Tax Policy In Washington State

by Richard S. Davis

We asked one of our state's premiere research analysts, Dick Davis, to provide a section for this report on Washington State tax policy. Mr. Davis is the president of the Washington Research Council and an expert in this field. We appreciate his contribution.

General Overview of System

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Washington's basic tax structure was established in the 1930's and has remained relatively unchanged for six decades. Despite periodic, unsuccessful efforts at major tax reform, the state has no personal or corporate income tax. In general, the overall state and local tax burden in Washington is relatively high with an unusually high initial incidence on business (see below).

According to 1992 data provided by the U.S. Department of Commerce, Bureau of Census (at this writing, the most recent information available), state and local taxes in Washington amounted to $118.54 per $1,000 of personal income, ranking the state 16th in the nation (including the District of Columbia). Looked at another way, state and local taxes represented $2,325.59 per capita, placing the state 13th nationally. For most of the last decade, the state and local tax burden in Washington State has exceeded the U.S. average.

For general revenues, state government relies primarily on the business and occupations (B&O) tax, the sales and use tax, and the property tax.

The state retail sales and use tax of 6.5 percent produces more than half the revenues for the state general fund. Washington has a relatively broad sales tax base, applying to most goods and certain services (e.g., repair, cleaning, construction). Groceries and prescription drugs are exempt.

The business and occupations tax is paid exclusively by businesses operating in Washington and is based on a company's gross receipts. Washington is one of three states imposing a broad-based tax on gross receipts. The B&O tax rate varies by industry, and was substantially increased on service industries in 1993, fueling tax limitation efforts by voters. B&O taxes provide about 17 percent of state general fund revenues. In the 1995 legislative session, lawmakers voted to reduce the 1993 increase in B&O rates by 50 percent, an action subsequently vetoed by the governor, who argued that slow revenue growth made the tax cut unaffordable.

The state property tax is expected to raise about 12 percent of state general fund. The 1995 legislature reduced the state property tax levy ($3.60 per $1,000) by just under 5 percent for collections in 1996. A permanent 5 percent reduction was vetoed.

A 1988 study by the Research Council found that "in most years Washington's system of state taxes produces revenues for state government at a pace similar to or ahead of growth in the economy," however, during recessions tax collections will decline faster than the economy. The Research Council also reports that the tax structure appears to be slightly regressive (i.e., lower income households pay a larger share of their income in taxes than do high income households), however, for the broad range of taxpayers, the system is nearly proportional. This is particularly true when regressive taxes on alcohol, tobacco, and gasoline are ignored.

Local Taxes

Property taxes, a major revenue source for local governments, represent a recurring taxpayer concern, despite several limits which have kept state and local property taxes below the US average. Statewide, businesses pay about 40 percent of all property taxes; however, there is considerable variation in the composition of the property tax base between jurisdictions.

Municipalities impose various business charges, including gross receipts (B&O) taxes and fees based on particular business activities, employees, and floor space owned. In addition, cities and counties share local sales and use tax revenues.

Business Taxes in Washington

A 1988 study for the Department of Revenue estimated that about 44 percent of state and local taxes in Washington are paid by business initially. Nationally, it is estimated that the initial business tax burden is about one-third of state and local taxes. Recently, the department reviewed the study and tax changes since 1988, concluding the share has not changed significantly.

Recent efforts to improve Washington's tax treatment of technology industries have removed disincentives to investment in the state (as opposed to creating new incentive programs) and recognized the unique research and development costs incurred by these industries.

In 1994 the legislature passed two measures important to technology businesses: a sales tax deferral (made an exemption in 1995) for qualifying research and development projects or pilot-scale manufacturing and a B&O tax credit of up to $2 million for firms investing a large share of their gross income on research and development.

Of broader application is the 1995 manufacturing machinery and equipment exemption, which eliminated a substantial impediment to capital investment in Washington. The legislation exempts from the sales or use tax machinery and equipment (and installation labor and services) used directly in manufacturing operations.

Economic War Among the States?

The national mania for what might be termed "microchip chasing" generally has been resisted by Washington state, although our economic development specialists must occasionally envy the well-stocked quivers of some of their out-of-state competitors. Most policy experts advise lawmakers against the high-stakes bidding wars that may have reached their apex with Alabama's $330 million incentive package to woo Mercedes-Benz (a $220,000 per job deal). Few, however, have gone as far as the Federal Reserve Bank of Minneapolis economists who call on "...Congress to exercise its Commerce Clause power to end another economic war among the states... a war in which states are actively competing with one another for businesses by offering subsidies and preferential taxes."

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Business leaders as well are sometimes wary of incentive programs. Hal Hovey, a nationally recognized public finance authority, cites three objections to such inducements: a) they represent government favoritism for some firms relative to competitors, including in-state competitors, b) they involve closer than normal government involvement with business, and c) they threaten higher taxes on existing businesses.

What Is The Role Of Taxes On Business Location?

There's also the legitimate question: what difference do taxes make? Most studies, including one by the Washington Research Council, suggest that taxes are a "second tier" factor in location decisions, generally trailing owner's residential preference, land, labor supply, markets and transportation. Compared with the other factors, however, tax policy can be changed relatively swiftly, assuming the requisite political support. And, as others have found, taxes become more important when the economy is contracting, when geographic alternatives narrow, and when interstate competition is intense (i.e., when the financial packages offered by state or local governments are too large to ignore).

Of course, taxes do matter, as do all costs associated with business decisions. And perhaps more than the general studies document. As Robert Tannenwald, senior economist of the Federal Reserve Bank of Boston has written in this context, "Can thousands of economists be wrong? Certainly." He observes that tax competitiveness is not easily measured and says analysts must examine impact of taxation on profits, often information not available to policy analysts.

General Conclusions

Despite its unique and occasionally-reviled features, the state tax system has proved remarkably resilient, adequate and reliable. Recent legislation has addressed the dominant concerns of high technology and manufacturing firms and the state appears to be generally competitive. Additional improvements ought to focus on changes that can be accomplished within the existing tax structure.

Efforts to ease the property tax burden on homeowners should not result in a classified property tax system, with different classes of property owners subject to different tax treatment. Focused, incremental changes in the property tax system, including assessment reforms, should be accommodated prior to any major property tax overhaul.

General tax system improvements ought to take precedence over targeted financial inducements and tax preferences for selected industries. The 1993 Legislature substantially increased the tax burden on thousands of businesses, jeopardizing their survival and contributing to the state's current cash surplus. The legislature should reaffirm its commitment to repeal the 1993 tax increases.

Mr. Davis can be reached at the WA Research Council, 1301 5th Ave. Ste 2810, Seattle, WA 98101. (206) 467-7088 Fax: (206) 467-6957