Washington State and Local Tax System: Dysfunction & Reform

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Technical Advisory Group
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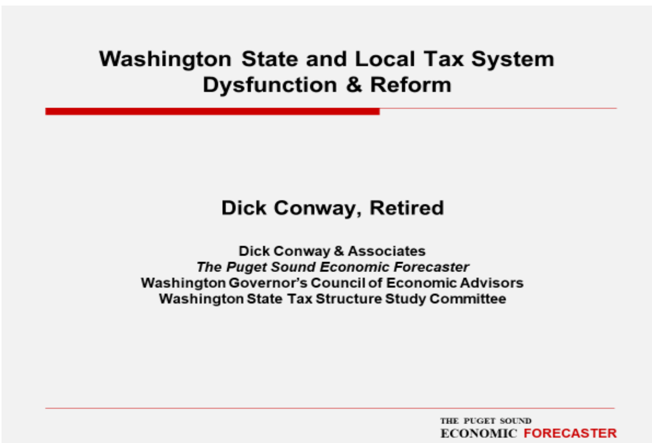
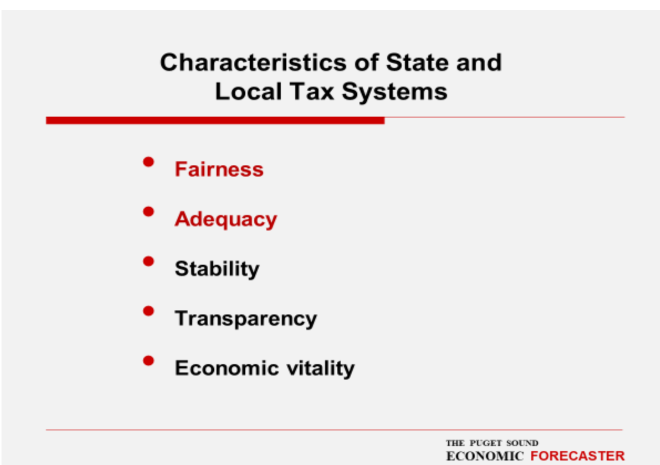
Introduction. As a member of the Washington Governor's Council of Economic Advisors and the Washington State Tax Structure Study Committee, I have studied Washington's state and local tax system for twenty years. The analysis and findings can be found in "Washington State and Local Tax System: Dysfunction & Reform," February 2017 and "Washington State and Local Tax System: Dysfunction & Reform (Nine Comments)," February 2020."



Characteristics. The following presentation compares the Washington tax system with the tax systems of the other states. It focuses on five characteristics: fairness, adequacy, stability, transparency, and economic vitality. This presentation begins with a discussion of the two most egregious characteristics of the Washington tax system: unfairness and inadequacy.



Regressive tax systems. The Institute on Taxation & Economic Policy (ITEP) has determined that "lacking an income tax…Washington has the most unfair tax system in the nation." In 2018, the 20 percent of families with the lowest incomes paid 17.8 percent of their income on state and local taxes, while the 1 percent of families with the highest incomes paid only 3.0 percent. This meant that the lowest-income families had to work 9.3 weeks out of the year to satisfy their state and local tax obligations, while the highest-income families had to work only 1.6 weeks.

Regressive State and Local Tax Systems, 2018
Taxes as Percent of Family Income

Rank	State	Poorest 20 Percent	Middle 60 Percent	Top 1 Percent	Poorest-Top Ratio
	United States	11.4	9.9	7.4	1.5
1	Washington	17.8	10.9	3.0	5.9
2	Texas	13.0	9.7	3.1	4.2
3	Florida	12.7	8.1	2.3	5.5
48	Delaware	5.5	5.8	6.5	0.8
49	Vermont	8.7	9.4	10.4	0.8
50	California	10.5	8.9	12.4	0.8

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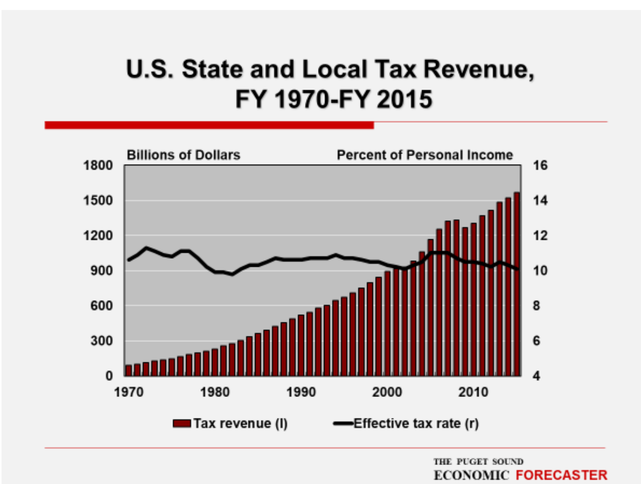
Note that the findings for Washington are consistent with the results from a similar study conducted by the Washington State Tax Structure Study Committee twenty years ago. In 1999, the tax burden for the lowest income households was 15.7 percent, while for the highest income households it was only 4.4 percent.

U.S. state and local tax revenue. Adequacy refers to the ability of a tax system to generate sufficient revenue to meet the public needs of a growing economy and population.



This raises a critical question. How much should state and local governments tax? As evident in this chart, the state and local effective tax rate for all states (tax revenue as a percent of personal income) has averaged 10.4 percent and has been quite stable since 1970. The 10.4 percent rate is not necessarily the optimal tax rate. But it is the fifty-year norm followed on average by state and local governments.

This finding has important implications for Washington tax policy: (1) The Washington state and local effective tax rate should average about 10.4 percent. (2) The Washington tax structure should be designed such that tax revenue grows along with personal income, thereby maintaining the desired effective tax rate without having to raise individual tax rates or broaden the tax base. (3) Any tax change proposal should include an explicit estimate of its impact on the effective tax rate.

Washington and U.S. effective tax rates. As an indicator of adequacy, how has the Washington state and local effective tax rate performed over the years? Poorly. Between FY 1995 and FY 2015, while collectively the other state and local governments maintained a 10.4 percent effective tax rate, the Washington effective tax rate fell from 11.4 percent (the eleventh highest in the nation) to 9.1 percent (the thirty-eighth highest). No other state experienced a bigger drop.

Washington and U.S. State and Local Effective Tax Rates, FY 1987-FY 2017
Percent of Personal Income

	Washington Effective Tax Rate	U.S. Effective Tax Rate	Washington Rank
FY 1987	10.6	10.6	19
FY 1992	10.8	10.7	16
FY 1995	11.4	10.8	11
FY 1997	10.9	10.6	13
FY 2002	9.8	10.0	28
FY 2007	10.3	11.0	31
FY 2009	9.5	10.5	37
FY 2012	9.3	10.2	36
FY 2015	9.1	10.2	38
FY 2017	9.4	10.2	30

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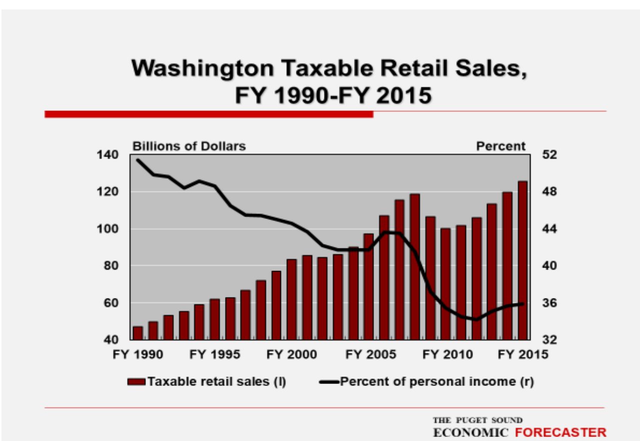
Washington taxable retail sales. The unprecedented decline in the state and local effective tax rate was due to the inadequacy of our sales-based tax system working in conjunction with Initiative 601.



This chart illustrates the inadequacy of taxable retail sales, Washington's largest tax base. Between FY 1990 and FY 2015, taxable retail sales nearly tripled, increasing from $47 billion to $130 billion. As a percent of personal income, however, taxable retail sales fell from 50 percent to 36 percent. If taxable retail sales had been an adequate tax base—had remained at 50 percent of personal income—it would have grown to $180 billion in FY 2015 and yielded an additional $3.2 billion in state sales tax revenue.

The conventional remedy for inadequate tax revenue is raising the current tax rates or broadening the tax base. Because of the inadequacy of the sales tax base, state government has had to increase its sales tax rate from 2.0 percent in 1935 to 6.5 percent today.

But Initiative 601, enacted in 1993, changed the rules of the game. I-601 was the first of several voter-approved initiatives requiring a two-thirds vote of the Legislature to raise taxes. Declared unconstitutional in 2013, the supermajority rule nevertheless thwarted tax increases for 20 years. The last time state government raised its sales tax rate was 1983.

Forfeited state and local tax revenue. Taxing below the 10.4 percent norm has had a significant fiscal impact on state and local governments in Washington. With a 9.1 percent effective tax rate, the lowest on record, Washington state and local governments forfeited $4.9 billion in taxes in FY 2015. The foregone tax revenue from FY 2008 to FY 2017 totaled $32.7 billion.

Washington Forfeited State and Local Tax Revenue, FY 2005-FY 2014
Billions of Dollars

	Personal Income	Tax Revenue (actual)	Tax Revenue (10.4% rate)	Forfeited Tax Revenue
FY 2008	288.4	28.6	30.0	1.4
FY 2009	285.8	27.2	29.7	2.5
FY 2010	282.0	27.1	29.3	2.2
FY 2011	296.6	28.8	30.8	2.0
FY 2012	316.4	29.4	32.9	3.5
FY 2013	333.0	30.8	34.6	3.8
FY 2014	348.2	32.2	36.2	4.0
FY 2015	375.8	34.2	39.1	4.9
FY 2016	396.0	36.9	41.2	4.3
FY 2017	420.8	39.7	43.8	4.1
Total	---	314.9	347.6	32.7

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Elementary and secondary school spending. Because of the tumbling effective tax rate, Washington public school spending per $1,000 of personal income fell from slightly above the national average in FY 1992, one year before Initiative 601 became law, to 18.7 percent below the national average in FY 2007. Only two states spent less than Washington on K-12 education in FY 2007. It would have taken another $2.1 billion to lift Washington elementary and secondary school spending up to the national norm.

Washington and U.S. Public School Spending, FY 1987-FY 2017
Dollars per $1,000 of Personal Income

	Washington School Spending	U.S. School Spending	Washington Rank
FY 1987	41.14	42.92	36
FY 1992	44.07	43.68	32
FY 1995	42.79	42.90	33
FY 1997	39.36	41.32	34
FY 2002	36.30	42.10	46
FY 2007	34.98	43.02	48
FY 2009	34.46	41.29	46
FY 2012	33.22	39.30	46
FY 2015	32.37	37.97	44
FY 2017	32.57	37.46	42

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Public school spending by state. Only Colorado and Florida trailed Washington in public school spending in FY 2007 and that by only one dollar per $1,000 of personal income. The top four states—Alaska, Vermont, New Jersey, and West Virginia—outspent Washington by more the 50 percent. Not surprising FY 2007 was the year *McCleary* petitioned for full funding of basic education as required by the state constitution.

Elementary and Secondary School Spending Per $1,000 of Personal Income, FY 2007
Dollars

Rank	State	Spending
	United States	43.02
1	Alaska	62.71
2	Vermont	58.33
3	New Jersey	55.00
4	West Virginia	53.56
48	Washington	34.98
49	Colorado	34.35
50	Florida	33.83

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Unstable tax base. Cyclically sensitive sales-based tax systems are relatively unstable. The impact of the Great Recession on Washington was not only severe but also enduring. The Washington effective tax rate fell from 10.3 percent (nearly the national norm) in FY 2007 to 9.5 percent in FY 2009. Real per capita state and local tax revenue measured in 2012 dollars fell 10.9 from $4,995 to$4,450. Surprisingly, by FY 2015, six years after the end of the downturn, state and local tax revenue failed to fully recover in two respects. The effective tax rate continued to fall, reaching 9.1 percent in FY 2015, its lowest mark on record. Despite a modest rebound to $4,547, real per capita state and local tax revenue stood 9.0 percent below its starting point in FY 2007.

Washington State and Local Tax Revenue, FY 2007-FY 2015

	FY 2007	FY 2009	FY 2015	FY 2007-15 Percent Change
State tax revenue (bils. $)	27.5	27.2	34.2	24.4
Personal income (bils. $)	267.2	285.8	375.8	40.6
Effective tax rate (%)	10.3	9.5	9.1	-11.7
State and local deflator (12=1.000)	0.858	0.924	1.058	23.3
Population (thous.)	6,416.2	6,614.8	7,109.3	10.8
Real per capita tax revenue ($12)	4,995	4,450	4,547	-9.0
Personal income (bils. $)	267.2	285.8	375.8	40.6
Consumption deflator (12=1.000)	0.902	0.940	1.029	14.1
Population (thous.)	6,416.2	6,614.8	7,109.3	10.8
Real per capita income ($12)	46,169	45,964	51,371	11.3

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How much do you pay in taxes? A KUOW reporter asked two baristas how much they paid in state and local taxes. The barista in Oregon had a good idea, since that state had an income tax but no sales tax. The barista in Washington had no clue.

A test of transparency based on five types of taxes (personal income tax, business tax, sales tax, property tax, and excise tax) indicated that Oregon had the most transparent tax system, while Washington beat only Nevada for the least transparent. If a tax is not transparent, how can we make rational tax policy?

State and Local Government Tax Systems Transparency Index, FY 2014
Total Transparency=1.000

Rank	State	Index
	United States	0.673
1	Oregon	0.767
2	Maryland	0.738
3	Massachusetts	0.730
4	Connecticut	0.723
47	North Dakota	0.554
48	Tennessee	0.554
49	Washington	0.550
50	Nevada	0.549

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Best business tax climate. Does an income tax promote or hinder economic development? This is a controversial issue, since the evidence is mixed. The Tax Foundation ranks states according to a business tax climate index based on the use of five taxes: personal income tax, corporate tax, sales tax, property tax, and unemployment insurance tax. States judged to have the best business tax climate made little or no use of an income tax. The top five states—Wyoming, South Dakota, Alaska, Florida, and Nevada—do not have a personal income tax. However, four of these states have major alternative sources of tax revenue: severance taxes from resource extraction (Wyoming and Alaska) and tourist-related taxes (Nevada and Florida). They presumably have no need for an income tax.

Best Business Tax Climate and Employment Change, 1970-2015

Business Climate Rank	State	1970-15 Employment Change (thous.)	Percent of U.S. Employment Change
	United States	68,841.0	100.0
1	Wyoming	172.9	0.3
2	South Dakota	233.0	0.3
3	Alaska	233.0	0.3
4	Florida	5,910.8	8.6
12	Washington	2,079.5	3.0
47	Minnesota	1,520.2	2.2
48	California	9,280.2	13.5
49	New York	1,834.9	2.7
50	New Jersey	1,261.2	1.8

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The Tax Foundation provides no evidence that a personal income tax either helps or hinders economic growth. According to a simple statistical test, there is no correlation (0.011) between a business tax climate ranking and its ability to generate jobs. Illustrating the lack of correlation, with the third worst business tax climate because of its substantial reliance on an income tax, California created 9.3 million payroll jobs—more than one out of every eight new jobs in the nation—between 1970 and 2015.

Washington and Oregon. A comparison of these two states gives some insight into how an income tax affects economic growth. No other pair of geographically adjacent states have more different tax systems. Washington has a sales tax but no income tax, while Oregon has an income tax but no sales tax.

Despite fundamentally different tax structures, the Washington and Oregon economies have both performed well over the past fifty years, growing significantly faster than the nation since1970. In terms of jobs, Washington has marginally outpaced Oregon, 2.2 percent versus 2.0 percent annually. By comparison, U.S. employment increased at only a 1.4 percent rate.

The difference in the growth rates of the two states is largely due to the emergence high-paying tech jobs at Microsoft and Amazon in Washington. Excluding the direct and indirect economic impacts of these two companies, the Washington employment growth rate for 1970-18 decreases to 2.0 percent, right in line with the Oregon rate.

It is apparent that tech companies are attracted to Washington because of its regressive tax system. With an estimated tax burden of only 6.0 percent, rather than 10.4 percent with a personal income tax, and an average annual personal income of $250,000, each tech worker is subsidized $11,000 per year. The total annual subsidy for the 120,000 tech workers is $1.3 billion.

Washington and Oregon Economic Growth, 1970-2018

	1970	2018	Annual Percent Change
Washington			
Employment (thous.)	1,282.1	3,613.0	2.2
Personal income (bils. $)	15.0	467.4	7.4
Per capita income ($)	4,400	62,026	5.7
Population (thous.)	3,417.4	7,535.6	1.7
Oregon			
Employment (thous.)	767.7	1,993.4	2.0
Personal income (bils. $)	8.5	213.1	7.0
Per capita income ($)	4,065	50,843	5.4
Population (thous.)	2,100.4	4,190.7	1.5

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How Washington ranks. One of the objectives of this twenty-year study has been to compare Washington's state and local tax system with the tax systems of the other forty-nine states based on the five major characteristics. While these tests are not perfect, as a group they indicate that Washington has an inferior tax system. Its most shameful feature is unfairness, which alone should qualify the Washington tax system as the worst in the nation.

Characteristics of Current State and Local Tax System

	Rank Among States
• Fairness	50
• Adequacy	36
• Stability	42
• Transparency	49
• Economic vitality	No rank

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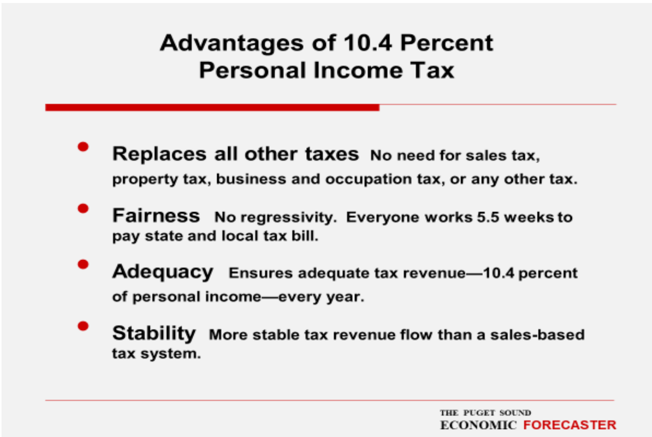
Advantages of a personal income tax. There are four principal advantages of the proposed income tax system. (1) A 10.4 percent personal income tax would eliminate the need for all other taxes. (2) A single-rate personal income tax would be perfectly fair. Every household, no matter what its income, would have to work 5.4 weeks to pay its state and local tax bill. (3) The income tax would ensure adequate tax revenue—10.4 percent of personal income (the national norm) every year. (4) It would also provide a reasonably steady flow of tax revenue, even during economic downturns.



The adequacy of a 10.4 percent personal income tax would eliminate a dilemma for the Legislature. Under the current tax system, there is a tendency for the state and local effective tax rate to decline over time. In the course of combating this inadequacy, lawmakers periodically have to increase the current tax rates or broaden the existing tax base. Such measures further exacerbate the regressive tax system, which is already deemed the most unfair in the nation.