Washington State Tax Study Update

Executive Summary

An Examination of:

Washington State Tax History

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Relationship with Local Jurisdictions

Tax Alternatives

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League of Women Voters of Washington

Washington State Tax Study 2004

Executive Summary

The League of Women Voters of Washington created a tax committee with the charge to conduct a two-year project 1. to update the League's previous studies regarding the state tax structure and 2. to develop an educational campaign about taxes for use by the League membership and the general public. The purpose of this study is to stimulate discussion of the current tax structure of Washington State. The study provides readers with background knowledge to better evaluate tax reform proposals that are intended to achieve a more fair, adequate and transparent tax structure.

The following is a summary of the League study that can be found in its entirety at www.lwvwa.org.

The Study Update of 2004 provides a brief history of Washington taxes; a history of the League's involvement; a primer on Washington State budget basics including explanations about revenues and expenditures; basic taxes, relationships with local jurisdictions; legal considerations; and trends.

History of Washington Taxes

Pioneer Years

When Washington State was founded in the late 1800s, almost everyone worked the land. Nearly 100% of all tax revenue came from property taxes on agricultural land owned by mostly small farmers. There was also a poll tax (a flat fee per person) on all white males and an estate tax.

20th Century

As manufacturing grew in the early 1900s, more people moved to the cities and more services were needed. In the 1930s farmers, about 40% of the population, were paying nearly all the taxes. Consequently, there was a populist movement to shift the tax burden more equitably to the business sector, primarily manufacturing.

> …a graduated income tax was passed. The tax was immediately challenged …

To accomplish this, the legislature passed a graduated income tax. The tax was immediately challenged by the business community leading to a holding by the State Supreme Court that income was to be considered property. Therefore, a graduated tax was a violation of the state Constitution that required all like property to be taxed at a like rate. To meet the resulting gap in tax receipts needed to cover expenses, the legislature enacted new taxes including the Business & Occupations ("B&O") tax that taxed a business's gross receipts from sales; special excise taxes that taxed items such as alcohol, cigarettes and gasoline; and the sales tax on consumer goods.

As the state experienced economic upturns and downturns, various tax advisory committees were convened. In the 60s, school levies began to fail as concerns about property taxes grew. A large portion of the property taxes funds K-12 schools. 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 flat rate. Despite Gov. Evans' support, the legislature defeated the proposal in 1969.

In the prosperous1970s, cities and counties were allowed to impose sales taxes for local purposes and the sales tax on food was eliminated. The 70s also brought a citizens' initiative for a state constitutional amendment that set limits on property tax increases.

In the 1980s tax revenues fell. Once again there were calls for an income tax. Governor John Spellman rejected these proposals resulting in the legislature enacting large budget cuts and tax increases including hikes in the retail sales and B&O taxes.

In the prosperous 1990s, Governor Booth Gardner's Committee on Washington's Financial Future recommended an income tax that the legislature promptly rejected along with any provisions for a rainy day fund. The prosperous days of the 90s came to an end with the crash of the stock market in 2000. Tax revenues dropped dramatically.

The Current Situation

> … began to show a dissymmetry similar to the change of the '30's, and it resulted in a similar public outcry.

By the year 2000, there were even fewer people working the land (about 4%), the manufacturing sector had shrunk and the service sector comprised of businesses like software, insurance and financial capital had grown. The shift meant that the manufacturing sector (with the most taxable property) and the service sector (that was often exempted from taxation) began to show a dissymmetry similar to the change of the '30's, and it resulted in a similar public outcry.

In 2001 the Legislature created and funded the Washington State Tax Structure Committee (often referred to as the "Gates" study after its chair Wm. Gates, Sr.) to study and recommend changes to the tax structure. Ideas being discussed include a reduction of the property, sales and B&O taxes and, once again, an income tax.

History of the League's 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. League studies on taxation include:

1. *The Tax Primer*, 1957, produced a position favoring an income tax on individuals and businesses and a repeal of the sales tax on food.
2. *The Basic Tax System,* 1992, produced the resolve to oppose Initiatives 601 and 602 limiting the legislature's ability to impose taxes to support programs.
3. *The Washington State Tax Study Update,* 2004, (the study this paper summarizes).

(All these studies can be found at www.lwvwa.org)

Throughout this time, the League has continued to update and expand its positions with studies on topics like property taxes, assessments, and county tax and revenue systems. Since 1953, the League has consistently supported various progressive tax proposals based on a person's ability to pay.

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Tax Criteria

There are a number of generally accepted criteria for evaluating a tax system. The first six criteria were listed both in the Gates study and previous League studies. The seventh was a League criterion. It is worthwhile to consider these as you read through the descriptions of Washington State taxes. (For an assessment by the League tax committee, see the full study at www.lwvwa.org.)

1. <u>Adequacy</u>. Do tax revenues keep up with normal growth in public services as the state's population and economy expand?
2. <u>Stability:</u> Can the tax system provide the revenues necessary to maintain public services during upturns and downturns in economic activity?
3. <u>Equity and Fairness</u>: Is the tax burden distributed fairly? Are the taxes paid by individuals and businesses related to the ability to pay and related to the benefits received?

4. Economic Vitality and Harmony: Does the tax system place businesses at a competitive disadvantage compared to other states? An educated healthy workforce and good roads are examples of competitive advantages. Onerous tax rates would be a disadvantage.
5. Economic Neutrality and Efficiency: Do businesses or consumers make decisions based upon economic advantages rather than tax advantages? (For example, do consumers buy from catalogs and internet to avoid the sales tax?)
6. Transparency: Is it clear to taxpayers how much they are paying?
7. Safeguards: Are there proper safeguards and limits to raising money without the taxpayers' approval and are there protections against uncontrolled spending?

Washington State Budget Basics

Expenditures

In the 2003–05 biennium, the state of Washington will spend a total of $52.2 billion. The money is distributed in three different budgets:

1. Transportation budget that includes roads and mass transit -- 9%, $4.8 billion
2. Capital budget that includes buildings.-- 5%, $2.6 billion
3. Operating budget covering the day-to-day operations of government -- 86%, $44.8 billion

The Operating budget is comprised of

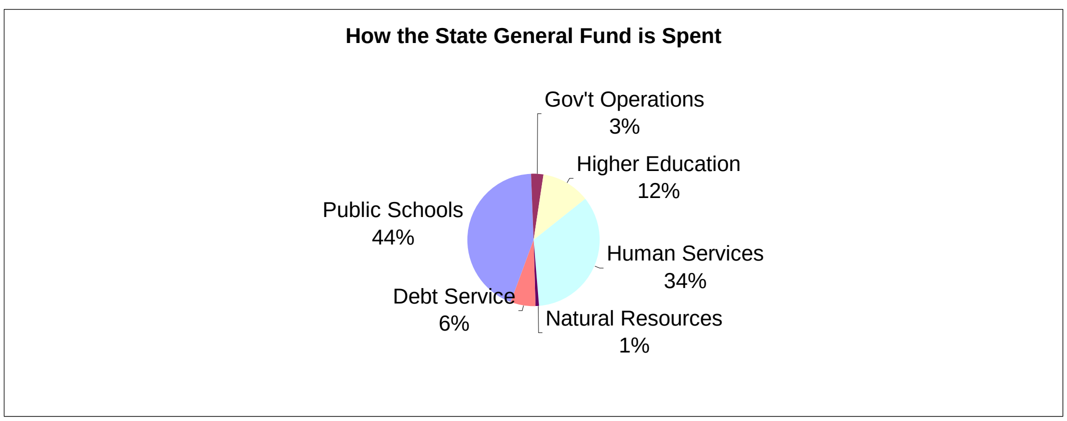
1. Dedicated funds that include Federal funds such as gasoline taxes for transportation purposes and Federal grants for Medicaid.

2. General Fund (GF-S) is $22.8 billion. It is the main source of support covering the operation of state government and where all state tax monies go.

GENERAL FUND

Expenditures

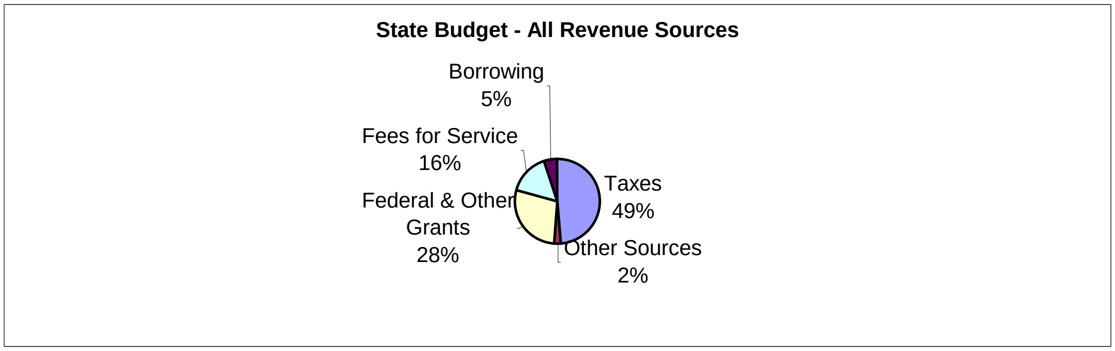
How the money is spent.



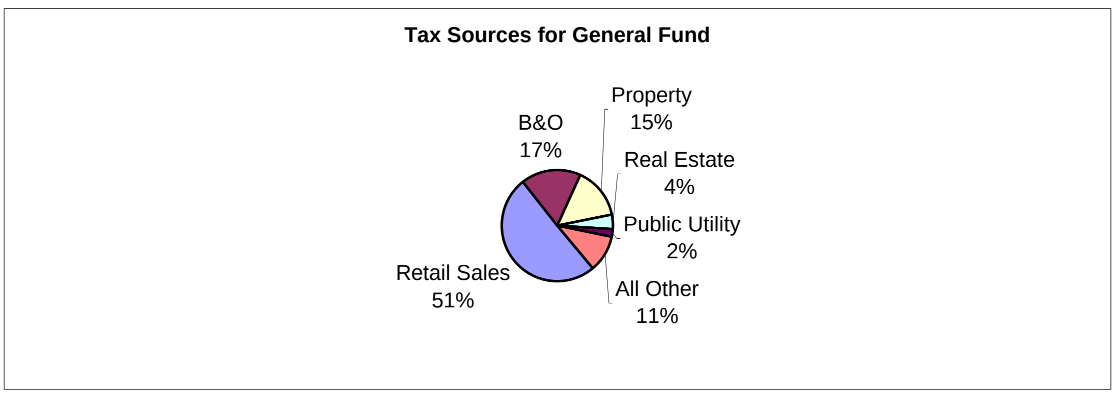
Public schools include K-12 for more than 1 million students. Human Services include the Department of Social and Health Services (DSHS), the Dept. of Corrections, and the Department of Health. Higher Education includes funding for 6 public universities, 34 community colleges, and technical schools and financial aid for about 294,000 students. Natural Resources include the Department of Natural Resources, the Department of Ecology and the Department of Agriculture, Fish and Wildlife.

Revenues
Where do the monies come from for the State?

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, and 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:



All tax revenues for the state are deposited in the General Fund. The three largest sources of taxes are the retail sales tax, the Business and Occupation tax, and the property tax.



Retail Sales Tax

Retail sales taxes are added to the selling price of most goods sold for consumption e.g., clothing, movies, cars, manufacturing inputs, construction. Some services like haircuts and dry cleaning are taxed and some services like lawyers and stockbroker fees are excluded. Food and prescription drugs are currently exempt. The tax rate levied by the state is 6.5%. Local jurisdictions are authorized to add local sales taxes not to exceed an additional 3.1%. The current top state and local combined rate is 8.9%. The taxes are collected for a variety of purposes by cities, counties and special districts.

Features:

- People see small amounts going out for each purchase and are not aware of the aggregate amount they pay.
- It is one of the few ways to obtain tax money from nonresidents.
- It is regressive in nature meaning everyone pays the same amount regardless of ability to pay.

- It is not a stable source of funds because in economic downturns, people consume less.
- It motivates people to buy in regions with less sales tax like Oregon or Skagit County.

Comparisons with Other States: Washington's per capita average sales tax, $1513 per year, is the highest in the nation. Washington has the highest reliance on the retail sales tax as a funding source as well. (Yr 2000 data)

Business & Occupation Tax

The B&O tax is a tax on the gross receipts of a business, unrelated to any profit. It is levied on all business conducted within the state except utility activities, agricultural products, rental of real estate, and investment income earned by businesses other than financial institutions. Although the rates are low, with such a large base the tax raises a considerable amount of revenue. In fiscal year 2002 it generated nearly $2 billion, covering about 17% of the General Fund tax revenues. In addition to the state, some cities assess a B&O tax.

Features:

- The tax assures that all businesses, even unprofitable ones, contribute something for the government services they use.
- It treats corporate and non-corporate businesses alike.
- It imposes a heavy burden on startup firms and those with low profit margins.
- It is charged on the total value of goods multiple times as the goods move through the production chain on the way to the consumer.
- It has more exemptions than any other area of taxation.

Comparisons with Other States: No other state government has a tax on gross receipts. Forty-five states impose a traditional corporate net income tax similar to the Federal corporate income tax.

Other Excise Taxes

An excise tax is generally a tax on transactions. In addition to the two major excise taxes, the sales and B&O, there are many minor ones that focus on particular goods and services. These include the so-called "sin taxes" on tobacco and alcoholic beverages, gasoline, utility, and real estate transfers. When more tax revenue is sought, special excise taxes are frequently the easiest to pass.

Features:

- Some people feel excise taxes can achieve social goals such as lowering consumption of alcohol.
- Consumers can avoid taxes by avoiding consumption.
- Taxes are paid by non-residents as well as residents.
- These taxes are regressive -- everyone pays the same dollar amount regardless of wealth.
- Taxes on necessities such as utilities and gasoline impose a much heavier burden on the poor.

Comparisons with Other States: Washington cigarette, alcohol, and gasoline taxes are among the highest in the country.

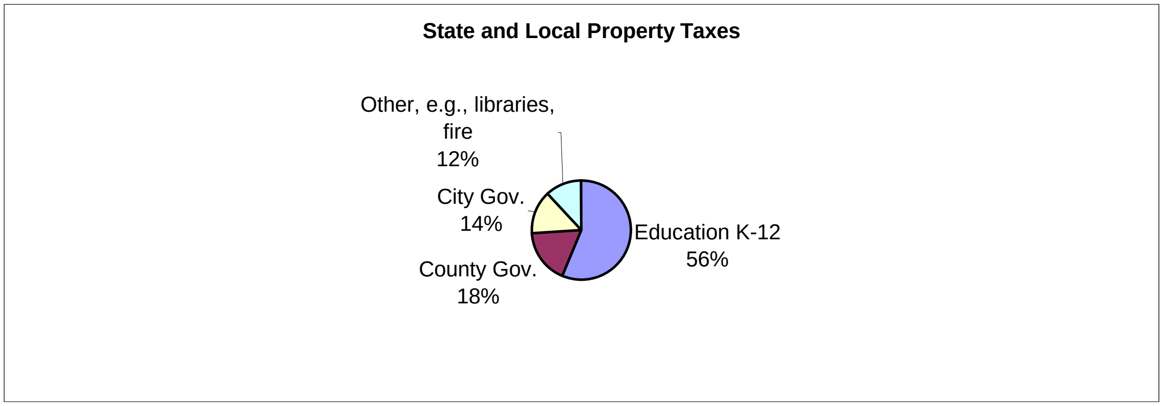
Property Tax

Property taxes are levied by the state, counties, cities and many local jurisdictions like ports and schools on the value of real property (land and buildings) and personal property (moveable items like business equipment) owned by individuals and businesses. Property taxes collected by all the jurisdictions in Washington State totaled $5.412 billion in the year 2000. Of the total taxes collected by all taxing authorities ($14.886 billion), property taxes contributed 30% and sales taxes contributed 50%.

The statewide average property tax was $13.53 per $1000 of assessed value in 2000. Commercial property contributed 42% of the total property taxes paid and residences contributed 58%. In 1991 commercial property contributed 48% and households 52% showing a trend for homeowners to pick up an increasing share.

How the money is spent

Public education K-12 schools receive 56% of the monies collected from property taxes. The rest goes into the general funds budgets for cities and counties and other taxing jurisdictions like libraries, emergency medical, and ports.



Property Assessment

Property tax bills are determined by taking the assessed valuation of property (determined by the county tax assessor based on the market value) and multiplying it by the tax rates that are fixed by the various taxing jurisdictions. There are many taxing jurisdictions in addition to the state, county and city governments. These include ports, schools, roads and fire departments.

Regular and Excess Levies: The regular taxes levied against property are now limited in the amount by which they may increase each year. In 1972, voters amended the state constitution to establish a 1% limit on regular property levies. The provision requires that the aggregate of all tax levies upon real and personal property shall not exceed one percent of the true fair value of that property annually.

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%.

In addition to the 1% of value limitation for regular levies, 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 in that each parcel gets an itemized bill each year. 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 (25 states have higher property taxes) when measuring property taxes as a share of state and local taxes and fees and 16th when measuring on a per capita basis which is calculated by taking the total property taxes paid divided by the total population.

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 (permission to pay later). The effect of such tax relief in the 2003-2005 biennium is an estimated $64.7 billion.

Tax exemptions are growing. In 1997 there were more new exemption statutes adopted than in any other year since 1935. Between 1998 and 2000, thirty-one new exemption statutes were adopted, plus broadening of others. In 2002-04, fifty-five tax exemptions, most in the form of business incentives, were added or extended.

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. Once tax exemptions are enacted into law they tend to be permanent, even if the policy reason disappears.

Relationships with Local Jurisdictions

Cities and counties, and special purpose taxing districts such as the ports, derive their power to act and to raise the revenue needed to carry out their functions from the state. Consequently, changes in the state tax structure will have effects on the local jurisdictions. Small cities can be particularly impacted. Anti-tax initiatives like I-695, the motor vehicle license tax repeal, 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 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 taxes by 60% affirmative vote.

The full report of the 2004 updated study, available on the League web site at www.lwvwa.org sets out examples of the different shares of local taxes in different locations within the state.

Legal Considerations

Washington State Constitutional Restrictions

Article VII, Section 1 of the state constitution 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 (and so invalidated the initiative that had passed with over 70% of the vote) is *Culliton v. Chase,* 174 Wash. 363, 289 P2d 81 (1933), which held that income was property, and therefore could not be taxed at different rates. The courts in the late '20's and early '30's made some rulings to that effect which have since been overruled in all but Washington and Pennsylvania, neither of which seems to have challenged the early cases.

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 residents 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 U.S. 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.

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.

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 which is often pledged to repay for highways. 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.

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 from the use of the initiative process on the legislature's ability to balance budgets; 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.

Three developments in particular have had or will have a significant impact on Washington state's financial equilibrium

Initiative and Referendum

A succession of initiatives in recent years has reflected the public dissatisfaction with the current tax system. Examples of recent initiatives include I-695, the Elimination of Motor Vehicle Excise Tax and I-747, Limitation on Property Taxes.

Often the initiative process does not lend itself to comprehensive analysis of all parts of the budget. This will make it exceedingly difficult for Washington's legislature to develop a comprehensive 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 by the Growth Management Act. 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 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. Rates vary among jurisdictions.

Impact fees have a potential for decreasing local property taxes and bond measures and reduce the "growth penalty" which causes taxes to be higher in growing communities compared to those in places that remain more stable.

Remote Sales

As more consumers have acquired computers in the home, there has been a switch from store purchases to internet shopping, allowing Washington residents to avoid the sales tax on the purchases. (The alternate Use Tax is practically unenforceable.)

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

In Conclusion

The LWVWA Tax Committee hopes that the 2004 study will stimulate consideration and discussion of the tax structure of Washington as it exists in today's economic and social environment. This summary of the report is being distributed to all League members in the state and is available to the public, along with the full report, on the state League website www.lwvwa.org.

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.)

Discussion Questions

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

LEAGUE OF WOMEN VOTERS OF WASHINGTON
EDUCATION FUND

The full “Washington State Tax Study Update,” as well as this 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.