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# Washington State and Local Tax System: Dysfunction & Reform

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# Preface

Washington's dysfunctional state and local tax system is badly in need of reform. This was evident in the 2015 legislative session, which lasted 176 days, an all-time record.

In addition to dealing with routine budget matters, the Legislature had to come up with a down payment to adequately fund basic education as mandated by the Washington State Supreme Court. Lawmakers also felt the need to implement a long-overdue transportation plan.

With an anticipated General Fund budget of about \$39 billion for the 2015-17 biennium, the initial estimate of the state government tax revenue shortfall ranged from zero to \$4 billion. Some legislators contended that the expected tax revenue was sufficient to balance the budget. The Governor, on the other hand, proposed a carbon tax and a capital gains tax.

After three special sessions, a \$38.2 billion budget was adopted. This included a \$1.3 billion boost for K-12 education. Lawmakers also approved a 16-year \$16.1 billion transportation plan. The budgeting process was facilitated by a projected \$3.6 billion increase in tax revenue for the 2015-17 biennium due to the strong economy. Nevertheless, the Legislature still had to pass an 11.9 cent per gallon increase in gasoline taxes to pay for the transportation plan.

Political wrangling aside, the legislative session was destined to drag on because of fundamental problems with the Washington tax system. In a study conducted in 2014 ("Washington State and Local Tax System: Dysfunction & Reform"), I concluded that Washington had the worst state and local tax system in the nation. Its two most egregious characteristics were inadequacy and unfairness, both of which were on display during the legislative session.

Regarding inadequacy, the Washington state and local effective tax rate (total state and local tax revenue as a percent of personal income) is substantially lower than the average rate for all other states (9.4 percent compared to 10.4 percent in FY 2014, according to the latest data). Because of inadequate tax revenue, Washington ranked a deplorable forty-second among the fifty states in K-12 spending in FY 2014 (\$32.60 per \$1,000 of personal income versus \$38.46 nationally). This implied that just to reach the national norm Washington needed to spend an additional \$4 billion on basic education in the 2015-17 biennium.

Shamefully, Washington is also recognized as having the most unfair state and local tax system in the nation because of its heavy reliance on sales taxes. Thus, while raising the gasoline tax helps to maintain and expand our transportation infrastructure, it aggravates the regressivity of the tax system by unduly adding to the tax burden of low-income households.

Following is an updated version of my 2014 study. It compares the Washington state and local tax system with the tax systems of all other states, focusing on five characteristics: fairness, adequacy, stability, transparency, and economic vitality. The latest data reveal that even in good economic times the Washington state and local tax system continues to be dysfunctional. The analysis shows that the tax system best suited for Washington—one that is superior to all other tax systems in the nation—is a flat-rate personal income tax that eliminates the need for all other taxes.

*Dick Conway*  
*February 28, 2017*

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# Summary

In 1932, Washington citizens overwhelmingly passed an initiative to enact a graduated income tax, but it was ruled unconstitutional by the Washington State Supreme Court. Eight decades later, Washington is one of only seven states without an income tax.

This study compares the Washington state and local tax system with the tax systems of the other forty-nine states, focusing on five characteristics: fairness, adequacy, stability, transparency, and economic vitality. The findings indicate that, because of an extreme reliance on sales taxes, Washington has the worst state and local tax system in the nation.

## Fairness.

Fairness refers to the tax burden—taxes as a percent of income—placed on households and businesses. With regard to households, progressive tax systems have relatively high tax rates for high-income households, while regressive tax systems have relatively high tax rates for low-income households.

→ Due to Washington’s regressive sales-based tax system, the Washington State Tax Structure Study Committee estimated that in 1999 the state’s lowest-income households (\$20,000 or less) paid 15.7 percent of their income on state and local taxes, while the highest-income households (\$130,000 or more) paid only 4.4 percent. This meant that the lowest-income households had to

work 8.2 weeks out of the year to pay their state and local tax bill, while the highest-income households had to work only 2.3 weeks.

### Fairness

*The Institute on Taxation & Economic Policy has concluded that “lacking an income tax...Washington has the most unfair tax system in the nation.”*

→ The Institute on Taxation & Economic Policy (ITEP) estimated that in 2015 state and local taxes paid by the 20 percent of Washington families with the lowest incomes amounted to 16.8 percent of their income (the equivalent of 8.7 weeks of work). In contrast, the tax burden borne by the one percent of families with the highest incomes was just 2.4 percent of their

income (1.2 weeks of work). The ITEP analysis revealed that, due to the heavy reliance on sales taxes, Washington had by far the most regressive tax system in the nation (Table 5).

## Adequacy.

Adequacy is the ability of a tax system to generate sufficient revenue to meet the public needs (e.g., education and transportation) of a growing economy. If tax revenue is inadequate, it becomes necessary to raise tax rates or expand the tax base, which in a sales-based tax system like Washington’s exacerbates its unfairness.

→ Adequacy raises a critical but contentious issue: how much should government tax? The state and local effective tax rate of all states (tax revenue as a percent of personal

income) has averaged 10.5 percent and been quite stable since 1970. Thus, an adequate state and local tax system maintains a more or less 10.5 percent effective tax rate.

erage of \$38.46 per \$1,000 of income, Washington allotted only \$32.60. It would have taken another \$2.2 billion to bring K-12 expenditures up to the national standard.

→ Washington has one of the most inadequate tax systems in the nation (Table 7). Between FY 1995 and FY 2014, its state and local effective tax rate fell from 11.4 percent (the eleventh highest in the nation) to 9.4 percent (the thirty-sixth highest). No other state experienced a greater decline over this period.

→ If the state and local effective tax rate had equaled the 10.5 percent national norm in each year from FY 2005 to FY 2014, Washington state and local governments would have collected an additional \$23.0 billion in tax revenue (Table 8). This would have been

→ The extraordinary fall-off in the effective tax rate has been due to the inadequacy of Washington's sales-based tax system working in concert with Initiative 601, which was enacted in 1993. I-601 was the first of several voter-approved initiatives requiring a two-thirds vote of the Legislature to raise taxes. Declared unconstitutional in 2013, the supermajority rule thwarted tax increases for twenty years, even as Washington's state and local effective tax rate continued to drift down from the 10.5 percent national norm.

**Adequacy**  
*Reflecting the inadequacy of the sales-based tax system, the Washington state and local effective tax rate (state and local taxes as a percent of personal income) fell from 11.4 percent (the eleventh highest in the nation) in FY 1995 to 9.4 percent (the thirty-sixth highest) in FY 2014.*

sufficient to adequately fund basic education as mandated by the Washington State Supreme Court, build the new 520 bridge, replace the Alaska Way Viaduct, improve mental health services, fight and prevent wildfires, and maintain the State Highway Patrol at full force.

→ The inadequacy of the Washington state and local tax system has had a detrimental effect on public education. In FY 1992, one year before I-601 took effect, Washington spending for elementary and secondary education amounted to \$44.07 per \$1,000 of personal income, a bit more than the U.S. average of \$43.68. By FY 2014, however, only eight states spent less on K-12 education than Washington. Compared to the national av-

→ Inadequacy is a permanent fixture of Washington's sales-based tax system. As a percent of personal income, taxable retail sales, which is the state's largest tax base, declined from 50.0 percent in FY 1990 to 35.7 percent

in FY 2015. Forecasts developed with an econometric model indicate that, without legislated changes to tax rates or the tax base, the state and local effective tax rate will decline from 9.3 percent in FY 2015 to 8.5 percent in FY 2025. This would place it among the states with the lowest effective tax rates in the nation, such as Alabama, South Dakota, and Oklahoma.

→ The fact that Washington's state and local effective tax rate is well below the national norm and falling indicates the need for additional tax revenue. But, given the extreme

regressivity of the current tax system, the only fair resolution to the adequacy problem is tax reform.

## Stability.

A stable tax system facilitates government operations. Since every state is subject to economic cycles, no state has a stable flow of state and local tax revenue. Some tax systems, however, are more unstable than others due to the sensitivity of their state and local effective tax rate to economic fluctuations. Recognizing that a state has little control over the ups and downs of personal income, the measure of stability for this study is the variability of the state's effective tax rate relative to the U.S. effective tax rate during the course of economic cycles as well as over the long run.

→ Washington has a highly unstable tax system due to its inadequate and volatile sales tax base (Table 10). Between FY 1992 and FY 2014, the Washington state and local effective tax rate fell from 10.87 percent to 9.38 percent (-1.49 percentage points), while the U.S. average rate declined from 10.69 percent to just 10.36 percent (-0.33 percentage points). This yielded a stability index of 4.52 ( $=1.49/0.33$ ), indicating that in the long run the Washington effective tax rate was nearly five times more unstable than the average of all states. Among the fifty states, Washington had the forty-second most stable—the ninth most unstable—tax system in the nation.

→ The Washington tax system was most unstable when the U.S. effective tax rate was declining (FY 1992-00 and FY 2007-10), which meant that the Washington effective

tax rate was falling even more. The period of greatest instability occurred between FY 1992 and FY 2000 in the aftermath of Initiative 601, when the stability index registered 5.31. On the other hand, with a 0.76 stability index reading, the economic upturn between FY 2004 and FY 2007 was a period of relative stability. Unfortunately, since both the Washington and U.S. effective tax rates were rising at the time, this meant that the state's effective tax rate

continued to slip further behind the national rate. This experience contradicts a commonly-held belief that, while Washington's sales-based tax system is volatile, economic rebounds result in a full recovery of tax revenue.

→ Washington state government collects fifty cents out of every dollar of state

and local tax revenue. Between FY 2007 and FY 2009, state government suffered an unprecedented loss of tax revenue from which it has not yet recovered. Due to the Great Recession and the state's volatile tax system, per capita tax revenue measured in constant 2009 dollars fell from \$2,376 to \$1,947, a decline of 18.1 percent (Table 11). Although it bounced back to \$2,108 in FY 2015, it was still 11.3 percent below the level in FY 2007. In other words, on a per capita basis, state government tax revenue had one-ninth less real purchasing power—ability to provide public goods and services—in FY 2015 than it did in FY 2007.

## Transparency.

Like other transactions in the economy, taxes should be transparent. Transparency is a prerequisite for making rational tax policy.

### Stability

*Due to the inadequacy and volatility of its large sales tax base, Washington had the forty-second most stable tax system in the nation between FY 1992 and FY 2014.*

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In Washington, however, hardly anyone knows how much he or she pays in state and local taxes.

→ Personal income taxes are totally transparent, as there is always a record of payment. Sales taxes are only partially transparent, since “most households are unaware of their annual sales tax burden.” Even the business and occupation tax is not transparent, as many businesses can pass the tax on to their customers in the form of higher prices.

→ A test of transparency encompassing five types of taxes (personal income tax, business tax, sales tax, property tax, and other excise tax) shows that Washington has the second least transparent tax system in the nation, ahead of only Nevada (Table 12). With no income tax and a heavy reliance on the sales tax and the business and occupation tax, the Washington total transparency index was 0.550 in FY 2014. This meant that its tax system was 55 percent transparent. With a total transparency index of 0.767, Oregon had the nation’s most transparent tax system. Unlike Washington, Oregon has an income tax but no sales tax.

## **Economic vitality.**

Some economists argue that low taxes are the best way to promote job and income growth, while others contend that high-quality education, good roads, and a safe and healthy environment are necessary conditions for a strong economy. Central to this debate in Washington is whether or not to implement an income tax.

→ A widely cited study by the Tax Foundation on the best business tax climates contends that “states with the best tax systems will be the most competitive in attracting new businesses and most effective at generating economic and employment growth.” In 2016, the five states with the best business tax climates were Wyoming, South Dakota, Alaska, Florida, and Nevada. Over the two prior years, Washington’s business tax climate ranking dropped from sixth place to

twelfth for no apparent reason. Nevertheless, one thing these six states (including Washington) have in common is the absence of an income tax, which is presumed to give their economies a competitive advantage.

→ While all of the six states do not levy an income tax, their tax systems are hardly

comparable. Four states have major alternative sources of tax revenue, principally severance taxes from resource extraction (Wyoming and Alaska) and tourist-related taxes (Nevada and Florida). They therefore have no need for an income tax. Washington, which does not have a major alternative tax source, must rely heavily on regressive and inadequate sales taxes to generate tax revenue.

→ A statistical test shows that there is in fact virtually no correlation (0.011) between a state’s business tax climate ranking, as measured by the Tax Foundation, and its ability to generate jobs (Table 13). For example, with the third worst business tax climate, California created 9,280,200 wage and salary jobs—about one out of every eight new jobs in the nation—between 1970 and 2015.

### **Transparency**

*Without a personal income tax, the only totally transparent tax, Washington has the second least transparent tax system in the nation.*

→ The contention that the lack of an income tax gives an economy a competitive advantage is also at odds with the long-term growth rates of Washington and Oregon (Table 14). With opposite tax systems—Washington has a sales tax but no income tax, while Oregon has an income tax but no sales tax—the two economies have performed equally well over time. Since 1970 the Washington and Oregon employment growth rates have averaged 2.2 percent and 2.0 percent, respectively.

→ While there is no evidence that having an income tax hinders economic growth and welfare, it is increasingly apparent that the lack of an income tax is putting the Washington economy in jeopardy. Washington’s sales-based tax system is not only highly regressive but also incapable of generating adequate revenue—without constantly raising tax rates or broadening the tax base—to provide the public goods and services, such as education, needed to maintain a strong economy and a high quality of life.

## Tax reform.

Based on the analysis of the major characteristics of state and local tax systems, it is evident that Washington has the worst tax system in the nation. Among the fifty state and local tax systems, Washington ranks at or near the bottom in terms of fairness (50), adequacy (36), stability (42), and transparency (49). The findings further imply that a superior alternative to Washington’s current tax system is a single-rate personal income tax.

→ Forty-three states have a personal income

tax. Most of them also utilize a sales tax, a property tax, and various other excise taxes. As a consequence of these latter taxes, all state and local tax systems are regressive, inadequate, unstable, and opaque, at least to a degree. Thus, all states would benefit from greater use of a personal income tax.

→ A personal income tax is hardly an unorthodox means of raising public revenue, as evident by the fact that most states make use of it. In 1932, 70 percent of Washington voters passed an initiative for a progressive income tax. In 1987, the Washington State Economic Development Board, composed of business and government leaders, recommended that the state tax base be broadened and stabilized “by reducing the sales tax rate and instituting a flat-rate personal income

tax.” In 2002, the Washington State Tax Structure Study Committee recommended “a flat-rate personal income tax to reduce the state sales tax rate and eliminate the state property tax.”

→ The preferred tax system for Washington would be a personal income tax with a single rate of 10.5 percent (Table 15). Being the average effective tax rate of all state and local governments in the nation since 1970, the 10.5 percent tax rate would be neither too high nor too low. Moreover, with a 10.5 percent rate, Washington would have no need for a sales tax, a business and occupation tax, a property tax, or any other tax.

→ The 10.5 percent single-rate personal income tax system would be fair. Every

### Economic vitality

*There is no correlation between the business tax climate ranking of a state—namely, whether or not it has an income tax—and its ability to generate jobs.*

household would have to work 5.5 weeks out of the year to pay its annual state and local tax bill. The tax system would be adequate. State and local tax revenue would always equal 10.5 percent of personal income, the national norm. Apart from economically induced fluctuations, the state and local tax system would be perfectly stable. The effective tax rate would never vary from 10.5 percent. The tax system would be totally transparent. Every household would know exactly how much it pays in state and local taxes. The tax system would not adversely affect the economic vitality of Washington. Indeed, an income tax would likely enhance it.

→ There are many other benefits of a single-rate personal income tax. The tax system would be simple, making it easy to understand and comply. It would be universal, as everyone earning personal income would pay taxes (have “skin in the game”). The tax system would be inexpensive to administer and would simplify the legislative budgetary process by eliminating the need to debate taxes. The personal income tax—by replacing regressive sales and property taxes—would reduce the income disparity among households and the income disparity among regions of the state.

→ A significant but underappreciated benefit of a personal income tax is the savings on

federal income taxes due to the deductibility of state and local personal income, property, and general sales taxes (Table 17). The federal deduction offset (federal offset) is commonly measured as the percentage point reduction in the state and local effective tax rate. As estimated by ITEP, the current federal offset for Washington is only 0.3 percentage points, since the state lacks a personal income tax. The national average is 0.9 percentage points.

### **Tax Reform**

*If Washington were to adopt a 10.5 percent single-rate personal income tax, replacing all other taxes, the tax system would be fair, adequate, stable, and transparent and would not adversely affect economic vitality. Nor would the higher effective tax rate increase Washington’s total state and local tax burden because of the offsetting savings on federal income taxes due to the deductibility of state and local personal income taxes.*

→ In FY 2015, state and local taxes amounted to an estimated \$34.1 billion, implying a 9.3 percent state and local effective tax rate. Thus, the 0.3 percentage point federal offset, effectively lowering the tax rate to 9.0 percent, meant that Washington taxpayers saved \$1.1 billion on their federal taxes (0.3 percent of the \$357.4 billion in household personal income).

→ With a 10.5 percent personal income tax in FY 2015, state and local governments would have raised \$38.3 billion in tax revenue, \$4.2 billion more than under the current tax system. The federal offset, however, would have climbed to 1.5

percentage points. Thus, the state and local effective tax rate, net of the federal offset, would have been 9.0 percent, the same as it was under the current tax system. The realized savings on federal taxes would have totaled \$5.6 billion or \$4.5 billion more than under the current tax system. Since the \$4.2 billion gain in total state and local tax

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revenue would have been offset by the \$4.5 billion increase in federal tax savings, the extra revenue generated by the 10.5 percent personal income tax would have come at no cost to Washington taxpayers, thanks to the generosity of federal tax law.

- A 10.5 percent personal income tax would not only increase state and local tax revenue but it would also shift the business tax burden to households. Nevertheless, due to the elimination of all regressive taxes combined with the ability of taxpayers to take maximum advantage of the federal offset, three-fifths of Washington households would experience a decline in their state and local taxes under the personal income tax system (Table 18).
- The twenty percent of households with the lowest incomes would see the biggest relative drop in taxes from the proposed tax system. Even without any benefit from the federal offset, their average state and local effective tax rate would fall from 16.8 percent to 10.5 percent. The average tax rate for the twenty percent of households with the highest incomes would rise from 4.8 percent to 8.3 percent, taking into account the federal offset. The comparable tax rates for the top household income groups are 7.1 percent in Oregon and 8.2 percent in California, according to ITEP.
- Ultimately, the proposed 10.5 percent personal income tax is regressive because of the federal deduction offset. Due to the graduated tax brackets of the federal income tax system, high-income households reap greater federal income tax savings from the deductibility of state and local personal income taxes than do low-income households. Consequently, the state and local tax rate net of the offset for the one percent of Washington

households with the highest incomes—those in the 30 percent tax bracket or higher—is only 7.1 percent. This is considerably less than the 10.5 percent rate for the lowest-income households, which do not benefit from the federal offset since they pay little or no federal income taxes.

- The 10.5 percent personal income tax is still much fairer than Washington's current array of regressive taxes. One measure of regressivity used by ITEP is the ratio of the tax burden of the lowest-income households to that of the one percent of households with the highest incomes, taking into account the federal offset. Under the current tax system, the ratio for Washington is 7.0, the highest among the fifty states. With a 10.5 percent personal income tax, the ratio would be 1.5, down among the states with the fairest tax systems, such as Oregon (1.3) and California (1.2).

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# Washington State and Local Tax System: Dysfunction & Reform

In 1932, Washington citizens overwhelmingly passed an initiative to enact a graduated income tax, but it was ruled unconstitutional by the Washington State Supreme Court. Eight decades later, Washington is one of only seven states without an income tax. The major components of the current state and local tax system include a retail sales tax, a business and occupation tax, a property tax, and various excise taxes.

Throughout its existence the Washington tax system has been problematic. Its heavy reliance on retail sales taxes, whose tax base does not keep up with the growth of the economy, has made it necessary to raise the state government sales tax rate from 2.0 percent to 6.5 percent. This in turn has greatly increased the regressivity of the Washington tax system, which is now broadly recognized as the most unfair in the nation.

In 2001, the Legislature established the Washington State Tax Structure Study Committee to evaluate “the elasticity, equity, and adequacy of the state’s tax system.” Notwithstanding the wide-ranging and thoughtful effort, the study brought about no fundamental change to the tax system.

Carrying on the work started by the tax structure study committee, this study compares the Washington state and local tax system with the tax systems of the other forty-nine states. The analysis focuses on

## THE SOCIAL CONTRACT

“The organizer of industry who thinks that he has ‘made’ himself and his business has found a whole social system ready to his hand in skilled workers, machinery, a market, peace and order—a vast apparatus and a pervasive atmosphere, the joint creation of millions of men and scores of generations. Take away the social factor and we are but... savages living on roots, berries, and vermin.”

Source: **L. T. Hobhouse**, *The Elements of Social Justice*, 1922.

five characteristics of the tax systems: fairness, adequacy, stability, transparency, and economic vitality. Based on the findings of the study, it is evident that Washington has the worst state and local tax system in the nation. Moreover, the analysis indicates that the most logical resolution to its various failings is a single-rate personal income tax.

# Government Finances

## Federal, state, and local tax revenue.

In a *Seattle Times* article published in 2010, a state legislator said, “We can’t have a world where public employees are the haves and the taxpayers are the have-nots.” Such statements have wide appeal, since few of us like to pay taxes. But are these sentiments based on fact?

It is true that government commands a lot of the nation’s economic resources. In FY 2015, U.S. households and businesses paid \$3.6 trillion in taxes for the goods and services—national security, education, highways, police and fire protection, healthcare, personal assistance, parks and recreation—provided by federal,

state, and local governments, according to the national income and product accounts (Table 1). More than \$1.5 trillion in taxes went to state and local governments.

*The U.S. state and local effective tax rate (state and local taxes as a percent of personal income) has averaged 10.5 percent and been quite stable since 1970.*

Nevertheless, in recent years taxes have been relatively low by historical standards. From FY 1970 to FY 2000, the effective tax rate (tax revenue as a percent of personal income) for federal, state, and local governments combined averaged 24.8 percent. However, since President Bush’s tax cuts in 2001 and 2003, the effective tax

rate has averaged 22.9 percent.

The rate of taxation is not only subject to changes in tax policy but also to fluctuations in economic activity, falling during recessions and

TABLE 1 U.S. FEDERAL, STATE, AND LOCAL TAX REVENUE, FY 1970-FY 2015

Billions of Dollars

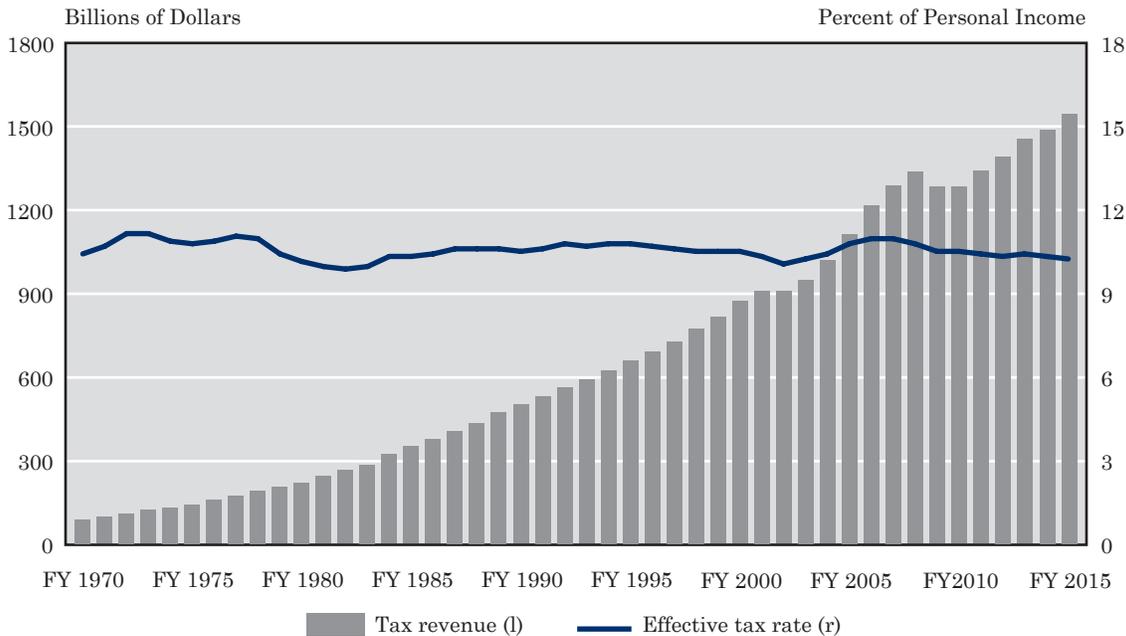
	FY 1970	FY 1985	FY 2000	FY 2007	FY 2009	FY 2011	FY 2013	FY 2015
Tax revenue	229.5	792.4	2136.9	2901.8	2591.4	2816.4	3192.1	3619.5
Federal	142.4	442.5	1264.1	1621.5	1308.4	1475.3	1736.2	2072.2
State and local	87.1	349.9	872.8	1289.3	1283.0	1341.1	1455.9	1547.3
State	46.2	212.8	527.6	744.7	717.2	747.4	835.6	904.5
Local	40.9	137.1	345.2	544.6	565.8	593.7	620.3	642.8
Personal income	835.2	3410.4	8307.0	11701.1	12275.3	12883.2	14026.4	15155.4
<b>Effective tax rate (% of income)</b>	<b>27.5</b>	<b>23.2</b>	<b>25.7</b>	<b>24.8</b>	<b>21.1</b>	<b>21.9</b>	<b>22.8</b>	<b>23.9</b>
Federal	17.1	13.0	15.2	13.9	10.7	11.5	12.4	13.7
<b>State and local</b>	<b>10.4</b>	<b>10.3</b>	<b>10.5</b>	<b>11.0</b>	<b>10.5</b>	<b>10.4</b>	<b>10.4</b>	<b>10.2</b>
State	5.5	6.2	6.4	6.4	5.8	5.8	6.0	6.0
Local	4.9	4.0	4.2	4.7	4.6	4.6	4.4	4.2

Source: U.S. Bureau of Economic Analysis ([www.bea.gov](http://www.bea.gov)).

rising during recoveries. Although the federal effective tax rate has varied considerably over time, the state and local effective tax rate has been quite stable. Since FY 1970, while the federal effective tax rate has averaged 13.6 percent, it has ranged from a low of 10.2 percent in FY 2010 to a high of 17.1 percent in FY 1970. The state and local effective tax rate, which has averaged 10.5 percent, has varied from only 9.8 percent in FY 1982 to 11.2 percent in FY 1973 (Figure 1).

## Washington and U.S. state and local revenue and expenditures.

FIGURE 1 U.S. STATE AND LOCAL TAX REVENUE, FY 1970-FY 2015



Source: U.S. Bureau of Economic Analysis.

### SHORT HISTORY OF WASHINGTON TAXES

In 1932, attempting to reduce the burden of property taxes on farmers, seventy percent of the voters passed an initiative to enact a graduated income tax. When the business community challenged its legality, the Washington State Supreme Court ruled in a 5-4 decision that the graduated income tax was an “unconstitutionally non-uniform property tax.”

If one more judge had ruled that an income tax was not a property tax or the initiative had proposed a flat-rate income tax, Washington would have an income tax today.

Instead, the current state and local tax system consists of a retail sales tax, a business and occupation tax, a property tax, and various other excise taxes. Since the adoption of the retail sales tax in 1935, the state government retail sales tax rate has risen from 2.0 percent to 6.5 percent.

Source: **Washington State Tax Structure Study Committee**, *Tax Alternatives for Washington State*, 2002.

States differ in how the responsibility of governing—raising revenue and providing public services—is divided between state government and local governments. Thus, when comparing fiscal policies across states, it is important to treat state and local governments in each state as a “single government.”

In FY 2014, the latest year for which there are data, Washington state and local government revenue amounted to \$62.3 billion (Table 2). This included \$32.2 billion

from taxes (51.7 percent of total revenue), \$12.9 billion from federal transfers (e.g., payments for social programs), \$13.3 billion from current charges (e.g., university tuitions), and \$4.0 billion from miscellaneous sources. Relative to personal income, Washington garnered significantly less state and local revenue (18.2 percent of personal income on average) than other states (19.2 percent). The shortfall in Washington revenue amounted to \$3.5 billion in FY 2014.

Washington was

notably deficient in tax revenue. In FY 2014, tax collections totaled only 9.4 percent of personal income, considerably less than the U.S. average of 10.4 percent. Washington had the fifteenth lowest state and local effective tax rate in the nation. If Washington had taxed at the 10.4 percent national rate, it would have brought in another \$3.3 billion in tax revenue.

*In FY 2014, Washington state and local tax collections totaled 9.4 percent of personal income, considerably less than the U.S. average of 10.4 percent for that year.*

In FY 2014, Washington state and local government expenditures

totalled \$62.0 billion. The major spending categories included education (\$21.0 billion), social services (\$17.9 billion), transportation (\$5.1 billion), and other expenditures (\$18.0 billion). As a percent of personal income, Washington spent less (18.1 percent) than the national average (18.8 percent). The spending difference amounted to \$2.5 billion. If Washington had not made excessive use of direct charges for government services, such as higher education

TABLE 2 WASHINGTON AND U.S. STATE AND LOCAL REVENUE AND EXPENDITURES, FY 2014

Billions of Dollars

	Washington	Percent of Total	Percent of Income	United States <sup>1</sup>	Percent of Total	Percent of Income
<b>General revenue</b>	<b>62.3</b>	<b>100.0</b>	<b>18.2</b>	<b>2758.1</b>	<b>100.0</b>	<b>19.2</b>
Federal transfers	12.9	20.7	3.8	602.2	21.8	4.2
<b>Tax revenue</b>	<b>32.2</b>	<b>51.7</b>	<b>9.4</b>	<b>1490.8</b>	<b>54.1</b>	<b>10.4</b>
Income	0.0	0.0	0.0	395.7	14.3	2.7
Personal	0.0	0.0	0.0	341.1	12.4	2.4
Corporate	0.0	0.0	0.0	54.6	2.0	0.4
Sales and gross receipts	19.4	31.2	5.7	517.4	18.8	3.6
Property	9.6	15.4	2.8	466.4	16.9	3.2
Other taxes	3.1	5.0	0.9	111.4	4.0	0.8
Current charges	13.3	21.3	3.9	453.8	16.5	3.2
Education	3.2	5.1	0.9	120.7	4.4	0.8
Hospitals	3.6	5.8	1.0	133.4	4.8	0.9
Other charges	6.4	10.3	1.9	199.7	7.2	1.4
Miscellaneous revenue	4.0	6.4	1.2	211.2	7.7	1.5
<b>General expenditures</b>	<b>62.0</b>	<b>100.0</b>	<b>18.1</b>	<b>2706.9</b>	<b>100.0</b>	<b>18.8</b>
Education	21.0	33.9	6.1	915.5	33.8	6.4
Social services	17.9	28.9	5.2	803.4	29.7	5.6
Transportation	5.1	8.2	1.5	191.7	7.1	1.3
Public safety	5.2	8.4	1.5	235.0	8.7	1.6
Other expenditures	10.2	16.5	3.0	454.0	16.8	3.2
Interest on debt	2.6	4.2	0.8	107.4	4.0	0.7
Personal income	343.2	---	---	14394.7	---	---

<sup>1</sup>All state and local governments in the United States.

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

and hospital care, the spending gap would have been \$4.8 billion.

One important public function that has been harmed by the shortfall in Washington state and local tax revenue is elementary and secondary school education (Table 3). Whereas state and local governments nationally spent on average \$38.46 per \$1,000 of personal income on K-12 education in FY 2014, Washington allotted only \$32.60 or one-seventh less. Among the fifty states, Washington ranked forty-second in K-12 expenditures relative to personal income.

The single feature of the tax system that distinguishes Washington from most other states is the absence of a personal or corporate income tax, which accounted for 26.5 percent

of U.S. total state and local government tax revenue in FY 2014. Only six other states (Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming) do not levy an income tax.

Instead, Washington relies heavily on general and selective sales taxes. Including the business and occupation tax, sales and gross receipt taxes amounted to \$19.4 billion or 60.2 percent of total state and local tax revenue. Nationally, the dependence on sales and gross receipts taxes was only 34.7 percent. As a share of total tax revenue, Washington

property taxes (29.8 percent) and other taxes (9.6 percent) were more or less in line with other states.

*Although one-third of state and local expenditures went to education in FY 2014, Washington ranked forty-second among the states in elementary and secondary school expenditures per \$1,000 of personal income.*

**TABLE 3 PUBLIC ELEMENTARY AND SECONDARY SCHOOL CURRENT SPENDING PER \$1000 OF PERSONAL INCOME, FY 2014**

Dollars

Rank	State	Spending
	<b>United States</b>	<b>38.46</b>
1	Alaska	63.61
2	Vermont	55.35
3	New York	53.72
4	New Jersey	50.76
5	Wyoming	48.50
<b>42</b>	<b>Washington</b>	<b>32.60</b>
46	California	32.30
47	Colorado	31.57
48	South Dakota	30.94
49	Arizona	29.33
50	Florida	29.28

Source: U.S. Bureau of the Census.

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# Evaluation of the Washington State and Local Tax System

## Characteristics of tax systems.

The objective of this study is to compare the Washington state and local tax system with the tax systems of all other states. While the number of issues that could be analyzed (e.g., tax avoidance by shopping in Oregon or online) is virtually limitless, this analysis focuses on what are deemed to be five critically important characteristics of a state and local tax system: fairness, adequacy, stability, transparency, and economic vitality:

**1. Fairness.** Fairness refers to the tax burden—taxes as a percent of income—placed on individuals and businesses. There are two guiding principles: the benefit principle, where individuals and businesses are taxed based on the benefits they receive from gov-

ernment; and the ability-to-pay principle, where individuals and businesses are taxed based on their income or wealth.

**2. Adequacy.** Adequacy is the ability of a tax system to generate sufficient tax revenue to meet the public needs, such as education and transportation, of a growing economy. An inadequate tax system requires periodic enhancements to tax rates or the tax base in order to yield the needed tax revenue.

**3. Stability.** A stable tax system produces a regular and predictable flow of tax revenue. A volatile tax system can create problems for the planning and operation of state and local governments.

## PER CAPITA OR PER \$1,000 OF INCOME?

When comparing states, which measurement is preferred: educational expenditures per student or per \$1,000 of personal income? Since spending per student does not take into account differences in the cost of living across states, the nod should go to spending per \$1,000 of income.

Estimates by C2ER, Stirling Best Places, and others indicate that the cost of living is about 7.0 percent higher in Washington than the United States. It is not a coincidence that this reflects the 7.9 percent difference between Washington and U.S. per capita incomes in FY 2014 (\$48,886 and \$45,288). High income states tend to be relatively expensive places to live.

Washington's higher cost of living implies that in providing the requisite goods and services for education (teachers, equipment, and materials) the state should spend 7.0 percent more per student than the nation, an objective that is clearly not being met.

In FY 2014, Washington spent \$10,202 per student for K-12 education, 7.3 percent less than the U.S. average of \$11,009, as reported by the Census Bureau. Adjusted for the 7.0 percent higher cost of living, Washington expenditures per student amounted to only \$9,535, 13.4 percent below the national norm.

Since the cost of living is to a degree related to per capita income, the difference between Washington and U.S. educational expenditures per student adjusted for the cost of living should be similar to the difference between their respective educational expenditures per \$1,000 of personal income. In FY 2014, while the United States spent \$38.46 per \$1,000 of personal income on K-12 education, Washington spent only \$32.60 or 15.2 percent less.

No matter how one measures it, educational spending in Washington has slumped to an inexcusably low level.

**4. Transparency.** In a perfectly transparent tax system, every individual and business knows exactly how much they pay in taxes.

**5. Economic vitality.** This refers to the ability of the state and local tax system to favorably affect economic growth and welfare. Because fostering economic vitality involves striking a balance between the need for public goods and services on the one hand and taxes on the other, government fiscal policy is a contentious issue.

## Fairness.

In this study, fairness primarily refers to the tax burden placed on households. Two tax systems are considered to be fair: the proportional tax system, which taxes the income of all households at the same rate; and the progressive tax system, which taxes the income of high-income households at relatively high rates. Economically advanced countries tend to utilize progressive income taxes. The U.S. federal income tax system is progressive.

In contrast, a regressive tax system taxes the income of low-income households at relatively high rates.

The unfairness notwithstanding, the Institute on Taxation & Economic Policy (ITEP) points out that every state and local tax system in the nation is fundamentally regressive.

State and local governments adopt a mix of progressive and regressive taxes. Personal income taxes are typically progressive, but sales taxes, property taxes, and

other excise taxes are regressive. Sales taxes are often very regressive because low-income households spend a disproportionately large share of their income on goods subject to sales taxes. The overall regressivity of state and local tax systems is due to the fact that the personal income tax, the only progressive tax, accounts for less than one-fourth of the total state and local tax revenue.

Absent an income tax, Washington relies heavily on sales taxes. One would therefore expect that Washington would have a relatively regressive tax system. Two independent studies, conducted thirteen years apart, arrived at a much stronger conclusion:

**1. Washington Tax Structure Study.** The Washington State Tax Structure Study Committee calculated the tax burden of retail sales taxes, other excise taxes, and property taxes on Washington households in 1999 (Table 4). The analysis was conducted with the Washington Excise and Property Tax Micro-Simulation Model, which was designed to estimate the tax burden by level of household income.

The analysis estimated that 15.7 percent of the income of the lowest-income households (incomes up to \$20,000 with an average of \$11,689) went to pay state and local sales taxes, other excise taxes, and property taxes in 1999. The state and local effective tax rate for the highest-income households (incomes over \$130,000 with an average of \$206,840) was only 4.4 percent.

TABLE 4 **WASHINGTON STATE AND LOCAL TAX BURDEN ON HOUSEHOLDS, 1999**

Percent of Household Income				
Household Income	Retail Sales Tax	Other Excise Tax <sup>1</sup>	Property Tax	Total Tax
<b>\$20000 and under</b>	<b>6.7</b>	<b>3.2</b>	<b>5.8</b>	<b>15.7</b>
\$20000-30000	4.4	1.9	3.5	9.8
\$30000-40000	4.0	1.6	3.9	9.4
\$40000-50000	3.7	1.4	3.2	8.3
\$50000-60000	3.7	1.3	3.2	8.2
\$60000-70000	3.5	1.2	3.1	7.7
\$70000-80000	3.3	1.0	3.1	7.4
\$80000-100000	3.2	0.9	2.7	6.8
\$100000-130000	2.9	0.7	2.5	6.0
<b>\$130000 and over</b>	<b>2.2</b>	<b>0.4</b>	<b>1.8</b>	<b>4.4</b>

<sup>1</sup>Other excise taxes include taxes on alcohol, cigarettes, and gasoline.  
Source: Washington State Tax Structure Study Committee.

This disparity in effective tax rates violates both the proportional and progressive principles of tax fairness.

While the highest-income households paid more in state and local taxes (\$9,198 on average) than the lowest-income households (\$1,837) in 1999, the tax system was still grossly unfair. Strapped with a 15.7 percent tax burden, the lowest-income households had to work 8.2 weeks out of the year to pay their annual state and local taxes. With a 4.4 percent tax burden, the highest-income households had to work only 2.3 weeks.

*Based on findings by the Washington State Tax Structure Study Committee, the lowest-income households had to work 8.2 weeks out of the year to pay their annual state and local taxes, while the highest-income households had to work only 2.3 weeks.*

gy, the Institute on Taxation & Economic Policy (ITEP) estimated the state and local tax burden on families by level of income for each of the fifty states. States were then ranked according to the regressivity of their tax systems (Table 5).

The institute reported three measures of regressivity: (1) taxes as a percent of income for the twenty percent of families with the lowest incomes; (2) the ratio of the tax burden for the twenty percent of families with the lowest incomes to the tax burden for the one percent of families with the highest incomes; and (3) a

tax inequality index measuring the degree to which the tax system increases family income inequality in the state.

Acknowledging that all state and local

## 2. Who pays? Using a similar methodolo-

TABLE 5 STATE AND LOCAL TAX BURDEN ON FAMILIES, 2015<sup>1</sup>

Taxes as Percent of Family Income of Non-Elderly Taxpayers<sup>2</sup>

Rank	State	20 Percent of Families with Lowest Incomes	60 Percent of Families with Middle Incomes	One Percent of Families with Highest Incomes	Ratio of Lowest to Highest	Tax Inequality Index (%)
	United States	10.9	9.2	5.4	2.0	---
<b>1</b>	<b>Washington</b>	<b>16.8</b>	<b>10.1</b>	<b>2.4</b>	<b>7.0</b>	<b>-12.6</b>
2	Hawaii	13.4	11.2	7.0	1.9	-6.0
3	Illinois	13.2	10.9	4.6	2.9	-8.1
4	Florida	12.9	8.3	1.9	6.7	-9.5
5	Texas	12.5	8.8	2.9	4.3	-8.5
46	Oregon	8.1	7.6	6.5	1.2	-1.3
47	South Carolina	7.5	7.4	4.5	1.7	-2.8
48	Alaska	7.0	4.3	2.5	2.8	-3.4
49	Montana	6.1	6.2	4.7	1.3	-1.4
50	Delaware	5.5	5.3	4.8	1.1	-0.5

<sup>1</sup>Rank based on the tax burden for the 20 percent of families with the lowest incomes. <sup>2</sup>The tax burden includes the “federal offset,” which is the savings on federal income taxes due to the deductibility of state and local personal income, property, and general sales taxes. The federal offset effectively reduces the state and local tax burden, especially for households in high federal income tax brackets.

Source: Institute on Taxation & Economic Policy, “Who Pays?,” 2015.

tax systems are to a degree regressive, the institute called attention to the “Terrible Ten,” the ten most regressive states. These states rely heavily on sales and excise taxes, making little or no use of a personal income tax.

With no income tax and three-fifths of its tax revenue derived from sales and excise taxes, ITEP concludes that “Washington has the most unfair tax system in the nation.” In 2015, state and local taxes paid by the 20 percent of Washington families with the lowest incomes amounted to 16.8 percent of their income (the equivalent of 8.7 weeks of work). In contrast, the tax burden borne by the one percent of families with the highest incomes was just 2.4 percent of their income (the equivalent of 1.2 weeks of work).

Based on all three measures of regressivity, Washington had by far the most unfair tax system in the nation. For example, the state’s tax burden for the lowest-income families was 16.8 percent of income. Hawaii ranked a distant second with a 13.4 percent burden. ITEP labeled Washington “#1 of the Terrible 10.”

Why does Washington continue to tolerate the nation’s most unfair tax system? One answer lies in the opaqueness of the tax system, which will be discussed later. If you do not know how much you pay in taxes, how can you determine whether it is fair or not?

## Adequacy.

Adequacy is arguably the most critical characteristic of the Washington state and local tax system. If tax revenue fails to keep up with the demand for public goods and services, it eventually becomes necessary to increase tax

rates or expand the tax base. In a sales-based tax system like Washington’s, this makes the tax system even more unfair.

**1. State and local tax burden.** Adequacy raises a question at the core of the debate over taxes: how much should government tax? Given that this is a

value-laden question, it is better to ask: how much does government tax? Or, how much are citizens willing to be taxed (Figure 1 and Table 6)?

Since FY 1970 total tax revenue for all state and local governments in the United States has averaged 10.5 percent of personal income (\$105 per \$1,000 of income). Moreover, the state and local effective tax rate has been very stable over time, ranging from a low of 9.8 percent in FY 1982 to a high of 11.2 percent in FY 1973. During the Great

Recession and recovery, the rate never dropped below 10.2 percent.

The 10.5 percent average state and local effective tax rate is not necessarily the optimal tax rate. Rather, it is the norm or the rate that U.S. state and local governments have tended to maintain for nearly five decades. Nevertheless, if a state adopts a significantly higher effective tax rate than the norm, it should ask itself whether

*Lacking an income tax, the Institute on Taxation & Economic Policy has determined that “Washington has the most unfair tax system in the nation.”*

*The long-term norm for the U.S. state and local effective tax rate implies that the Washington effective tax rate should be about 10.5 percent.*

it is unduly burdening taxpayers. Conversely, if a state adopts a significantly lower effective tax rate, it should ask itself whether it is underfunding the public goods and services necessary to make the state a good place to live and locate a business.

## 2. Tax policy implications.

The existence of a stable long-term norm for the state and local effective tax rate has implications for tax policy. (1) The state and local effective tax rate should average about 10.5 percent of personal income. (2) The state and local tax structure should be designed such that tax revenue grows along with personal income, thereby maintaining the desired effective tax rate without raising tax rates or broadening the tax base. (3) Any tax change proposal should include an explicit estimate of its impact on the effective tax rate.

## 3. Washington's inadequate tax system.

How has the Washington state and local effective tax rate performed relative to the average effective tax rate for all state and local governments in the United States?

TABLE 6 U.S. STATE AND LOCAL TAX REVENUE, FY 1970-FY 2015

Billions of Dollars

	Tax Revenue	Personal Income	Effective Tax Rate (%) <sup>1</sup>
FY 1970	87.1	835.2	10.4
FY 1975	141.2	1306.5	10.8
FY 1980	220.5	2190.3	10.1
FY 1985	349.9	3410.4	10.3
FY 1990	500.8	4765.3	10.5
FY 1995	659.9	6115.8	10.8
FY 2000	872.8	8307.0	10.5
FY 2005	1114.5	10327.6	10.8
FY 2010	1284.2	12212.0	10.5
FY 2015	1547.3	15155.4	10.2
<b>Average (FY 1970-15)</b>	<b>---</b>	<b>---</b>	<b>10.5</b>
Low (FY 1982)	264.3	2701.1	9.8
High (FY 1973)	121.2	1080.2	11.2

<sup>1</sup>Effective tax rate is the state and local tax revenue as a percent of personal income. The U.S. effective tax rate is the average state and local effective tax rate of all states.

Source: U.S. Bureau of the Economic Analysis.

*As tax revenue failed to keep pace with the growth of personal income, the Washington state and local effective tax rate fell from 11.4 percent (the eleventh highest in the nation) in FY 1995 to 9.4 percent (the thirty-sixth highest) in FY 2014.*

Since FY 1995 Washington has had one of the most inadequate tax systems in the nation (Table 7 and Figure 2).

In FY 1995, the Washington state and local effective tax rate rose to 11.4 percent. It was well above the 10.5 percent historical norm and the 10.8 percent average for all states in that year. The Washington effective tax rate was the eleventh highest in the nation.

By FY 2000, however, the effective tax rate had fallen to 9.9 percent, well below the 10.5 percent norm and the 10.5 percent nationwide

average at that time. The effective tax rate ranked thirty-seventh highest in the nation, a decline of twenty-six places in just five years.

Since FY 2000 Washington's effective

tax rate has stayed well below the norm and the average for all states. Between FY 2002 and FY 2007, the period of economic recovery from the Dot-Com/911 Recession, the Washington effective tax rate rebounded, rising from 9.8 percent to 10.3 percent. But even at its highest point in FY 2007, it fell 0.2 percentage points short of the 10.5 percent norm and 0.7 percentage points short of the 11.0 percent national average.

Between FY 2007 and FY 2014, the

Washington state and local effective tax rate plummeted 0.9 percentage points to 9.4 percent, 1.0 percentage point below the U.S. average. Washington had the thirty-sixth highest effective tax rate in FY 2014.

Between FY 1995 and FY 2014, while the U.S. state and local effective tax rate decreased from 10.8 percent to 10.4 percent (0.4 percentage points), the Washington tax rate fell from 11.4 percent to 9.4 per-

TABLE 7 WASHINGTON AND U.S. STATE AND LOCAL TAX REVENUE, FY 1992-FY 2014

Billions of Dollars

	Washington Tax Revenue	Washington Personal Income	Washington Effective Tax Rate (%) <sup>1</sup>	Rank <sup>2</sup>	U.S. Tax Revenue	U.S. Personal Income	U.S. Effective Tax Rate (%)
FY 1992	11.9	109.9	10.9	16	558.2	5236.5	10.7
FY 1993	12.8	117.6	10.9	17	594.3	5539.3	10.7
FY 1994	13.9	122.9	11.3	14	625.5	5778.2	10.8
<b>FY 1995</b>	<b>14.8</b>	<b>129.9</b>	<b>11.4</b>	<b>11</b>	<b>660.6</b>	<b>6115.8</b>	<b>10.8</b>
FY 1996	15.5	138.2	11.2	10	689.0	6464.3	10.7
FY 1997	16.4	149.3	11.0	13	728.6	6865.0	10.6
FY 1998	17.3	162.1	10.7	23	774.0	7337.8	10.5
FY 1999	18.1	175.0	10.4	25	815.3	7788.2	10.5
FY 2000	18.7	189.5	9.9	37	872.4	8307.0	10.5
FY 2001	na <sup>3</sup>	196.9	na	na	na	8871.7	na
FY 2002	19.5	199.7	9.8	28	905.1	9051.2	10.0
FY 2003	na	205.8	na	na	na	9285.6	na
FY 2004	21.4	215.7	9.9	33	1010.5	9754.6	10.4
FY 2005	23.0	233.5	9.8	37	1098.5	10327.6	10.6
FY 2006	25.1	246.8	10.2	38	1205.7	11029.8	10.9
FY 2007	27.5	267.2	10.3	31	1283.3	11701.1	11.0
FY 2008	28.6	289.6	9.9	38	1329.6	12329.8	10.8
FY 2009	27.2	286.8	9.5	37	1282.2	12275.3	10.4
FY 2010	27.1	279.6	9.7	37	1278.8	12212.0	10.5
FY 2011	28.8	292.8	9.8	33	1344.2	12883.2	10.4
FY 2012	29.4	313.2	9.4	36	1388.2	13555.6	10.2
FY 2013	30.8	330.6	9.3	38	1455.5	14026.4	10.4
<b>FY 2014</b>	<b>32.2<sup>4</sup></b>	<b>343.2</b>	<b>9.4</b>	<b>36</b>	<b>1490.8</b>	<b>14394.7</b>	<b>10.4</b>

<sup>1</sup>Estimates in this table differ slightly from those in Table 1 because of minor differences in the definition of state and local taxes. <sup>2</sup>States ranked according to the size of their effective tax rate. <sup>3</sup>U.S. Bureau of the Census did not report tax revenue by state for FY 2001 and FY 2003. <sup>4</sup>Based on the reported change in state tax revenue, the estimated Washington state and local tax revenue was \$34.1 billion in FY 2015. With \$365.0 billion in personal income, the implied state and local effective tax rate was 9.3.

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

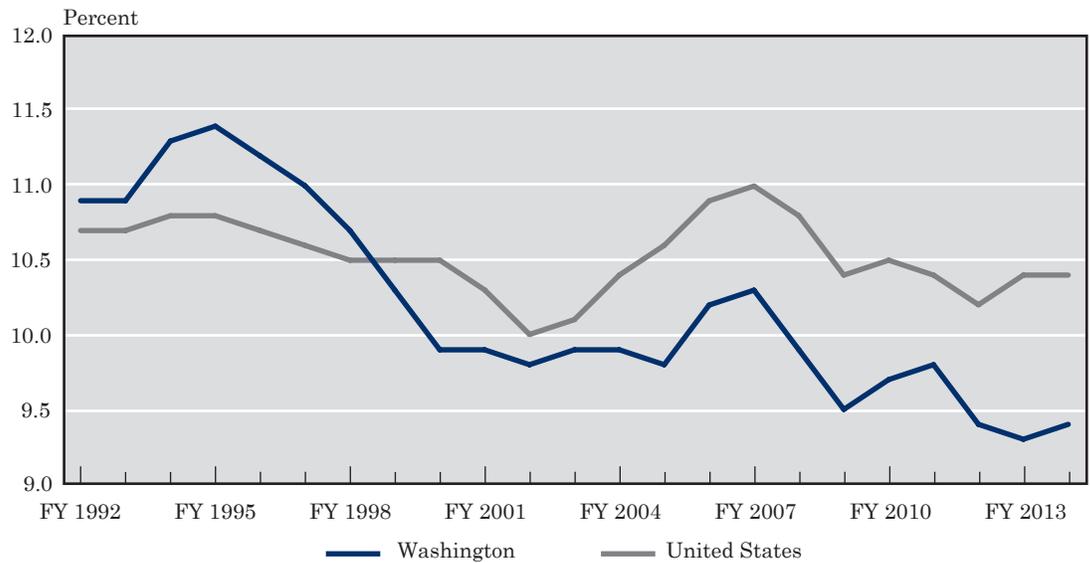
cent (2.0 percentage points). No other state experienced a bigger decline.

#### 4. Initiative 601.

The extraordinary fall-off in the Washington state and local effective tax rate was due to the inherent inadequacy of the state's sales-based tax system in concert with Initiative 601.

The Fed Slam Recession from 1980 to

FIGURE 2 WASHINGTON AND U.S. STATE AND LOCAL EFFECTIVE TAX RATES, FY 1992-FY 2014



Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

1982 dealt a serious blow to the Washington economy, greatly curtailing state and

#### I-1033 LID

Proposed in 2009, Initiative 1033 was designed as a lid to protect taxpayers. It stipulated that state and local general fund revenue could not rise faster than population growth plus inflation in the previous year. While the premise seemed reasonable, opponents portrayed the measure as a financial disaster for government, eroding its ability to provide needed public goods and services.

It is not difficult to show how I-1033 would have worked in practice. Between FY 1996 and FY 2006, for example, Washington state and local taxes increased at a 4.9 percent annual rate, climbing from \$15.5 billion to \$25.1 billion. Because personal income grew even more rapidly, expanding at a 6.0 percent rate from \$138.2 billion to \$246.8 billion, Washington's state and local effective tax rate (taxes as a percent of personal income) declined from 11.2 percent to 10.2 percent. At the same time, the U.S. state and local effective tax rate increased from 10.7 percent to 10.9 percent. Thus, even without the I-1033 lid, the Washington effective tax rate was plummeting relative to other states.

If the I-1033 lid had been in effect, the fiscal situation for Washington state and local

governments would have been grim. Between FY 1996 and FY 2006, total tax revenue would have grown at a 3.3 percent annual rate—the sum of the population growth rate (1.4 percent) and the inflation rate as measured by the consumer expenditures deflator (1.9 percent) between FY 1995 and FY 2005. As a result, state and local tax revenue would have amounted to only \$21.4 billion in FY 2006, 14.7 percent less than the actual revenue (\$25.1 billion).

In FY 2006, Washington's state and local effective tax rate under I-1033 would have dropped to 8.7 percent of personal income, well below the 10.9 percent national average for that year. Washington would have ranked forty-eighth among states in effective tax rates and the ability to pay for public goods and services, sharing company with South Dakota (8.5 percent), New Hampshire (8.6 percent), Tennessee (8.8 percent), and Alabama (8.9 percent).

Due to the inadequacy of the I-1033 tax lid—the inability to generate sufficient tax revenue in the long run—the initiative was defeated 55 percent to 45 percent on November 3, 2009.

Source: **Richard Conway, Jr.**, *Initiative 1033: Lid or Hammer*, 2009.

local tax revenue. In response, the Legislature raised the state retail sales and use tax rate from 4.5 percent in 1979 to 6.5 percent in 1983, an unprecedented four-year increase.

In 1993, perceiving that taxes were too high, voters approved I-601. It was the first of several voter-approved initiatives requiring a two-thirds vote

of the Legislature to raise taxes. Declared unconstitutional by the Washington State Supreme Court in 2013, the supermajority rule nevertheless thwarted tax increases for twenty years, even as the state and local effective tax rate continued to drift down from the 10.5 percent national norm.

**5. Fiscal impact of inadequacy.** The inadequacy of the Washington state and local tax system has had a detrimental effect on public education. In FY 1992, one year before I-601 took effect, Washington spending for elementary and secondary education amounted to \$44.07 per \$1,000 of personal income, a bit more than the U.S. average of \$43.68. By FY 2014, however, only eight states spent less on K-12 education than Washington. Compared to the national average of \$38.46 per \$1,000 of income, Washington allotted only \$32.60. Another \$2.2 billion would have been required to lift expenditures for elementary and secondary education up to the national standard.

Here is another way of looking at the

TABLE 8 WASHINGTON STATE AND LOCAL TAX REVENUE, FY 2005-FY 2014

Billions of Dollars

	Personal Income	Tax Revenue (Actual)	Tax Revenue (10.5% rate)	Tax Revenue Difference
FY 2005	233.5	23.0	24.5	-1.5
FY 2006	246.8	25.1	25.9	-0.8
FY 2007	267.2	27.5	28.1	-0.6
FY 2008	289.6	28.6	30.4	-1.8
FY 2009	286.8	27.2	30.1	-2.9
FY 2010	279.6	27.1	29.4	-2.3
FY 2011	292.8	28.8	30.7	-1.9
FY 2012	313.2	29.4	32.9	-3.5
FY 2013	330.6	30.8	34.7	-3.9
FY 2014	343.2	32.2	36.0	-3.8
<b>Total</b>	<b>—</b>	<b>279.7</b>	<b>302.7</b>	<b>-23.0</b>

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

cost of inadequacy. If the Washington state and local effective tax rate had equaled the 10.5 percent national norm in each year from FY 2005 to FY 2014, state and local governments would have collected an additional \$23.0 billion in tax revenue (Table 8). This would have been sufficient to adequately fund basic education as mandated by the Washington State Supreme Court, build the new 520 bridge, replace the Alaska Way Viaduct, improve mental health services, fight and prevent wildfires, and maintain the State Highway Patrol at full force.

**6. A permanent fixture.** Inadequacy is a permanent fixture of the Washington state and local tax system, as illustrated in the chart on taxable retail sales, the state's biggest source of tax revenue (Figure 3). Taxable retail sales nearly tripled between FY 1990 and FY 2015, increasing from \$47.2 billion to \$130.2 billion. As a percent of Washington personal income, however, taxable retail sales plunged from 50.0 percent to 35.7 percent. If taxable retail

sales had been an adequate tax base—had remained at 50.0 percent of personal income—it would have totaled \$182.5 billion in FY 2015. That in turn would have yielded an additional \$3.4 billion in sales taxes for state government alone.

## 7. Future tax revenue growth. Without

continuing legislated changes to the tax rates or the tax base, the future of Washington state and local tax collections is problematic because of the inadequate tax system. This can be shown with a few calculations (Table 9 and Figure 4).

With constant tax rates, the long-run growth of state and local tax revenue de-

### ILL-BEHAVED TAX BASE

On a technical note, state and local tax bases, such as taxable retail sales, are forecast using econometric models. Tax revenue is determined by multiplying the tax base by its corresponding tax rate. The state government retail sales tax rate is 6.5 percent.

The current tax base forecasting models are formulated in accordance with economic theory and calibrated with forty years of historical data. Following is an approximation of the equation that predicts Washington taxable retail sales:

$$\Delta \text{taxable retail sales} = 0.8017 \Delta \text{personal income} - 0.1189 \Delta \text{unemployment rate} + 0.0264 \Delta \text{housing permits}$$

The “Δ” signifies the percentage change in each variable. The estimated regression coefficients, called elasticities, show the responsiveness of taxable retail sales to changes in the explanatory variables. For example, a 10.0 percent increase in personal income is expected to elicit an 8.0 (=0.8017[10.0]) percent gain in taxable retail sales, all else being equal.

Since personal income is the only explanatory variable that increases over time, it is the primary determinant of the long-term growth of taxable retail sales. The unemployment rate and housing permits (residential building permits), which fluctuate significantly in the short run but remain relatively constant in the long run, help predict the cyclical changes in taxable retail sales.

The taxable retail sales equation embodies the inadequacy and volatility of the Washington tax system. The income elasticity of 0.8017 indicates that the retail sales tax base is grossly inadequate. Without raising the retail sales tax rate or broadening the retail sales tax base, retail sales taxes as a percent of personal income—the retail

sales effective tax rate—will decline over time.

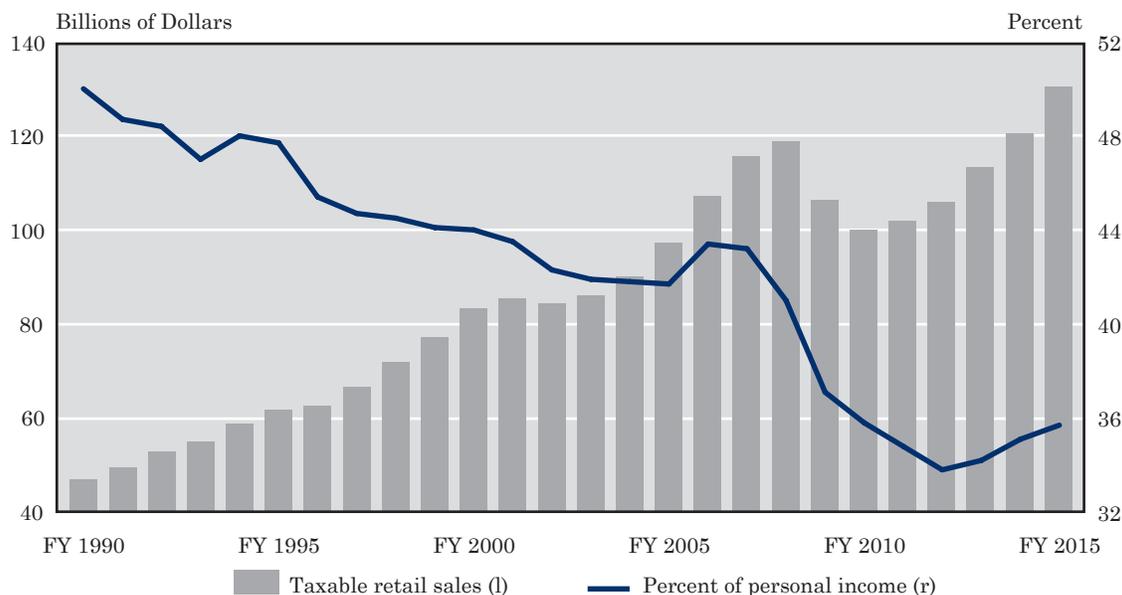
It is possible to observe the income elasticity of taxable retail sales. All that is required are two distantly separated years—in this analysis calendar-year data are used—over which there are no significant changes in the unemployment rate or housing permits. In both 1990 and 2007, the Washington unemployment rate was close to 5 percent and housing permits numbered around 48,000. Over the seventeen-year period, taxable retail sales increased 143.1 percent (from \$48.9 billion to \$118.9 billion), while personal income increased 183.1 percent (from \$96.3 billion to \$272.6 billion). The implied income elasticity for this observation period is 0.78 (=143.1/183.1), close to the estimate shown in the above taxable retail sales forecasting equation.

As a percent of personal income, taxable retail sales declined from 50.8 percent in 1990 to 43.6 percent in 2007. With a constant 6.5 percent sales tax rate for state government, the retail sales effective tax rate (retails sales taxes as a percent of personal income) fell from 3.3 percent to 2.8 percent.

Subsequently, the Great Recession further weakened the retail sales tax base. Between 2007 and 2010, the unemployment rate jumped from 4.6 percent to 9.6 percent (a 108.7 percent increase) and housing permits plummeted from 47,400 to 20,200 (a 57.4 percent decrease). With little change in income, the cyclical forces represented by these two variables were expected to cause a 14.4 (=−0.1189[108.7] + 0.0264[−57.4]) percent decline in taxable retail sales. The actual drop was 15.6 percent over the three-year period.

Source: **Richard S. Conway, Jr.**, “Revenue Forecast,” 2013.

FIGURE 3 WASHINGTON TAXABLE RETAIL SALES, FY 1990-FY 2015



Source: Washington Economic and Revenue Forecast Council.

depends on how fast the state economy, as measured by personal income, expands the overall tax base. The responsiveness of the tax base to changes in income is measured by the so-called income elasticity. The income elasticity for the aggregated state and local total tax base is estimated to be 0.71. It is the weighted-average of the income elasticities obtained from econometric equations for the sales tax base (0.80), the business and occupation tax base (1.01), the property tax base (0.50), and the other excise tax base (0.70). The weights are determined by the amount of revenue collected by each type of tax. The aggregate elasticity means that a 10.0 percent increase in personal income yields a 7.1 percent gain in the aggregate state and local tax base, which in turn implies a 7.1 percent increase

TABLE 9 WASHINGTON STATE AND LOCAL TAX REVENUE, FY 1995-FY 2025

	Tax Revenue	Personal Income	Effective Tax Rate (%)
<b>FY 1995</b>	<b>14.8</b>	<b>129.9</b>	<b>11.4</b>
FY 2000	18.7	189.5	9.9
FY 2005	23.0	233.5	9.8
FY 2010	27.1	279.6	9.7
FY 2015	34.1	365.0	9.3
FY 2020	41.6	465.8	8.9
<b>FY 2025</b>	<b>50.7</b>	<b>594.5</b>	<b>8.5</b>

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Conway.

in state and local tax revenue.

Based on historical trends, the estimate of the aggregate elasticity is reasonable. Between FY 1995 (about the time Initiative 601 took effect) and FY 2014, Washington state and local tax revenue increased 117.6 percent, while personal income increased 164.2 percent. The implied elasticity is 0.72 (=117.6/164.2).

See an “Ill-Behaved Tax Base” for more information.

After falling from 11.4 percent in FY 1995 to 9.5 percent in FY 2009, the trough of the Great Recession, the state and local effective tax rate rebounded to 9.8 percent in FY 2011. But the effective tax rate fell back to 9.4 percent in FY 2012, where it has more or less stabilized with the help of the economic recovery. Based on reported state government tax revenue, which is highly correlated with state and local tax revenue, the state and local effective tax rate slipped to an estimated 9.3 percent in FY 2015.

When the economic recovery has run its course, the cyclical lift from increased housing activity and falling unemployment will dissipate, causing a further decline in the effective tax rate. Assuming no legislated changes to the tax rates or the tax base

and a 5.0 percent annual growth rate for current-dollar personal income, the state and local effective tax rate is predicted to decline from 9.3 percent in FY 2015 to 8.9 percent in FY 2020 and 8.5 percent in FY 2025. By FY 2025, Washington could possibly have the lowest state and local effective tax rate in the nation. Relative to personal income, Washington tax collections would be one-fifth less than the national average.

The fact that Washington's state and local effective tax rate is low and falling relative to other states indicates a clear need for additional tax revenue. But raising billions of dollars to bring Washington's tax collections into line with the national norm without further aggravating the regressivity of the tax system is only achievable with major tax reform. Working around the edges, such as closing tax loopholes and legalizing marijuana, does little to halt the growing tax revenue shortfall and

does nothing to correct the unfairness of the tax system.

### Stability.

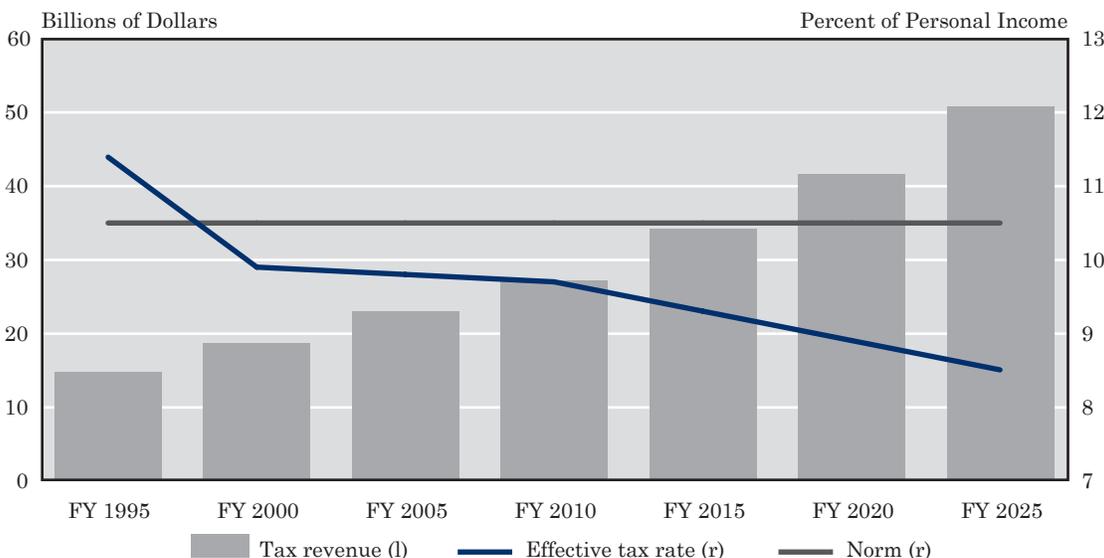
No state can escape economic cycles. Thus, no state has a perfectly stable state and local tax system. Even if its state and local effective tax rate remains constant, tax revenue will rise and fall with the cyclical movements of personal income.

Some state and local tax systems, however, are more unstable than others due to the sensitivity of their effective tax rate to economic fluctuations. The variability of an effective tax rate depends

upon the composition of the state and local tax base. If a state draws significant revenues from consumer durable sales and new construction, as does Washington, its effective tax rate will tend to be relatively volatile. A state with a personal income tax but no capital gains tax will tend to have a relatively stable state and local tax system.

*Forecasts indicate that without legislated changes to the tax rates or the tax base, the Washington state and local effective tax rate will decline from 9.3 percent in FY 2015 to 8.5 percent in FY 2025.*

FIGURE 4 WASHINGTON STATE AND LOCAL TAX REVENUE, FY 1995-FY 2025



Source: Conway.

Given that states have no control over economic cycles, the following test of stability focuses on the variability of the state and local effective tax rate. For purposes of comparison, a stability index is developed for each state. It is defined as the ratio of the absolute change in its state and local effective tax rate to the absolute change in the

national rate (the average effective tax rate of all states). If the absolute change in the state's effective tax rate equals the national change, the state's stability index is 1.00. If the state experiences no change in its effective tax rate—that is, the tax rate is perfectly stable—its stability index is 0.00. Note that there is no consideration given to the direction of change in the effective tax rate. However, it should be pointed out that with the exception of states with large severance taxes, such as Alaska, the effective tax rates of all states tend to rise and fall together.

*Due to its inadequate and volatile sales tax base, Washington had the forty-second most stable tax system in the nation between FY 1992 and FY 2014.*

**1. Two decades of instability.** The test involves measuring the relative change in the state and local effective tax rate for each of the fifty states over six time periods, including three expansions (FY 1992-00, FY 2004-07, and FY 2010-14), two recessions (FY 2000-04 and FY 2007-10), and trend (FY 1992-14).

The Washington state and local tax system was most unstable when the U.S. effective tax rate was declining appreciably (FY 1992-00 and FY 2007-10), which meant that the Washington effective tax rate was falling even more (Table 10). Not surprisingly, the period of greatest instability occurred between FY 1992 and FY 2000 in the aftermath of Initiative 601. The Washington state and local effective tax rate fell from 10.87 percent to 9.88 percent, while the U.S. rate declined from 10.69 percent to just 10.50 percent. The

respective changes were -0.99 and -0.19. Thus, the Washington stability index was 5.31 (=0.99/0.19), implying that the Washington state and local effective tax rate was five times more unstable than the U.S. rate. During that period of time, Washington had the fortieth most stable state and local tax system in the nation.

In contrast, with an index reading of

TABLE 10 **STABILITY OF WASHINGTON STATE AND LOCAL TAX SYSTEM, FY 1992-FY 2014**

	FY 1992- FY 2000	FY 2000- FY 2004	FY 2004- FY 2007	FY 2007- FY 2010	FY 2010- FY 2014	FY1992- FY 2014
Economic phase	Expansion	Recession	Expansion	Recession	Expansion	Trend
Washington first-year effective tax rate (%)	10.87	9.88	9.89	10.35	9.56	10.87
Washington last-year effective tax rate (%)	9.88	9.89	10.35	9.56	9.38	9.38
Effective tax rate change (%)	-0.99	0.01	0.47	-0.80	-0.18	-1.49
U.S. first-year effective tax rate (%)	10.69	10.50	10.37	10.98	10.49	10.69
U.S. last-year effective tax rate (%)	10.50	10.37	10.98	10.49	10.36	10.36
U.S. effective tax rate change (%)	-0.19	-0.14	0.61	-0.49	-0.13	-0.33
<b>Stability index<sup>1</sup></b>	<b>5.31</b>	<b>0.08</b>	<b>0.76</b>	<b>1.62</b>	<b>1.43</b>	<b>4.52</b>
<b>Rank<sup>2</sup></b>	<b>40</b>	<b>2</b>	<b>27</b>	<b>36</b>	<b>16</b>	<b>42</b>

<sup>1</sup>Stability index is the ratio of the absolute percentage point change in the state and local effective tax rate of a state to the absolute percentage point change in the U.S. state and local effective tax rate. <sup>2</sup>States ranked according to the stability of their state and local effective tax rate.

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Conway.

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0.76, the economic recovery between FY 2004 and FY 2007 was a period of relative stability. Unfortunately, since both the Washington and U.S. effective tax rates rose at the time, this meant that the state's effective tax rate slipped even further behind the national rate. In FY 2004, the Washington effective tax rate was already trailing the U.S. tax rate, the difference being -0.48 (=9.89-10.37) percentage points. Over the next three years, as the effective tax rates in other states climbed faster than the Washington rate in response to the expansion, the gap widened to -0.63 (=10.35-10.98) percentage points. This experience contradicts a commonly held belief that, while Washington's sales-based tax system is volatile, economic rebounds result in a full recovery of tax revenue.

Between FY 1992 and FY 2014, the Washington state and local effective tax rate declined from 10.87 percent to 9.38 percent, while the U.S. rate decreased from 10.69 percent to 10.36 percent. With a stability index of 4.52, Washington had the nation's forty-second most stable state and local tax system over the twenty-two year period.

**2. Inadequacy and stability.** It should be emphasized that the inadequacy of the Washington tax system has been a major source of its instability. The extremely high value of the trend stability index (4.52) is due in large part to the long-term decline in the state and local effective tax rate caused by Washington's inadequate tax system. Inadequacy also hindered the growth of tax revenue during the economic recovery between FY 2004 and FY 2007, resulting in a period of "unwanted stability."

To the extent that inadequacy precludes tax revenue from growing with personal income, it is a major problem in its own

right. But inadequacy can also adversely affect the stability as well as the fairness of a state and local tax system. This is why inadequacy is perhaps the most critical shortcoming of the Washington tax system.

**3. California and Oregon.** The California state and local tax system is purported to be unstable due to its erratic capital gains taxes. However, with a trend stability index of 0.64, California had the twelfth most stable tax system in the nation between FY 1992 and FY 2014. The California tax system was highly unstable (5.08) during the 2000-04 recession but surprisingly stable (0.85) during the 2007-10 recession.

With a trend stability index of 2.76, Oregon had the nation's thirty-fifth most stable tax system in the long run. Like Washington, Oregon has let its state and local effective tax rate drift below the national norm over time. While the national rate remained relatively constant, the Oregon rate fell from 11.1 percent in FY 1992 to 10.2 percent in FY 2014.

**4. The Great Recession and state tax revenue.** During the Great Recession, caused by the collapse of the housing and financial markets, Washington state and local budget imbalances were often blamed on "run-away spending." But data show that in no single year from FY 2007 to FY 2014 did Washington outspend the rest of the nation relative to personal income. Over the eight-year period, Washington and U.S. state and local direct general expenditures averaged 18.9 percent and 19.6 percent of personal income, respectively.

Rather, the budget difficulties of Washington state and local governments stemmed from an unprecedented loss of revenue caused by the extreme volatility of the tax system during the recession.

The impact of the recession on state government tax revenue was not only severe but also enduring (Table 11). Between FY 2007 and FY 2009, while current-dollar personal income increased 7.3 percent, rising from \$267.2 billion to \$286.8 billion, state government tax revenue decreased 8.8 percent, falling from \$14.2 billion to \$12.9 billion. This lowered the state government effective tax rate from 5.3 percent to 4.5 percent (-0.8 percentage points). By comparison, the U.S. state government effective tax rate declined from 6.5 percent to 5.8 percent (-0.7 percentage points).

*Despite enhancements to state government tax revenue, such as a temporary increase in the business and occupation tax for services, real per capita state tax revenue measured in 2009 dollars fell from \$2,376 in FY 2007 to \$2,108 in FY 2015, a drop of 11.3 percent. This meant that the real purchasing power of state government tax revenue—the ability to provide public goods and services—declined by one-ninth over the eight-year period.*

Because of a 7.9 percent rise in the cost of government goods and services due to inflation and a 3.1 percent increase in population, real per capita state tax revenue plummeted from \$2,376 measured in 2009 dollars to \$1,947, an 18.1 percent loss over the two-year period.

Washington state government tax revenue began to rebound in FY 2010. Tax revenue climbed from \$12.9 billion in FY 2009 to \$16.9 billion in FY 2015, causing the effective tax rate to increase from 4.5 percent to 4.6 percent. But much of the modest gain in the effective tax rate was due to non-economic changes, principally a consolidation of accounts, a tax amnesty program, and a temporary

TABLE 11 WASHINGTON STATE GOVERNMENT GENERAL FUND TAX REVENUE, FY 2007-FY 2015

	FY 2007	FY 2009	FY 2011	FY 2013	FY 2015	FY 2007-15 Percent Change
State tax revenue (bils. \$)	14.2	12.9	14.3	15.4	16.9	19.3
Personal income (bils. \$)	267.2	286.8	292.8	330.6	365.0	36.6
<b>Effective tax rate (%)</b>	<b>5.3</b>	<b>4.5</b>	<b>4.9</b>	<b>4.6</b>	<b>4.6</b>	<b>-12.8</b>
State tax revenue (bils. \$)	14.2	12.9	14.3	15.4	16.9	19.3
State and local price deflator (09=1.000)	0.930	1.004	1.044	1.090	1.127	21.1
Population(thous.)	6416.2	6614.8	6784.0	6936.5	7118.0	10.9
<b>Real per capita state tax revenue (\$09)</b>	<b>2376</b>	<b>1947</b>	<b>2020</b>	<b>2032</b>	<b>2108</b>	<b>-11.3</b>
Personal income (bils. \$)	267.2	286.8	292.8	330.6	365.0	36.6
Personal consumption deflator (09=1.000)	0.958	0.999	1.027	1.069	1.093	14.1
Population(thous.)	6416.2	6614.8	6784.0	6936.5	7118.0	10.9
<b>Real per capita income (\$09)</b>	<b>43470</b>	<b>43383</b>	<b>42009</b>	<b>44601</b>	<b>46907</b>	<b>7.9</b>

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and the Washington State Economic and Revenue Forecast Council ([www.efrc.wa.gov](http://www.efrc.wa.gov)).

increase in the business and occupation tax rate for services. The non-economic changes added an estimated \$1.7 billion to tax revenue in FY 2015. Thus, without the non-economic enhancements, state tax revenue in FY 2015 would have amounted to only \$15.2 billion, implying an effective tax rate of 4.2 percent.

Even with the enhancements to revenue, real per capita state government tax revenue hardly improved, inching up from \$1,947 in FY 2009 to \$2,108 in FY 2015. This was hardly enough to recoup the earlier loss. Thus, on net, state per capita tax revenue measured in 2009 dollars fell from \$2,376 in FY 2007 to \$2,108 in FY 2015, a drop of 11.3 percent. In other words, the real purchasing power of state government tax revenue—the ability to provide public goods and services (education, safety, healthcare, and infrastructure) for Washington’s people and businesses—declined by one-ninth over the eight-year period.

A common tactic to counteract an unstable tax system is a rainy day fund. Proposed by the Washington State Tax Structure Study Committee, voters approved a constitutional amendment to create a rainy day fund in 2007. Although designed to cushion the ups and downs of tax revenue, rainy day funds seldom have sufficient financial resources to offset the tax losses caused by a recession.

At the beginning of FY 2009, almost one year into the Great Recession, the Washington state government rainy day fund had a balance of less than \$1 billion. It was no match for the tax revenue deficit—the difference

between actual and forecast revenue—that would total \$10 billion over the next five years. Some fiscal experts recommend a fund balance equal to 15 percent of the annual general fund expenditures. For Washington state government that would mean a rainy day fund balance of about \$3 billion. After appropriating nearly \$0.2 billion for fighting wildfires in

2014 and 2015, the current balance is again approximately \$1 billion.

### **Transparency.**

The real error of our ways during the housing bubble was that we allowed a major part of our economy to become opaque. We neglected a basic tenet of a market economy: both buyers

and sellers should have “perfect information” about their transactions. When transactions are not transparent, we are susceptible to Ponzi schemes and the financial shenanigans associated with subprime lending and mortgage-backed securities. More importantly, we place our economy in jeopardy.

Taxes should also be transparent if Washington is to have a rational tax system. As a KUOW news reporter discovered, Washington taxes are far from transparent. The reporter asked two baristas how much they paid in state and local taxes. The barista in Oregon had a good idea, since that state has an income tax. The barista in Washington had no clue.

The Washington State Tax Structure Study Committee stated that “households should be able to determine their overall annual state tax burden, including any taxes embodied in the prices of goods and services that they buy... The finding (of the study) is that a significant part of the Washington state tax system is not transparent to households. To the extent that (business) taxes are passed on to consumers

*The Washington State Tax Structure Study Committee concluded that “a significant part of the Washington state tax system is not transparent to households.”*

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in the form of higher prices, the taxes are not transparent. In addition, most households are unaware of their annual sales tax burden even though sales tax paid on consumer purchases is explicitly stated on receipts and invoices.” In other words, no one in Washington knows how much he or she pays in state and local taxes.

**1. Business and occupation tax.** Business taxes are ostensibly paid by businesses. However, the business and occupation tax can sometimes be passed on to customers in the form of higher prices. This is likely to occur when competing local businesses are selling goods and services in local markets. Even without collusion, they soon realize that it is mutually advantageous to increase

their prices to cover the tax. Oftentimes, in the process of maximizing profits, businesses pass on the tax without conscious effort.

The potential for local tax-shifting is great, according to the Washington input-output table, which is a detailed account of the sales and purchases made by businesses in the state. The latest table shows that sales of Washington businesses totaled \$603.7 billion in 2007. An estimated \$357.0 billion (59.1 percent) went to Washington businesses, consumers, and governments, while \$246.7 billion (40.9 percent) was exported. This implied that up to three-fifths of the business and occupation tax base was subject to local tax-shifting.

The ability to pass on the business and occupation tax to customers has two undesirable effects. It reduces the transparency

of the tax system, since it is unclear how much of the business and occupation tax burden ultimately falls on Washington businesses, households, and government.

Tax-shifting also results in pyramiding, which is the multiple payment of the business and occupation tax on

a product as it moves from firm to firm up the production chain. To the extent that pyramiding raises the cost of producing exports, the key driver of the Washington economy, it hinders economic growth.

The business and occupation tax is unique to Washington. Despite its lack of transparency, the tax has a number of features that are popular with government officials. It has an adequate tax base—as previously noted the estimated income elasticity is 1.01—because of

its broad coverage of the economy. Unlike the sales tax base, which consists of goods and new construction, the business and occupation tax base encompasses services. Due to its extensive coverage, the business and occupation tax base is also relatively stable.

Nevertheless, in addition to opaqueness and pyramiding, there are other drawbacks to the business and occupation tax that make it an undesirable tax. As a gross receipts tax, it is not levied on business income. Thus, a business is obligated to pay the tax even if it earns no profit. In this way, the gross receipts tax can retard the formation of start-ups.

The direct burden of the business and occupation tax is also very high. In FY 2014, business and occupation tax revenue for

*While the business and occupation tax has an adequate and relatively stable tax base, it has several drawbacks: it is opaque; it is subject to tax pyramiding; it is regressive; it has a high tax burden; and it features numerous tax rates, which raises questions about the potentially unfair application of the tax.*

city and state governments in Washington amounted to \$3.7 billion. Relative to personal income, the effective tax rate was 1.1 percent, nearly three times the corporate income effective tax rate (0.4 percent) for all state and local governments in the United States.

The relatively high business and occupation tax can put exporting companies, the main engines of the Washington economy, at a competitive disadvantage. Being in competition with firms around the world, Washington exporters cannot readily increase the prices of their goods and services to cover the cost of the tax.

Recognizing this, the state offers selective preferential tax rates. For example, manufacturing pays a lower tax rate (0.004840) than services (0.015000). Boeing, facing strong competition from

Airbus and being constantly courted by other states, pays an even lower tax rate (0.002904). The Washington Department of Revenue specifies thirteen different tax rates for thirty-five categories of business activities. The rationale for each rate is

not always clear. The preferential tax rates also raise questions about the potentially unfair application of the business and occupation tax.

## 2. Test of transparency.

Comparing the transparency of state and local tax systems across states is a somewhat subjective exercise, requiring a “quantitative” estimate of the transparency of each type of tax. A state’s

rank is determined by a total transparency index, which is defined as the weighted average of the transparency of five types of taxes: personal income tax, business tax (business and occupation tax or corporate income tax), sales tax, property tax, and other excise tax. The weights are equal to each tax’s share of total state and local tax revenue. A totally transparent tax system would have an index equal to 1.000.

As an example of how the transparency index is calculated, suppose a state collects one-half of its tax revenue from personal income taxes and one-half from sales taxes. If personal income taxes are totally transparent (that is, have a transparency index of 1.000) but sales taxes are only 50 percent transparent (have an index of 0.500), the state’s total transparency index is 0.750 ( $=0.50 \times 1.000 + 0.50 \times 0.500$ ).

Personal income taxes are totally transparent, as there is always a record of payment. Since “most households are unaware

*A transparent tax system is a prerequisite for rational tax policy. In the absence of a personal income tax, the only truly transparent tax, Washington has the forty-ninth most transparent tax system in the nation.*

TABLE 12 STATE AND LOCAL GOVERNMENT TAX SYSTEM TRANSPARENCY INDEX, FY 2014

Total Transparency = 1.000

Rank	State	Index
	United States	0.673
<b>1</b>	<b>Oregon</b>	<b>0.767</b>
2	Maryland	0.738
2	Massachusetts	0.730
4	Connecticut	0.723
5	Virginia	0.723
46	Alaska	0.563
47	North Dakota	0.554
48	Tennessee	0.554
<b>49</b>	<b>Washington</b>	<b>0.550</b>
50	Nevada	0.549

Source: U.S. Bureau of the Census and Conway.

of their annual sales tax burden,” as noted by the Washington State Tax Structure Study Committee, the transparency index for sales taxes is assigned a value of 0.500. Based on the input-output analysis, which suggests that businesses can pass on up to 60 percent of their taxes, the business and occupation tax and the corporate income tax transparency indexes are each given a value of 0.400. The property tax transparency index, which is assumed to be 0.700, presumes that residential and nonresidential property owners are aware of the property taxes they pay but renters are not. Finally, the transparency index for excise taxes is assumed to have the same value as the sales tax transparency index.

With a total transparency index of 0.767, Oregon had the nation’s most transparent tax system in FY 2014 (Table 12). This meant that its tax system was 77 percent transparent. Its top ranking is due to a significant reliance on a personal income tax coupled with the absence of a sales tax. Also heading the list are four east coast states: Maryland, Massachusetts, Connecticut, and Virginia.

In contrast, Washington edged out only Nevada for having the least transparent tax system among the fifty states. The total transparency index was 0.550. In this case, the opaqueness of the Washington state and local tax system is attributable to the lack of an income tax and its dependence on sales and business and occupation taxes.

Note that the total transparency index is sensitive to the assumption regarding the transparency of sales and other excise taxes. If the indexes of these two taxes are

increased from 0.500 to 0.750, Washington’s total transparency index rises to 0.699.

But, because the transparency indexes for all states also increase, Washington’s ranking—next to last—remains unchanged.

Without a personal income tax, Washington has one of the most opaque tax systems in the nation. If a tax system is not transparent, how can we make rational tax policy? Even

fundamental questions are difficult, if not impossible, to answer. How much are my taxes? Are they too high? Am I paying my fair share? Is the tax system good or bad for the economy? It is arguable that the main reason why Washington does not have an income tax is that we do not realize how dys-

functional our current tax system is.

*The literature regarding the effect of taxes on economic vitality is inconclusive, which makes the issue contentious.*

### **Economic vitality.**

The literature regarding the relationship between taxes and economic vitality is inconclusive. Some economists argue that low taxes are the best way to promote job and income growth, while others contend that high-quality education and good roads are necessary for a strong economy. With regard to tax policy, the issue reduces down to two questions: how much should we pay in taxes; and what types of taxes should be utilized? Some prominent business leaders have asserted that the lack of an income tax gives the Washington economy a competitive advantage.

As a preface to the following discussion, there are three facts to keep in mind. First, for nearly a half century the effective tax rate for all state and local governments has averaged 10.5 percent with little variation. Second, forty-three states utilize a personal income tax. Third, neither of the first two facts applies to

Washington. Indeed, Washington has a distinctly unique tax system.

**1. Best business tax climate.** In its latest study, the Tax Foundation concludes that, among the fifty states, Wyoming has the best business tax climate. The overall business tax climate rank-

ing for each state is based on a weighted-average of scores—the weights are shown in parentheses—for five types of taxes: personal income tax (33.1 percent), corporate tax (20.1 percent), sales tax (21.5 percent), property tax (14.0 percent), and the unemployment insurance tax (11.4 percent). The score for each tax is determined by its tax rate and tax base.

The Tax Foundation contends that “states with the best tax systems will be the most competitive in attracting new businesses and most effective at generating economic and employment growth.”

The top five states are Wyo-

### BUSINESS TAX CLIMATE SPREADSHEET

Here is a business tax climate analysis that you can do at home. Calculate the change in wage and salary employment between 1970 and 2015 for each state, according to data reported by the U.S. Bureau of Economic Analysis ([www.bea.gov](http://www.bea.gov)). The U.S. and Washington employment changes are 68,841,000 and 2,079,500, respectively. Next, enter the changes in state employment down a column of an Excel spreadsheet. Then, in the adjacent column, enter the corresponding 2016 state business tax climate rankings as estimated by the Tax Foundation ([www.taxfoundation.org](http://www.taxfoundation.org)). Wyoming is 1 and Washington is 12. Finally, calculate the correlation (correl) between the business tax climate ranking and employment change. There is virtually no correlation (0.011).

ming, South Dakota, Alaska, Florida, and Nevada. After being ranked sixth in earlier studies, Washington has fallen to twelfth for no apparent reason. One thing that these states (including Washington) have in common is the lack of a major tax (personal income tax, corporate tax, or sales tax). In this case, none of them has a personal income tax. The Tax Foundation concludes

that “the lesson is simple: a state that raises sufficient revenue without one of the major taxes will, all things being equal, have an advantage over those states that levy every tax in the state collector’s arsenal.”

But a closer look reveals that the lesson is not so clear. While the six states do not have an income tax, their tax systems are not the same. Four states have major alternative sources of tax revenue: severance taxes from resource extraction (Wyoming and Alaska) and tourist-related taxes (Nevada and Florida). As such, they do not require an income tax. Wyoming, for example, earns about one-fourth of its general fund revenue from severance

TABLE 13 **BEST BUSINESS TAX CLIMATE AND EMPLOYMENT CHANGE**

Rank <sup>1</sup>	State	1970-15 Employment Change (thous.) <sup>2</sup>	Percent of U.S. Employment Change
	United States	68841.0	100.0
1	Wyoming	172.9	0.3
2	South Dakota	233.0	0.3
3	Alaska	233.0	0.3
4	Florida	5910.8	8.6
5	Nevada	1065.6	1.5
<b>12</b>	<b>Washington</b>	<b>2079.5</b>	<b>3.0</b>
46	Vermont	152.1	0.2
47	Minnesota	1520.2	2.2
48	California	9280.2	13.5
49	New York	1834.9	2.7
50	New Jersey	1261.2	1.8

<sup>1</sup>Rank based on best business tax climate in 2016. <sup>2</sup>Wage and salary employment.

Source: Tax Foundation, *State Business Tax Climate Index, 2016* and U.S. Bureau of Economic Analysis.

taxes on coal, oil, and gas extraction. In contrast, Washington, which does not have an alternative tax source, has to rely heavily on regressive and inadequate sales taxes to generate its state and local tax revenue.

The Tax Foundation presumes that states with the lowest taxes have the best business tax climate. But Wyoming is in fact a high-tax state. Even after energy prices began to fall, Wyoming's state and local effective tax rate was 11.2 percent of personal income in FY 2014, appreciably above the 10.5 percent national norm. During the five prior years, Wyoming's effective tax rate averaged 14.5 percent.

Severance taxes have made it possible for Wyoming not only to get by fiscally without an income tax but also to generously fund education. In FY 2014, Wyoming ranked fifth nationally in terms of educational expenditures. Wyoming spent \$48.50 per \$1,000 of personal income, \$10.04 more than the U.S. average and \$15.90 more than Washington.

## 2. No correlation with job growth.

Despite having the best business tax climate, there is no evidence that it has done the Wyoming economy much good. Between 1970 and 2015, Wyoming grew faster than the nation (1.9 percent per year versus 1.4 percent) but added only 172,900 wage and salary jobs, 0.3 percent of the total gain in U.S. employment. Moreover, back-of-the-envelope calculations indicate that one-half to two-thirds of the new jobs were directly or indirectly related to mining activity. The only other basic industry exhibiting growth was tourism.

There is in fact no correlation (0.011) between a state's business tax climate and its ability to generate jobs, as a simple statistical test reveals (see "Business Tax Climate Spreadsheet").

Illustrating the lack of correlation, with the third worst business tax climate, California created on net 9,280,200 payroll jobs—more than one out of every eight new jobs in the nation—between 1970 and 2015 (Table 13).

**3. Another issue of fairness.** It has been argued that a Washington income tax would make it more difficult—that is, more costly—for high-tech firms to attract talented workers. Each

*There is no correlation between the business tax climate of a state—namely, whether or not it has an income tax—and its economic vitality, as measured by its ability to generate jobs.*

### BUSINESS OR PERSONAL?

"Washington Works Worldwide" was an economic development strategy for the state prepared in response to the 1981-82 recession.

When the subject of an income tax came up for discussion among the members of the Economic Development Board, the representative of a company that had recently moved to Washington said that he did not want to talk about it. As a consultant for the project, I asked why he would not consider an income tax, since the business and occupation tax could be a greater burden on a firm than a corporate income tax. He responded that his business had located in Seattle not because Washington did not have a corporate income tax but because it did not have a personal income tax.

In the final report, the Economic Development Board recommended that Washington "broaden and stabilize the tax system by reducing the sales tax rate and instituting a flat-rate personal income tax."

Source: **Washington State Economic Development Board**, *Washington's Challenges and Opportunities in the Global Economy*, 1987.

high-tech job creates two or three other jobs in the economy through the multiplier process. These workers and their families place demands on the public sector for schools, roads, and safety. If the added costs of these public goods and services were to fall disproportionately on low and middle-income households, as they do now under Washington's sales-based tax system, those households would in effect be subsidizing the high-tech companies and their employees.

#### 4. Washington and Oregon.

Some opponents to an income tax argue that it would hamper economic growth in Washington. But one only needs to look next door to see that there is no evidence for that contention. Washington and Oregon are a curiosity in the tax world, as there is no other pair

of geographically adjacent states that have more different tax systems. Washington has no income tax, while Oregon has an income tax but no sales tax or business and occupation tax.

Despite fundamentally different tax structures, the Washington and Oregon economies have performed equally well over time (Table 14). Both states have grown significantly faster than the nation since 1970. In terms of jobs, Washington has slightly outpaced Oregon (2.2 percent annually versus 2.0 percent). Washington has also experienced marginally faster per capita income growth (5.6 percent per year versus 5.4 percent). But the latter difference is largely due to the emergence of

high-paying jobs at Microsoft and Washington's generally higher inflation rate. When these two factors are taken into account—using data from a Microsoft impact study and

*The contention that the lack of an income tax gives the Washington economy a competitive edge is contradicted by local history. With different tax systems—Washington has a sales tax but no income tax, while Oregon has an income tax but no sales tax—the two economies have performed equally well over time.*

TABLE 14 WASHINGTON AND OREGON ECONOMIC GROWTH, 1970-2015

	1970	1990	2015	Average Annual Percent Change		
				1970-90	1990-15	1970-15
Washington						
<b>Wage and salary employment (thous.)</b>	<b>1282.1</b>	<b>2350.1</b>	<b>3361.6</b>	<b>3.1</b>	<b>1.4</b>	<b>2.2</b>
Personal income (bils. \$)	15.0	98.9	372.1	9.9	5.4	7.4
Per capita income (\$)	4379	20162	51898	7.9	3.9	5.6
Population (thous.)	3417.4	4903.0	7170.4	1.8	1.5	1.7
Oregon						
<b>Wage and salary employment (thous.)</b>	<b>767.7</b>	<b>1315.2</b>	<b>1851.9</b>	<b>2.7</b>	<b>1.4</b>	<b>2.0</b>
Personal income (bils. \$)	8.5	51.7	176.4	9.5	5.0	7.0
Per capita income (\$)	4033	18065	43783	7.8	3.6	5.4
Population (thous.)	2100.4	2860.4	4029.0	1.6	1.4	1.5

Source: U.S. Bureau of Economic Analysis.

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estimates of the Seattle and Portland consumer price indexes—the Washington per capita income growth rate from 1970 to 2015 decreases to 5.4 percent, right in line with the Oregon rate.

A common shortcoming of tax policy studies, like that of the Tax Foundation, is the presumption that states with the lowest taxes will generate the most jobs. They fail to acknowledge that reduced tax revenue can mean a diminished ability to provide the kind and level of public goods and services needed to make a state a good place to live and operate a business. As evident by the nearly zero correlation between the business tax climate ranking of a state and its job creation, there is much more to economic development than low taxes or, for that matter, whether or not a state has an income tax.

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# Tax Reform

## Tax policy options.

Based on an analysis of the major characteristics of state and local tax systems, it is evident that Washington's sales-based tax system is the worst in the nation.

Among the fifty state and local tax systems, Washington ranks at or near the bottom in terms of fairness (50), adequacy (36), stability (42), and transparency (49). Moreover, there is no evidence that having an income tax adversely affects economic vitality.

Fixing Washington's dysfunctional tax system is no simple task. Given the severity of the problems, particularly with regard to regressivity and inadequacy, many of the recently proposed remedies—a capital gains tax, closing tax loopholes,

taxing marijuana—are helpful but only on the margin.

Doing nothing is not an option given the inadequacy of the Washington state and local tax base. If the state and local effective tax rate is allowed to continue on its long-term downward path, Washington will increasingly fall behind other states in its ability to provide high-quality education, a safe place to live, adequate healthcare, and much needed infrastructure.

Working within the framework of the current tax system, however, creates a dilemma. If in the course of combating inadequacy Washington chooses to increase current tax rates or broaden the existing tax base, it will exacerbate the regressivity

*Washington has the worst state and local tax system in the nation. Among the fifty tax systems, the state ranks at or near the bottom in terms of fairness, adequacy, stability, and transparency.*

## MIXED MESSAGES

No, no, no to increased taxes...At a time like this, you don't raise taxes because raising taxes is demanding more, and there isn't any more. There is less...Government should not add to people's economic hurt (April 17, 2009).

I am appalled that you want middle-class workers and the working poor, who are the hardest hit by this recession, to continue to bear the heaviest state taxes in the country (June 27, 2010).

\$1 billion in new taxes will cost Washington state resident jobs...These tax hikes will...depress the economy. The damage will be greater than it would have been had lawmakers shown more restraint and cut spending deeper (March 8, 2010).

Fully funding education in Washington will require more tax revenue. The Joint Task Force on Education Funding estimates that we will need \$1.4 billion in 2013-15 just to meet the true costs of basic education for all children...(and) \$4.5 billion by 2017 (March 4, 2013).

In an unscientific poll conducted by *The Seattle Times* on the question of how to close a \$1.3 billion state budget shortfall and fund education, on-line readers responded: enhance revenue 57.4%, cut spending 17.6%, enhance revenue and cut spending 13.3%, prioritize spending putting education first 7.3%, and other 4.5% (March 21, 2013).

Source: *The Seattle Times*, various issues.

of the tax system, which is already deemed the most unfair in the nation.

Major tax reform, specifically instituting a personal income tax, is the only way out of the bind created by the regressivity and inadequacy of the current tax system. Ironically, tax reform would not be an issue today if eight decades ago just one more justice of the Washington Supreme Court had acknowledged the wishes of citizens and declared the proposed income tax constitutional.

### Single-rate personal income tax.

Initially, the objective of this study was simply to document the efficacy of the Washington state and local tax system. There was no thought given to an alternative tax system. The analysis, however, revealed that the major failing of the current tax system was the lack of an income tax. Upon further consideration, it became evident that the preferred state and local tax system, one better than any other, was a 10.5 percent single-rate personal income tax eliminating the need for all other taxes.

*If Washington were to adopt a 10.5 percent single-rate personal income tax, it would have the best—not the worst—tax system in the nation.*

Table 15 displays the proposed and current tax systems as they would have looked in FY 2014.

TABLE 15 **ALTERNATIVE WASHINGTON TAX SYSTEMS, FY 2014**

Billions of Dollars

	Tax Revenue	Percent of Total	Effective Tax Rate (%)
<b>Personal Income Tax System</b>			
Tax revenue	36.0	100.0	10.5
Income	36.0	100.0	10.5
Personal	36.0	100.0	10.5
Corporate	0.0	0.0	0.0
Sales and gross receipts	0.0	0.0	0.0
General sales	0.0	0.0	0.0
Business and occupation	0.0	0.0	0.0
Other excise	0.0	0.0	0.0
Property taxes	0.0	0.0	0.0
Other taxes	0.0	0.0	0.0
<b>Current Tax System</b>			
Tax revenue	32.2	100.0	9.4
Income	0.0	0.0	0.0
Personal	0.0	0.0	0.0
Corporate	0.0	0.0	0.0
Sales and gross receipts	19.4	60.4	5.7
General sales	10.9	34.0	3.2
Business and occupation	3.7	11.5	1.1
Other excise	4.8	15.0	1.4
Property taxes	9.6	29.9	2.8
Other taxes	3.1	9.7	0.9

Source: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis, and Conway.

Personal income, which is the income received by persons from all sources, is the tax base for the proposed income tax system. The major components of personal income include labor income (wages and salaries, including benefits, and proprietors' income), property income (dividend, interest, and rental payments), and government transfer payments (old-age and disability income, medical benefits, income maintenance,

and unemployment compensation). Quarterly and annual estimates of Washington personal income are reported by the U.S. Bureau of Economic Analysis.

The preferred single tax rate would be 10.5 percent of personal income. This rate would equal to the average state and local effective tax rate for all state and local governments in the United States since 1970. Of course, Washington citizens would have the option of selecting a rate different from the norm.

A personal income tax is hardly an unorthodox idea, as evident by the fact that most states utilize it. In 1932, 70 percent of Washington voters passed an initiative for a progressive income tax. In 1987, the Washington State Economic Development Board, composed of business and government leaders, recommended that the state tax base be broadened and stabilized “by reducing the sales tax rate and instituting a flat-rate personal income tax.” In 2002, the Washington State Tax Structure Study Committee recommended “a flat-rate personal income tax to reduce the state sales tax rate and eliminate the state property tax.”

In terms of fairness, adequacy, stability, transparency, and economic vitality, a single-rate personal income tax is vastly superior to Washington’s current tax system. Indeed, it would be the best state and local tax system in the nation:

**1. Fairness.** A single-rate personal income tax would be perfectly fair, as it would eliminate all regressivity in the state and local tax system. If the tax rate were 10.5 percent, every Washington household, no matter what its income, would have to

work 5.5 weeks out of the year to pay its annual state and local tax bill.

While some policymakers would prefer to have a progressive income tax, it should be noted that because all states use a mix of taxes (income, sales, property, and other excise taxes), every state and local tax system in the nation is regressive, at least to a degree, according to the Institute on

Taxation & Economic Policy. Thus, a single-rate personal income tax system would be the least regressive—or, in a sense, the most progressive—state and local tax system in the nation.

**2. Adequacy.** A 10.5 percent single-rate personal income tax would be perfectly adequate. With a 10.5 percent rate, there would be no need for a sales tax, a business and occupation tax,

a property tax, or any other tax. Being the average rate for state and local tax systems in the United States since 1970, the 10.5 percent rate would be neither too high nor too low. In the future, legislators would never have to raise tax rates or enhance the tax base in order to generate adequate revenue for the public sector.

**3. Stability.** Apart from the ups and downs in tax revenue caused by the uncontrollable fluctuations in personal income, a single-rate personal income tax system would be perfectly stable. Thus, tax revenue would be relatively easy to forecast, thereby facilitating the public planning process.

**4. Transparency.** A single-rate personal income tax system would be perfectly transparent. Every household would know

*In addition to eliminating the need for all other taxes, a 10.5 percent single-rate personal income tax would be fair, adequate, stable, and transparent and would not adversely affect economic vitality.*

exactly how much it is paying in state and local taxes. As noted, a major impediment to tax reform in Washington has been the opaqueness of the current tax system, precluding citizens from realizing how dysfunctional it is.

**5. Economic vitality.** Based on the findings of this study, one cannot argue that an income tax per se ensures economic vitality. Nor is there evidence that an income tax hinders economic growth and welfare.

On the other hand, what is increasingly

apparent in Washington is the mounting threat to the economy posed by its inadequate sales-based tax system, which has short-changed the public sector for two decades. Among other things, this has prompted the Washington State Supreme Court to order the Legislature to provide adequate funding for basic education.

Unless Washington is willing to tolerate a deteriorating public sector—education, transportation, safety—which would hardly be conducive to the long-run health of the state economy, it has two options:

#### **SIDE BENEFITS OF TAX REFORM**

Fairness, adequacy, stability, transparency, and economic vitality are the principal advantages of a single-rate personal income tax, but there are other benefits as well:

- *Simplicity.* A single-rate personal income tax is the simplest tax structure possible, making it easy to understand and comply.

- *Universality.* Everyone earning personal income, whether it is wages and salaries or transfer payments, would pay taxes. Thus, every income earner would have “skin in the game.”

- *Economic competitive advantage.* Doing away with business taxes (business and occupation, sales, and property taxes) would enhance the competitive advantage of Washington’s basic industries, such as aerospace and tourism, which are the drivers of the economy.

- *Government efficiency.* A single-rate income tax system would be inexpensive to administer. It would also simplify the budgetary process by diminishing the need to argue over taxes, since tax revenue would always be adequate.

- *Neutrality.* A flat-rate personal income tax would eliminate the non-neutralities—taxes that cause individuals and firms to alter their economic decisions—in the current tax system. One example of a non-neutrality is the pyramiding of business and occupation taxes in the chain of production, which causes the effective business and occupation tax to vary across industries. Another example is the non-

uniform taxation of consumer goods and services.

- *Tax harmony with bordering states.* Eliminating Washington’s sales tax would reduce the incentive to shop out of state.

- *Home ownership.* Eliminating the property tax and the sales tax on new construction would increase the affordability of home ownership by hundreds of dollars per month.

- *Income diversity.* Eliminating the regressivity of the current state and local tax system would reduce household income inequality. The after-tax incomes of the lowest-income households would increase about eight percent, while the after-tax incomes of the highest-income households would decline about four percent (see text).

- *Geographical income disparity.* The current tax system is also regressive with respect to counties. A flat-rate income tax would shift some of the tax burden from low-income counties to high-income counties, helping to equalize the after-tax incomes of Washington’s rural and urban regions. With less than 30 percent of the Washington population, King County would generate more than 40 percent of the total state and local tax revenue.

- *Federal income tax deduction.* Washington taxpayers would be able to take maximum advantage of the federal income tax deduction for state and local personal income taxes, significantly reducing their federal income taxes (see text).

(1) continue to increase the tax rates or broaden the tax base of the current tax system, thereby exacerbating its regressivity; or (2) adopt a 10.5 percent personal income tax, which would guarantee sufficient funding for the public sector with a fair tax system.

TABLE 16 WASHINGTON POPULATION, HOUSEHOLDS, AND PERSONAL INCOME, FY 2015

	FY 2015
Population (thous.)	7118.0
Group-quarter population (thous.)	147.5
Household population (thous.)	6970.4
Persons per household	2.58
Households (thous.)	2701.7
Personal income (bils. \$)	365.0
Per capita personal income (\$)	51272
Per household personal income (\$)	132282
Household personal income (bils. \$)	357.4

Source: U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

There would be other benefits of a single-rate personal income tax. For example, the tax system would be simple, making it easy to understand and comply. It would be universal, as everyone earning personal income would pay taxes and “have skin in the game.” It would also help reduce the income disparity among households (see “Side Benefits of Tax Reform”).

## Tax burden.

TABLE 17 WASHINGTON STATE AND LOCAL TAX BURDEN, FY 2015

	Personal Income Tax System	Current Tax System
State and local taxes (bils. \$)	38.3	34.1
Households <sup>1</sup>	38.3	26.4
Business, government, and visitors	0	7.7
State and local effective tax rate (%)	10.5	9.3
Federal deduction offset (%)	-1.5	-0.3
Net state and local tax rate (%)	9.0	9.0
State and local taxes (bils. \$)	38.3	34.1
Federal deduction offset (bils. \$)	-5.6	-1.1
Net state and local taxes (bils. \$)	32.7	33.0

<sup>1</sup>Household taxes include an estimate of Washington business taxes passed onto households in the form of higher prices.

Source: Institute on Taxation & Economic Policy, “Who Pays?,” 2015 and Conway.

A significant but underappreciated benefit of an income tax is the savings on federal income taxes due to the deductibility of state and local personal income, property, and general sales taxes. The federal deduction offset (federal offset) in effect shifts some of the tax burden borne by state and local taxpayers to the federal govern-

ment. The federal offset is commonly measured as the percentage point reduction in the state and local effective tax rate.

**1. Total state and local tax burden.** Based on reported state government tax revenue, Washington state and local taxes were estimated to be \$34.1 billion in FY 2015 (Table 17). Since personal income amounted to \$365.0 billion, the effective tax rate was 9.3 percent. In the absence of a state and

local personal income tax and with few households itemizing general sales taxes on their federal income tax forms—instead taking the standard deduction—the federal offset for Washington was only 0.3 percentage points, one-third the 0.9 percentage point average for state and local governments nationally, according to the Institute on Taxation & Economic

## NOTE ON ESTIMATING TAX BURDEN

The previous analyses of the Washington state and local tax system are straightforward and easily replicated. Estimating the Washington tax burden by household income group requires several steps (Tables 16-18):

- 1. Households and personal income.** The year of analysis is FY 2015. Based on data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, estimates are made for Washington population (7,118.0 thousand), group-quarter population (147.5 thousand), household population (6,970.4 thousand), average persons per household (2.58), households (2,701.7 thousand), personal income (\$365.0 billion), per capita personal income (\$51,272), per household personal income (\$132,282), and total household personal income (\$357.4 billion).
- 2. Household income distribution.** In the 2015 issue of “Who Pays?,” the Institute on Taxation & Economic Policy (ITEP) provides estimates of the average money income for five Washington family income groups headed by non-elderly taxpayers. The average income ranges from \$11,900 for the lowest-income families to \$235,200 for the highest-income families. But family money income of non-elderly taxpayers understates personal income. Thus, ITEP’s family money income estimates are increased proportionally to be consistent with the estimate of Washington total household personal income in FY 2015. The final average household personal income estimates range from \$19,090 to \$377,290. Taking into account inflation between 1999 and 2015, these estimates are in line with the Washington household income estimates reported in the regressivity analysis conducted by the Washington State Tax Structure Study Committee fifteen years ago (Table 4).
- 3. Total state and local taxes.** The latest Census Bureau estimate of Washington total state and local tax revenue is \$32.2 billion in FY 2014, implying a 9.4 percent effective tax rate. State and local tax revenue and state tax revenue are highly correlated. Thus, the 5.9 percent increase in state tax collections in FY 2015, as reported by the Washington Economic and Revenue Forecast Council, indicates that state and local tax revenue rose to \$34.1 billion in FY 2015, implying a 9.3 percent state and local effective tax rate.
- 4. State and local tax burden.** ITEP provides estimates of Washington household tax burdens (state and local taxes as a percent of family income) under the current tax system. They ranged from 16.8 percent for the lowest-income families to 4.8 percent for the highest-income families. ITEP’s estimates are adopted for two reasons. First, the tax burdens are remarkably similar to those estimated by the Washington State Tax Structure Study Committee. Second, the total household tax burden implied by ITEP is \$26.4 billion, roughly three-quarters of the \$34.1 billion total tax burden in FY 2015. This split compares favorably with other findings (e.g., Conway, 1990), presuming that up to 60 percent of businesses taxes can be passed on to customers (mostly consumers) in the form of higher prices.
- 5. Federal income tax deduction offset.** The federal deduction offset (federal offset) is the savings on federal income taxes due to the deductibility of state and local personal income, property, and general sales taxes. How much a household can save on federal taxes depends upon its tax bracket. As a fraction of the state and local tax bill, the offset can vary from zero for the lowest-income households to one-third for the highest-income households. In the absence of a state and local personal income tax and with few households itemizing their sales taxes—taking the standard deduction instead—Washington taxpayers benefit little from the federal offset. ITEP estimates that the federal offset under the current tax system reduces Washington’s state and local effective tax rate by 0.3 percentage points from 9.3 percent to 9.0 percent. This amounted to a \$1.1 billion savings on federal income taxes in FY 2015. Nationally, the federal offset averages 0.9 percentage points. However, if Washington adopted a flat-rate 10.5 percent personal income tax, giving taxpayers the ability to deduct all of their state and local taxes, the federal offset would increase to 1.5 percentage points. In FY 2015, that would have amounted to a \$5.6 billion dollar savings on federal income taxes. The 1.5 percentage point estimate can be derived from the tax burden calculations in Table 18.

Policy (ITEP). This in effect lowered the Washington state and local effective tax rate in FY 2015 from 9.3 percent to 9.0 percent. The savings on federal income taxes amounted to \$1.1 billion, thus effectively reducing the Washington state and local tax bill from \$34.1 billion to \$33.0 billion.

With a 10.5 percent personal income tax in FY 2015, Washington would have raised \$38.3 billion in state and local tax revenue, \$4.2 billion more than under the current tax system. Moreover, since the entire \$38.3 billion would have been deductible under federal income tax rules, the federal offset would have jumped to 1.5 percentage points, nearly twice the national average. Thus, the state and local effective tax rate, net of the federal offset, would have declined to 9.0 percent, equalling the net state and local effective tax rate under the current tax system. The 1.5 percentage point offset would have represented a \$5.6 billion savings on federal income taxes. This means that the net cost to taxpayers of raising \$38.3 billion in tax revenue would have been only \$32.7 billion with the 10.5 percent personal income tax.

Comparing the current and proposed tax systems, it is clear that with a personal income tax Washington taxpayers could achieve the goal of adequate revenue at virtually no additional cost. Because of the generosity of the federal tax system, Washington taxpayers would have saved \$0.3 (=32.7-33.0) billion in net taxes to raise an additional \$4.2 (=38.3-34.1) billion in tax

revenue. In other words, by not utilizing a 10.5 percent personal income tax, Washington is currently forfeiting more than \$4 billion per year in state and local tax revenue.

## 2. Household state and local tax burden.

How would a 10.5 percent personal income tax affect taxpayers? Following the methodology of the Institute on Taxation & Economic Policy (ITEP), we calculate tax burdens for five household income groups as well as for the one percent of households with the highest incomes in FY 2015. This permits a direct comparison of the tax burdens under the current tax system, as estimated by ITEP, with the tax burdens under the personal income tax system (Table 18).

The 10.5 percent personal income tax would increase state and local tax revenue and shift the business tax burden to households. Nevertheless, by eliminating all regressive taxes and taking maximum advantage of the federal offset, three-fifths of Washington households would experience a drop in their state and local taxes. The highest income households, on the other hand, would see a substantial increase in taxes.

Consider the “average household” in two household income groups. In each case, they are obligated to pay a 10.5 percent state and local personal income tax. The middle income household, with an estimated annual income of \$84,690, pays \$8,892 in state and local income taxes. However, since the federal marginal tax rate for this household is 6.5 percent, the offsetting sav-

*A 10.5 percent single-rate personal income tax would increase state and local tax collections by about 12 percent. But the gain would cost Washington taxpayers nothing because of the offsetting savings on federal income taxes due to the deductibility of state and local personal income taxes.*

ings on federal income taxes is \$578. Thus, net state and local taxes amount to \$8,314, implying a net state and local tax rate of 9.8 percent. Under Washington's current tax system, ITEP estimates that state and local taxes, net of the federal offset, amount to \$8,554. Thus, the personal income tax results in a modest savings of \$240 for this household.

Under the current tax system, the twenty percent of households with the highest incomes bear a relatively small tax burden. The average household, with an income of \$377,290 and a 4.8 percent net tax rate, pays only \$17,921 in state and local tax-

es. With a 10.5 percent personal income tax, state and local taxes jump to \$39,615.

While a federal marginal tax rate of 20.5 percent in effect lowers the tax bill by one-fifth to \$31,494, it still exceeds the household's current taxes by three-fourths. Despite the substantial increase in the net tax rate from 4.8 percent to 8.3 percent, it still remains the lowest tax rate among the five household income groups.

While the net state and local tax rates for high-income households would rise significantly under a personal income tax, they would not be out of line with the tax rates of other states. As noted, the net tax rate for the twenty percent of households with the highest incomes would increase to 8.3 percent. According to ITEP, the compara-

*The proposed Washington state and local income tax would increase tax revenue and shift the total tax burden to households. Nevertheless, because of the reduced regressivity of the tax system as well as the ability to take maximize advantage of the federal offset, the state and local tax bill for three-fifths of Washington households would be less than under the current tax system.*

**TABLE 18 WASHINGTON STATE AND LOCAL TAX BURDEN ON HOUSEHOLDS WITH PERSONAL INCOME TAX SYSTEM, FY 2015<sup>1</sup>**

Household Income Group	Lowest 20 Percent	Second 20 Percent	Middle 20 Percent	Fourth 20 Percent	Fifth 20 Percent	Top One Percent
Average personal income (\$)	19090	48600	84690	131840	377290	2434860
State and local effective tax rate (%)	10.5	10.5	10.5	10.5	10.5	10.5
State and local taxes (\$)	2004	5103	8892	13843	39615	255660
Personal income taxes (\$)	2004	5103	8892	13843	39615	255660
Federal deduction offset (% of income taxes)	0.0	2.5	6.5	11.0	20.5	32.0
Federal deduction offset (\$)	0	128	578	1523	8121	81811
Net state and local taxes (\$)	2004	4975	8314	12320	31494	173849
Net state and local tax rate (%)	10.5	10.2	9.8	9.3	8.3	7.1
ITEP net state and local taxes (\$)	3207	5686	8554	11206	17921	58437
ITEP net state and local tax rate (%)	16.8	11.7	10.1	8.5	4.8	2.4

<sup>1</sup>The above calculations are based on the personal income of all households. The Institute on Taxation & Economic Policy limits its analysis to family money income of non-elderly taxpayers.

Source: Institute on Taxation & Economic Policy, "Who Pays?," 2015 and Conway.

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ble tax rate is 7.1 percent in Oregon and 8.2 percent in California.

For the one percent of Washington households with the highest incomes, the net tax rate would be 7.1 percent. This compares to 6.5 percent in Oregon and 8.7 percent in California.

The shift in the state and local tax burden among households from a 10.5 percent personal income tax would result in a modest reduction in income disparity. The average after-tax income of the lowest-income households would rise from \$15,883 to \$17,086, a 7.6 percent gain. On the other hand, the one-fifth of households with the highest incomes would experience a 3.8 percent drop from \$359,369 to \$345,796.

The last observation with regard to the flat-rate income tax is that the federal offset ultimately makes the state and local tax system regressive. The federal offset for the highest-income households amounts to one-third of the state and local personal income taxes paid. In contrast, the lowest income-households do not benefit from the offset, since they pay no federal income tax. Thus, the net state and local tax rate for the one percent of households with the highest incomes is 7.1 percent, while it is 10.5 percent for the lowest-income households.

Nevertheless, the personal income tax system is much fairer than the current tax system. As one measure of regressivity, ITEP calculates the ratio of the tax burden of the lowest-income families to the tax burden of the one percent of families with the highest incomes. Under the current tax system with the federal offset, the ratio for Washington is 7.0 ( $=16.8/2.4$ ), the highest among the fifty states, again reflecting the fact that Washington has the most regressive tax system in the nation. With the proposed flat-rate income tax, the ratio would be 1.5 ( $=10.5/7.1$ ), down among the

states with the fairest tax systems, such as Oregon (1.3) and California (1.2).

### **Final word.**

Since 1932 when the business community objected to a voter-approved initiative to institute an income tax, tax reform has been a highly contentious issue. Even today the resistance to an income tax is great. Many Washington lawmakers believe that an income tax is the “third rail” of politics. Some taxpayers object to an income tax because it would cause them to pay higher taxes. Others fear that tax reform is just another way for government to get into their wallets. But the overriding fact of the matter is that the Washington state and local tax system has become—and will continue to become—increasingly dysfunctional over time, especially with regard to fairness and adequacy. In light of this, tax reform, including instituting an income tax, is inevitable.

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