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Washington State and Local Tax System Dysfunction and Reform

Remarks by Dick Conway
Seattle City Council
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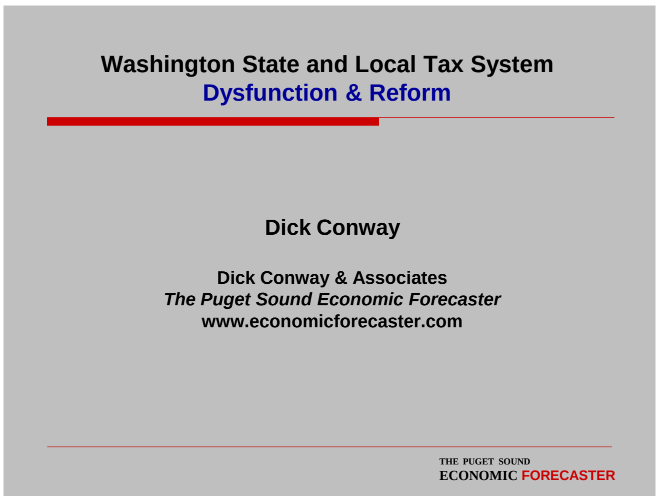


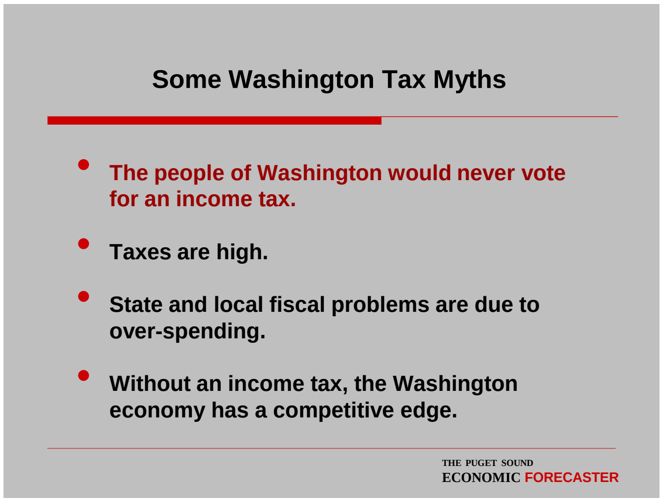
Thank you for the opportunity to talk about tax reform, which arguably is the most important economic issue facing Washington today. I would like to summarize the findings of a study that I completed last November, “Washington State and Local Tax System: Dysfunction and Reform.”

For the sake of brevity and clarity, I will read my remarks.

As a member of the Washington State Tax Structure Study Committee (the Gates Committee), I focused on the question of how much state and local governments should tax. During the course of my committee work, I began to realize that our tax system is built in part on myths. By that I mean beliefs about the tax system that have no basis in fact.

Tax myths. Here are four commonly heard myths. (1) The people of Washington would never vote for an income tax. (2) Taxes are high. (3) State and local fiscal problems are due to over-spending. (4) Without an income tax, the Washington economy has a competitive edge.

I will touch on these myths in my talk, but I would like to elaborate on the first one—we would never vote for an income tax. In 1932, 70 percent of Washington voters passed an initiative for a progressive income tax. When the business community objected, the Washington Supreme



Court ruled in a 5-4 decision that the progressive income tax was "an unconstitutional non-uniform property tax." Think about that. If the initiative had proposed a flat-rate income tax or if one more judge had thought that an income tax was not a property tax, we would have an income tax today.

Report card. Let me begin with my report card on Washington's tax system. I analyzed what I considered to be the five most important characteristics of a state and local tax system: fairness, adequacy, stability, transparency, and economic vitality. I compared our tax system with all other states and the District of Columbia, thereby obtaining Washington's rank among the states with regard to each characteristic.

Before discussing in greater depth the issues of fairness, adequacy, and economic vitality, let me quickly summarize the findings of the study.

Fairness. Washington's sales-based tax system is the most regressive in the nation. The Washington tax system ranks fifty-first in terms of fairness and therefore earns a grade of F.

Adequacy. This is the ability of a tax system to generate sufficient revenue to meet the public needs of a growing economy. It is measured by the state and local effective tax rate (total state and local taxes as a percent of personal income). Since FY 1995, only one other state has experienced a greater decline in its effective tax rate than Washington. Another F.

Stability. This refers to the stability of the state and local effective tax rate. In other words, do fluctuations in the effective tax rate exacerbate the swings in tax revenue caused by economic cycles? Washington has a highly unstable tax system due to the inadequacy and volatility of its large sales tax base. In terms of stability, it ranked forty-seventh between FY 1995 and FY 2011. F.

Characteristics of Tax Systems

	Washington Grade
FAIRNESS	F (51)
ADEQUACY	F (50)
Stability	F (47)
Transparency	F (50)
ECONOMIC VITALITY	No grade

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Transparency. Every household and business should know how much it pays in taxes. Transparency is a prerequisite for rational tax policy. Individual income taxes are transparent, but sales taxes are only partially transparent since few of us keep track of our total tax payments. Without an income tax, Washington has the second least transparent tax system in the nation. Yet another F.

Economic vitality. The issue in this case is whether the lack of an income tax gives the Washington economy a competitive advantage. Statistics show that it does not matter one way or the other. Thus, I give no grade for economic vitality.

The findings indicate that Washington has the worst tax system in the nation. Compared to other tax systems, Washington ranks at or near the bottom in terms of fairness, adequacy, stability, and transparency.

Let's take a closer look at fairness, adequacy, and economic vitality.

Fairness. Regressive tax systems have relatively high tax rates for low-income households, while progressive tax systems have relatively high tax rates for high-income households.

In an understatement, the Washington State Tax Structure Study Committee concluded that Washington has a regressive tax system. The committee found that in 1999 the state's lowest-income households paid 15.7 percent of their income on state and local taxes, which the highest-income houses paid just 4.4 percent.

Reflecting what is in fact the extreme regressivity of the Washington state and local tax system, the lowest-income households had to work 8.2 weeks out of the year to pay their state and local tax bill, while the highest-income households had to work only 2.3 weeks.

Washington State and Local
Tax Burden on Households, 1999
Percent of Household Income

Income	Retail Sales Tax	Other Excise Tax	Property Tax	Total Tax
$20,000 and under	6.7	3.2	5.8	15.7
$20,000-30,000	4.4	1.9	3.5	9.8
$30,000-40,000	4.0	1.6	3.9	9.4
$40,000-50,000	3.7	1.4	3.2	8.3
$50,000-60,000	3.7	1.3	3.2	8.2
$60,000-70,000	3.5	1.2	3.1	7.7
$70,000-80,000	3.3	1.0	3.1	7.4
$80,000-100,000	3.2	0.9	2.7	6.8
$100,000-130,000	2.9	0.7	2.5	6.0
$130,000 and over	2.2	0.4	1.8	4.4

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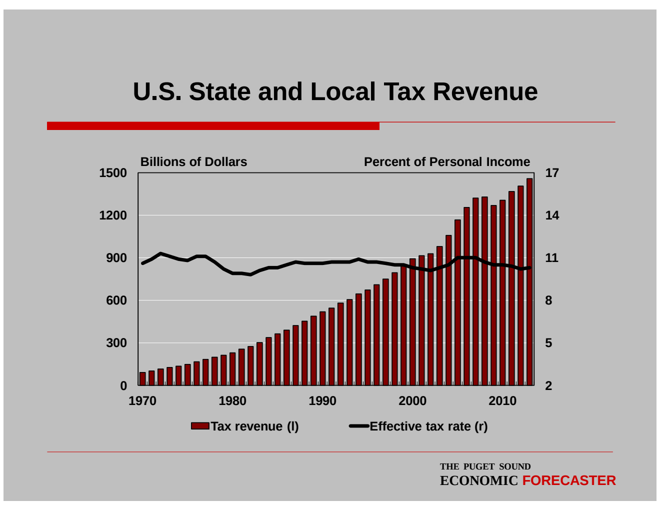
This finding was echoed in a 2013 study of all states by the Institute of Taxation & Economic Policy (ITEP). ITEP determined that the tax burden of the 20 percent of Washington households with the lowest incomes was 16.9 percent of income. Illinois ranked a distant second with a 13.8 percent tax burden. Thus, ITEP concluded that Washington's sales-based tax system was by far the most unfair in the nation.

Adequacy. If tax revenue fails to keep up with the demand for public goods and services—if the tax system is inadequate—it becomes necessary to increase tax rates or broaden the tax base. In a sales-based tax system like Washington's, this makes the tax system even more unfair.



Adequacy raises the question—how much should state and local governments tax? Nationally, state and local tax revenue as a percent of personal income (the state and local effective tax rate) has averaged 10.6 percent and been quite stable since 1970. The effective tax rate has tended to rise during economic booms and fall during economic busts, but in general it has moved sideways for more than forty years.

Not all states tax at the 10.6 percent norm. States with high per capita incomes tend to have high effective tax rates, while states with low per capita incomes tend to have low effective tax rates. In FY 2012, for example, Connecticut had the nation's highest per capita income (36.3 percent above average) and the fifth highest effective tax rate (11.9 percent). In contrast, Idaho had the third lowest per capita income (20.5 percent below average) and the eleventh lowest effective tax rate (8.9 percent). Thus, Idaho's per capita tax revenue was 31.2 percent below the U.S. average and 56.2 percent below Connecticut's. Not surprisingly, Idaho ranked forty-fifth nationally in elementary and secondary school spending per $1,000 of personal income in FY 2012.

Washington and U.S. State and Local Effective Tax Rate, FY 1995-FY 2012
Percent of Personal Income

	Washington	Rank	United States
FY 1995	11.4	12	10.8
FY 2000	9.9	38	10.5
FY 2005	9.8	38	10.6
FY 2006	10.2	34	10.9
FY 2007	10.4	30	11.0
FY 2008	10.0	34	10.8
FY 2009	9.5	37	10.5
FY 2010	9.6	37	10.5
FY 2011	9.8	36	10.5
FY 2012	9.4	37	10.3

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So, how does Washington's state and local effective tax rate stack up? Not good—we are beginning to look like Idaho. Reflecting the gross inadequacy of the tax system, the Washington state and local effective tax rate fell from 11.4 percent (the twelfth highest in the nation) in FY 1995 to 9.4 percent (the thirty-seventh highest) in FY 2012. Only South Dakota experienced a greater fall-off. As a consequence, Washington ranked forty-sixth in the nation—one place behind Idaho—in elementary and secondary school spending per $1,000 of income in FY 2012.

Washington State and Local Tax Revenue, FY 2005-FY 2012
Billions of Dollars

	Personal Income	Tax Revenue (actual)	Tax Revenue (10.6% rate)	Revenue Difference
FY 2005	233.4	23.0	24.7	-1.7
FY 2006	245.8	25.1	26.1	-1.0
FY 2007	265.3	27.5	28.1	-0.6
FY 2008	285.7	28.6	30.3	-1.7
FY 2009	286.3	27.2	30.3	-3.1
FY 2010	281.9	27.1	29.9	-2.8
FY 2011	295.1	28.8	31.3	-2.5
FY 2012	313.6	29.4	33.2	-3.8
Total	---	216.7	233.9	-17.2

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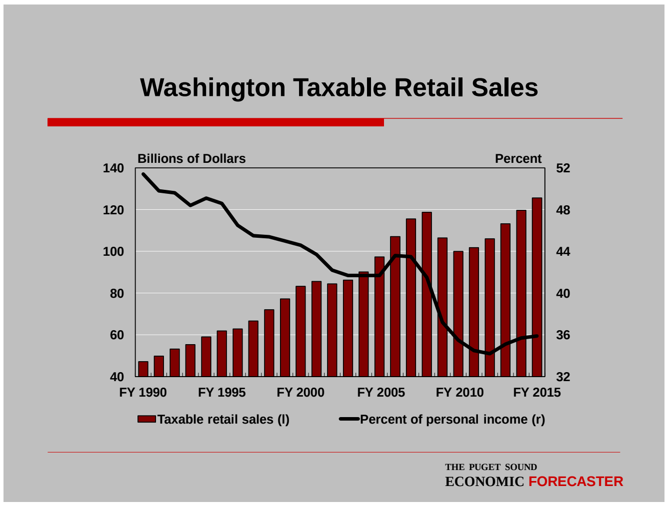
It is possible to assign a dollar figure to the inadequacy of our state and local tax system. If the Washington state and local effective tax rate had equaled the 10.6 percent national norm from FY 2005 to FY 2012, state and local governments would have collected an additional $17.2 billion in tax revenue. That would have been sufficient to pay for the new 520 bridge, the Alaska Way Viaduct replacement, and the Washington Supreme Court-ordered basic education funding requirement. By the end of FY 2015, the forfeited tax revenue will climb to an estimated $28.4 billion.



Inadequacy is not an intermittent problem of the sales-based Washington state and local tax system; it is a permanent fixture. Taxable retail sales, the state's biggest source of tax revenue, more than doubled between FY 1990 and FY 2012, increasing from $47.2 billion to $106.0 billion. As a percent of Washington personal income, however, taxable retail sales plunged from 51.4 percent to 34.2 percent. If taxable retail sales had been an adequate tax base—had remained at 51.4 percent of personal income—it would have totaled $159.3 billion in FY 2012 and would have yielded an additional $3.5 billion in sales taxes for state government alone.

Washington State and Local Tax Revenue, FY 1995-FY 2025
Billions of Dollars

	Tax Revenue	Personal Income	Effective Tax Rate (%)
FY 1995	14.8	129.8	11.4
FY 2000	18.7	189.6	9.9
FY 2005	23.0	233.4	9.8
FY 2010	27.1	281.9	9.6
FY 2015	32.6	350.3	9.3
FY 2020	39.0	447.1	8.7
FY 2025	46.6	570.6	8.2

Note: Forecast assumes no change to tax rates or tax base.

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Forecasts from a model of the Washington economy and tax system indicate that, without legislative changes to the tax rates or the tax base—including no change to the restriction limiting the annual increase in property taxes to one percent plus taxes on new property—the state and local effective tax rate will decline to 9.3 percent in FY 2015 and 8.2 percent in FY 2025. In ten years, Washington could have the lowest effective tax rate in the nation.

Economic vitality. In 2013, the Tax Foundation rated Washington as having the sixth best business tax climate. The foundation contends that the lack of an income tax gives Washington and the other five top-rated states an advantage in attracting businesses and jobs.

But it is not clear that Washington belongs to this group. Four of the states have major alternative sources of tax revenue—severance taxes from resource extraction (Wyoming and Alaska) and tourist-related taxes (Nevada and Florida). These states simply do not need an income tax. In contrast, Washington must rely on its regressive and inadequate sales tax base to generate its required tax revenue.

Business Tax Climate and Employment Change

Rank	State	1970-12 Employment Change (thous.)	Percent of U.S. Employment Change
---	United States	60,632.0	100.0
1	Wyoming	168.7	0.3
2	South Dakota	221.3	0.4
3	Nevada	954.5	1.6
4	Alaska	230.6	0.4
5	Florida	5,219.2	8.6
6	Washington	1,807.6	3.0
47	Rhode Island	79.5	0.1
48	Vermont	143.8	0.2
49	California	7,550.4	12.5
50	New Jersey	1,150.6	1.9
51	New York	1,382.0	2.3

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Moreover, in spite of having the best business tax climate in the nation, there is no evidence that it has done the Wyoming economy much good. Between 1970 and 2012, it added only 168,700 wage and salary jobs, just 0.3 percent of the total gain nationally. Moreover, one-half to two-thirds of these jobs were related directly or indirectly to mining activity.

Indeed, a statistical test shows no correlation (0.001) between the business tax climate of a state and its ability to generate jobs. For example, with the third worst business tax climate, California created 7,550,400 wage and salary jobs—one out of every eight jobs in the nation—between 1970 and 2012

The contention that the lack of an income tax gives the Washington economy a competitive advantage is contradicted by the long-term growth of the Washington and Oregon economies. With fundamentally different tax systems—Washington has no income tax, while Oregon has an

Washington and Oregon Economic Growth, 1970-2010

	1970	2010	Annual Change (%)
Washington			
Employment (thous.)	1,282.1	2,998.3	2.1
Personal income (bils. $)	14.3	286.7	7.8
Per capita income ($)	4,189	42,521	6.0
Population (thous.)	3,417.4	6,743.6	1.7
Oregon			
Employment (thous.)	767.7	1,677.9	2.0
Personal income (bils. $)	8.2	137.7	7.3
Per capita income ($)	3,927	35,869	5.7
Population (thous.)	2,100.4	3,838.2	1.5

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income tax but no sales tax or business and occupation tax—the two economies have performed equally well over time. Since 1970 the Washington and Oregon annual employment growth rates have averaged 2.1 percent and 2.0 percent, respectively. Washington has enjoyed somewhat faster nominal personal income growth, but that is largely due to the emergence of Microsoft and a higher inflation rate.

Single-rate personal income tax. When I began this study, I knew that our tax system was dysfunctional. But I did not realize I would conclude that it was the worst in the nation. I also had no intention of recommending an alternative tax system. But the analysis led directly to a single-rate personal income tax.

Single-Rate Personal Income Tax, FY2012
Billions of Dollars

	Income Tax System		Current Tax System	
	Tax Revenue	Effective Tax Rate (%)	Tax Revenue	Effective Tax Rate (%)
Tax revenue	33.2	10.6	29.4	9.4
Income	33.2	10.6	0	0
Individual	33.2	10.6	0	0
Corporate	0	0	0	0
Sales and gross receipts	0	0	20.2	6.4
General sales	0	0	9.7	3.1
Business and occupation	0	0	3.4	1.1
Other excise	0	0	7.1	2.3
Property	0	0	9.2	2.9

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Consider the advantages of a single-rate personal income tax:

Simplicity. A single-rate income tax is the simplest tax system possible, making it easy to understand and apply.

Fairness. A single-rate income tax is neither regressive nor progressive. On the other hand, ITEP has found that all state and local tax systems in the United States are regressive, since the regressivity of sales and property taxes dominates the progressivity of income taxes. Thus, a flat-rate income tax would not only eliminate the regressivity of the Washington state and local tax system, it would also constitute the fairest tax system in the nation.

Adequacy. Adopting a specific target for Washington's state and local effective tax rate, such as the 10.6 percent national norm, would ensure adequate tax revenue and a reasonable tax rate. There would be no need for future changes to the tax rate or tax base. Importantly, there would be no need for a sales tax, a property tax, a business and occupation tax, or any other tax.

Stability. With a constant effective tax rate, the tax system would be perfectly stable. Tax revenues would fluctuate but only because of the cyclical changes in personal income.

Transparency. Unlike the sales tax, the personal income tax would be totally transparent.

Economic vitality. There is no statistical evidence suggesting that the implementation of an income tax would impair economic vitality. On the other hand, if the absence of an income tax results in grossly inadequate tax revenue—Washington's fiscal bind for the last fifteen years—it will eventually endanger the health of the economy.

Conclusion. There is no good reason why Washington has to live with its dysfunctional state and local tax system. Indeed, if the state adopted a flat-rate personal income tax with a preferred rate of 10.6 percent, it could have the best—not the worst—tax system in the nation.

There is one hitch. Since Washington is currently taxing well below the norm, the 10.6 percent rate implies an increase in taxes, though not for everyone. Low-income households would pay less, middle-income households would pay about the same, and high-income households would pay more.

No doubt critics would object to an income-based tax system, arguing that it would hinder economic growth, despite evidence to the contrary. But the findings of this study suggest that the concern over an income tax is not only unfounded but also misdirected. Since 2000 the chief internal threat to the Washington economy has been the inadequacy of its sales-based tax system. Without major tax reform or substantial increases in taxes, the latter aggravating the regressivity of the current tax system, Washington's schools, highways, public transportation, parks, police and fire departments, public health operations, and environment face a bleak future. Such a deterioration in the public sector due to the lack of an income tax would hardly be conducive to long-run economic growth and welfare.