WashACE

COMPETITIVENESS BRIEF

Washington Alliance for a Competitive Economy

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Tax Increases Would Stifle Fragile Recovery

THE BOTTOM LINE

A strong recovery depends on rekindling growth in critical sectors of the state's economy that continue to suffer lingering effects of the recession.

Any increase in the burden of taxes on these businesses will reduce their likelihood of growing in Washington.

Lawmakers faced with a nearly $1.8 billion budget shortfall have already begun talking about tax increases. Gary Locke, in one of his last acts as governor, set the stage by saying a no-new-revenue budget would be unacceptable and proposing approximately $600 million in new taxes. Gov. Christine Gregoire has yet to propose a budget, and she says she is determined to look for efficiencies and set priorities within current revenues. Yet, she has not closed the door on new revenues.

When Gov. Locke developed his 2003-2005 budget, he used the Priorities of Government process to craft a budget that did not require new taxes. At the time, he believed that the state's precarious economy would be damaged by tax increases, a theme echoed during the recent gubernatorial campaign by both candidates as the economy continues to struggle. This year, Locke again used the Priorities of Government system, but found that he could not fund his priorities within current revenues. The Gregoire administration may have more success using the same tool. Keep in mind, revenues to the state general fund are expected to grow by nearly 7 percent for the coming biennium.

A tax increase now would threaten the state's recovery. Two things should be remembered: The state and local tax burden in Washington falls heavily on business, and the state economy remains extremely fragile.

BUSINESS TAXES

Washington's unique tax structure places an extraordinary burden on the state's private sector employers. The 2002 Tax Structure Study Committee (TSSC), which William Gates, Sr. chaired, concluded that "high business tax burdens reduce the economic vitality of the state, discourage firms from locating their operations here, and invite firms already located in Washington to consider other locations." (Page 52) The fiscal discipline exercised two years ago avoided adding to the tax burden, and targeted economic incentives eased the burden for certain industries. Nonetheless, taxes continue to act as a drag on economic growth and job creation.

An assessment of the business tax burden in Massachusetts by Robert Tannenwald, Assistant Vice President and Economist at the Federal Reserve Bank of Boston, provides a useful perspective on business taxes and competitiveness. He writes,

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> A competitive tax promotes a jurisdiction's economic growth by enhancing its ability to attract and retain geographically mobile capital, labor, and consumption. In recent decades, concern about business tax competitiveness has intensified as technological and regulatory changes have increased the mobility and geographic range of employers. (Page 6)

Although businesses will attempt to pass on the taxes – to employees, customers, and suppliers – most measures of business tax competitiveness assume the burden is borne solely by owners. Tannenwald says,

> Indicators based on this assumption are useful for several reasons. First, in making their tax systems more competitive, state and local governments are interested in retaining a subset of firms whose ability to shift their taxes forward is relatively limited. These businesses—those selling their products in multistate markets—are highly valued because they "import" income into the states in which they are located, thereby driving the growth of secondary and tertiary industries (such as suppliers, wholesalers, and retail and service establishments). Firms selling into such geographically broad markets are wary of shifting their taxes forward because they fear that their customers might switch their patronage to competitor producers who could gain market share by offering lower prices. Second, while conditions in some states may be more conducive to tax shifting than conditions in others, evidence quantifying interstate differences in such conditions is not available and, indeed may be impossible to obtain. In the absence of such evidence, the assumption of no interstate differences in tax shifting potential is as good as any. Third, when comparing states in terms of business tax competitiveness, business groups assume, explicitly or implicitly, that business owners bear the entire burden of state and local business taxes. By embracing this assumption, therefore, one can evaluate the implications of these groups' analyses for the tax competitiveness of particular states. (Page 7)

Without question, business taxes in our state are high. Even as the overall burden has lessened slightly in recent years, with repeal of the Motor Vehicle Excise Tax and property tax limitations, the relief has primarily benefited nonbusiness taxpayers. The principle benefit of recent exemptions (e.g., aerospace, research and development) has been to provide relief to businesses to offset future obligations, obligations that would only be incurred if the taxpayer generated revenue in the state.

A recent decision by the Sixth Circuit Court of Appeals, which found that Ohio's tax incentives to DaimlerChrysler violated the U.S. Constitution's commerce clause, may threaten tax incentives nationally. Currently the decision, which will be appealed to the U.S. Supreme Court, applies only in the four states – Ohio, Michigan, Kentucky and Tennessee – under the jurisdiction of the Sixth Circuit Court. Loss of these incentives would substantially increase business costs.

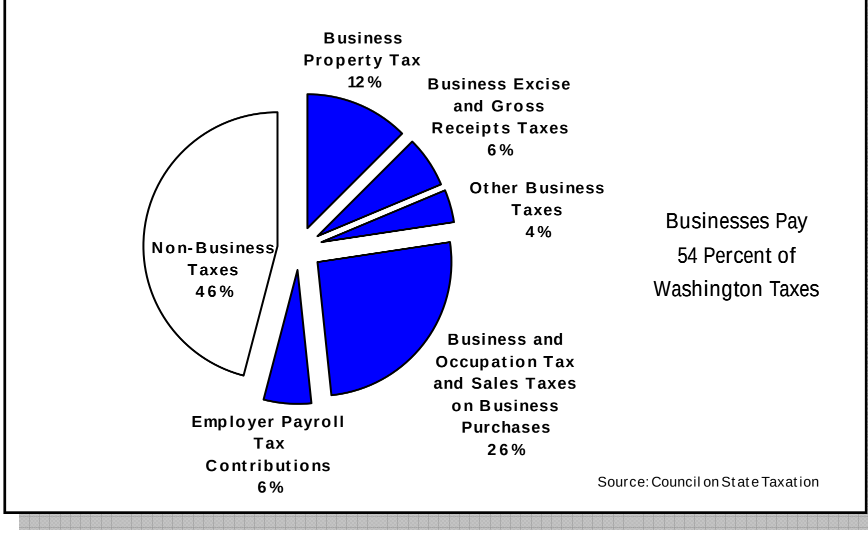
Following Tannenwald, for this analysis we can assume that the business tax burden is being borne by business owners, whose location and expansion decisions will be affected in part by tax costs.

The tax burden has been measured several ways, all of which place Washington well out of the mainstream in the distribution of the tax burden. The TSSC found that businesses here pay 46 percent of all state and local taxes, compared with a 30 percent average business tax burden for the seven Western states.

More recently, a 2003 study for the Council on State Taxation (COST) by Ernst and Young LLP found Washington business paid 54 percent of state and local taxes, compared with a U.S. average of 43 percent. By this measure, which includes unemployment taxes and workers' compensation premiums, Washington had the 10th highest business tax share in the nation. Chart 1 below shows the distribution of the Washington State tax burden. The WashACE 2005 Competitiveness Redbook shows Washington as having the nation's highest average unemployment insurance taxes per employee (first quarter, 2004). Our state's workers' compensation benefits – the most reliable measure of costs – are also among the nation's highest.

On other COST measures of the tax burden Washington looks even less business-friendly. The state ranks fourth on two measures and seventh on a third.

Chart 1: Washington Businesses Pay the Nation's 10th Highest Share of Taxes



The average business tax cost per employee in Washington of $5,355 exceeds the U.S. average of $3,737 by 43 percent. Only Alaska, Wyoming, and New York impose a higher per-employee tax load. And severance taxes paid by out-of-state business interests for mineral extraction account for most of the Alaska and Wyoming tax burden.

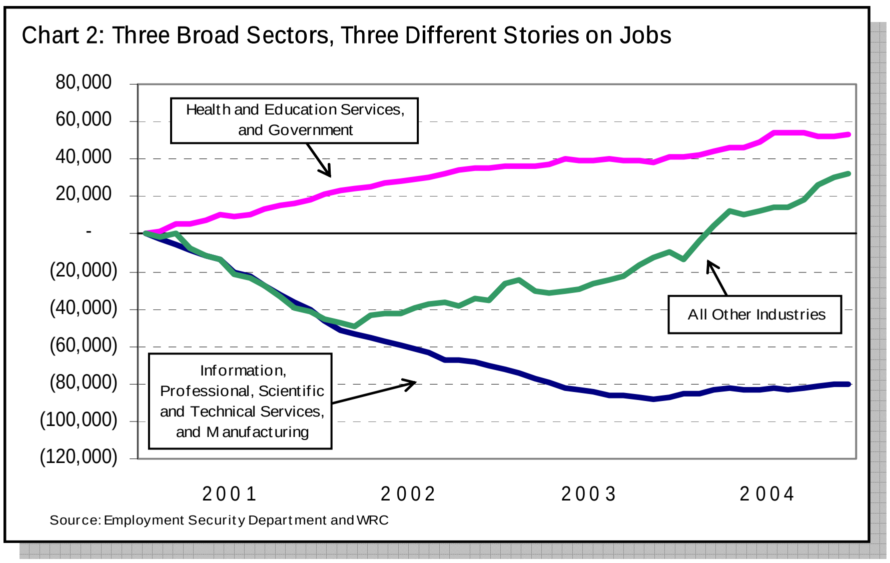
Washington also ranks fourth in taxes paid as a share of capital income, which COST considers a comprehensive measure of taxes on capital invested in the state. Taxes represent 22.6 percent of capital income, compared with a U.S. average of 15.6 percent, behind only Maine, Montana, and West Virginia.

COST's fourth measure examines business taxes as a percentage of private sector economic activity, which includes income earned by both labor and capital employed in the state. On this indicator, Washington ranks seventh, with taxes representing 6.3 percent of private sector economic activity, nearly one-third higher than the U.S. average of 4.8 percent.

Tannenwald estimates the business share of Washington state and local taxes for 2000 to be 59.6 percent. His calculation uses the COST data along with Census Bureau estimates of total general taxes plus unemployment insurance taxes and workers' compensation premiums. Despite a slightly different allocation methodology, the Tannenwald estimate is quite consistent with the Ernst and Young result; for 2000, Ernst and Young ranked Washington ninth, with a business share of 54.2 percent.

For 2000, Tannenwald also calculated business taxes as a percent of statewide personal income, again reaching a conclusion mirroring that of COST. Where COST pegged business taxes at 5.8 percent of personal income, ranking Washington ninth, Tannewald calculates business taxes to be 6.8 percent, ranking the state fifth.

By any measure – and the 2003 COST study represents the best estimate available, one that has been replicated and validated – Washington's tax structure relies to an uncommon extent on business activity. This burden falls on a business sector already struggling with high costs. The 2005 Competitiveness Redbook cites a Milken Institute study ranking Washington as the 8th most expensive state in which to do business. The Milken index includes five components: wages, taxes, electricity, industrial rent and office rent . Washington exceeds the national average on four. Only in electricity does Washington have a cost advantage, and business fears that low snow pack this year threatens higher prices in the coming months.



The distribution of the tax burden is important, because the dampening effect of higher business taxes sends an immediate and negative signal to private sector employers. But of nearly equal concern would be the effect of an unsustainable increase in nonbusiness taxes. Proposals to raise "sin taxes" to sustain spending for rapidly growing services like health care are doomed to fail: The tax bases simply cannot and do not keep pace with the services for which additional revenues are sought. That lack of sustainability foreshadows future budget pressures. Using such temporary expedients underscores the legislature's unwillingness to control spending growth, set priorities, and manage within current revenues.

In the following section, in which we examine the nature of the state's economic recovery, we find serious weaknesses in key sectors of our employment base.

FRAGILE RECOVERY

The national recession of 2001-2002 was quite mild by historical standards. The recovery that followed the recession, however, has been frustratingly slow, and the forecast is for only moderate growth (3 to 4 percent per year) in real GDP in the national economy over the next several years.

With the combination of the dot-com bust and the collapse in demand for commercial airplanes after the 9/11 terror attacks, the recession hit

Washington worse than most states. Non-farm wage and salary employment reached a pre-recession peak of 2,729,000 (seasonally adjusted) in December 2000. It then bottomed at 2,645,000 in March of 2002. Washington's unemployment rate peaked at 7.7 percent in mid 2003 and for many months, was the nation's second or third highest. By December of 2004, employment had climbed back to 2,728,000 (seasonally adjusted).

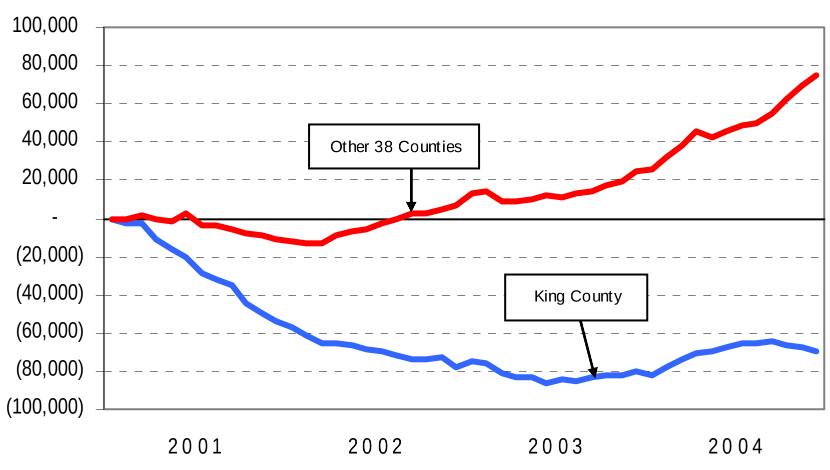
Although Washington's economy is now growing and its unemployment rate is only a few tenths of a point above the national average, key sectors remain weak and the recovery is uneven. This unevenness is illustrated in Charts 2 and 3.

Chart 2 combines the state's industries into three groups and for each shows changes in non-farm wage and salary employment from January 2001. The data are seasonally adjusted.

The first group, *Information, Professional, Scientific and Technical Services, and Manufacturing*, provides 20 percent of state jobs. This group includes the manufacturing industries that have traditionally been key drivers of the state's economy as well as the "new-economy" services (including software, telecommunications, computer design, and biotechnology research) that emerged as drivers in recent years. The overall decline in employment in this group continued until late 2003, with a loss of 87,800 jobs from January 2001 to November 2003. Since that point this grouping has recovered 7,600 jobs.

The second group, *Health and Education Services, and Government*, accounts for 30 percent of jobs. The category includes private health services, social services and education as well as federal, state, and local government. With most funding coming from private and social insurance and government tax revenues, employment in this group shows no signs of the recession. Between January 2001 and December 2004 this group added 52,800 jobs, an average annual growth rate of 1.6 percent.

Chart 3: Job Growth in King County Lags the Balance of the State



Source: Employment Security Department and WRC

The third group includes the remainder of the state's industries and 50 percent of employment. This group suffered a sharp downturn in employment from March 2001 to March 2002, with a total job loss of 49,800. Employment for this group of industries then turned upward, with 81,400 jobs added from March 2001 and December 2004, an average annual growth rate of 2.2 percent.

This uneven pattern plays out geographically. The job losses in the information, professional, scientific and technical services, and manufacturing group were concentrated in King County. Chart 3 shows changes in employment from January 2001 for King County and for the balance of the state.

Employment in King County is 41 percent of the state total. The recession hit the county hard, and it has yet to recover. From January 2001 to June 2003, the county lost 86,100 jobs. From that point to July 2004, the county regained about a quarter of the lost jobs. Since mid 2004, however, employment in the county has been flat. In contrast, the contraction in employment for the balance of the state was short and mild. Employment in March 2002 was only 13,500 less than January 2001. From March 2002 to December 2004 the 38 counties added 88,100 jobs.

Overall, the state's recovery remains fragile until King County and its key driving industries are back on their feet.

CONCLUSION

A strong recovery depends on sustained growth in critical sectors that continue to show the lingering effects of the recession: information, professional, scientific and technical services, and manufacturing. Businesses in these industries face intense interstate and global competition and remain particularly sensitive to cost factors. Any increase in their tax burden will negatively affect their likelihood of growing in Washington.

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