

OVERVIEW OF THE WASHINGTON TAX SYSTEM

State and Local Government Revenues

According to the latest survey data compiled by the Census Bureau of the U.S. Department of Commerce, total revenues received by Washington state and local jurisdictions amounted to \$54.7 billion during Fiscal Year 2004 (see Table 1).

"General" revenues accounted for 73 percent of the total revenues in Washington. The expenditure of these revenues is typically determined by the legislative bodies of the various governmental jurisdictions (State Legislature, County Commissioners, City Councils, etc.) via the annual or biennial budget process. Taxes are the most important of the general revenue sources for the state and second to intergovernmental revenues for local governments; they represent 39 percent of total revenues. Other significant revenue sources are charges for services and federal grants; each account for about 14 percent of total revenues. Intergovernmental transfers, including state-shared tax revenues, are especially important for local jurisdictions.

Nongeneral revenue sources represent the remaining 27 percent of total revenues; these revenues are usually not available for general programs but are often dedicated to specific purposes. Examples include enterprise funds received for municipal utility functions, profits derived from liquor sales, payroll taxes that are dedicated for workers' compensation programs, and employee contributions for pensions.

Taxes can be defined as compulsory payments to a governmental entity in which the amount paid is not directly related to the cost of or benefits received from a service provided by the public jurisdiction. Examples of items which are directly related to a specific service and which are not considered as general taxes include benefit assessments for local improvement districts and payroll taxes levied upon employers for compensation to unemployed or injured workers.

The Census Bureau figures indicate that Washington state and local taxes totaled \$21.4 billion for Fiscal Year 2004. By far the largest source was the general sales and gross receipts tax category, which represented 45.7 percent of all state and local taxes in Washington. In addition to the state and local retail sales/use taxes, this category includes the state business and occupation tax and municipal business taxes since they are generally based on gross sales. (Few other states levy taxes measured by gross receipts, so the Census Bureau includes these in the general sales tax category.) The property tax was Washington's second largest tax source representing 29.8 percent of all state and local taxes; it remains by far the most important local revenue source, accounting for 64.5 percent of all local tax receipts.

State taxes accounted for 65 percent of all state/local taxes in Washington; local government taxes comprised the remaining 35 percent. Washington's ratio of state taxes is higher than many states (compared with 58.4 percent nationally) because Washington finances a greater proportion of governmental services at the state level, particularly funding of public K-12 and vocational schools, community colleges, public assistance programs, and criminal justice expenditures.

TABLE 1
REVENUE OF STATE AND LOCAL GOVERNMENTS IN WASHINGTON¹
 Fiscal Year 2004 (Dollars in Millions)

<u>Source of Revenue</u>	<u>State Level</u>	<u>Local Level</u>	<u>Total</u>
Taxes:			
Property taxes	\$ 1,526.6	\$ 4,859.7	\$ 6,386.3
General sales taxes ²	8,423.2	1,365.1	9,788.3
Motor fuel taxes	925.7	-.-	925.7
Liquor taxes	192.6	-.-	192.6
Tobacco taxes	352.5	-.-	352.5
Utility taxes	353.1	414.6	767.8
Other sales taxes	617.4	355.0	972.4
Vehicle license taxes	334.2	30.7	365.0
Other taxes	1,169.9	504.4	1,674.3
Subtotal	13,895.3	7,529.6	21,424.9
Current Charges:			
Education	1,697.8	285.0	1,982.8
Hospitals	710.9	1,259.6	1,970.5
Sewerage/garbage	6.9	1,600.8	1,607.7
Other charges for service	471.6	1,583.1	2,054.7
Federal Grants	6,669.3	1,069.2	7,738.4
State and Local Inter-governmental Transfers	284.2	8,003.0	-.-*
Interest Earnings	464.4	540.8	1,005.1
Other General Revenue	1,001.4	972.8	1,974.4
Non-General Revenue:			
Utility operations	-.-	4,537.0	4,537.0
Liquor store revenue	418.1	-.-	418.1
Insurance trust revenue	9,466.1	558.5	10,024.5
TOTAL REVENUE	\$35,085.9	\$27,939.3	\$54,738.1*

¹Source: Bureau of the Census, U.S. Department of Commerce, State and Local Government Finances, 2003-04.

²Includes gross receipts business taxes which are generally measured by sales.

*Duplicative intergovernmental transactions are excluded.

There are three general types of taxes: property, income, and excise. Property taxes consist of annual payments by owners of real property (land and structures) and personal property (tangible and intangible). Property taxes are measured by the value of the property (i.e., ad valorem tax) determined either by the fair market value or a statutory assessment formula. Property taxes are the oldest form of general taxation in this country and are levied in all states.

Income taxes include the federal, state, and local taxes measured by the annual income of individuals and corporations. Washington is one of seven states that does not levy a personal income tax upon households and one of only five states – the others are Nevada, South Dakota, Texas, and Wyoming - that does not impose any form of income tax (Alaska and Florida have corporate income taxes but not a personal income tax).

Excise taxes include virtually every other type of tax. Although there is not a single definition of excise taxes, generally these refer to a specified type of transaction or privilege. In Washington most excise taxes are measured by the selling price or some other measure of sales such as gross receipts. The retail sales tax is the single largest excise tax levied in this state. The major business tax is the business and occupation tax; although measured by gross "income," it is levied on the privilege of engaging in business and is categorized by the Census Bureau as an excise tax rather than an income tax. Other excise taxes include the selective sales taxes on specific products (cigarettes, gasoline, etc.) and the various taxes which are levied in lieu of property tax (e.g., harvested timber, leaseholds, etc.).

For more details on tax collections in various states, see the Census Bureau website: www.census.gov/govs/www/estimate.html. Also, see the final section in this chapter for comparisons of tax burdens among the states.

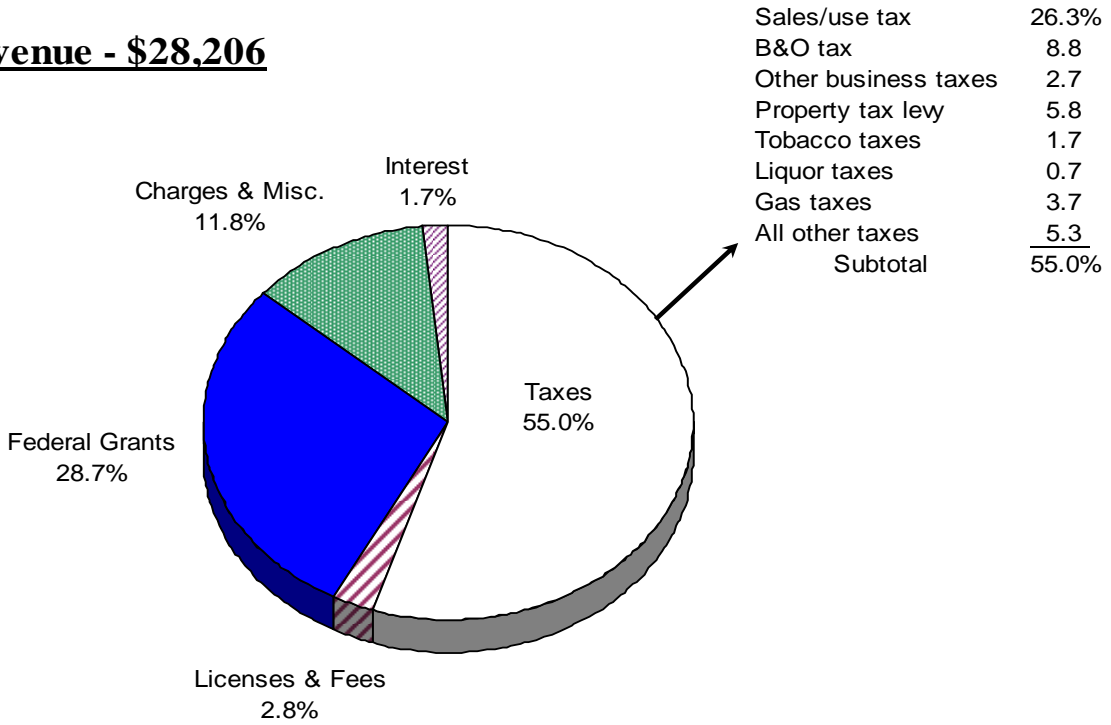
State Government Revenues and Expenditures

Data compiled by the Office of Financial Management (OFM) and published in its Comprehensive Annual Financial Report (CAFR) form the basis for the state revenue and expenditure information shown in the following charts; local governments are not included in these data. It should be noted that accounting differences may exist between the OFM figures indicated here and those reported by various tax collecting agencies in the remainder of this book. The first set of charts reflects the revenues and expenditures for all state government funds; the following page shows the state general fund. The general fund is the source of funding for most programs which are not financed by dedicated revenue sources. Most transportation expenditures (and the fuel taxes and federal revenues which fund transportation) are outside of the general fund. Likewise, workers' compensation programs, which provide benefits to employees who become injured or unemployed, and pension programs of public employees are financed outside of the general fund.

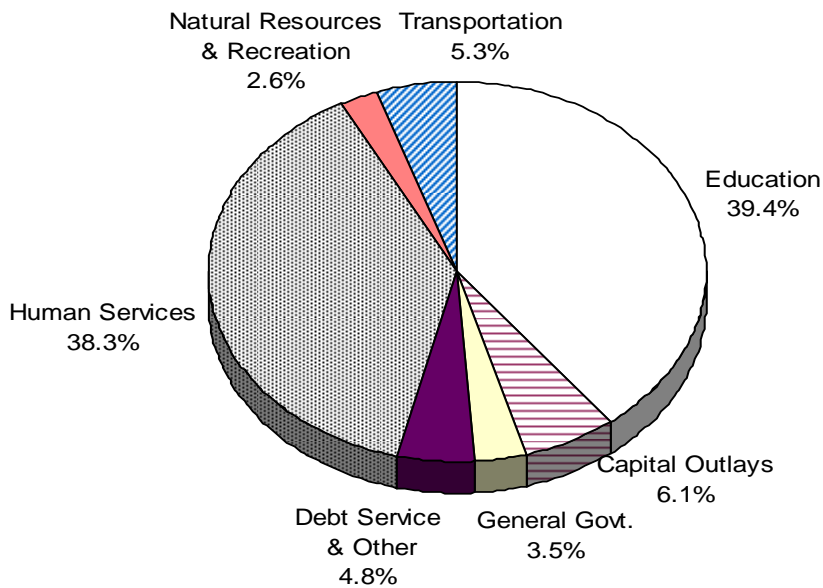
For Fiscal Year 2006 total state revenues for all state government funds, excluding enterprise activities, amounted to \$28.2 billion. Taxes accounted for \$15.5 billion or 55 percent of the total. Receipts from the federal government constitute the other major category of state revenue; federal grants equaled \$8.1 billion and represented 28.7 percent of the total. Education, including support

WASHINGTON STATE FINANCES
Fiscal Year 2006
All State Funds (\$ in millions)

Revenue - \$28,206

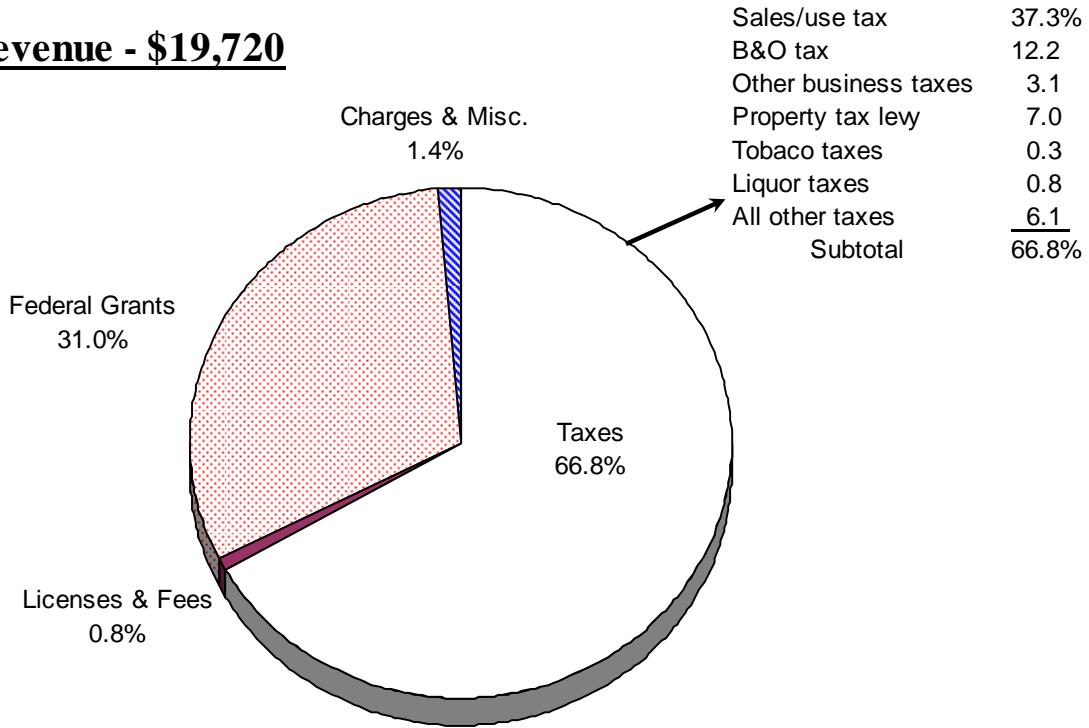


Expenditures - \$28,165

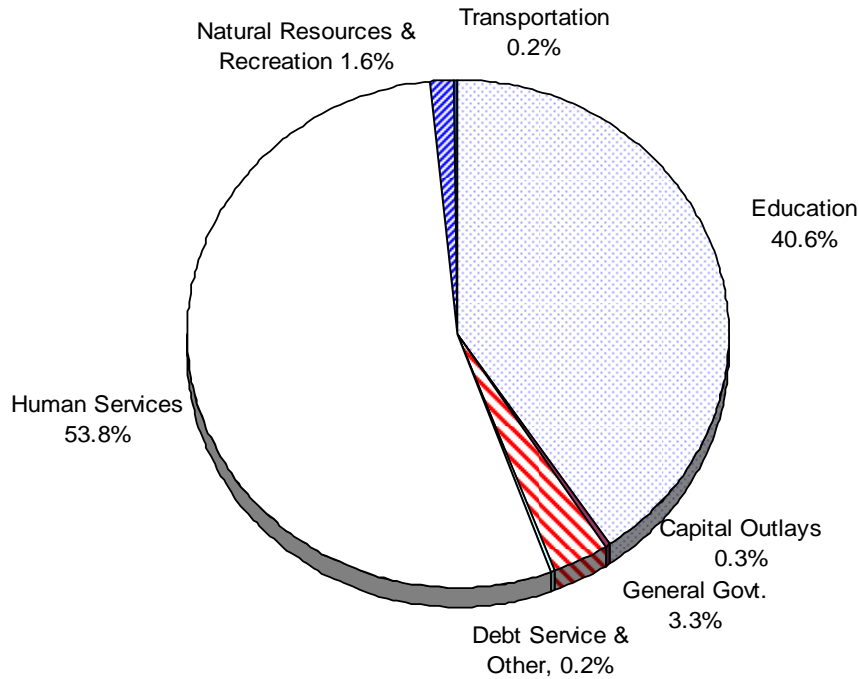


WASHINGTON STATE FINANCES
Fiscal Year 2006
State General Fund (\$ in millions)

Revenue - \$19,720



Expenditures - \$18,252



for K-12 schools and expenditures for public colleges and universities, accounts for 39.4 percent of all state expenditures. The other major state expenditure category was for human service programs; these represented 38.3 percent of state expenditures from all funds.

Washington State's general fund revenues amounted to \$19.7 billion for Fiscal Year 2006. Two-thirds (66.8 percent) of the total was attributable to tax revenues, while federal grants represented 31 percent of all general fund revenues. Within the tax category, the retail sales/use tax represented by far the largest source, accounting for 37.3 percent of state general fund revenues. The two other major state taxes were the business and occupation tax and the state property tax levy; these produced 12.2 and 7 percent respectively of state general fund revenues. Human services represents 53.8 percent of general fund expenditures, while education comprises 40.6 percent of general fund programs. The cost of operating general state government programs--including most executive branch agencies, the Legislature, state judicial expenses, licensing and regulation activities, financial administration, and a variety of other general administration functions--amounted to 3.3 percent of general fund expenditures.

Net Washington State Tax Collections

Further detail on taxes collected for state purposes is shown in Table 2, according to information compiled by the various tax-collecting agencies. The data in this table are consistent with the amounts indicated for each particular state tax source in the body of this report; however, the figures may be slightly different than those reported by the Office of Financial Management or by the Census Bureau due to differences in definitions (e.g., the Census Bureau includes a variety of license fees as miscellaneous tax revenues) and because some of the reported revenues may be on the basis of cash collections and others may represent accrued tax liability (GAAP basis).

The total of all state taxes covered in this manual for Fiscal Year 2006 was \$15.4 billion, an increase of 11.4 percent over the previous year. As seen in Table 2, by far the largest state tax source is the retail sales tax which totaled \$6.9 billion. Together with its companion use tax, the sales/use tax represents 47.8 percent of total state tax collections. In second place was the business and occupation tax with 16.1 percent of the total. The third largest state source was the state property tax levy; it produced 10.6 percent of state tax revenues. In fourth place among state tax sources was the motor vehicle fuel tax; together with the special fuel tax the gas taxes produced almost 7 percent of total state taxes, followed closely by the real estate excise tax that generated 6.6 percent of all state tax revenues.

Initiative 601 Limit on State Expenditures and Tax Increases

In November 1993 the voters of Washington approved Initiative 601 (Chapter 43.135 RCW). This measure limits the amount which state government may spend from the general fund and also imposes a supermajority voting requirement on increases in state taxes. It replaced another limitation mechanism, Initiative 62, which was approved by the voters in 1979; this had limited the growth in state revenues to the growth rate in state personal income.

TABLE 2
NET WASHINGTON STATE TAX COLLECTIONS*
Fiscal Years 2005 and 2006 (\$ in thousands)

<u>Tax Source</u>	<u>Fiscal 2005</u>	<u>Fiscal 2006</u>	<u>% Change</u>	<u>2006 % of Total</u>
General/Selective Sales Taxes				
Retail sales	\$6,166,266	\$6,882,255	11.6%	44.7%
Use	453,901	471,744	3.9	3.1
Cigarette	323,580	435,813	34.7	2.8
Tobacco products	27,542	26,610	(3.4)	0.2
Liquor sales	74,102	78,806	6.3	0.5
Liquor liter	77,124	108,428	40.6	0.7
Wine	17,548	19,588	11.6	0.1
Beer	29,899	30,370	1.6	0.2
Motor vehicle fuel	753,068	841,009	11.7	5.5
Special fuel	203,129	212,913	4.8	1.4
Aircraft fuel	2,565	2,602	1.4	0.0
Convention center	42,948	49,514	15.3	0.3
Solid waste collection	27,860	29,644	6.4	0.2
Wood stove	225	288	28.0	0.0
Brokered natural gas	29,745	40,158	35.0	0.3
Rental car	19,282	21,954	13.9	0.1
Enhanced 911 telephone	16,677	17,486	4.9	0.1
Telephone assistance (WTAP)	5,026	5,605	11.5	0.0
Telephone relay (TRS)	5,413	4,171	(22.9)	0.0
Replacement tire fee	0	3,193	--	0.0
Tribal cigarette tax	0	6,258	--	0.0
General/Selective Business Taxes				
Business & occupation	2,269,105	2,477,831	9.2	16.1
Public utility	303,778	339,874	11.9	2.2
Insurance premiums	357,381	378,804	6.0	2.5
Food fish/shellfish	4,838	1,980	(59.1)	0.0
Hazardous substance	80,929	90,810	12.2	0.6
Soft drinks syrup	9,688	9,413	(2.8)	0.1
Petroleum products	3,688	41	--	0.0
Oil spill	6,170	5,287	(14.3)	0.0
Litter	7,190	7,909	10.0	0.1
Pari-mutuel	1,836	1,899	3.4	0.0
Boxing/wrestling	61	73	19.7	0.0
IMR	8,129	8,372	3.0	0.1
Nursing home fee	33,557	27,553	(17.9)	0.2
Property & In-lieu Taxes				
State levy	1,589,947	1,632,815	2.7	10.6
Aircraft excise	296	285	(3.7)	0.0
Watercraft excise	14,891	16,071	7.9	0.1
Timber excise	10,112	9,282	(8.2)	0.1
PUD privilege	38,024	38,894	2.3	0.3
Leasehold excise	19,918	22,506	13.0	0.1
Other Taxes				
Real estate excise	823,110	1,010,457	22.8	6.6
Estate & transfer	(42,229)	24,392	--	0.2
TOTAL	\$13,816,319	\$15,392,957	11.4%	100.0%

*Excludes local taxes and state payroll taxes for workers' compensation programs.

SPENDING LIMITATION

The 601 spending limitation prohibits the expenditure of state general fund revenues above a certain level that is determined by formula. The expenditure limit became effective on July 1, 1995, and therefore first impacted expenditures during Fiscal Year 1996. The limit is based on actual state general fund expenditures for the previous year multiplied by the fiscal growth factor which is currently calculated as the change in inflation and population for the state averaged over the prior three years. The growth factors for the two years of the current 2005-07 Biennium have been determined to be 2.82 and 3.38 percent respectively.

Starting July 1, 2007, SSB 6078 (Chapter 72, Laws of 2005) applies the spending limitation not only to the General Fund - State, but also to related "near-general fund" accounts as well. Those related or "near-general fund" accounts are the Health Services Account, the Violence Reduction and Drug Enforcement Account, the Public Safety and Education Account, the Water Quality Account, and the Student Achievement Account. Also, beginning in Fiscal Year 2007, the calculation of the fiscal growth factor is changed to the average growth in state personal income for the prior ten fiscal years. Projections for the 2007-09 Biennium are 5.53 and 5.38 percent respectively for Fiscal Years 2008 and 2009.

Because the expenditure limit applies on a fiscal year basis, determining the amount of appropriations within the biennial state budget must now be done on an annual basis so that the limit for individual fiscal years is not exceeded. Each November, the Expenditure Limit Committee (consisting of the Director of the Office of Financial Management, the Attorney General, and the chairs of the House and Senate fiscal committees) adjusts the limit for the previous fiscal year to reflect the actual level of expenditures which occurred. The Committee then forecasts the limit amount for succeeding years. The expenditure limits for each year of the current 2005-07 Biennium and the ensuing 2007-09 Biennium are shown below:

Fiscal Year 2006	\$13,620.9 million
Fiscal Year 2007	\$14,131.9 million
2005-07 Biennium	\$27,752.8 million
Fiscal Year 2008	\$16,206.2 million (projected)
Fiscal Year 2009	\$17,078.0 million (projected)
2007-09 Biennium	\$33,284.2 million

If revenues in the limited accounts exceed the expenditure limit, some of the excess is deposited into an emergency reserve fund. With the 2005 changes, only General Fund – State revenue is transferred when the revenue in the limited accounts exceed the expenditure limit, starting with the 2007-09 Biennium. The amount transferred is proportional to the General Fund – State share of all limited account expenditures. The emergency reserve fund is limited to an amount equal to 5 percent of the state revenues in the general fund. If that balance is equaled, the excess funds are then transferred to an education construction fund to be used for K-12 schools and higher education construction. The emergency reserve fund may only be utilized with a two-thirds vote of both houses of the Legislature and only up to the overall expenditure limit.

The changes in 2005 (SSB 6078) requires that **both** the revenue sources **and** the programs they support be shifted into or out of the general fund or related accounts to trigger a commensurate reduction in the expenditure limit. Prior to 2005, the expenditure limit was reduced if the cost of a program was moved out of General Fund - State **or** if money was moved out of General Fund - State. Likewise, Initiative 601 requires that local governments be compensated by the state for any new programs or expanded services they are required to perform by the Legislature. If program responsibility is shifted to or from the state to local jurisdictions or the federal government, the state expenditure limit shall be changed accordingly.

VOTING REQUIREMENTS FOR TAX INCREASES

Initiative 601 also limits the manner in which state revenue may be increased. After July 1, 1995, any measure which increases state revenues or results in revenue-neutral tax shifts may only be adopted if two-thirds of the members of both houses of the Legislature approve. (This requirement was "lifted" by the Legislature in 2005 for the period between April 18, 2005, and June 30, 2007.) Further, the increased revenues must not result in expenditures above the spending limit. If the additional revenues will cause the limit to be exceeded, then the measure must also be approved by a simple majority vote of the statewide electorate. The initiative allows temporary tax increases to combat the effects of natural disasters for up to 24 months upon declaration of an emergency by the Governor and a two-thirds vote of the Legislature; no referral to the voters is required for such emergencies.

Comparisons with Other States

No other state relies so heavily on sales taxes as does Washington. Per capita state/local general and selective sales tax collections amounted to \$2,094 for this state in Fiscal Year 2004; this statistic ranked first among all states. The reliance on general sales taxes in Washington is nearly twice the national average: 45.7 percent versus 24.2 percent. (The Census Bureau includes Washington's B&O tax in the general sales category, since it is measured by gross sales.) Including taxes on the sale of specific goods, the overall general sales tax category accounts for more than 60 percent of state and local taxes in Washington. Balancing the heavy reliance on sales taxes is the absence of an individual or corporate net income tax, which produces an average of 24.6 percent of total tax revenues in other states. Property taxes represent 29.8 percent of total taxes in Washington; this is slightly less than the national average reliance of 31.5 percent.

Table 3 illustrates the utilization of major state and local tax sources in Washington compared with the national average for the latest year that comparable data are available.

There are two principal methods for measuring tax burdens among the states. The first simply divides the total tax collections by the population of a state to obtain a per capita figure. (The calculation usually includes taxes paid by businesses, since it is not possible to separately identify business tax payments for all tax sources; in any case, these are often assumed to be passed on to individual consumers.) Based on the latest available data (Fiscal Year 2004), Washington state and

TABLE 3
PERCENTAGE RELIANCE ON MAJOR STATE/LOCAL TAXES

Washington State and National Average
Fiscal Year 2004

<u>Tax Source</u>	<u>Washington</u>	<u>All States</u>
General sales taxes*	45.7%	24.2%
Selective sales taxes	15.0	11.5
Property taxes	29.8	31.5
Income taxes	.-	24.6
All other taxes	9.5	8.2
TOTAL	100.0%	100.0%

*includes retail sales/use and gross receipts taxes.

Source: State and Local Government Finances in 2003-04, Bureau of the Census.

local taxes per capita amounted to \$3,452. This statistic ranked 18th from the highest among all states in tax burden and was just slightly above the national average of \$3,447.

However, because there are significant differences among individual residents of the state, the per capita method only produces meaningful data for persons who are "average" in terms of income and other relevant criteria such as age, family size, geographical location, etc. For example, the household tax burden for a very large family may not simply be the statewide per capita amount multiplied by the number of persons in the family, since the tax burden attributable to children is likely somewhat lower than for adults. Likewise, actual taxes might be higher for persons during their household formation years (making purchases of a residence, household goods, etc.) than in retirement years. Further, there are significant differences in personal income among states, and hence they do not all have the same ability to finance government services.

Washington's tax system is driven largely by consumption, and consumption depends most directly upon income. Thus, comparing tax burdens to income yields a more representative tax burden indicator for most households. Total tax collections divided by a state's aggregate personal income (a statistic developed by the Bureau of Economic Analysis of the U.S. Department of Commerce) produces such a comparison. In Fiscal Year 2004 Washington's state and local taxes amounted to \$106.27 per \$1,000 of personal income. This compared with the national average of \$110.33 and ranked 29th from the highest in overall tax burden.

Table 4 provides a recent history of Washington's comparative tax burden. The table shows that tax burdens were relatively lower during the early 1980s as the recession impacted Washington more severely than many states. The income comparison indicates that Washington tax burdens reached an all-time low in 1981, when state and local taxes were higher in 38 other states. Tax burdens returned to more typical levels during the remainder of the decade, as Washington's economy

rebounded relative to other states and per capita personal income returned to previous levels. During most of the 1990s the tax rankings for Washington were at all-time high levels, ranking as high as 9th by the income measure and 10th on the per capita basis. In the latest several years Washington's tax rankings have moderated due to the repeal of tax increases enacted in 1993, the impact of Initiative 601 in restraining state expenditure growth, adoption of Referendum 47 which has restrained the growth in property taxes, repeal of the motor vehicle excise tax, and a variety of tax incentives to encourage economic development enacted in recent years.

TABLE 4
WASHINGTON TAX BURDEN SINCE 1980
 State/Local Taxes in Relation to Population and Personal Income

<u>Fiscal Year</u>	<u>Taxes Per Capita</u>		<u>Taxes Per \$1,000 Income</u>	
	Amount	Rank	Amount	Rank
2004	\$3,452	18	\$106.27	29
2003*	n.a.	n.a.	n.a.	n.a.
2002	3,216	16	100.90	32
2001*	n.a.	n.a.	n.a.	n.a.
2000	3,178	15	107.53	32
1999	3,148	13	111.25	20
1998	3,038	13	115.00	17
1997	2,916	11	117.49	11
1996	2,795	10	119.79	12
1995	2,728	10	123.00	11
1994	2,596	10	121.24	15
1993	2,433	10	117.95	17
1992	2,326	12	122.17	11
1991	2,236	11	121.75	9
1990	2,123	11	122.98	10
1989	1,910	15	118.76	16
1988	1,783	17	117.04	16
1987	1,697	15	114.99	19
1986	1,589	14	113.89	16
1985	1,435	18	108.47	25
1984	1,416	13	112.85	21
1983	1,306	13	109.22	16
1982	1,172	20	101.80	34
1981	1,037	21	100.45	39
1980	989	19	108.75	28

*The Census Bureau did not compile figures for local governments in FY 2001 or FY 2003.

Source: State and Local Government Finances, Bureau of the Census, U. S. Department of Commerce.