Washington State Tax Study Update

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WASHINGTON STATE TAX STUDY UPDATE

This committee was charged by the 2003 Convention of the League of Women Voters of Washington to conduct a two-year project to update the League's previous studies regarding the state tax structure and to develop an educational campaign. This report is the update of the studies. The second year of the project will be devoted to developing the educational campaign. Prior studies and current positions are included in the Appendix.

History of Washington Taxes

The Pioneer Years

When Washington State was founded almost everyone owned or worked on the land. In an agricultural economy, land was the principal asset. Taxes were based on how much land a person owned. The revenue generated went to pay for the services needed by that society: protection of property rights (land record offices, sheriffs, courts, schools, roads). Also, there was a transactional tax: a poll tax on all white males. Other early taxes were directed at people with the presumed ability to pay, and included a tax on insurance premiums (1891) and an estate tax (1901).

The 20th Century

As more people moved to cities and towns, more government services were required. A one-cent motor fuel tax was enacted in 1921, doubled in 1929, and doubled again in 1931. The tax on real property doubled every 10 years or so, with the result that many property owners could not pay their taxes during the depression years. By the early '30's, the farm population, then about 40% of the total, was paying nearly 100% of the state and local taxes through the property tax. This led to a populist movement to limit the property tax and impose a graduated income tax, which was passed by about 70%. The income tax was challenged by the business community leading to a holding by the State Supreme Court that income was property and therefore a graduated tax was a violation of the state constitution requiring all like property to be taxed at a like rate. To meet the resulting gap in tax receipts, the Business & Occupations ("B&O") tax was passed on the gross receipts of businesses. The B&O Tax is an invention unique to the State of Washington.

By the early 30's, the farm population, then about 40% of the total, was paying nearly 100% of the state and local taxes through the property tax.

In an effort to broaden the tax base, other taxes were introduced to the system during the 1930's: Retail sales and use tax, beer and wine excise tax, liquor sales tax, cigarette tax, public utility tax, pari-mutuel tax, boxing and wrestling tax, fuel oil tax, conveyance tax, admissions tax. As will be seen from the list of kinds of taxes in the Appendix, Washington has been prolific in identifying a number of different tax bases.

More variations in the tax bases reduced the volatility of collections, and made the tax system more equitable in the sense that it was distributed more evenly between landowners and businesses, particularly manufacturing businesses.

... tax advisory bodies tended to prefer increases in rates rather than new kinds of taxes on income or services, setting the stage for the property tax concerns of the mid '60s.

As a result of the New Deal and the World War II economic activity, the state showed tax surpluses. They were short lived. Shortfalls were anticipated and tax advisory bodies were convened that tended to prefer increases in rates rather than new kinds of taxes on incomes or services, setting the stage for the property tax concerns of the mid ‘60’s. Schools were relying more and more on special levies (many failing), and the state eventually partially exempted seniors and the disabled from property taxes (1966). Governor Daniel Evans convened a tax advisory council that proposed a reduction of property taxes, sales taxes and the B&O tax in favor of an income tax at a single rate. Despite the governor’s support, the measures were defeated in 1969.

In the early 1970’s, cities and counties were allowed to impose sales taxes for local purposes and an amendment to the state constitution placed a limit on the aggregate of all tax levies on real and personal property of 1% of the fair market value of the property.. This was an amendment to the state constitution that limited the aggregate of all regular tax levies on real and personal property to 1% of the fair market value of the property. The economic cycle swung positive and so did tax receipts. The Legislature was satisfied to eliminate the sales tax on food for off-site consumption, drop surtaxes on retail sales and B&O taxes, and repeal the estate taxes except for picking up the state’s credit against the federal estate tax.

Economic reversal hit again in 1981, with tax revenues falling accordingly. A tax advisory committee was again established that proposed an income tax. Governor John Spellman rejected the idea. Consequently, there were large budget cuts, return of the sales tax on food, increases in the retail sales tax and the B&O tax, and the addition of surtaxes. (Food was again exempted from the sales tax in 1983 and remains so today.)

Upon the return of prosperity in the late1980s revenue collections increased and deficits ceased. The Legislature funded a program to forecast the state’s needs and Governor Booth Gardner’s Committee on Washington’s Financial Future recommended an income tax, albeit with limitations, which the Legislature promptly rejected. Need for a rainy day fund was discussed, but the Legislature also did not act in that regard.

The Current Situation

By the end of the 20th century, there were even fewer people working the land (about 4%), and the manufacturing sector had shrunk while the service sector (which was primarily not taxed) grew. This shift meant that the real property sector and the business and occupations sector of the economy began to show a dissymmetry similar to the shift of the ‘30’s, which has resulted in a similar public outcry.

The 2001 Legislature created and funded the Washington State Tax Structure Committee, which has become commonly referred to as "the Gates Committee," named for its chairman, William Gates, Sr. Although there have been assorted bills filed following receipt of its report in November of 2002, there has, as yet at least, been no further legislative action.

History of League Involvement

Records of the League of Women Voters of Washington show that state taxes have been on the agenda more or less continuously since 1953. The League has continually worked for the goal of a balanced, adequate, fair, flexible, and economically sound tax system by self-education and by participation in appropriate coalitions.

A study based on the League's publication "The Tax Primer" (1957) produced a position favoring an income tax on individuals and businesses and repeal of the sales tax on food (1959). The League has continued to update and expand our positions with studies of property taxes, assessments, state expenditures, state and local fiscal relations, exemptions, and (1980-81) a review of state tax policies.

The League has joined with other groups in emphasizing the flaws in Washington's tax system and has, over the years, lent support to various proposals based on the ability to pay. We worked for reform in accordance with the task force resulting from the report of Governor Gardner's committee, but the effort never got past the Senate.

The League has joined with other groups in emphasizing the flaws in Washington's tax system and has, over the years, lent support to various proposals based on the ability to pay.

The 1991 League convention called for a tax update. In 1992, "The Basic Tax System in Washington" was published in the Spring VOTER, of which a copy is included in the Appendix, and in 1993, the convention resolved to oppose Initiatives 601 and 602, which limited the legislature's ability to impose taxes to support programs. The 1999 convention authorized a one-year study on, "A Comparison and Contrast of Tax and Revenue Systems in Washington Counties," which was published in partnership with the *Institute for Washington's Future,* a copy of which is also included in our Appendix*.* The 2001 convention passed a resolution essentially authorizing this current study, but the matter was postponed because of the work then undertaken by the Gates Committee.

It is the purpose of this report from the present committee to bring the League membership up to date, and to solicit suggestions as to fulfilling the second part of our charge -- how best to educate not only the League, but the general public as well.

<u>Tax Criteria</u>

There are a number of generally accepted criteria for evaluating a tax system, many of which go back hundreds of years. The Study Committee considered seven. Six were well articulated by the 2002 *Washington State Tax Structure Study Committee Report* (the Gates Study) and the seventh relates to effective citizen oversight of the raising and distribution of tax revenues. It is important to keep these criteria in mind as we describe the state's tax system:

Adequacy -- The ability of the tax system to provide for growth in revenue adequate to fund normal growth in public services as the state's population and economy expand.

Stability -- The ability of the tax system to provide the revenue necessary to maintain public services, notwithstanding fluctuations in economic activity over the business cycle.

Equity and Fairness -- are typically defined according to the relationship between the amount of taxes paid by taxpayers and their relative ability to pay, or to the benefits received by them from government programs.

<u>Vertical equity</u> -- requires that taxpayers with different income levels pay taxes according to the different abilities to pay. Some say this principle is satisfied when taxes paid are the same percentage of income for taxpayers at all income levels (proportional tax burden). Others argue that the principle is only met when taxpayers with a higher income level pay tax at a higher percentage rate (progressive tax burden).

<u>Horizontal Equity</u> -- requires that taxpayers with similar abilities to pay do pay a comparable amount of tax. In general this means that a tax should not arbitrarily distinguish among taxpayers in similar circumstances.

<u>Benefits Received</u> -- For certain taxes that are levied to provide a particular government service to a specific group of taxpayers (e.g., the motor vehicle fuel tax), the tax is considered fair if the taxes paid are matched by the benefits received.

Economic Vitality and Harmony with Other States -- requires that the state tax system as a whole not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises in other states. It should support a stable economic infrastructure conducive to a vital and growing economy.

Economic Neutrality and Efficiency -- requires that different production and consumption activities will be subject to the same effective rate of tax. Such a neutral tax system is efficient when taxpayers make decisions based on economic advantages rather than tax advantages.

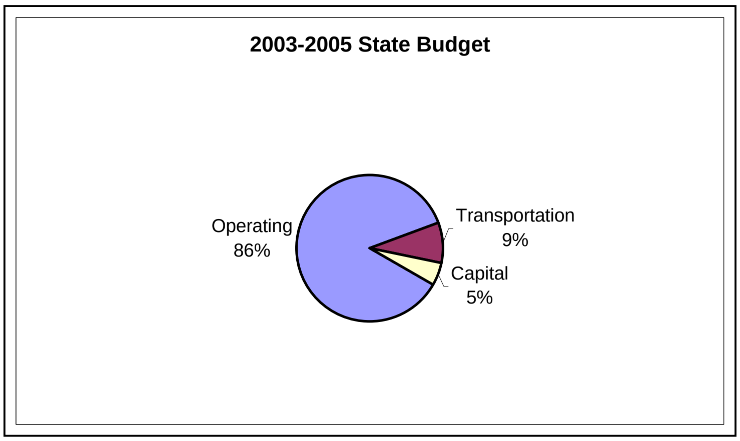
Transparency and Administrative Simplicity -- A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

In addition to the above, one criterion from the LWVWA 1992 Study is:

Safeguarded -- The system should contain proper safeguards and limits to raising money without the taxpayers' approval, and protect against uncontrolled spending. Our Initiative and Referendum process may have been the intended safeguard, but if so, over use may lead to imbalanced results.

State Budget Basics

In the 2003-05 biennium, the State of Washington will spend a total of $52.2 billion. There are three different budgets in that total: A Transportation Budget of $4.8 billion, a Capital Budget of $2.6 billion and an Operating Budget of $44.8 billion.



2003-05 State Budget
(Dollars in Billions)

Operating	$44.8
Transportation	4.8
Capital	2.6
Total	$52.2

Source: *2004 Citizen's Guide to the Washington State Budget, State of Washington Senate Ways and Means Committee.*

The Transportation Budget pays for transportation activities such as designing and maintaining roads and mass transit. It includes funds for both operating and capital, some of which is raised through taxes and fees and some by borrowing.

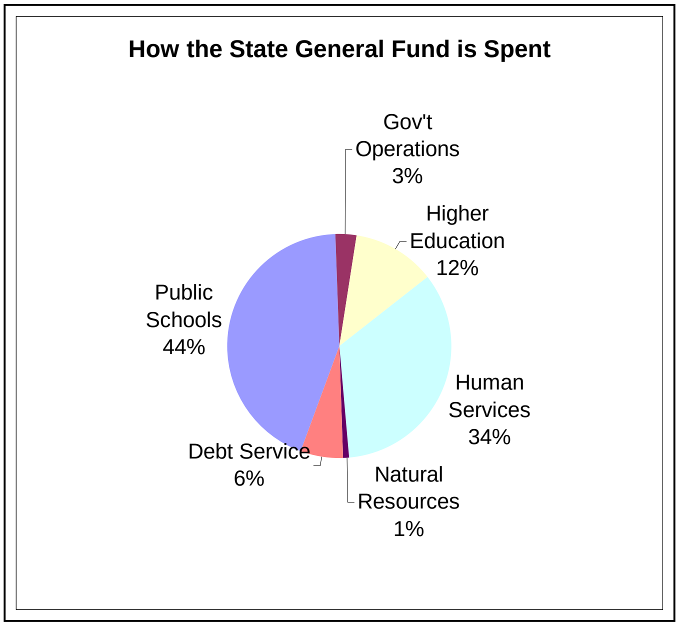
The Capital Budget is used to acquire and maintain state buildings, public schools, higher education facilities, public lands, and other assets.

The Operating Budget pays for the day-to-day operation of state government and includes federal funds and dedicated funds as well as state taxes. The largest portion of the Operating Budget is called the State General Fund (GF-S). It is the principal fund supporting the operation of state government. For the 2003-05 biennium, the GF-S will receive and spend about $22.8 billion.

The difference between the total budget of $52.2 billion and the GF-S of $22.8 billion is made up mostly of revenues dedicated to specific uses. The largest funds dedicated for specific uses are:

Federal funds for specific federal programs ($12.2 billion)
Higher Education specific funds, such as the Tuition and Fees Account, the University of Washington Hospital Account and others ($4.9 billion)
Bonds for Capital Purposes ($2.6 billion)
Gas taxes for transportation purposes ($1.8 billion)

How the State General Fund is Spent



2003-05 General Fund-State Expenditures
(Dollars in Billions)

Public Schools	$10.1
Human Services	7.9
Higher Education	2.7
Government Operations	0.6
Natural Resources	0.3
Debt Service/Other	1.5
Total	$23.1

Source: *2004 Citizen's Guide to the Washington State Budget, State of Washington Senate Ways and Means Committee.*

K-12 Education. The largest single state general fund program is public schools, which includes state support for K-12 education. More than one million children are now enrolled in Washington's public schools.

Higher Education spending includes funding for six public universities, 34 community colleges and technical schools, and financial aid to about 294,000 students.

Natural Resources includes:

The Department of Natural Resources, which oversees management of forest, land, and aquatic resources. It manages three million acres of land held in trust for common schools, universities, county governments, and other trusts established at the time of statehood or by subsequent legislation.
The Department of Ecology, which was established by the Legislature in 1970 to protect the state's air, land and water resources.
Department of Agriculture, of Fish and Wildlife, and other offices having to do with environmental, conservation, energy, and parks and recreation serving the citizens of the state.

Human Services. Spending in the state general fund includes the Department of Social and Health Services, the Department of Corrections, and the Department of Health.

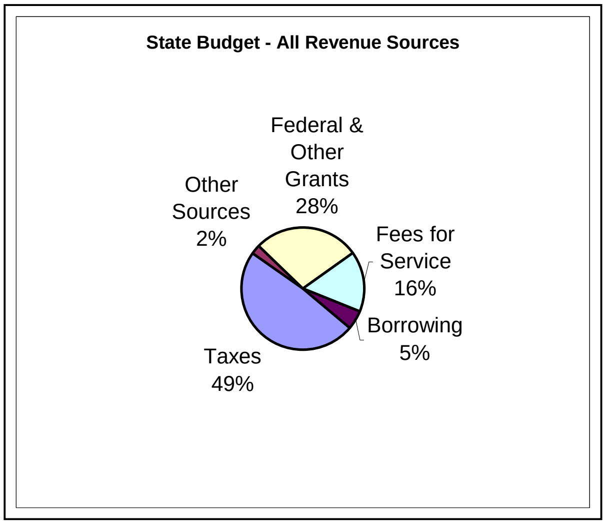
The Department of Social and Health Services (DSHS) is the state's welfare system, with over 64 Community Service offices in all of the state's 39 counties. Services to children are provided in two major categories: for those who remain in their own homes and those who are placed in residential settings. DSHS programs include:

Temporary Assistance to Needy Families. Assistance is provided to families in which children are deprived of support by the death, incapacity or continued absence of a parent.
Aging and Adult Services Administration regulates nursing home care. They license and inspect adult family homes and boarding homes, provide chore service, health service, group day care, legal service, older worker employment and adult protection service.
Low Income Home Energy Assistance Program provides once yearly payments for home heating.
Food Stamp Program, which is federally funded. The state receives matching funds for administering the program.
Disability Insurance benefits, available under two programs -- Social Security Disability and Supplemental Security Income. These benefits are federally funded.
The Medical Assistance Division of DSHS administers many programs including Medicaid, prenatal care and care for children up to age six, adult dental care, and care for medically indigent.
A number of other programs include: Division of Alcohol and Substance Abuse, Refugee Assistance, Developmentally Disabled Services, Vocational Rehabilitation, Child Support, which aids in collection of support payments, Juvenile Rehabilitation, and Mental Health.

The Department of Corrections protects the public through confinement, supervision and rehabilitation of adult felons. There are 17 correctional facilities in the state and 16 work release facilities. The Department of Juvenile Rehabilitation (DJR) operates three medium-to-maximum security institutions, two medium-security forestry camps, and five minimum-security group homes providing custody and treatment for committed offenders.
The Department of Health is responsible for preserving public health, monitoring health care costs, maintaining minimal standards for quality health care delivery and planning activities related to the health of the citizens of Washington. Programs include environmental health, prevention and treatment of infectious diseases including AIDS, health promotion, chronic disease prevention, rural health improvement, and licensing of health professionals and services.

The Washington State Revenue System

Taxes are one means of government revenue generation. Others include borrowing (issuing bonds), charges for services (e.g., college tuition, public hospital charges), grants from the federal government, selling assets (e.g., timber from state lands, surplus equipment and materials, leasing rights), licenses and permits, interest earnings, and intergovernmental transfers. The following chart shows the sources of the $52.2 billion total state revenues for the 2003-05 biennium:

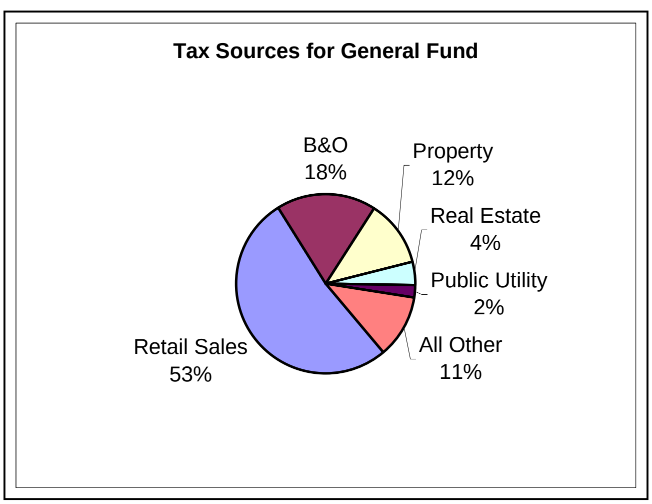


2003-05 Sources of Revenue
(Dollars in Billions)

Taxes	$25.8
Federal & Other Grants	14.7
Licenses, Permits & Charges for Services	8.2
Borrowing	2.6
Other Sources (including Transfers)	1.2
Total	$52.5

Source: *2004 Citizen's Guide to the Washington State Budget, State of Washington Senate Ways and Means Committee.*

There are at least 50 different taxes authorized in Washington State law for the state and/or local governments to raise money. All major state tax revenues are deposited in the General Fund. As seen by the chart below, the three major tax sources are the retail sales tax, the business & occupations (B&O) tax, and the property tax. These three taxes together account for more than 80% of all state General Fund revenues. Additional taxes include real estate excise, public utility, insurance premium, and a number of other excise taxes, including the so-called "sin taxes" on cigarettes and alcohol.



2003-05 Sources of State General Fund Revenue
(Dollars in Billions)

Retail Sales	$11.9
Business & Occupations (B&O)	4.1
Property	2.7
Real Estate	1.0
Public Utility	0.5
All Other	2.6
Total	$22.8

Source: *2004 Citizen's Guide to the Washington State Budget, State of Washington Senate Ways and Means Committee*

Retail Sales Tax

Retail sales taxes are added to the selling price of most personal property and certain services purchased by consumers. The sales tax applies to goods, construction, repairs, lodging for less than 30 days, telephone service, and participatory recreational activities.

The tax rate levied by the state is 6.5%. It has been at that rate for almost 20 years. Local jurisdictions are authorized to add local sales taxes, so that the total has increased and presently ranges between 7% and 8.9%. The maximum allowable combined rate under state law is 9.6% since there is a limit of 3.1% on the total of local levies. There are various reasons for the local components. It is estimated that a combined sales tax rate of 8.5% or more applies to 60% of the taxable sales in the state.

Local sales taxes are collected for a variety of purposes including those by cities and counties, for transit purposes, for funding high capacity transportation, for criminal justice, for correctional facilities, for public facilities, for libraries and zoos.

Between 1935 and 1997 the tax rate increased from 2% with no part for local jurisdictions to the current average of 8.5%. (See the Appendix for a brief history of the changes in the sales tax.)

Features: People see only small amounts going out at a time, and therefore the sales tax is less noticed than other taxes. It is a large and efficient revenue producer. It assures that all persons contribute to the cost of government. It is one of the few ways to obtain tax money from non-residents who are in the state temporarily.

Sales taxes are regressive in nature. Rich and poor pay the same rate and amount for each purchase, and poor people must spend much of their income for everyday needs instead of saving or investing. As a result, a much higher proportion of their income is taxed through consumption. Despite the exemption of food and prescription drugs, the tax remains regressive. Collections fluctuate, as people spend in good times and cut spending in bad times, dropping collections when money is most needed to supply certain services; they are very volatile and thus do not provide long-term adequacy. High rates prompt people to evade sales taxes by making their purchases in other states with lower or no sales tax, producing a negative impact on retail businesses and local governments in border areas. While use tax is supposed to be paid by residents on items bought out of state, few people pay it, and the state has not found a cost effective way to collect it. Local jurisdictions that do not contain a retail center cannot raise adequate revenue with a retail sales tax, as the tax stays where the money is spent rather than where the consumer lives. Businesses do not like to bear the costs of collection.

Comparison with Other States: Washington state's rate is 6.5%. Mississippi and Rhode Island are higher, at 7%, but they do not add local sales taxes. Washington's highest combined rate is 8.9%, and combined rates are higher in some parts of Louisiana, Oklahoma and Alabama. Washington's per capita average sales tax collection, at $1513 per year, is the highest in the nation (Hawaii is second at $1268). Alaska, New Hampshire, Montana, Delaware and Oregon do not have a retail sales tax. Washington has the highest reliance on the retail sales tax in the nation. (Figures are for the year 2000.)

Trends: The shift to a service-based economy tends to reduce the amount collected by a retail sales tax. Addition of taxes on service has been partially undertaken, fostering some resentment. Remote sales, through catalog and Internet selling, which continue to grow, are not taxed by the consumer's state.

Business and Occupations Tax

The Business and Occupations tax ("B&O tax") is a peculiar devise of Washington's, unknown as a state tax elsewhere. It is a tax on the gross receipts of a business, unrelated to any profit. It is levied for the privilege of doing business in the State of Washington on all business conducted within the state except utility activities, agricultural production, rental of real estate, and investment income earned by businesses other than financial institutions. It is measured by gross sales, gross income, or the value of products made within the state. Unlike a corporate or individual income tax, there are no deductions for any of the costs of doing business.

Although the rates are low, with such a large base the tax raises considerable amounts of revenue. In the 2002 fiscal year, it generated nearly $2 billion, covering about 17% of state tax revenues. It is estimated that it will raise approximately $4.1 billion in the 2003-2005 biennium, for about 18% of revenues for the general fund into which all of it flows, making it the largest source after the retail sales tax.

Rates as of December 1, 2003:

Retailing	0.471%
Services	1.500%
Manufacturing, Wholesaling & Extraction	0.484%
Processing Some Ag. Products	0.138%
Travel Agents and a few others	0.275%

There is some relief for small businesses: Non-retailing businesses with gross incomes under $12,000 per year do not need to register or file a return. Non-retailing businesses up to $28,000 per year must register, but do not need to file returns. There is also a small business tax credit, with nothing due if the tax would otherwise be $420 or less and a $840 credit less the amount of tax due if more than $420. Other credits against the B&O tax are for creation of certain jobs or jobs in certain locations, job training, research and development, and for machinery, equipment and structures for the reduction of agricultural burning.

In addition to the State B&O tax, some cities also assess a B&O tax, at a lower rate. Counties do not do so, and there is no administrative connection between state and city B&O taxes.

Features: The tax assures that all firms, even unprofitable ones, pay something for the government services they use. It treats both corporate and non-corporate businesses alike.

The B&O tax is afflicted with more exemptions than any other area of taxation...

It does, however, impose a heavy burden on new firms that have not yet reached maximum operating efficiency. In many instances, the tax favors established, profitable business activity at the expense of start-up firms and those with low profit margins. The tax burden varies widely, not only among different types of businesses, but also among firms within the same business sectors. The B&O tax is afflicted with more exemptions than any other area of taxation (112 in the 1999-2000 biennium). Strategies to minimize the tax add to the complexity and the level of effort to review and fairly enforce the tax. Finally, the tax pyramids. Because it is paid on the total value of the goods and services at each of the multiple times those goods move through the production chain, the same item may be taxed more than once as it passes through to the consumer. (See chart p.17 for an explanation of how the tax works)

Comparison with Other States: No other state imposes such a tax. Cities in some states impose a B&O tax just as do some cities in Washington, albeit at a low rate. Forty-five states impose a traditional corporate net income tax, similar to the federal tax. Michigan levies a form of value added tax. Nevada relies on taxes on the gaming and entertainment industry. South Dakota utilizes special taxes on contractors and banks, and Wyoming receives major revenues from severance taxes (on oil and minerals). The tax burden of Washington's B&O tax is greater than most of these others. State taxes on business income in those 45 states produce an average of about 4.2% of the respective state's general funds, whereas Washington derives about 18% of its general fund revenues from the B&O tax.

Other Excise Taxes

Both political parties recognize that taxes are needed to fund state expenditures and find that these taxes are easy to enact compared to fears of an income tax.

In addition to the two major excise taxes--sales and B&O--there are many minor ones. The so-called "sin taxes" on tobacco products and alcoholic beverages, gasoline tax, utility taxes, real estate transfer taxes and others are levied by various state agencies under different schemes. Both political parties recognize that taxes are needed to fund state expenditures and find that these taxes are easier to enact than a state income tax. As a result, Washington's cigarette, liquor and gasoline taxes are among the highest in the country. (See the Appendix for a chart showing excise taxes by state.)

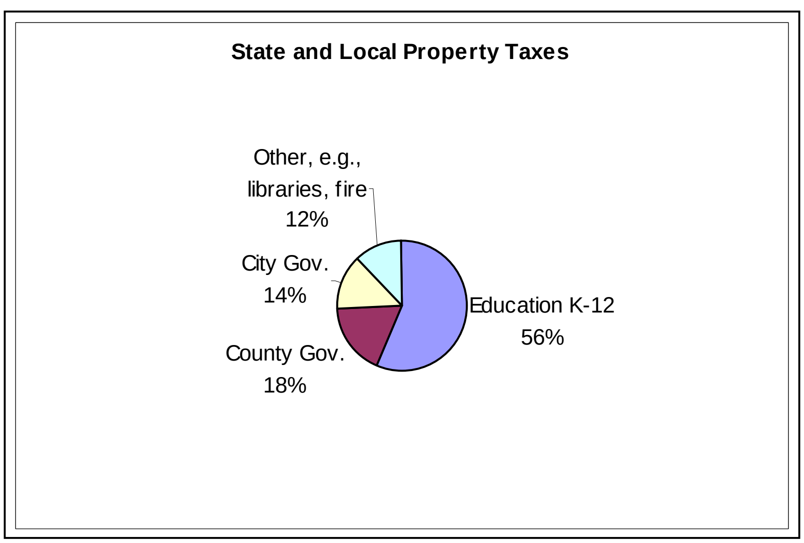
Features: Some people argue for various of these taxes as helping to achieve social goals, such as reducing consumption. Consumers have some discretion over their tax liability by avoiding purchases of some of the items taxed. Taxes are paid by non-residents as well as by residents. Revenues from specific taxes are easily designated to pay for particular programs.

These taxes tend to be regressive since they are based largely on consumption. Some are levied on necessities, such as utilities and gasoline. As a result they can impose hardships on low-income families and elderly persons living on fixed incomes. Those that are allocated for specific purposes cannot be diverted to alternative funding needs, reducing flexibility.

Property Tax

Property taxes are levied by the state, counties, cities and many local jurisdictions like ports and schools. The tax is on the value of real property (land and buildings) and personal property owned by businesses and individuals – mainly business equipment. Property taxes collected by all taxing jurisdictions totaled $5.412 billion in 2000. It is the third largest revenue source for the state and provides for 12% of the state's general fund. For state and local governments combined, property taxes are second only to retail sales taxes as a source of revenues. Of the total taxes collected by all taxing jurisdictions in Washington ($14.886 billion FY 2000) property taxes contributed 30% of all state and local government tax revenue in FY 2000 and retail sales tax contributed 50%.

The statewide average assessment was $13.53 per $1000 of assessed value. In FY 2000, commercial property contributed 42% of the total and household residences paid 58%. In 1991, commercial property contributed 48% and households paid 52%. This shift could be explained by both the escalation in prices of residential property and property tax exemptions for businesses.



How the money is spent: The majority of the money goes to the general funds of the state, cities and counties. Public education (K-12) receives 56% of the total money collected from property taxes. Of the remaining 44%, county governments receive 18%, cities 14%, and other entities e.g., libraries, fire and other districts get 12%. The State constitution mandates that all the property taxes collected by the state be returned to local jurisdictions for K-12 education.

Local levies are also placed on property to help pay for things like schools, fire districts, libraries, ports, parks, emergency medical services including 911 and hospital emergency rooms, hospitals, utilities, and county roads. Local schools receive approximately 30% of the monies raised by local levies on property.

Description of the tax base: Everything that can be owned is property. Property taxes are applied annually to the value of real and personal property. Real property includes land and structures attached to it, while personal property is composed of that which is moveable, like business machinery and equipment, as well as personal boats and RV's. Household goods, business inventories and intangibles, such as stocks, bonds and savings accounts, are exempt. Personal property comprises about 8% of the tax base, with 92% being real property.

Assessment and Distribution: County treasurers collect the tax based on the assessed value of the property. The value of the property is determined by the county tax assessor's assessment based on the true market value. Your tax bill is determined by taking the assessed valuations of the property multiplied by the tax rates that are fixed by the various taxing jurisdictions. This also applies to the valuations of personal property, which includes machinery, equipment, boats and recreational vehicles.

Over time, reliance on the property tax has decreased dramatically. Before the depression of the '30's, property taxes were about 90% of the state funds. Now, they are about 17%.

Regular and Excess Levies: The regular taxes levied against property are now limited in how much they can increase each year. In 1972, voters amended the state constitution to establish a 1% limit on regular property tax levies. The provision requires that the aggregate of all regular tax levies (those required by law without a vote of the electorate) upon real and personal property shall not exceed one percent of the fair market value of that property annually. A 1% levy equals $10.00 per $1,000 of valuation. Of that $10, $3.60 goes to the state, $0.50 is available for open space preservation, emergency medical services and affordable housing, and the remaining $5.90 is available for local districts, of which there are some 1700: counties, cities, 911, hospitals, fire departments, libraries, ports. Levies beyond the 1%, which require 60% voter approval, are called excess or special levies. Parks and schools are examples of special levies. Regular levies represent approximately 66% of property tax collected and special levies 34%.

There are now two limits on regular property tax levies. In addition to the constitutional provision (described above) that limits regular levies to1% of property value, an initiative adopted in 2001 limits the annual increase in regular levy revenues for all taxing districts to 1%.

Features: Everyone pays the same rate. People with higher value property and more property pay more taxes. Property taxes are more transparent and real property is geographically bound and therefore easier to identify than profits or sales. In times of depression, falling prices cause decreases in assessed values, and therefore in the tax base. This can result in plummeting revenue as valuations are assessed every year or two.

Comparison to Other States: Washington's property taxes are significantly below the national average. Washington ranks 26th when measuring property taxes as a share of state and local taxes and fees.

Exemptions and Deductions

Washington's tax laws are replete with provisions granting tax relief to select groups of taxpayers.

Washington's tax laws are replete with provisions granting tax relief to select groups of taxpayers. Most of the relief is in the form of exemptions and deductions from the tax, but some is in the form of reduced rates or deferrals. The effect of such tax relief in the 2003-2005 biennium is an estimated $64.7 billion.

With the adoption of Initiative 601 limiting state expenditures, the Legislature has more incentive to return excess revenues that cannot be spent to taxpayers in the form of new exemptions, deductions and credits. Thus, in 1997 more new exemption statutes were adopted than in any other year since 1935. Between the 1998 and 2000 Department Of Revenue Tax Emption Studies, 31 new exemption statutes were adopted, plus broadening of others. In 2002-04, 55 tax exemptions, most in the form of business incentives, were added or extended.

It should be noted that the savings to taxpayers if exemptions were eliminated would not necessarily equate with potential government revenue. In fact, the Department of Revenue estimates that only about $13.6 billion could be collected if all of the tax exemptions were repealed. This is because of certain constraints in law. There are constitutional prohibitions against taxing certain activities, and there is the limit in the State constitution against taxing property in excess of 1% of its value. Also, changes in taxpayer behavior may limit the actual amount of revenue realized. Elimination of an exemption may lower the tax burden for other taxpayers.

In addition to such constraints, exemptions, deductions and deferrals may be for a policy objective that the Legislature deems important. Once tax exemptions are enacted into law, they tend to be permanent, even if the policy reason disappears. There are currently no general sunset or review provisions in the laws. A number of specific exceptions have expiration dates and/or include disclosure of information by firms using the exemption. This is the case with most recent economic development tax incentives.

Relationship With Local Jurisdictions

Cities and counties, and special purpose districts are creatures of the state. They derive their power from the state to act and to raise the revenue needed to carry out their functions. Consequently, changes in the state tax structure will have effects on the local jurisdictions. Small cities can be particularly impacted. Anti-tax initiatives have already severely impacted local governments.

While taxes are not the only source of revenue for local jurisdictions, in Washington 61.5% of local revenue comes from the property tax and 19.1% from the locally imposed retail sales taxes. Cities have more latitude than counties to impose their own taxes; 37 of them impose their own B&O taxes. Most special districts have more limitations, sharing primarily in the property tax, but the Public Transportation Benefit Area derives 84% of its revenue from sales tax. The state receives a portion of property tax and redistributes it to school districts, which have taxing power only through special levies on property by 60% affirmative vote. See Appendix for city and county average shares of different forms of revenue.

For examples to compare, here are the rounded percentages of a property tax bill from a parcel in the City of Richland, Benton County, and a parcel in unincorporated Thurston County:

Distribution of Property Tax Bill

	Benton Co.	**Thurston Co.**
School District	33%	38%
City	27%	--
Fire District	--	10%
County Road District	--	13%
Medic One	--	3%
State	23%	20%
County	12%	11%
Port	4%	2%
Mosquito District, Weed District, and Horticulture District	1%	--
Library	--	3%

Other jurisdictions would have other examples of special districts. Utility taxes can be found on utility bills.

As to the sources of revenue for the entities in Benton County (rounded):

Sources of Revenue			
County of Benton		**City of Richland**	
Property Tax	39.8%	Property Tax	23.48%
Sales/Use Tax	18.76%	Business & Utility Tax	23.00%
Intergovernmental Transfers	14.13%	Sales/Use Tax	20.00%
Fines & Forfeitures	9.78%	Debt Proceeds	14.80%
Charges & Fees	8.44%	Licenses & Permits	6.82%
Interest & Investment Income	7.16%	Intergovernmental Rev.	4.05%
Rents, Contributions & Misc.	.91%	Charges & Fees	3.40%
Other Local Taxes	.92%	Fines & Forfeitures	1.08%
Licenses & Permits	.098%	Other Local Taxes	.01%
		Interest Income	.01%
		Rents, Contribs. & Misc.	.01%
Benton-Franklin Transit		**Richland School District**	
Passenger Fares	13.34%	State	73.00%
Aux. & non-transit revenues	4.49%	Property Tax	16.00%
Taxes directly levied	83.00%	Federal Grants	11.00%
State Grants	.08%		

Tax Alternatives

This committee will comment briefly on the Value Added Tax, which has not been considered in prior League studies, and comment on the comparison between a flat income tax and a graduated one. For further discussion of alternatives, see the Washington State Tax Structure Study (Gates) Committee report of November 2002, which has examined tax alternatives in detail using a revenue neutral analysis that would not change the total collected.

Experts say there are only five tax bases of sufficient size to support a modern state government: Retail sales, gross receipts, value added, net income, and property. None of them alone can do the job fairly, equitably and reliably.

Value Added Tax

The Value Added Tax, while commonly used in Europe, seems to have been more frequently talked about than seriously considered in the United States. The VAT is so named because only the increase in the value of a product contributed by each commercial enterprise is taxed as it passes through the economy to the consumer. This is accomplished by allowing a credit at each stage for the VAT paid by the previous enterprises in the chain. This mechanism avoids the pyramiding that occurs under the B&O tax when different enterprises are involved in the chain of production. That pyramiding effect produces an inequitable result when a competing product passes through several hands versus a vertically integrated business making the entire product to marketable completion. One analysis shows an average pyramiding effect of the B&O tax being imposed on successive enterprises in Washington is 2.5 times.

The chart below demonstrates the difference in the effect of a B&O tax, a Value Added Tax, and a Retail sales tax. For all three taxes, at each stage the seller remits the tax to the government. Note that with identical rates on a product with identical initial cost and markups the VAT and the Retail Sales Tax both collect the same amount of tax while the B&O Tax collects substantially more.

Manufacturer → **Wholesaler →** **Retailer**

10% B&O Tax

Widget	$5.00	Widget Cost	$5.50	Widget Cost	$11.00
Tax	.50	Markup	4.50	Markup	1.00
Sale	5.50		10.00		12.00
		Tax	1.00	Tax	1.20
		Sale	11.00	Sale	13.20

10% Retail Tax

Widget	$5.00	Widget Cost	$5.00	Widget Cost	$9.50
Sale	5.00	Markup	4.50	Markup	1.00
			$9.50		10.50
				Tax	1.05
				Sale	11.55

10% VAT

Widget	$5.00	Widget Cost	$5.50	Widget Cost	$10.45
Tax	.50	Markup	4.50	Markup	1.00
Sale	5.50		10.00		11.45
		Credit VAT paid to Mfr.	.50	Credit VAT paid to Whlslr.	.95
			9.50		10.50
		Tax	.95	Tax	1.05
		Sale	10.45	Sale	11.55

Flat Rate Income Tax

Previous League studies did not cover a flat income tax, but since the 1992 study there has been considerable discussion of the concept. Under a graduated rate income tax, the rate of tax imposed gradually increases with income, so that lower income taxpayers pay a lower rate of tax than higher income taxpayers. Under a flat rate income tax, all taxpayers pay the same rate of tax whatever their income level. One criticism of a flat rate income tax is that it is unfair because, for example, paying a tax of 5% of income is more burdensome for a person making $20,000 than for a person making $200,000. It is possible, however, to ameliorate this aspect by the use of exemptions and tax credits. In fact, analysis shows that enactment of either a graduated or flat rate income tax with exemptions to replace or reduce the rates of the current sales and property taxes would lessen the regressivity of Washington's current tax structure.

How Washington's Tax System Measures Up

After a year of intensive study of Washington's tax system, the *Washington State Tax Structure Study (Gates) Committee* reached the following conclusions using the principles identified earlier in this report:

Adequacy:

Adequacy is usually measured by whether tax revenue growth is commensurate with the demand for state government services, which tends to grow at least as fast as or faster than growth in the state's economy as measured by the total of personal income. Analysis shows that over the past 30 years general fund revenues for Washington have grown more slowly (average annual rate of 8.3%) than the total state personal income (8.8%) while at the same time the demand for government services has increased at a slightly greater rate (8.9%) than the increases in state income.

> ***… general fund revenue under Washington's present tax system is likely to grow 10 to 15 percent more slowly than personal income (or the general economy) in the long run.***

Taken together, historical revenue growth, trends in consumer spending habits, and the effects of recent voter-approved tax reduction measures suggest that general fund revenue under Washington's present tax system is likely to grow 10 to 15 percent more slowly than personal income (or the general economy) in the long run. Voter-approved initiatives that have reduced the growth in revenues included Referendum 47 and Initiative 747 that reduced allowable growth in state and local property taxes, and Referendum 49 that eliminated the general fund portion of the motor vehicle excise tax.

Stability:

Washington's mix of taxes, with its heavy dependence on the retail sales tax that exempts food and prescription drugs, causes tax revenues to grow faster than the economy in good times and contract more in downturns. The shortfalls during downturns can cause destabilizing fiscal crises, while in good times excess revenues may result in permanent tax cuts or adoption of new spending programs that exacerbate the problems when the next economic downturn occurs.

Equity and Fairness:

Washington's tax structure is regressive, with the sales tax being the main cause of the regressivity. In addition, the property tax is independent of people's ability to pay. The lowest income households pay 15.7% of income for total excise and property taxes, while the highest income households pay 4.4% for the same taxes. A 2003 study by the

Institute on Taxation and Economic Policy places Washington's tax system as the most regressive in the nation.

For businesses, new and expanding businesses have a higher relative tax burden than do established businesses.

Economic Vitality and Harmony with Other States:
Washington State relies more heavily on taxes collected from businesses compared to households than other states -- 46% from business in Washington compared to 30% average in western states. Because of the B&O tax, our system places a relatively high tax burden on low profit margin firms and firms that are new or expanding. On the other hand, firms with higher profit margins may enjoy a lower tax burden in Washington than similar business in competitor states. Business taxes in Oregon are generally lower than Washington, which could entice businesses to locate there.

Washington has one of the highest sales tax rates and broadest tax bases in the nation. This high sales tax creates a significant incentive to shop out of state and causes equity problems for Washington retailers. Sales tax revenues in the counties bordering Oregon and Idaho are very sensitive to changes in tax rates. In the 14 affected counties, sales and revenues would increase by an estimated 22% if the sales tax differential were eliminated.

Economic Neutrality and Efficiency:

Washington's tax system creates incentives for taxpayers -- both businesses and individuals -- to change their behavior in order to take advantage of differential tax treatment.

Washington's tax system creates incentives for taxpayers -- both businesses and individuals -- to change their behavior in order to take advantage of differential tax treatment. Because the B&O tax pyramids, the incentive is for businesses to find ways to avoid the pyramiding. A tax pyramids when goods or services of one company are inputs for another company's production or sales and no credit is given for taxes previously paid. Hence, the tax is paid multiple times as a product moves through the production chain. (See chart on p. 17) To reduce their Washington B&O tax levels, businesses use strategies such as conducting a portion of the manufacturing operation in another state or creating subsidiaries to receive part of their income in another state.

Individuals can change their behavior to avoid the sales/use tax in several ways. For example, the sales tax is not imposed on non-restaurant purchases of food and many consumer services are not taxed. The use tax can be illegally avoided by purchasing through the Internet or by catalogs of companies that have no nexus with Washington, and by making purchases in states with a lower or no sales tax such as Oregon.

Transparency and Administrative Simplicity:
A significant part of the state's tax system is not transparent to households. To the extent that taxes on businesses, primarily the B&O tax, are passed on to consumers in the form of higher prices, these taxes are not transparent. In addition, most households

are not aware of their annual sales tax burden even though the sales tax is explicitly stated on invoices and receipts.

Most of Washington's taxes are relatively simple to administer for both government and households. The retail sales tax is very cost effective for the government to administer, but a significant cost is shifted to retailers who act as collection agents without any reimbursement.

Legal Considerations

Washington State Constitutional Restrictions

Article VII, Section 1, requires that all taxes shall be uniform on the same class of property. Real estate is one class of property, and therefore must be taxed uniformly in any taxing district. The case that has led to the belief that an income tax is unconstitutional in this state is *Culliton v. Chase,* 174 Wash. 363, 289 P2d 81 (1933), That case, evaluating the graduated income tax that was passed in 1932, held that income was property and, therefore, could not be taxed at different rates, thus invalidating the initiative that had passed with over 70% of the vote.

Culliton relied on *Aberdeen Savings & Loan v. Chase,* 157 Wash. 351, 289 P 536, which did not discuss an income tax, but held that a different rate of tax on an incorporated business and an unincorporated one violated the equal protection clause of the United States Constitution. *Aberdeen* did not discuss whether income was property or not, but *Culliton* ostensibly relied on it in holding that income was property. The courts in the late '20's and early '30's made some rulings to that effect that have since been overruled in all but Washington and Pennsylvania, neither of which seems to have challenged the early cases, and a flat rate income tax has never been tested in Washington.

Article XI, Section 12, prohibits the state from imposing a tax within a local jurisdiction for local government purposes. Instead, the state may grant municipalities the authority to impose specified taxes for local purposes.

Article XI, Section 9, requires that state taxes not be released or commuted. Thus, a provision to allow resident of border counties to pay a lower rate of sales tax than residents of other counties was ruled unconstitutional.

United States Constitutional Restrictions

In tax cases before the United States Supreme Court, it has been determined that the Due Process and Commerce clauses of the federal constitution require that there be a nexus (a connection) between the government imposing the tax and the activity sought to be taxed.

The Commerce clause provides that Congress has the authority to regulate commerce with foreign countries and among the states. The Supreme Court has held that, in the absence of Congressional action, a state may impose a tax on interstate commerce provided that it is (i) applied to an activity with a substantial nexus with the taxing state, (ii) is fairly apportioned, (iii) does not discriminate against interstate commerce, and (iv) is fairly related to the services provided by the taxing state.

The Equal Protection clause of the U.S. Constitution and the Privileges and Immunity clauses of both the U.S. and Washington State Constitutions require that persons be treated equally under similar circumstances. In the area of taxation, however, the Legislature has very broad discretion. One class may be taxed and another may be exempted, as long as the distinction between classes is reasonable and not arbitrary or capricious.

Article I, Section 10, of the U.S. Constitution and Article I, Section 23, of the Washington Constitution both prohibit the state from passing any law impairing existing contracts. Bonds and other evidences of indebtedness are contracts between the borrowing government and the lending bond holder, so the State may not repeal a tax expressly pledged to secure outstanding bonds, such as the motor vehicle fuel tax that is often pledged to repay for highways. These provisions limit the time period within which an existing tax can be replaced. At the state level, none of the three major taxes (B&O, retail sales, and property) have been expressly committed to bond debt service, but the Legislature has permitted a number of special local excise taxes to be pledged as security, including local real estate excise taxes, various local sales and use taxes.

Public Law 86-272 prohibits a state from imposing a net income tax on a business whose only contact with the state is to solicit sales of tangible personal property through employees or contractors. This does not affect our B&O tax, which is on gross receipts.

Developments and Trends

Since the 1992 LWVWA tax study, there have been changes in the social, political and economic climate that have influenced tax policy and are sure to be of major consideration in the future.

In general, Washington's demographics are changing. The lower income sector of the population is growing faster than other sectors, leading to higher costs for education, health and human services, and public safety. Our population also is aging, leading to higher health care costs and costs for infrastructure support, such as public transportation and handicapped access. These added demands on government put pressure on state and local budgets.

Three developments in particular have had or will have a significant impact on Washington state's financial equilibrium: Limitations on the legislature's ability to balance budgets from the use of the initiative process; the effort to manage growth through the imposition of impact fees; and the use of the Internet for commercial purposes, particularly the growth of Internet sales.

Initiative and Referendum

From the inception of initiatives in 1914 to 1992 there were just 139 initiatives to the legislature. In the last seven years, we have averaged 17 per year. Initiatives to the people have multiplied even faster, although only a handful of each qualifies for consideration. The significance, however, is that those issues raised in later years have seriously affected the state budget. A succession of initiatives have reflected the public dissatisfaction with the current tax system:

I-601 (1997) Limitation on Expenditures
I-695 (1999) Elimination of Motor Vehicle Excise Tax
I-747 (2001) Limitation on Property Taxes
I-773 (2001) Increased Cigarette Tax Committed to Health Care
I-776 (2002) Local Government Vehicle Tax Eliminated

Other initiatives, while not directly about taxes, have nonetheless had major fiscal impacts:

I-728 (2001) Class Size Reduction
I-732 (2001) Teacher Cost-of-Living Increase

Often the initiative process does not lend itself to comprehensive analysis of all parts of the budget. For example, Initiative 601 has not proved to be an accurate measure of the rate of inflation on the revenue needs of an increasing population; elimination of the property tax portion of the vehicle tax produced a major impact on local jurisdictions; Initiatives 728 and 732 placed an increased demand for funding K-12 at the same time that Initiatives 747, 695 and 776 were reducing the money available for education.

In addition, social and political issues were the subject of many petitions indicating a lessening of faith in the legislative process and a willingness to make laws by popular vote rather than representative government. This will make it exceedingly difficult for Washington's legislature to develop a responsible policy on tax reform.

Impact Fees

Impact fees have been imposed by certain cities and counties that have elected to do so under the powers given them in 1990 as part of the Growth Management Act as a means for growth to pay for the impact it imposes on the existing community. While all basic services are influenced by new residences, impact fees are only approved to provide for streets, school buildings, parks and some fire stations needed by growing communities.

The law limits the amount that may be levied, and the rates vary among the jurisdictions that impose them. The money must be directly related to the benefits the new residents will receive and must be based on the real cost of the new facility minus state and federal contributions.

Impact fees have a potential for decreasing local property taxes and bond measures, although they are still not widely used.

Impact fees have potential for decreasing local property taxes and bond measures, although they are still not widely used. One study estimated that in the year 2000, the growth subsidy in Washington was $2.87 billion, or about $500 for every person in the state that year. The use of impact fees to recover some or all of that cost could relieve the need for additional property taxes or bond issues. Impact fees eliminate the inequity of the "growth penalty", which causes taxes in growing communities to be higher than in places that are remaining stable. This form of taxation also eliminates the subsidy that current populations are forced to provide for new populations and the development industry. Collection of impact fees during expansion can lead to pay-as-you-go construction schedules, eliminating the need for debt financing and reducing the tax burden for the newcomer as well.

With impact fees, those who benefit from the infrastructure are those who pay for it; for this reason, the fees are perceived as transparent and fair. On the other hand, there is very little understanding of impact fees among the population, and the construction industry, -- a very powerful lobby -- opposes them.

Remote Sales

As more consumers have acquired computers in the home, there has been a crucial switch from store and catalog purchases to buying on the Internet. Currently this practice allows Washington residents to avoid sales tax, which is the greatest contributor to the state general fund.

Remote sales now cost the state and local jurisdictions an estimated $86 million a year in lost sales/use tax revenue.

Remote sales now cost the state and local jurisdictions an estimated $86 million a year in lost sales/use tax revenue. States have lobbied Congress to allow them to collect sales tax from all Internet and catalog sales. Now states can collect sales tax only from businesses that have an actual presence in the state of the buyer's residence. Absent such nexus, Washington is losing an increasing part of the primary funding source for its discretionary spending.

There has recently been some discussion about the efficacy of allowing states to collect sales taxes at their individual rates from Internet trade, which may already exceed the volume of catalog sales. In light of the complexity of this suggestion and the dire need for funds at the national level, there could be a federal tax on Internet commerce. If a federal law were passed, the on-line merchant would be responsible for delivering to each state the appropriate tax due. Any limits on commercial Internet activity are, however, looked upon by many users as a foot in the door to control of the Internet which could, in their view, lead to restriction on free speech.

In Conclusion

It is the hope of this committee that this study will stimulate consideration and discussion of the tax structure of Washington as it exists in the current environment of today's culture. It may then be possible that new information and vigorous educational programs will prepare the way for a fair, adequate and transparent tax structure to be adopted for the State of Washington. We submit it to discussion by the full membership of the state League that it may modernize and refine its position, determine a course for its action, and undertake appropriate advocacy with renewed vigor.

GLOSSARY

Adequacy: Enough to do what is required. When applied to taxes, whether or not the taxes collected are sufficient to pay for the expenses budgeted.

Assessed Value: The full fair value of property, as determined by the County Assessor, for the purpose of fixing the basis for taxing it.

Budget Deficit: The shortage by which revenue fails to meet appropriations to be expended. The State of Washington is not allowed, by its constitution, to so budget in a negative way.

Business & Occupations Tax (B&O): A tax levied on the gross receipts of a business.

Deficit: See "Budget Deficit."

Discretionary Funds: Revenues that are not restricted to a particular program and, therefore, elected officials may determine how they may be used.

Equity: When applied to a tax, whether it appears fairly in accordance with the ability to pay. When applied to an ownership of property, the net value to the owner after deduction of encumbrances against it.

Excise Tax: A tax which is levied on a transaction concerning property, such as the sale of it, rather than on the value of wealth held.

Exemption: A provision by which one is freed from an obligation generally applied to others.

Fairness: A subjective measure of equity among taxpayers.

Flat Tax or Flat Rate Income Tax: One which is imposed at the same rate on all net taxable income.

Graduated Income Tax: One which is imposed at different rates on net taxable income in different brackets.

Gross Receipts: The total amount of money taken in.

Income Tax: A tax imposed on the net (as defined in the tax statute) income of a business, an individual or a family.

Levy: The act by which a tax is imposed.

Personal Property: Moveable tangible assets, exclusive of intangible paper investments.

Progressive: Moving forward by steps. When applied to taxation, a tax which is imposed more heavily upon those persons in a greater position to pay it.

Property Tax: A tax imposed on the value of property owned. "Property" may be real or personal, but the term "property tax" is frequently used to apply to the tax on real property.

Rainy Day Funds: Also known as "budget stabilization funds." In general, funds in which revenues are saved when state finances are healthy for use when the state experiences an economic downturn. Individual states impose their own unique requirements for deposits into and expenditures from their funds.

Real Property: Land and the structures attached to it.

Regressive Tax: A tax which impacts persons with less ability to pay more heavily than those with greater ability to pay, although imposed at the same rate on all taxpayers.

Retail Sales Tax: An excise tax imposed directly at the time of purchase by the ultimate consumer, on goods and/or services.

Revenue: All income to a government, from taxes, licenses, transfers or otherwise.

Stability: When applied to a tax, whether or not it remains reasonably predictable.

Surtax: An additional tax beyond a tax which has already been levied; for example, if one must pay a 10% tax on a $1,000 income, that is a tax of $100; if, then, there is a 10% surtax, that is $10 more, being 10% of the $100 original tax, not another $100.

Tax: (noun) An imposition by a government upon its citizens to provide funds to pay for government functions. (verb) To require such payment.

Transparency: Easily understood or detected; obvious. With regard to taxes, so that the taxpayer understands why his money is extracted, at what rate, and for what purpose.

User Fees: Fees charged to users of goods or services provided by a governmental entity. In levying or authorizing these fees, the government determines whether the revenue should go into the general fund or should be available to the agency providing the goods or services.

Value Added Tax: A tax imposed on goods as it flows through commerce assessed against the value added, at each stage of its production, by the efforts of the taxpayer.

Volatility: Taxes are volatile when they are rapidly responsive to changes in the general state of the economy, rather than in response to need.

Washington State Tax Structure Study Committee: A committee established by the Washington State Legislature to study and report back to the Legislature how the state's tax structure might be changed to better serve the needs of the citizens in the 21st Century, which was chaired by William Gates, Sr. and is therefore familiarly called "the Gates Committee", and which did, in fact, make its report in November of 2002. (Its full report is on file with the Department of Revenue and is available on its web site.)

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Discussion Questions

1. How does our present state tax system, as a whole, rate under the seven criteria mentioned in the study?

   How does each of the major components of the present system – sales tax, property tax, and business & occupations tax – rate under those criteria?

2. Is the Washington tax system "fair" in the broadest sense
   --to individuals?
   --to businesses?

3. Is ability to pay an important consideration for a tax system?

4. Recognizing that public schools (K-12) receive funds from the lottery, from timber sales and from federal subsidies, but still make a large demand on state taxes, is there a more equitable way of funding the schools, particularly considering the needs of different communities within the state?

5. How far might user fees, charged to users of goods or services provided by a government source, be substituted for taxes assessed against citizens generally?

6. Is there a sound method of providing for a "rainy day fund" to stabilize government receipts during economic downturns?

7. Should exemptions from tax be allowed for policy reasons? If so,
   --for what policy reasons?
   --what provisions should be used for review and termination?

APPENDIX

From the Washington State VOTER, Volume 34, No. 4, Spring 1992:

The Basic Tax System in Washington

The most basic tax question of all is "Why do we have taxes?" A common answer is that *governments assess and collect taxes in order to fund activities that benefit the common good* -- activities that could not be funded as well, if at all, through private enterprise. Included in this category are such things as roads, police, common schools, parks and social services.

To understand taxes, the distinction between a tax base and a tax rate must be clarified. The tax base deals with the number of people taxed, the tax rate refers to how much each taxpayer is assessed. As an example, if $100.00 is needed, 10 people could be assessed $10.00 each, or 100 people could be assessed $1.00 each. A broad tax base means that the burden is lighter for each taxpayer. The money a given tax can raise is expressed by the equation:

Tax Revenue = Tax Base x Tax Rate

The state gets money from a number of sources. These sources are divided into two basic groups. The first is "general" revenues which are the revenue sources typically available for program expenditures. Budgetary decisions over the use of these funds are determined by the various governments involved -- state legislature, county commissioners, city council, etc. The other basic category consists of revenue sources which are usually not available for general programs but are dedicated to specific purposes. Major sources of revenue to the state not included in the general fund are some federal funds and State Department of Transportation funds. The DOT funds originate in the transportation committee, general funds raised by the state originate either in the House Revenue committee or the Senate Ways and Means Committee.

State taxes account for approximately 72% of state/local taxes in Washington, while local government represents approximately 28%. The ratio of state to local taxes is much higher in this state than in other states because Washington finances a greater proportion of governmental services at the state level, particularly the funding of K-12 education, vocational and community college education and public assistance programs.

Raising public money through taxes can take place in a number of ways. Each type of tax has advantages and disadvantages. Taken together the various taxes make up the tax system we love or hate as the case may be.

It is possible to measure our tax system against some standard criteria. The League of Women Voters of Washington concurs with most authorities that a high quality state revenue system should be:

Fair Fairness means that the burden of payment should not fall unequally on taxpayers when the ability to pay is taken into consideration.

Adequate A tax system must raise enough money in bad times and good times to cover the services requested by the citizens.

Balanced Tax revenues should be obtained from a variety of sources to help achieve fairness and stable revenue.

Flexible A flexible system does not have too many restrictions. It can meet the strains brought on by increases in population, fluctuating job rates and changes in society.

Manageable The tax system should be easily understood by the taxpayer, should encourage voluntary compliance and be easily administered by the state.

Economically Sound The tax system should not cause business to be at a competitive disadvantage with similar businesses located elsewhere.

Safeguarded The system should contain proper safeguards and limits to raising money without the taxpayers' approval and protect against uncontrolled spending. (Distrust of tax increases has been a major source of resistance to tax reform.)

Non-Burdensome A tax system should not take more money from the taxpayer than he can afford.

How Does the Washington State Tax System Measure Up?

To answer this question it helps to consider Washington State's major sources of general revenue and their advantages and disadvantages.

Washington's major revenue sources are the property tax and various excise taxes. An excise tax is simply a tax on the manufacture, sale or consumption of a commodity. Together these taxes made up about 75% of the state general fund in 1990. Receipts from the federal government made up about 20% of the general fund and miscellaneous licenses and fees made up about 5%.

An important factor in the Washington State tax system is that our tax base has become smaller over the years due to exemptions and deductions.

The Retail Sales Tax

The largest excise tax is the retail sales tax. It is Washington's principal source of revenue. Alone, this tax makes up nearly half of the state general fund. City and county governments and transit systems also depend on the tax. It is their second leading revenue source. The state rate is 6.5%. Local governments can impose additional percents. Most items of tangible personal property purchased by consumers are subject to the tax. Currently there is no sales tax on food.

The sales tax has positive features . . .

It is a large and efficient revenue producer. Since it is usually paid in small increments, it is relatively painless. The tax assures that all persons contribute toward the cost of government. It is one of the few ways we have to obtain tax money from non-residents who are in the state temporarily.

. . . and negative features

Despite the exemption of food, the tax remains regressive. Low-income families pay a greater share of their income for state and local taxes than wealthier families.

Collections fluctuate. In good times people buy a lot, and the state has an easy time balancing the budget, but when the economy is bad people cut their spending. This causes revenue to drop precipitately just when money is most needed to supply state services.

High tax rates prompt people to evade Washington taxes by purchasing items in other states which have lower tax rates. Citizens are supposed to pay a substitute tax on items bought out of state, but of course, few people do, and the state so far has not found it cost effective to collect this "use tax," costing the state millions in lost general funds each year. Also, the high tax in border areas makes it difficult for retail businesses to compete with other states and provinces and causes serious problems for financing local governments.

The Business and Occupation Tax

The B&O tax is the second leading source of state revenue in the general fund. It accounts for nearly 15% of state tax revenue sources supporting the general fund. It is a tax unique to Washington State in that it is a tax on the gross income of a business.

The B&O tax has positive features . . .

The tax is a very stable revenue source. It assures that all firms, even unprofitable ones, pay something for the government services they use. The tax treats both corporate and non-corporate businesses alike.

... and negative features

The tax imposes a very heavy burden on new firms that have not yet reached maximum operating efficiency. In many instances, the tax favors established, profitable business activities at the expense of start-up firms and those with low profit margins such as grocery stores.

Since no other state levies a B&O tax, firms which are located in other states and do business in Washington are not used to it.

The burden of the tax varies widely, not only among different types of businesses, but also among firms within the same business sectors. The details are complex because the B&O tax is afflicted with more exemptions and deductions than any other area of taxation except the property tax.

Other Excise Taxes

There are other excise taxes aside from the two big ones. These include the tax on cigarettes, the gasoline tax, taxes on liquor and other taxes such as utility taxes which you will probably not notice unless you examine your bill carefully. These taxes have been assessed over the years because Republicans and Democrats alike recognize that the state needs a certain amount of money. We do not have an income tax -- excise taxes are comparatively cheap politically. The result is that in 1989 our liquor taxes were the highest in the country, our cigarette tax ranked second and our gas taxes ranked sixth.

Excise taxes have positive features . . .

Some people would argue that these taxes help achieve social goals (e.g., fuel conservation or reduced liquor consumption). Taxes are paid by non-residents as well as residents. Consumers have some discretion over their tax liability by avoiding purchases of some of the items that are taxed, and revenues from specific taxes are easily designated to pay for particular programs.

. . . and negative features

These taxes tend to be regressive since they are based largely on consumption. Some of them are levied on necessities such as utilities and gasoline. As a result they can impose hardships on low-income families and elderly people living on fixed incomes. High tax rates, as mentioned previously, encourage citizens from Washington to evade paying taxes by making purchases in other states.

Since revenues from specific taxes are allocated for particular programs, these funds cannot be used for alternate funding needs. This situation reduces flexibility in budgeting money for state services. There is also a tendency to use the tax for items not related to the tax. For example, the cigarette tax is used for water quality improvements although there is no perceivable relationship between water quality and smoking except that smokers are easy to dump on these days!

The Property Tax

The property tax is the oldest revenue source in Washington. It was established before statehood. It is second to the sales tax in total revenues produced each year. It is the chief tax of local government. State and local levies due in 1989 raised more that $2 billion. The state monies are chiefly for schools, while the local portion of the property tax is used by cities, counties and junior taxing districts for a multitude of services, from emergency services to schools, parks and libraries.

The tax mainly applies to the current value of real property -- land and buildings -- as determined by county assessors, and to personal property -- mainly business equipment, boats and RV's -- *as listed by the owners!*

Some categories of property are taxed at a reduced "current use" value or are exempt. Certain agricultural, timber and open space lands are valued at their current use. Exempt areas include government property, intangible property, property owned by churches and schools, and household goods. Taken together, more property is exempt from taxation than is taxed.

The property tax has positive features ...

The tax is levied in all states so property owners are familiar with it. Property ownership correlates well with the demand for certain local services such as police and fire protection and county governments largely administer the tax, so taxpayers can exert a certain amount of local control. A variety of rate limits protect against large tax increases.

. . . and negative features

Although the tax in Washington is in the middle range of all the states, people perceive it as being very high. Tax rates can vary throughout the state because of voter approved levies (mostly for schools). Administrative costs are high because of the appraisal process. Owners often disagree with the assessed value assigned by the appraisers, leading to additional costs through disputes and appeals.

Property owners in some counties pay higher rates than taxpayers in other counties for generally the same level of government services. This is because some counties have more industrial property which has a higher value than residential and other types of property. It is also possible that assessors work differently in different counties although state law is moving to make the process more even handed.

The Income Tax

Washington State does not have an income tax. In 1991 only six other states had no personal income tax -Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming -- although Alaska and Florida tax corporations.

The income tax has positive features . . .

An income tax is considered a fair tax by many in the sense that it is closely in accord with the ability to pay. When a taxpayer's income goes down, then his/her taxes are less. State income taxes are deductible in calculating federal income taxes. It responds to growth, the yield increasing as the economy expands. Even when the tax is withheld, the taxpayer is clearly aware of the amount paid. It reaches income from stocky, bonds and other intangible properties which are not currently taxed in Washington. It is affected less by depression than the sales tax.

. . . and negative features

Taxpayers in the state emphatically feel that an income tax is TOO MUCH in addition to our other federal and state and local taxes. They do not have any faith that the government will act in a responsible manner to lessen other taxes as an income tax is added to the total tax system.

Opponents say it would take a constitutional amendment to make it available in Washington. It requires individuals to report, which is a burden on the taxpayer, and in general it is complicated to administer and enforce.

Summary

Our state has the unhappy distinction of being one of the ten worst states in the union in the area of tax fairness because our system is so regressive. The lowest 20% of taxpayers contribute nearly 18% of family income to state taxes, while the top 1% contribute less than 4% of family income, and the next 4% contribute less than 6% of family income to state taxes. Our system relies vary heavily on excise taxes and property taxes. There is no income tax, there is no tax on intangibles. Even those taxes which are levied suffer from a narrowing of the tax base due to many exemptions and deductions. Wealthy citizens retire to Washington State where their taxes are among the lowest in the country while business and the poorer people pay more than their fair share. Nevertheless, it does work -- at least it raises enough money to limp along. Everyone pays something towards the services we all need, including the poorest.

Why Did We Say That?

An Updated Review of LWVWA Thinking on State Taxes

The League of Women Voters of Washington has been studying the state tax system since the 1950s. We have studied how we are taxed, how we spend the taxes, how we prefer to be taxed, what is taxed, what isn't taxed, and even some of the "terrible tales" of how heavily we are taxed.

In the forty years since we have studied taxes we have worked for a fair tax system, including an income tax. Ironically, we have never looked at the B&O tax, especially in regards to exemptions and deductions, we have not examined the proliferation of excise taxes, and we have not directly addressed the problems of tax loopholes.

It is time to review our position with care, so we know why we said what we did, so we can find our own "loopholes," and most especially, so we can bring all of our members up to date on our thinking over these many decades. The following section covers our positions sentence by sentence.

The basic LWVWA tax statement calls for *"Action to support a balanced state tax system that is adequate, flexible, equitable, and conducive to a sound economy."*

Each type of tax has its own characteristics. The previous section dealt with our taxes in some detail. A balanced tax system includes a variety of taxes so that the characteristics of each type mesh to produce a total system that satisfies all or at least most of the criteria explained in the previous section -- a tax system that is fair, adequate, balanced, flexible, manageable, economically sound, non-burdensome, and that includes safeguards.

Tax Structures (1959,1965)

"Inequities in the distribution of the tax burden should be removed."

Taxes, we agreed, should be borne evenly by all groups of people. No individual or group should have to bear a heavier proportion of the tax burden than another. Occupation, status, location or level of income should not be a factor or an advantage.

"Flexibility and recognition of changing times and needs is important in tax policy."

State tax policy should be reviewed periodically to determine whether economic, demographic or social change has resulted in inequities or inadequacies in the system. Flexibility of the tax structure tends to reduce inequities by allowing adjustments in rates and the tax base to accommodate changing needs. However, the property tax is limited to 1% of the value of the property, there is a 20% lid on excess levies, and increases in expenditures in tax districts cannot be more than 6% per annum. At the same time the value of money erodes through inflation. This process of limiting revenues, while the cost of government rises results in reduced services or finding other means of producing revenue. The effect is most noticeable in such taxes as the gasoline tax, whale less is collected while at the same time a given amount of money covers fewer services. This happens because the tax is a certain amount per gallon rather than a certain percent per cost of gasoline and cars are more efficient and use fewer gallons. The success of Initiative 402 which repealed the state gift tax and eliminated almost all revenue from inheritance taxes erased another part of the tax base.

"Only broad general principles of taxation should be included in the state constitution."

Specific details spelled out in the state constitution tend to make a tax system inflexible. Constitutional change is difficult and time-consuming. Our constitution includes great detail on how taxes are levied, limitation, validation of special levies -- all of which leave few alternative sources available to the legislature and the people. This is a basic problem.

"Income should be part of the tax base, preferably through a graduated net income tax."

In the 1930s the State Supreme Court ruled that income is a form of property and therefore subject to the constitutional limit imposed on real estate and personal property. In general, people with discretionary income tend to invest more in intangible property such as stocks, bonds, money market funds, and such, than people with lower incomes. Such intangibles are specifically exempt from property or other taxes. Household property is also exempt.

In March 1988, the District of Columbia based organization "Citizens for Tax Justice" released a study showing that Washington State's reliance on sales and other excise taxes puts a tax burden four times heavier on low income families and almost three times heavier on middle income families than the largest income families. This situation exists because almost everything that low and middle income families consume (with the exception of food and prescription drugs) is taxed.

"The sales tax should not be levied on food."

League members agreed that those who must live on a low income spend a greater proportion of their money on food than others who have more discretionary money. Those who must pay 35% of their income on food are more burdened than those for whom only 5% or 10% of income is required for food. Money directed to taxes cannot be used for the necessities of life. Humanitarian reasons as well as equity prompted the League to support this stand.

"Business should be taxed on net income rather than on gross sales."

The call for equity is the basis for our position on the business and occupation tax. The "gross receipts" of a firm are no sign of the ability to pay taxes, since one business may have a very large gross income with a very small profit margin, while another with a large profit margin may have a smaller gross income. Such a tax places Washington businesses at a competitive disadvantage to out-of-state firms which may pay taxes on net income. New businesses which do not make a profit in the first years are also at a disadvantage. Such competitive disadvantage does not provide a warm climate for business growth and development.

Property Tax Administration (1965)

"Specific figures and details such as assessment levels, millage limits, classification, etc., should be left to legislative determination according to the needs of the times."

Constitutional limitations on assessment, millage, etc. leave no flexibility as conditions change. Thus, in times when financial need rises or falls, the property tax burden remains static. As with most limitations, the tendency is for tax rates to stay at the top of the limit. Flexibility is lost.

"Constitutional provisions should be enforced with Affective penalties or regulation from the state level."

The constitution calls for uniform taxation on property within the borders of a taxing district. One method presently used to handle the enforcement of this requirement has resulted in providing tax advantages to some taxable property located in jurisdictions with assessment levels below the mandated level. It is a matter of conflict between equity for some and equity for others.

The state assesses property in two kinds of jurisdictions:

- ♦ Property belonging to public service businesses that cross county lines such as high tension wires, and
- ♦ A statewide district formed to tax property for school purposes.

County assessors, who are independently elected officials, perform their duties in taxing districts wholly within county lines. Since appraising is not an exact science, sometimes the two assessment levels do not coincide.

The relationship between a county's version of "true and fair value" (the constitutional standard) and the state's version is the "indicated ratio" for the county expressed as a percentage. On the state-assessed property of the qualified public service businesses, the indicated ratio Is multiplied by the state assessment figure, thus reducing the tax base to the level of the rest of that county if it is lower than the state standard.

county value/state value x state assessment = tax base

It follows that similarly valued properties in two different counties could be subject to different tax burdens. The result is inequities for other taxpayers in both counties, political encouragement to keep assessment levels low, and increasingly complicated efforts to improve the system. Each time the tax laws malfunction, another patch is put in place and each patch contributes to complicated and confusing laws and regulations. The message here seems to be "assess it right the first time! "

On the other hand, for purposes of the school tax, the indicated ratio is used to equalize assessments across the state. The county assesses the property and the figure is divided by the indicated ratio for that county thus raising the figure to the state's level.

"Training and quality of personnel and adequate budgets and staff should be a concern at both state and local levels."

Picture a county which, through inadequate and untrained staff, as well as inadequate administration of the property tax, is asked to add money to the budget of the assessor's office for more personnel, more training and new equipment. The question of "where do we fund the money since our property tax revenues are inadequate?" will arise. Politically it is a difficult problem. Any excess levy is based on the county assessment. Only when the state and local governments work together in improving assessment practices and informing the public will the public have confidence in these activities.

"The assessor should be a technical administrative officer and should not have tax policy-making powers. Qualifications should be set for the position of assessor. The decision as to whether or not the assessor's position is elected or appointed should be determined by the legislature and not specified in the constitution."

In the state of Washington no requirements or qualifications are provided by state or local legislation. Control of assessment levels controls the tax revenues, which in turn controls the policy of the county. The state of Washington is not known for excellence in the administration of the property tax. In some cases, the assessor is a technician hired by the state. Recently, legislation has been introduced to improve the quality of assessors and to improve the training for the assessor and staff.

"The taxpayer should have a greater role in the taxing process, and information should be more readily and understandable. More information should be included on, or along with, the tax statement. True and fair value (100% value) should be listed on the tax rolls and on the tax statement. Each taxpayer should receive tax statements."

Many of the recommendations in these statements have come to pass. Mortgagees do (or should) receive copies of the tax statements and generally the value is listed. Often, however, the information on a tax statement is difficult to interpret. Most county assessors do provide more information to taxpayers if requested. Tax law, however, has become so complicated that it is difficult to capture the attention of many long enough to explain the issues and the problems. An example is the length of this paper!

"The appeals procedures should be simple, convenient and responsive to the taxpayer. The taxpayer should be notified of revaluation in ample time to appeal should he or she desire to do so. Appeal boards or courts or boards of equalization should be separate, qualified boards at county and state levels."

Much has been done to improve the appeal procedures and their administration. Here, too, budget constraints inhibit the attainment of a "perfect" appeal process. Still while studies continue to show that many assessments are still not at 100% of value (a requirement for a 4-year assessment cycle), one wonders at the number of appeals which continue to reduce the assessment of the property in question.

Property Tax Exemptions (1969)

"Exemptions from property tax should be limited, but may be valid when used to further public policy such as to encourage education, culture or humanitarian causes."

The number of properties exempt from the property tax is staggering. Less than half of the property in the state is taxed. It is generally agreed that schools, roads, parks, governmental facilities, churches and other public service institutions should not be taxed. We allow tax exemptions to certain of the elderly and disabled with limited income. Some businesses also receive property tax exemptions, including some businesses run in or by churches. Each exemption further narrows the tax base, which means that more of the tax burden falls on that property which continues to be taxed. As with other areas of taxation where the base has been reduced, we must take care that we do not reduce the property tax base to the point where the few pay and the many benefit. The balance is tenuous. When seeking exemptions, charitable and opportunistic arguments can be convincing.

"Property tax exemptions should not be used to encourage location of industry or as a reward for public service; nor should property of private or non-profit groups used for business activities be exempt."

It was agreed that industries leasing sites and buildings from governmental units, businesses owned by property tax-exempt organizations, and other activities such as church-sponsored retirement homes or apartments were some examples of the misuse of exemptions. Some examples have been corrected but not all.

"The state should assume the responsibility for revenue lost to local governments because of property tax exemptions granted by the state; in any case, property otherwise exempt should pay for direct public services such as fire and police protection."

The state has not only restricted the options for local government taxation but also has placed such stringent limitations on the property tax that necessary services provided by local governments are in jeopardy. Only recently have the outcries from local jurisdictions forced the state legislators to accept, in principle at least, the necessity to provide state funding whenever the state requires that local governments provide services which they otherwise would choose not to provide.

"When exemptions are used, the state must assure uniform application. Exemption provisions should be carefully and periodically examined. There should be a periodic inspection of exempt property to assure compliance with tile law. Exempt property and its valuations should be listed, and the list be made available to the public."

The biennial report on tax exemptions, exclusions, etc., prepared by the State Department of Revenue, points up the magnitude of the amount of taxes not paid in the state. Little attention is paid to these exemptions with the result that they are increasing. When exemptions are used as loopholes to circumvent taxation, they create unfair competition with others who do not have the privilege, and inequity to all other taxpayers who must pick up the extra burden. This is particularly true since the 106% limitation was enacted. The limitation is placed on the taxing authority not the property owner. For example, if state-granted exemptions amounted to 1% of the total tax base, that 1% would be shifted to the other taxpayers. The local government would still get its share of last year's tax revenue plus an additional 6% for the succeeding year. It follows that no matter how worthy an original exemption seemed to be, the bottom line is that all exemptions narrow the tax base, and misuse of the exemption creates inequity in the tax system. Yet each year the legislature attempts new exemptions in response to requests from constituents while rarely, if ever, does it remove any exemptions. That has probably happened only once or twice in the state's history.

"Property on which the tax is unduly difficult or expensive to administer should be taxed in some other way --for example, income tax on intangibles, excise tax on boats and cars."

While the premise of maintaining a tax base as broad as possible in order keep rates low and still obtain adequate revenue is theoretically the most equitable method of taxation, taxation may be so expensive and difficult to administer that its economic good no longer exists. The statement proposes that, while one kind of tax is not economically feasible, another may be, and shifting to another kind of tax will not reduce the total tax base.

"Ability to pay is an important criterion of the tax structure. As reform of the tax structure is considered, methods other than exemption should be investigated for the purpose of relieving the property tax burden on low income families."

Scattered over the state are numerous households where property has increased in value so much that the owners cannot pay, although it is in the interest of the state that these people remain in their homes rather than being forced on to welfare. While no such proposals have been suggested for property tax in Washington, Michigan has enacted a measure which allows certain low income individuals to deduct amounts paid in property tax from the amount owed in income tax. Arguments are rife on this issue.

* * * * * * * *

The study of taxes is a truly taxing undertaking. However, it is so critical to the quality of our daily life that we gladly embark on the struggle to understand the details. The League of Women Voters of Washington has looked at the basics of taxation, at our tax structure, property tax administration and property tax exemptions. There is still much to do. We have not looked at the B&O tax and its exemptions and deductions. We have not addressed the problems of loopholes specifically and other measures that could be taken without an income tax in our search for an equitable tax system. The tax system is dynamic. We need to keep ourselves current on what is happening in the state and be ready to take action when the time is ripe.

The ordinary taxpayer is currently so angry at what is happening in the country as a whole, and is so dead set against any kind of tax increase, or perception of tax increase, that the conventional wisdom in Olympia is that any kind of tax reform is dead for the foreseeable future.

A Brief Summary of the Tax History of Washington

1854 The first legislature imposed a head tax of $1.00 pa each male in the territory and then imposed the first property tax.

1889 The state constitution said that the legislature shall provide by law a uniform and equal rate of assessment and taxation on an property in the state according to its value in money.

Various Income Tax Attempts

1929 Net income tax of 5% on financial institutions approved by the legislature. Overturned by the court on grounds of equal protection, since the tax did not apply to non-corporate banks and interest paid by banks was deductible, but not savings and loan dividends.

1930 Voters approved the 14th Amendment to the Constitution allowing classification of property. Intended to permit taxation of income at a rate different than real estate, but this distinction was not upheld by the court.

1931 Personal income tax with rates from 1% to 5% and corporate net income tax of 5% was adopted by the legislature as recommended by the 1929 Tax Investigation Commission. The tax was vetoed because the Governor felt administration costs would be too high.

1932 Personal and corporate net income tax with rates from 1% to 7% was adopted by initiative of the voters by a 70% margin. Overturned by the court in a 5 to 4 decision in *Culliton v. Chase*, declaring that income is property and thus subject to constitutional uniformity requirements.

1970 HJR 42 was submitted to the voters but defeated by a 2 to 1 margin. It included a single rate personal and corporate net income tax of 3.5% with reductions in existing taxes.

1973 HJR 37 was submitted to the voters but defeated by a 3 to 1 margin. It included graduated 2% to 6.5% personal and 10% corporate net income taxes with reduction and limitations on existing taxes.

1975 Initiative 314, containing a corporate net income tax of 12%, was defeated by the voters by a 2 to 1 margin.

1982 Initiative 435, containing a corporate net income tax of 10%, was defeated by the voters by a 2 to 1 margin.

1989 The League of Women Voters of Washington joined the Governor to put an income tax on the books. In spite of a year of hard work, this effort was also repulsed. It never even made it out of the Senate.

League of Women Voters of Washington Tax Actions

League records indicate that state taxes have been on our agenda since 1953.

During the 1950s the legislature increased the sales tax, B&O tax, and cigarette tax creating a renewed interest in the tax structure. League's publication, *The Tax Primer* (1957), produced a position favoring an income tax and repeal of the sales tax on food.

In the late 1970s, tax collections boomed. High inflation with its consequent high tax base and a growing population with its habit of spending money on taxable goods contributed to filling the state coffers.

At the same time, two events occurred with major impacts on the state's financial status:

1. The state under court order assumed financial responsibility for funding K-12 education. Collection of that portion of the property tax due to schools was transferred from local authorities to the state and dispersed through the general fund.

2. In 1978 a successful initiative exempted food and prescription drugs from the sales tax. Although this action reduced the regressive nature of the tax system it also removed a large stable source of state revenue.

League continued to update and expand its positions and in 1980 voted to review state tax policies.

During the 1981-1983 biennium state revenue collections were below projections. This led to the reimposition of the tax on food and an increase in most tax rates and fees. Per capita income rose, but business and personal spending, which are the basis of excise taxes, declined. Many people who still had discretionary funds switched from acquiring taxable goods to interest bearing investments. But since these intangibles (stocks, bonds, and various funds) and the income from them are exempt from state laws, the state revenue suffered. The League feels that the state's unduly heavy reliance on excise taxes has been proven to be not appropriate. However, recommendations made by the Governor's Tax Advisory council were not acted on and a proposal for a constitutionally limited income tax was not reported out of committee.

In 1985 the League convention called for an update of positions which was accomplished through articles in the *VOTER.*

In 1989 the League cooperated with the Governor's tax force to push for tax reform. This effort never got out of the Senate.

It is now 1992 -- the current bad times have driven home the inadequacy of our state tax system, but the current political climate makes any tax change or increase unpopular. Far from pushing a progressive tax reform, the League feels lucky to have recently helped to defeat Initiative 559 which would have seriously and negatively affected property tax values and administration.

Washington State Tax History

Early Taxes	
1853	Property tax: required that all taxes be assessed equally Poll Tax: levied on all adult males
1889	State constitution required that all taxes be levied uniformly on all property in accordance with its monetary value. The legislature granted authority for exemptions.
1891	2% Insurance premium tax adopted
1901	Inheritance tax established
1921	Gasoline tax imposed at 1 cent per gallon
Tax Commissions	
1921	Recommended re-establishment of the Tax Commission and administrative changes to property and inheritance taxes
1929	Recommended graduated individual income tax and single rate corporate net income tax to reduce state's reliance on property tax
Early Income Tax Attempts	
1929	Legislature approved a net income tax of 5% on financial institutions. The court overturned it on grounds of equal protection: the tax did not apply to noncorporate banks, and interest paid by banks was deductible, but not savings and loans dividends.
1930	Voters approved 14th amendment to the constitution, allowing classification of property. Intended to permit taxation of income at a rate different from real estate. The court ruled against the amendment.
1931	Recommended by the Tax Commission, the legislature adopted a personal income tax with rates from 1% to 5%, and corporate net income tax rate of 5%. The Governor vetoed.
1932	Personal and corporate net income tax, with rates of 1% to 7%, was adopted by initiative with a 70% voter margin. It was overturned by the court in a 5-4 decision in Culliton v. Chase, declaring that income was property and thus subject to the uniformity requirement in the constitution.
Excise Tax Era	
1932	Voters approved by initiative, a 40 mill limit on property levies, and a 5mill limit on a state levy. (This was reduced to 2 mills in 1934). This represented nearly a 50% reduction in total property taxes.
1932	Occupation tax levied on gross receipts of business activity, ranging from 0.2% to 3.0%. The court held that this tax was an Excise tax rather than a tax on income from doing business.
1935	Revenue Act of 1935, along with several taxes that were ruled unconstitutional or vetoed, established many of the state's tax revenue sources we have today. It established the retail sales tax, the B&O tax, public utility tax, cigarette tax, liquor tax, conveyance tax (included with real estate tax in 1987), and the admissions tax (given to local governments in 1943).
1937	Motor vehicle excise tax (MVET) was established in lieu of vehicles being assessed as personal property.
1944	Voters approved the 17th amendment, requiring a 40mill property tax limit, the 60% approval of levies, and assessment at 50% of market value. The 18th amendment, earmarking gas tax for highways, was also adopted.
1951	Legislature approved a tax upon the privilege of exercising corporate franchise,

	measured by net income. It was ruled unconstitutional by the court for non-uniformity, since noncorporate firms were not taxed. The real estate excise tax was established at the county level, with revenues dedicated to local schools. (Shifted to the state in 1981.)
1959	B&O taxes were extended to the rental of real property. Declared unconstitutional on grounds of double taxation.
More Income Tax Attempts	
1970	HJR 42, which included single-rate personal and corporate net income tax of 3.5%, with reductions in existing taxes, was defeated by a 2 to 1 margin by voters.
1973	HJR 37, which spoke to a graduated 2 to 6.5% personal and a 10% corporate net income tax, with limits and reductions in existing taxes, was defeated by voters by a 3 to 1 margin.
1975	Initiative 314, setting a corporate income tax rate of 12%, was defeated by a 2 to 1 margin by voters.
1982	Initiative 435, proposing a corporate new income tax on 105, was defeated by a 2 to 1 margin.

Property and Excise Tax Changes	
1966	Voters approved the 47th amendment to the constitution. It allowed property tax exemptions for retired and disabled homeowners, based on income.
1967	Hotel/motel tax established: allowed King County to receive 2.0% of the state and 4.5% sales tax on lodging facilities for its stadium construction.
1968	Voters approved the 53rd amendment, permitting property tax on open space, timber and farmland based on its current use rather than on highest and best use.
1970	Local sales tax of 0.5% authorized for cities and counties
1971	Local sales tax of 0.3% for transit districts authorized
1972	Voters approved constitutional amendment limiting regular property tax levies to 1.0% of fair market value. Timber excise tax was levied on stumpage value of the harvest. Economic assistance authority legislation established sales tax deferrals for manufacturing plant construction and equipment. (This program was terminated, due to the 1981-82 recession.)
1974	Limits on increasing regular levy revenues of local taxing districts was set at 6% per year, and extended the state levy in 1979. Credit against B&O taxes for personal property tax paid on business inventories was established, with a total exemption in 1984.
1975	Property tax levies shifted from millage to $/$1000. The statute set a maximum for regular levies of $9.15, including a new state levy of $3.60.
1977	Voters approved Initiative 345 exempting food for off-premise consumption from sales tax. The court decided that the state was to provide full funding of basic education; restriction on local maintenance and operations school levies.
1979	Voters approved Initiative 62 limiting increases in state expenditures to growth rate of personal income.
1981	Voters approved Initiative 402 repealing inheritance and gift taxes.
1982	Sales tax re-imposed on food for 14 months. Local option sales tax of 0.5% authorized for cities and counties. Tax on hotel/motel accommodations in King County approved, to fund convention center.
1984	Voters approved Initiative 464 that exempted the value of trade-ins from sales tax.

1985	Sales tax deferral program re-established for new/expanded manufacturing and Research & Development firms.
1987	US Supreme Court ruled B&O taxes on certain interstate transactions to be unconstitutional. Multiple activities exemption was repealed and credits provided for B&O taxes paid outside Washington for instate manufacturing against selling instate.
1983	The federal government remits to the state, a percentage of monies from the sales of timber and forest products from military installations. The revenue goes 50% to public schools, and 50% to public roads.
1984	Repealed the way state paid for upkeep of reforested land and replaced it with a surcharge on the reforested land. They are now subject to the Timber Excise Tax.
1993	Initiative 601 passed. This measure captured spending of revenue received by the state, also setting up a state emergency fund. This fund was restricted to a 2/3 positive vote by the legislature before it could be assessed. The spending portion was based on a projected population increase or decrease in the four years immediately preceding the spending of the revenue.
1994	Referendum 43 passed by voters, adding 7.5 cents to the cost of a package of cigarettes (a "sin" tax). The funds generated were to fight juvenile violence, and to create a match for federal funds.
1999	Voters overwhelmingly passed I-695, which removed the motor vehicle excise tax and lowered vehicle license fees to $30.00 per vehicle, with some exceptions. I-695 also provided that future taxes be approved by the voters.
2000	I-695 declared unconstitutional on grounds of multiple subjects included in initiative. Legislature passes law to keep the $30.00 per vehicle portion of the original initiative.
2000	Initiative 722 passed, which limited property tax growth to 2 percent a year and repealed some tax and fee increases.
2001	I-722 declared unconstitutional on grounds of multiple subjects included in initiative.
2001	Initiative 747 passed and limits a taxing district's revenue increase from property taxes to 1% annually.

History of Sales Tax Changes

Retail sales taxes are a relatively new concept that came with the development of the consumer society in the early 20th century. In Washington, the sales tax was adopted as part of the Revenue Act of 1935. The initial rate was 2.0 percent effective May 1, 1935 and it was limited to sales of personal property. Changes are made to this tax almost every year. Here are some highlights:

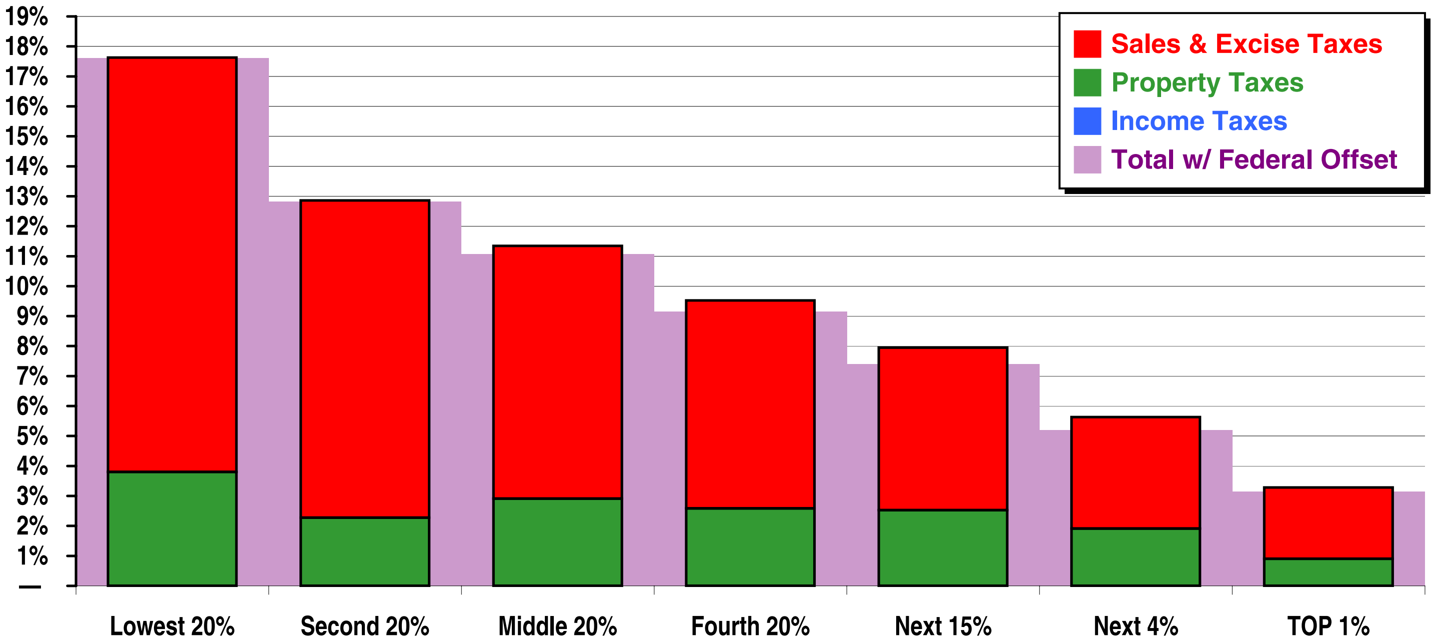
1939 - all food items and services to personal property became taxable.
1951 - tax extended to hotel and motel accommodations.
1961 - tax extended to amusement and recreation activities, parking of autos, title and escrow services.
1970 - initial local sales/use tax authorized.
1971 - state road construction is subject to tax.
1972 - sales tax deferral for certain manufacturing improvements.
1974 - prescription drugs exempted.
1977 - voters approve initiative exempting food for off-premises consumption, effective July 1, 1978.
1982 - tax temporarily reimposed on food for 14 months.
1983 - telephone service, except local residential and coin-operated, subject to tax.
1984 - voters approve initiative exempting trade-ins.
1985 - sales tax deferral for qualified improvements by manufacturing and R&D firms.
1993 - tax extended to landscape maintenance, tour operators, physical fitness and certain personal services such as health spas, massage (repealed in 1995), and tanning and dating services.
1994 - tax deferral for high technology businesses.
1995 - exemption for manufacturing machinery and equipment.
1997 - remittance for state sales tax paid on construction of certain large warehouse and distribution facilities and grain elevators.

Source: Washington State Department of Revenue, Tax Reference Manual, January 2002.

Washington

State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than $17,000	$17,000 – $31,000	$31,000 – $48,000	$48,000 – $75,000	$75,000 – $143,000	$143,000 – $922,000	$922,000 or more
Average Income in Group	$9,600	$23,200	$38,500	$60,000	$98,700	$225,100	$1,655,400
Sales & Excise Taxes	**13.8%**	**10.6%**	**8.4%**	**6.9%**	**5.4%**	**3.7%**	**2.4%**
General Sales—Individuals	4.9%	4.2%	3.5%	2.9%	2.3%	1.6%	0.9%
Other Sales & Excise—Ind.	4.1%	2.7%	2.0%	1.6%	1.2%	0.8%	0.4%
Sales & Excise on Business	4.8%	3.8%	3.0%	2.4%	1.9%	1.4%	1.1%
Property Taxes	**3.8%**	**2.3%**	**2.9%**	**2.6%**	**2.5%**	**1.9%**	**0.9%**
Property Taxes on Families	3.7%	2.2%	2.8%	2.5%	2.4%	1.6%	0.5%
Other Property Taxes	0.1%	0.1%	0.1%	0.1%	0.1%	0.3%	0.4%
Income Taxes	**—**	**—**	**—**	**—**	**—**	**—**	**—**
Personal Income Tax	—	—	—	—	—	—	—
Corporate Income Tax	—	—	—	—	—	—	—
TOTAL TAXES	**17.6%**	**12.9%**	**11.3%**	**9.5%**	**7.9%**	**5.6%**	**3.3%**
Federal Deduction Offset	–0.0%	–0.0%	–0.3%	–0.4%	–0.5%	–0.4%	–0.1%
TOTAL AFTER OFFSET	**17.6%**	**12.8%**	**11.1%**	**9.2%**	**7.4%**	**5.2%**	**3.1%**

Note: Table shows 2002 tax law at 2000 income levels.

Washington Tax Trends

Progressive Features

✔ None

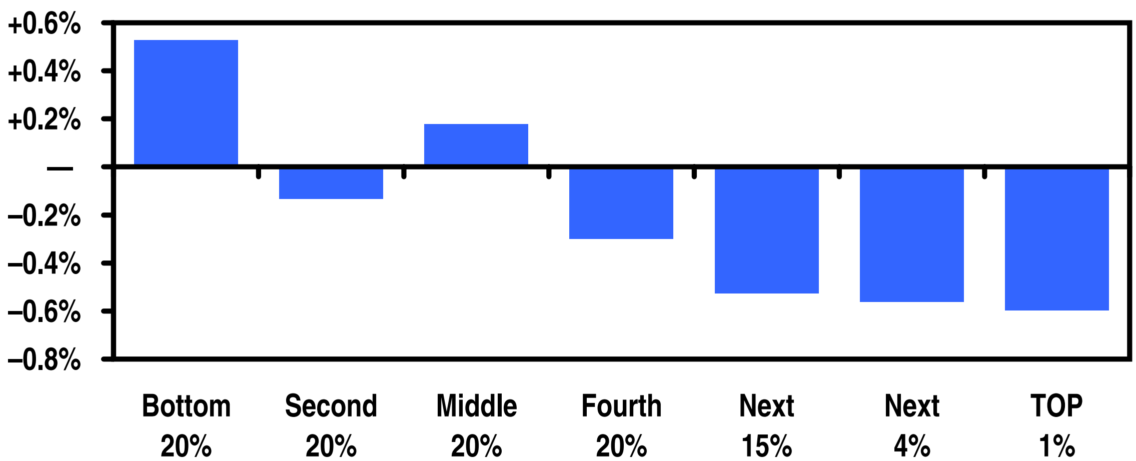
Regressive Features

✘ No income taxes

✘ High reliance on sales tax

✘ One of the highest cigarette taxes nationwide

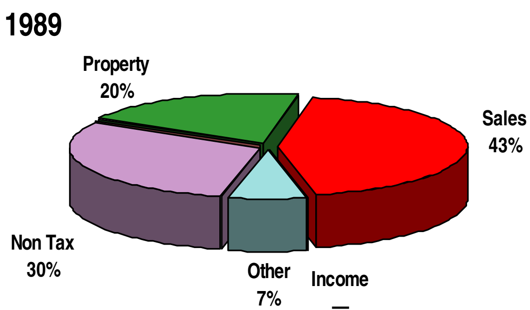
Changes in Taxes as Shares of Income, 1989 – 2002

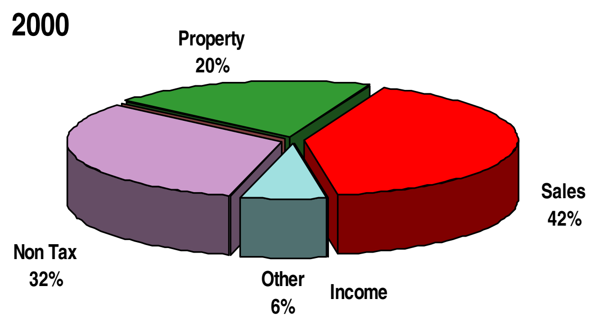


	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Sales & Excise	+0.0%	–0.3%	–0.3%	–0.2%	–0.2%	–0.2%	–0.1%
Property	+0.5%	+0.1%	+0.6%	+0.0%	–0.2%	–0.5%	–0.6%
Income	—	—	—	—	—	—	—
Federal Offset	+0.0%	–0.0%	–0.1%	–0.1%	–0.1%	+0.1%	+0.1%
Overall Change	+0.5%	–0.1%	+0.2%	–0.3%	–0.5%	–0.6%	–0.6%

Washington has increased its cigarette tax by $1.09 per pack since 1989. The repeal of the 2.2 percent vehicle license represented a slightly progressive, yet expensive, tax cut. Since the state has no income tax and consumption taxes are the major source of funding for government services, these changes collectively made the nation's most regressive tax system even more burdensome for the lowest income Washingtonians.

Composition of Revenues



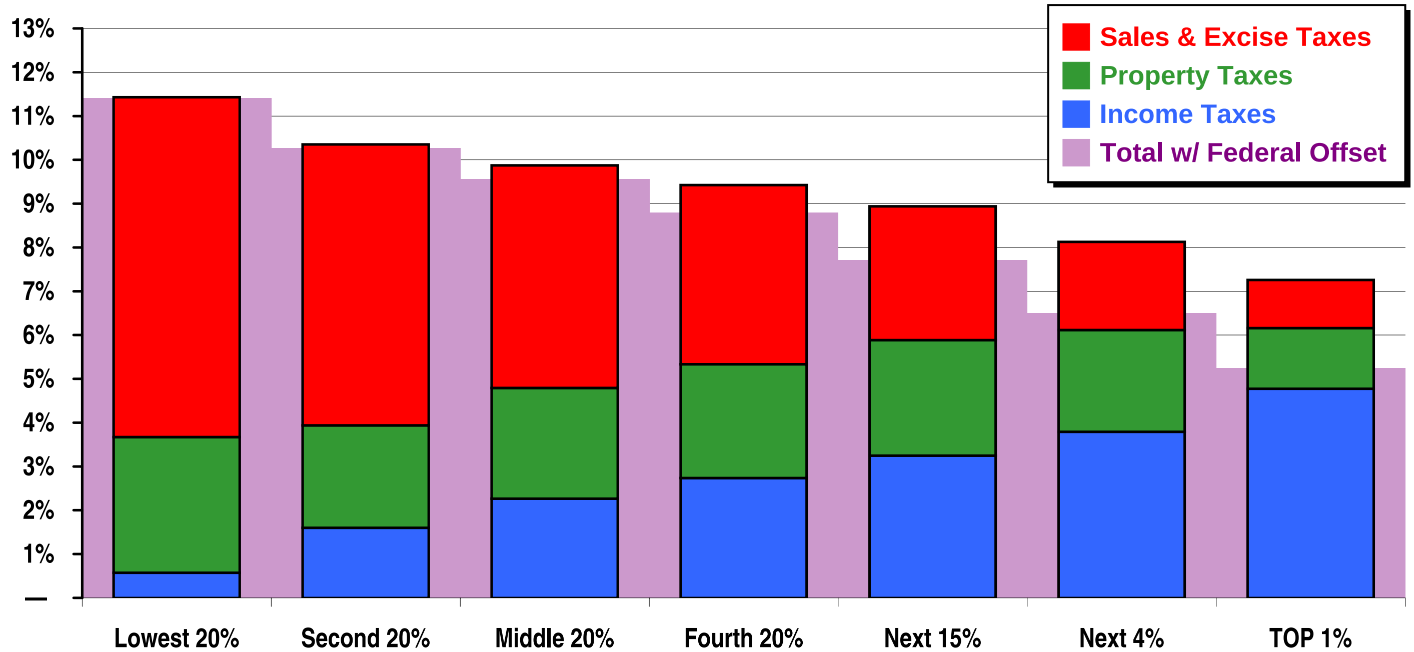


Source: Government Finances, US Department of Census

U.S. Averages

State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers

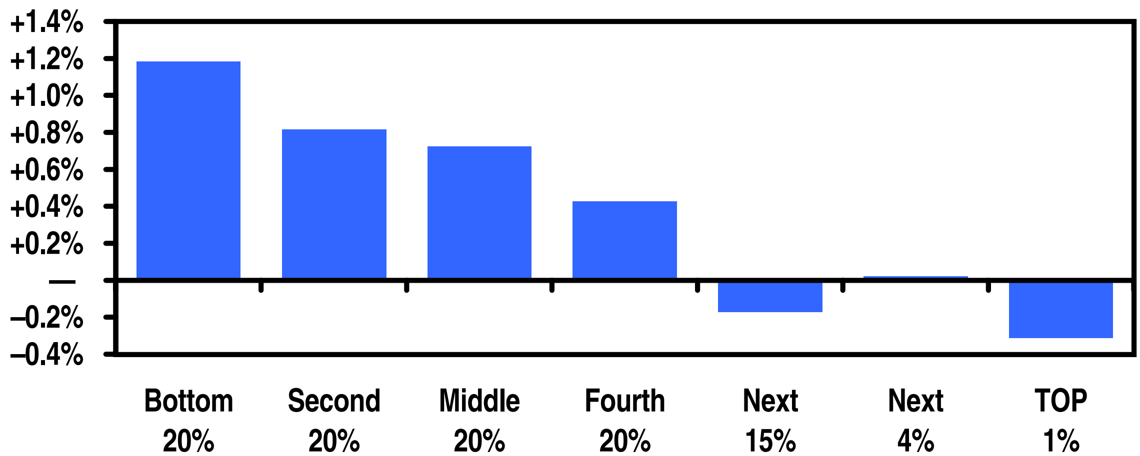


Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income Range	Less than $15,000	$15,000 – $25,000	$25,000 – $40,000	$40,000 – $69,000	$69,000 – $147,000	$147,000 – $304,000	$304,000 or more
Average Income in Group	$9,300	$19,700	$31,900	$52,500	$95,300	$202,300	$1,080,900
Sales & Excise Taxes	**7.8%**	**6.4%**	**5.1%**	**4.1%**	**3.1%**	**2.0%**	**1.1%**
General Sales—Individuals	3.6%	3.3%	2.7%	2.3%	1.8%	1.2%	0.6%
Other Sales & Excise—Ind.	1.9%	1.3%	0.9%	0.7%	0.5%	0.3%	0.1%
Sales & Excise on Business	2.3%	1.9%	1.4%	1.1%	0.8%	0.6%	0.4%
Property Taxes	**3.1%**	**2.3%**	**2.5%**	**2.6%**	**2.6%**	**2.3%**	**1.4%**
Property Taxes on Families	3.0%	2.2%	2.4%	2.4%	2.4%	2.0%	0.8%
Other Property Taxes	0.1%	0.1%	0.1%	0.2%	0.2%	0.3%	0.6%
Income Taxes	**0.6%**	**1.6%**	**2.3%**	**2.7%**	**3.2%**	**3.8%**	**4.8%**
Personal Income Tax	0.5%	1.6%	2.2%	2.7%	3.2%	3.7%	4.5%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%
TOTAL TAXES	**11.4%**	**10.4%**	**9.9%**	**9.4%**	**8.9%**	**8.1%**	**7.3%**
Federal Deduction Offset	–0.0%	–0.1%	–0.3%	–0.6%	–1.2%	–1.6%	–2.0%
TOTAL AFTER OFFSET	**11.4%**	**10.3%**	**9.6%**	**8.8%**	**7.7%**	**6.5%**	**5.2%**

Note: Table shows 2002 tax law at 2000 income levels.

U.S. Tax Trends

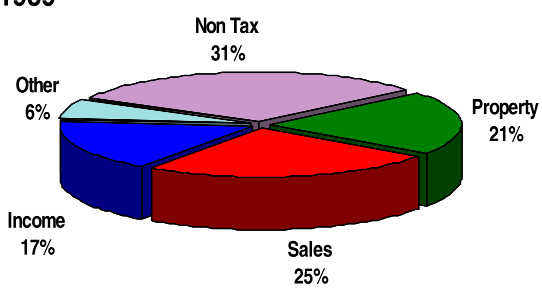
Changes in Taxes as Shares of Income, 1989 – 2002



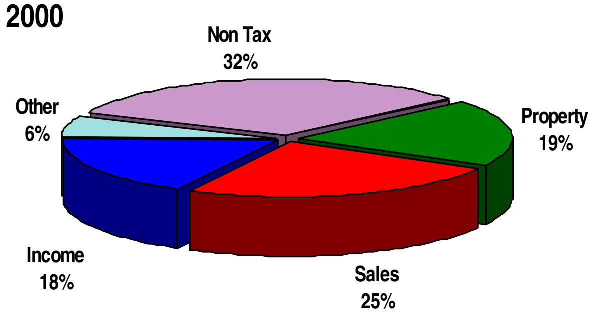
	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: TOP 1%
Sales & Excise	+0.8%	+0.5%	+0.4%	+0.3%	+0.2%	+0.1%	+0.0%
Property	+0.5%	+0.3%	+0.4%	+0.2%	–0.4%	–0.3%	–0.2%
Income	–0.1%	+0.0%	+0.1%	+0.2%	+0.2%	+0.4%	+0.5%
Federal Offset	–0.0%	–0.0%	–0.1%	–0.2%	–0.2%	–0.1%	–0.6%
Overall Change	+1.2%	+0.8%	+0.7%	+0.4%	–0.2%	+0.0%	–0.3%

Composition of Revenues

1989



2000



Source: Government Finances, US Department of Census

Comparison of State Cigarette and Gasoline Taxes, Rates Effective in July, 2004

State	Cigarette Tax $ Per Pack	State	Gasoline Tax ¢ Per Gallon
New Jersey [1]	2.40	Rhode Island [2]	31
Michigan	2.00	Wisconsin [2]	28.5
Rhode Island	1.71		
Connecticut	1.51	WASHINGTON	28
Massachusetts	1.51		
New York [1]	1.50	Montana	27
		Pennsylvania	26.2
WASHINGTON	1.425	Ohio	26
		Nebraska [2]	25.7
Hawaii	1.40	West Virginia [3]	25.35
Pennsylvania	1.35	Connecticut	25
Oregon	1.28	Idaho	25
Vermont	1.19	Maine	24.6
Arizona	1.18	North Carolina [2]	24.55
Alaska	1.00	Utah	24.5
Maine	1.00	Kansas	24
Maryland	1.00	Nevada [1]	24
Illinois [1]	0.98	Oregon [1]	24
New Mexico	0.91	Maryland	23.5
California	0.87	Delaware	23
Nevada	0.80	New York [3]	22.6
Kansas	0.79	Colorado	22
Wisconsin	0.77	South Dakota [1]	22
Montana	0.70	Arkansas	21.5
Utah	0.695	Tennessee [1]	21.4
Nebraska	0.64	Massachusetts [2]	21
Wyoming	0.60	North Dakota	21
Arkansas	0.59	Iowa	20.3
Idaho	0.57	Louisiana	20
Indiana	0.555	Minnesota	20
Delaware	0.55	Texas	20
Ohio	0.55	Vermont	20
West Virginia	0.55	Illinois[1][3]	19.8
South Dakota	0.53	New Hampshire	19.5
New Hampshire	0.52	Michigan [2][3]	19
Minnesota	0.48	New Mexico	18.9
North Dakota	0.44	Mississippi	18.4
Alabama [1]	0.425	Alabama [1]	18
Texas	0.41	Arizona	18
Georgia	0.37	California [1][3]	18
Iowa	0.36	Indiana [3]	18
Louisiana	0.36	Virginia [1]	17.5
Florida	0.339	Missouri	17.03
Oklahoma	0.23	Oklahoma	17
Colorado	0.20	Kentucky [2]	16.4
Tennessee [1]	0.20	Hawaii [1][3]	16
Mississippi	0.18	South Carolina	16
Missouri [1]	0.17	New Jersey	14.5
South Carolina	0.07	Florida [1][3]	14.3
North Carolina	0.05	Wyoming	14
Kentucky	0.03	Alaska	8
Virginia [1]	0.025	Georgia [3]	7.5 [4]

[1] Plus local taxes. [2] Variable rate based on fuel price, consumption or maintenance costs.
[3] Gasoline is also subject to retail sales tax. [4] Georgia = 7.5 cents/gallon, plus 3% of price.

Source: World Tax Database, Office of Tax Policy Research

The “Washington State Tax Study Update,” as well as an executive summary, is available for sale from the League of Women Voters of Washington. For ordering information, see the web site www.lwvwa.org or call 1-800-419-2596.