment, each state establishes a formula to determine the share of a business's income that it will tax. Currently, three-factor formulas are the most common. Under a three-factor formula, the share of the business's income that is taxable to a state is a weighted average of the shares of the business's payroll, property, and sales sourced to the state.

Depending on the different apportionment schemes used by the various states, the sum of a firm's tax base across all applicable states may be more or less than its true tax base. The choice of tax rates and apportionment method made at the state level could affect the location decision of a business that is trying to minimize its total tax burden.

For Washington's B&O tax, retail sales are apportioned according to where the sale is deemed to have taken place. In the case of services, if separate accounting is impractical, receipts are apportioned according to where the costs are sourced.

Property Tax

Property taxes provide the second largest share of the taxes and fees collected by Washington's state, and local governments, after general sales taxes. During 1995, state government levied \$1.1 billion in property taxes and local governments collected \$2.9 billion. Washington state government will collect over \$2.2 billion during the 1995-97 biennium, according to Forecast Council estimates. (See Figure 5 on page 12.)

Property is divided into two broad types. Real property, in general, consists of land and everything that is permanently affixed to it. All else is personal property. In 1995, personal property accounted for 8 percent of total assessed value. The remaining 92 percent was real property, either land or buildings. All property, both real and personal, is subject to the property tax, unless exempted by law.

Property Valuation

The state constitution stipulates that the property tax is to be levied against "the true and fair value" of property. For most property, values are assessed by locally elected county assessors and their staffs. Each year DOR conducts a property tax ratio study that estimates for each county the average relationship between the assessed value and the true and fair value of property. These estimates are used to assure that differences in county assessment practices do not result in inequities in the distribution of the burden of the state property tax. For the 1995 assessment, the ratio of assessed value to true value ranged from a low of 70 percent in both Pend Oreille and Whitman Counties to a high of 98 percent in Island County. The average assessment ratio for the state was 88 percent. That is, DOR believes that the aggregate value of real property as determined by the local assessors represented only 88 percent of the market value in 1995.

Property Tax Limitations

One Percent Limit

In 1971, voters established a one percent limit on levies. That works out to be \$10.00 per \$1,000 of assessed value. Four exceptions apply:

1. The limit does not apply to the levies of ports and public utility districts;
2. The limit may be exceeded if a three-fifths majority of the district's voters approves;

3. When a three-fifths majority of voters of a district approves the issue of general obligation bonds to fund capital investments, levies to pay interest and principal are not subject to the limit; and
4. A court of last resort may order levies to exceed the limit to prevent breaking contractual obligations.

Generally, taxes levied within the one percent levy limit are termed *regular* levies, while those outside of the one percent limit are called *excess* or *special* levies.

**Figure 5
Property Tax**

Enacted: 1889

Forecast 1995-97 yield: \$2,242.9 million*/State

1995 levy: \$1,065 million/State \$2,944 million/Local

1995 Rates:

State: \$3.57 per \$1,000 of assessed value
Local: \$9.96 per \$1,000 of assessed value**

<u>Exemptions and Special Rates</u>	<u>1995-97* (% of total) State Impact</u>	<u>1995-97* (% of total) Local impact</u>
Total	\$4,376.3 m.	\$14,984.4 m.
Intangibles	66.8%	63.9%
Public Property	21.8%	23.5%
Personal Property	7.4%	8.4%
Nonprofit Orgs.	2.5%	2.3%
Current Use Assessment	0.8%	0.8%
Senior Citizen Deferral	0.6%	0.9%
Private Property	0.1%	0.1%

* Estimated

**Local rates vary; rate is the statewide average

Source: DOR; Office of the Forecast Council.

106 Percent Limit

Spending decisions generally determine the property tax levy of local governments. The 106 percent limit restricts the total property tax revenue that any taxing district can raise. Because the 106 percent limit applies to the total tax received by the whole district rather than the tax paid by any one property owner, it does not restrict the taxes levied against a particular property. Moreover, it applies to *regular*, but not *special*, voter-approved levies. The cap on a district's total revenue in any year is equal to 106 percent of the highest amount levied in the preceding three years, plus the previous year's tax rate applied to the value of new construction and improvements.

Exemptions

A number of exemptions to the property tax have been established either constitutionally or through statute. Every exemption, by reducing the tax base,

increases the tax rate that property owners must pay if a district is to raise a fixed amount of money. DOR lists over 80 separate exemptions from the property tax and estimates the resulting savings to property owners for the current biennium to be \$4.4 billion in state property taxes and \$15 billion in local property taxes. These savings are summarized by broad categories of exemption in Figure 5.

Three mechanisms permit low-income homeowners who are seniors or who are retired as a result of a disability to gain property tax relief: an exemption, an assessed value freeze and a deferral of tax due.

Intangibles

Property that lacks physical substance — intangible property — creates difficulties for the property tax. Examples of intangible assets include stocks, bonds and currency; franchise agreements; businesses' customer

relationships; reputations for honesty or quality; patents, copyrights and trademarks; and unpatented, but proprietary, technological knowledge.

The general practice in the 19th century was to tax intangibles equally with tangible property, and this was initially the requirement of the Washington State Constitution. But over time, the trend nationally has been to reduce or eliminate taxation of intangibles.

Intangibles present administrative problems. The lack of physical substance makes it difficult for the tax collector to identify intangible assets if owners do not voluntarily reveal their existence. As a result, administrative costs are relatively high for the revenues raised, while the ease of avoidance results in nonuniform application of the tax. Furthermore, many intangible assets are simply claims on the returns to physical assets, which are themselves subject to the property tax. In these cases, intangible taxation is double taxation.

The 14th Amendment to the state constitution, approved in 1930, allowed intangible, as well as other classes of personal property, to be taxed differently from real property. In 1931 the Legislature exempted intangible financial assets such as cash, bank deposits, loans, and securities from the property tax. This is the largest personal property exemption, with an estimated value to taxpayers of \$6.3 billion annually.

Under the state constitution, the property tax applies to all property — tangible and intangible — except when specifically exempted. But in practice very little intangible property has been taxed in this state. Recently, some county assessors have sought to add intangibles to their tax rolls. This attempt to expand the taxation of intangibles, however, presents the potential for serious inequities.

Miscellaneous Taxes

Miscellaneous taxes include excise taxes on motor vehicles, motor vehicle fuel (gas), cigarettes, real estate, insurance premiums, and public utilities. In 1995-97, the Office of Financial Management (OFM) estimates that the state will collect more than \$3 billion in these taxes for the general fund (about 18 percent of general fund taxes) and more than \$3.3 billion for non-general fund purposes (about 97 percent of non-general fund revenue). (See Figure 6 on page 14.)

Motor Vehicle Excise Tax

The motor vehicle excise tax (MVET) is the state's fourth largest revenue-generating tax, with estimated receipts of more than \$1.4 billion in the 1995-97 biennium. The base for this tax is the manufacturer's suggested retail price of a vehicle. After a vehicle completes its second year of service, DOR begins to depreciate the base price on a graduated scale, until taxable value reaches 10 percent of the initial price in the vehicle's 13th year of service. More than 55 percent of MVET revenues go into the state general fund, with the balance distributed among 10 different funds. The MVET is levied in lieu of personal property tax.

Motor Fuel (Gas) Tax

Washington's gas tax is the state's fifth largest revenue source and is dedicated solely to funding highways

Figure 6
Miscellaneous Taxes

Tax	Enacted	95-97 Yield* All Funds (\$millions)	Percent of All Funds Misc. Taxes	95-97 Yield* Gen. Fund (\$millions)	Percent of Gen. Fund Misc. Taxes	95-97 Yield* Other Funds (\$millions)	Percent of Other Funds Misc. Taxes
Total		\$6,337.6		\$3,005.9		\$3,331.7	
Motor Vehicle Excise	1937	1,423.9	22.5%	788.6	26.2%	635.3	19.1%
Motor Vehicle Fuel	1921	1,156.5	18.2	-	-	1,156.5	34.7
Tobacco Products (2)	1935	558.6	8.8	167.6	5.6	391.0	11.7
Real Estate Excise	1981	530.5	8.4	488.5	16.3	42.0	1.3
Insurance Premiums	1891	421.7	6.7	318.0	10.6	103.7	3.1
Public Utility	1935	402.5	6.4	386.0	12.8	16.5	0.5
Liquor Products (5)	1935	269.6	4.3	142.9	4.8	126.7	3.8
Other	-	1,574.3	24.8	714.3	23.8	860.0	25.8

* Estimated

Source: Office of Financial Management.

under the 18th Amendment to the state constitution. This tax is a quantity-based tax applied to the number of gallons purchased, rather than to the price paid. Revenue generated by quantity-based taxes typically do not keep pace with prices or inflation.

The state gas tax is meant to act as a user fee for the use of Washington's roads and highways. Automobile fuel efficiency, which has increased by two-thirds over the past two decades, has substantially offset the 72 percent growth in vehicle miles over this period, resulting in an increase in fuel consumption of only 38 percent.

The Legislature has steadily increased gas tax rates over the last two decades. In 1967 the tax rate was 9 cents per gallon. This rate was taken to 11 cents in 1977, 12 cents in 1979, 16 cents in 1983, 18 cents in 1984, 22 cents in 1990, and to the current 23 cents in 1991. (In 1981 the Legislature indexed the tax rate to the price of gas. When the price of gas subsequently declined, however, the state reverted to a fixed per-gallon tax.)

OFM expects the state to collect nearly \$1.2 billion during the 1995-97 biennium, providing revenue for more than 15 different transportation-related funds.

Cigarette Taxes

At 82.5 cents per pack, Washington's cigarette tax is by far the highest in the nation. With a fivefold increase in the last 20 years, Washington's tax rate is more than double that of any other western state, except Hawaii and Arizona.

In the current biennium OFM expects the state to collect taxes of \$559 million on tobacco products. More than 30 percent of this revenue goes to the general fund. The remaining revenue is split between the Health Services Account, the Violence Reduction/Drug Enforcement Account and the Water Quality Account.

The Legislature has increased the rate 16 times over the past 60 years, most significantly by 20 cents in 1993 and by an additional 25 cents in 1995.

DOR estimates that \$87 million is lost each year due to evasion of this tax. Evasion is common to three primary points of purchase: Indian reservations, out-of-state locations, and military reservations.

In addition, the tax base reflects declining consumption. From a peak of over 465 million packs sold in 1981, sales have fallen steadily to the current 355 million-pack level. This is a 24 percent decline over 14 years.

Real Estate Excise Tax

OFM anticipates collecting more than \$530 million in real estate excise taxes (REET) during the 1995-97 biennium. More than 92 percent of this revenue goes to the state general fund. The remaining revenue goes into the Public Works Assistance Account (PWAA). The tax applies to real property sales. According to a WRC analysis conducted in 1990, the REET is a highly volatile source of revenue and very difficult to forecast.

The typical tax rate that applies to most urban areas is 1.78 percent of the full selling price. But there is the potential for a combined state and local rate of 3.28 percent.

Insurance Premiums Tax

OFM expects the state to collect almost \$422 million in revenue from the insurance premiums tax in the 1995-97 biennium. Over 75 percent of this revenue goes to the state general fund. The balance is shared by the Health Services Account and the Volunteer Firemen's Relief and Pension Fund. The base for this tax is net premiums received by insurance companies. This tax is levied in lieu of all other state and local taxes, except for property taxes and certain excise taxes. Insurance companies pay B&O tax on revenues other than insurance premiums.

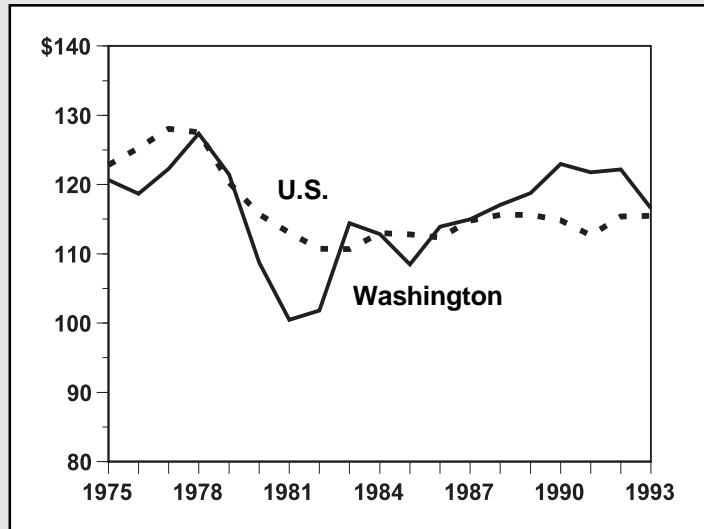
Public Utility Tax

OFM expects public utility taxes to total more than \$402 million in the 1995-97 biennium. Almost 96 percent of this revenue goes into the state general fund, with the balance going to the PWAA. Applied in lieu of the B&O tax, this tax is on the gross income derived from operating public or private utilities.

Other Miscellaneous Taxes

More than 20 additional taxes provide revenues for either the general fund or for some of the smaller funds. Ranging in magnitude from nearly \$200 million to less than \$50,000, they include selective sales taxes (aircraft fuel and refuse collection), selective business taxes (hazardous substance and pari-mutuel), additional in-lieu-of-property taxes (watercraft and timber excise tax), and others (estate and transfer, telephone, and metals mining). These other taxes account for nearly 30 percent of all tax collections at the state level.

Figure 7
Total Taxes
per \$1,000 Personal Income



Note: Washington's figure for 1985 includes only 11 months of collections, due to a change in accounting conventions.

Source: U.S. Bureau of the Census.

Tax Burden

At \$117 per \$1,000 of personal income, Washington's combined state and local tax burden ranked 17th highest in the country in FY 1993 (the most recent year for which these data are available). By comparison, the average burden for all states was \$116 per \$1,000. Throughout the country, states allocate responsibilities between local and state jurisdictions differently. Interstate comparison of tax burden, therefore, requires that state and local taxes be added together.

As Figure 7 shows, Washington's state and local tax burden reached a peak of \$120 per \$1,000 of personal income in FY 1978. From this high, the tax burden fell to \$96 per \$1,000 of personal income in FY 1981, as the state entered its deep recession of the early 1980s. It then commenced a steady climb to \$123 per \$1,000 of personal income in FY 1990 and has

fallen back from that point. Though the tax burden in Washington had been below the national average before FY 1983, it has regularly exceeded the national average since that time.

Figure 8
Distribution of Business Gross Income by Industry, 1995

<u>Industry</u>	<u># of Firms</u>	<u>Receipts (\$millions)</u>	<u>Receipts per firm (\$millions)</u>
Agri., Forestry, Fisheries	9,465	2,241.02	0.234
Mining	142	299.39	2.110
Construction	39,348	17,328.58	0.440
Manufacturing	13,792	57,874.21	4.200
Transportation	7,236	6,838.57	0.950
Comm. & Utilities	2,011	12,925.19	6.430
Wholesale Trade	21,464	80,894.58	3.770
Retail Trade	71,132	59,705.35	0.840
Fin. Insur. & Real Est.	12,375	14,519.10	1.170
Services	117,359	45,914.21	0.390
Total	294,324	\$298,540.19	\$1.010

Source: Quarterly Business Review, Calendar Year 1995, DOR, 1995.

Tax Incidence

Economists distinguish between two notions of who pays the burden of a tax. *Statutory incidence* shows from whom the government directly collects the money. *Economic incidence* shows who ultimately pays after accounting for all of the changes in market prices that the tax induces. The ultimate burden of taxes may be shifted in ways that are not transparent. Laurence Kotlikoff and Laurence Summers conclude their widely cited survey of tax incidence theory with the following observation:

Economics is at its best when it offers important insights that contradict initial, casual impressions. The theory of incidence provides a rich assortment of such insights. Tax incidence's basic lesson that [economic and statutory] tax burdens are not necessarily related means that taxes on capital may be borne by workers, that investment incentives may be injurious to capitalists, that taxation of foreigners may simply represent indirect domestic taxation, and that generations alive many decades in the future may be supporting those currently alive. The study of tax incidence is both fun, because it offers such surprising findings, and very important, because of its implications about the impacts of government policies.

Laurence Kotlikoff and Laurence Summers, "Tax Incidence," in Alan Auerbach and Martin Feldstein (eds.), *Handbook of Public Economics*, Vol. 2., Amsterdam: Elsevier Science Publishers, 1987, p. 1088.

Business Tax Burden

Figure 8 shows the diversity of the state's business base. Nearly 300,000 businesses reported income to DOR in 1995. Past studies have shown that businesses here pay a greater initial share of state and local taxes than do businesses in other states. As noted earlier, WRC estimates that business paid 43 percent of state and local taxes in Washington in 1995. The three largest taxes on business, with roughly equal magnitude, are the

Figure 9

Household State and Local Tax Burden (percent of income)

<u>Household Income</u>	<u>Retail Sales Tax</u>	<u>Property Tax</u>	<u>Misc.</u>	<u>Total</u>
\$15,000	5.7%	5.9%	4.0%	15.6%
\$25,000	4.5%	3.9%	2.7%	11.1%
\$35,000	3.9%	3.1%	2.2%	9.2%
\$45,000	3.6%	2.8%	1.8%	8.2%
\$55,000	3.4%	2.6%	1.6%	7.6%
\$65,000	3.2%	2.5%	1.5%	7.2%
\$75,000	3.1%	2.3%	1.3%	6.7%
\$100,000	2.9%	2.0%	1.1%	6.0%
\$125,000	2.7%	2.0%	1.0%	5.7%
\$150,000	2.6%	2.0%	0.9%	5.6%

Source: DOR/OPR.

property, sales and use, and B&O taxes. Businesses differ in the relative importance of these taxes. For example, DOR's recent manufacturing tax study calculated that for an established lumber/wood products firm, the property tax burden is two-thirds the size of the B&O burden, while for an established firm in the instruments industry, property taxes are three times the size of B&O taxes.

DOR regularly collects detailed data on the distribution of the B&O tax burden across businesses. It does not, however, collect comparable data on property and sales and use taxes. Thus, the information necessary to fully understand the total tax burden of different business sectors or of different size firms is not available. A partial analysis, based only upon B&O collections, would be misleading.

Figure 10

Index of Proportionality for a Family of Four

The Index of Proportionality is calculated by dividing the burden on families with \$100,000 income by the burden on families with \$25,000 income. An index value of 4 indicates a strictly proportional tax.

Tax	Index of Proportionality
Retail Sales	2.5
Property	2.1
Misc.	1.6
Alcoholic Beverages	3.7
Cigarettes and Tobacco Tax	0.8
Insurance Premiums Tax	2.7
MVET	2.2
Gasoline	1.7
Public Utility	1.5

Source: Calculated from Figure 9.

Statutory Incidence on Families of Four

DOR, with the legislative Office of Program Research (OPR), recently estimated the statutory incidence of Washington's state and local taxes for families of four across broad income classes. Figure 9 on page 17 illustrates their findings. According to the DOR/OPR estimates, an average family with income of \$25,000 pays \$2,775 in state and local taxes, while a family with income of \$100,000 pays \$6,000. Since taxes as a share of income falls as income rises (from 11 percent at \$25,000 to 6 percent at \$100,000) the state and local tax system is termed to be regressive.

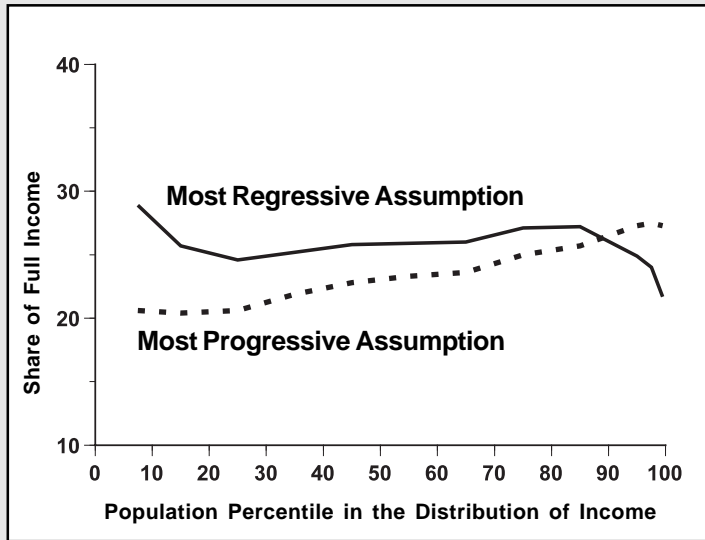
The table breaks the total tax burden into three categories: the retail sales tax, the property tax, and miscellaneous taxes, which include taxes on alcohol, tobacco, insurance premiums, motor vehicles, gasoline and public utilities. The retail sales tax represents the largest share of taxes for families all along the income scale: For the family

making \$25,000, about 4.5 percent goes to pay retail sales taxes, according to the DOR model, while the higher income family making \$100,000 uses about 2.9 percent of its income to pay retail sales taxes.

By itself, the retail sales tax has traditionally been viewed as a regressive source of revenue. In Washington, however, food and drugs are exempt from the tax, removing a large part of the regressivity. The elements of Washington's tax system that most heavily tip the balance toward regressivity are found among the miscellaneous taxes.

Figure 10 compares in more detail the taxes paid by families with incomes of \$25,000 and \$100,000. By far the cigarette tax is the most regressive. Next in regressivity are the public utility tax and the gasoline tax. Some argue that taxes on tobacco and gas should be ignored in discussions of tax regressivity. They contend that the gas tax is a user fee that should be paid by those who use the roads, while tobacco taxes are deliberately high to discourage smoking. Others argue that the distribution of burden matters even for these taxes.

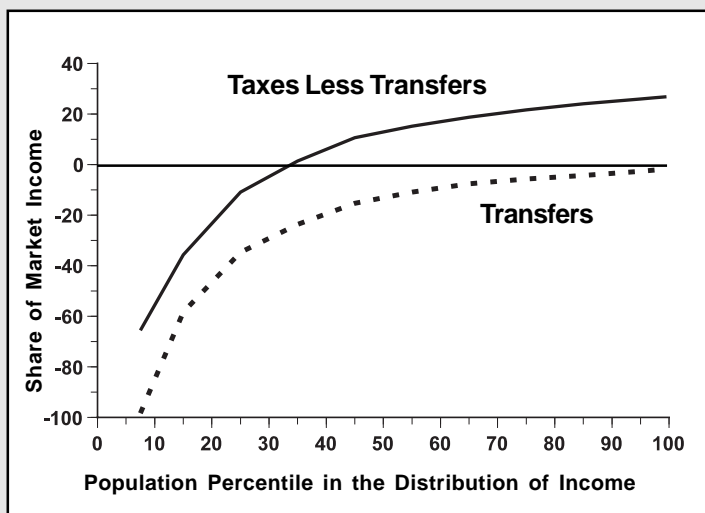
Figure 11
Taxes Paid as a Share of Income



Pechman considered nine different sets of assumptions on tax shifting. In all cases, total taxes paid increased with income. The figure shows the average tax rates under the assumptions that gave the most progressive and most regressive results. The other seven cases fall between these two. Income here includes transfer payments from government.

Source: Joseph A. Pechman. *Who Paid the Taxes?* 1966-85.

Figure 12
Transfer Payments and Taxes



Income does not include transfer payments from government.

Source: Joseph A. Pechman. *Who Paid the Taxes?* 1966-85.

As do most incidence studies, the DOR/OPR study uses the U.S. Bureau of Labor Statistics' *Consumer Expenditure Survey* to determine how family expenditures vary with income. According to this survey, families with incomes of \$25,000, on average, spend \$30,200, while families of \$15,000 spend \$22,000. Since in the long-run it is not possible for families to spend more than they make, the reported incomes must on average understate the economic well-being of these families.

Economic Incidence

The DOR/OPR numbers capture the statutory incidence of taxes. Accounting for the shifting of taxes would entail several significant adjustments. Economists generally agree that the property tax is borne by the owners of capital in general rather than by the consumers of housing services. As a result, the property tax is a more progressive tax than is shown by the statutory incidence. In addition, some of the taxes imposed on business will be shifted onto consumers. The distribution of this burden across consumers should be similar to that seen for the sales tax.

The groundwork for most of our understanding of economic incidence was laid by Joseph Pechman of the Brookings Institution in studies published in 1974 and 1985. Results from his 1985 study are shown in Figure 11, which illustrates the share of income taken in federal, state, and local taxes together for different income classes under several sets of assumptions on the way taxes are shifted.

From these results, Pechman concludes that "the tax system has very

little effect on the distribution of income.” When he examined these taxes separately, Pechman found that federal taxes are mildly progressive, while state and local taxes are mildly regressive.

Fairness Estimates Also Include Government Transfer Payments.

But the picture is incomplete. Missing are the transfer payments received by many low-income households from various tax-supported government programs. Figure 12 shows Pechman’s estimate of transfer payments relative to income, as well as the net of transfer payments and taxes. In contrast to the tax system, the system of transfer payments is highly progressive. And when taxes and transfers are combined, the system appears quite progressive.

Lifetime Tax Burden

Finally, considering the distribution of tax burden among taxpayers at a single point in time is thought by many economists to be misleading. A person’s earning capacity, and therefore, his or her perceived ability to pay taxes changes over time. In years of relatively low earning power — as a young adult just starting out and as a person reaching retirement years — borrowing or drawing down savings are rational choices that allow individuals to spend more than they earn. In years with relatively high earning potential, people typically save a significant portion of their income. And, as was noted above, the consumer expenditure survey shows that low-income families spend significantly more than they make.

In a book recently published by the Brookings Institution, Don Fullerton and Diane Lim Rogers argue that from a lifetime perspective the U.S. tax system is progressive at the bottom and at the top 2 percent of the income scale and proportional (that is, taking the same share of income for all income classes) in between. Fullerton and Rogers further conclude that the regressivity of state and local sales taxes is due to high taxes on alcohol, tobacco, and gas and that “a tax at the same rate on all consumption goods would be nearly proportional on a lifetime basis.” Thus, Washington’s state and local tax system would appear much less regressive from a lifetime perspective.

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