Chapter 7: Income Tax – A Major Replacement Alternative

Introduction

The question of an income tax has been debated in Washington ever since the 1930 McInnes Commission, in which a state income tax was a major recommendation. That Commission's income tax proposal was enacted by a 1932 initiative but was overturned by a 1933 State Supreme Court decision. In view of the fact that a state income tax was subsequently recommended numerous times without success, the Committee considered carefully the question of putting forward such a proposal once again—this time as a major replacement alternative. There are reasons for doing so, and in this introduction we attempt to articulate them.

In practice and in theory, only five tax bases exist that are of sufficient size and breadth to support modern state government—retail sales, gross receipts, net income, property, and value added to products and services. Gross receipts and sales are the bases of Washington's current tax system, and retail sales forms at least part of the base in 45 other states. Income is an important part of the tax base in 46 states, but not in the state of Washington. Value added is not used in any state, except for relatively insignificant business taxes in two states.

Thus, simply put, there are very few major alternatives for measuring a tax base, and for this reason alone, a state income tax must be listed among the major replacement alternatives in this report.

Besides the limited set of replacement alternatives, analysis supports our putting forward a state income tax as a replacement alternative. These reasons, which are enlarged upon later in this chapter, can be classified into two categories—the *intrinsic advantages* of the income tax itself and the *resulting advantages* of replacing an existing tax.

<u>Intrinsic Advantages of a State Income Tax</u>

- State income tax payments are deductible from federal taxable income for itemizing taxpayers.
- An income tax provides for growth in tax revenues commensurate with the growth in the demand for state government services, which historical evidence indicates grows at the rate of state income, or faster.

- An income tax provides for a less regressive tax system.
- An income tax is based on one measure of ability to pay – income.
- An income tax is relatively neutral and efficient because it has a broad base and a low rate.

Resulting Advantages of a State Income Tax

- A state income tax allows for a more competitive tax structure, comparable with those of other states, because the state can reduce the high percentage of revenue collected from businesses.
- A state income tax allows for a more rational assignment of taxes between the state and local governments because the state can reduce its unusually high property tax.
- A state income tax allows for an increase in tax harmony with other states and a reduction in tax avoidance via Internet and cross-border shopping because the state can reduce the high retail sales tax rate.
- A state income tax allows for a less regressive tax system because the state can reduce regressive sales and property taxes. It also allows for features, such as tax credits, that can mitigate undue burdens of sales and property taxes on specific groups of residents.

This chapter illustrates three forms of state income taxes: a flat rate tax on federal adjusted gross income of individuals, a graduated rate tax based on federal adjusted gross income of individuals, and a corporate net income tax. There are an almost unlimited number of possible ways to structure an income tax and use it to replace or reduce existing taxes. For purposes of illustrating how the first two options might be applied, the Committee considered four potential levels of replacing existing state taxes:

1) Reduction of the state retail sales/use tax rate from 6.5 percent to 3.5 percent.

2) The same degree of sales tax reduction, plus elimination of the state property tax levy.

3) Total elimination of the state retail sales/use tax.

4) The elimination of both the state retail sales tax and the state property tax.

In the third option, a flat rate personal income tax is combined with a corporate income tax to reduce the retail sales tax, the state property tax, and the business and occupation (B&O) tax. Each of the packages is designed to be revenue neutral for Calendar Year 2005, the initial year in which the proposal is presumed to be implemented.

The income tax alternatives are designed to replace state taxes only. The Committee decided not to address local taxation primarily because of long-term bond obligations tied to local revenues. However, local taxes are considered in the following illustrations of household tax burdens.

Finally, it appears a personal or a corporate income tax similar to any of the models presented would require a constitutional amendment. However, this conclusion is subject to some question. Please see the discussion in Appendix B.

Major Problems Addressed with Personal and Corporate Income Taxes

In the Introduction, we listed the advantages of a state income tax in point form. In this section, we describe the advantages in more detail.

The impact of an individual state income tax would be significantly offset for households that itemize their federal income tax deductions. As noted earlier, as a result of the federal Tax Reform Act of 1986, state income taxes are deductible for federal tax purposes, while the state sales taxes paid by households are not. It is estimated that Washington residents pay an additional $500 million annually in federal tax because of the inability to deduct state sales taxes. Replacing the state sales tax entirely with a personal income tax would save Washington itemizers $1.45 billion a year if a flat rate income tax were adopted. The savings increase to almost $2 billion a year if a graduated rate personal income tax is adopted. The net effect of tax savings and tax increases are discussed at the end of this chapter.

Table 7-1

Federal Tax Savings for Households Under Personal Income Tax Alternatives Tax Year 2001

Alternatives	Flat Rate	Federal Tax Savings ($millions)	Graduated Rates	Federal Tax Savings ($millions)
State Sales/Use Tax from 6.5% to 3.5%	2.6%	$680	1.0, 2.7, 4.5%	$725
State Sales/Use Tax to 3.5%, State Property Tax to 0%	3.8%	$999	2.2, 3.5, 6.0%	$1,046
State Sales/Use Tax to 0%	5.5%	$1,450	2.7, 5.7, 8.7%	$1,542
State Sales/Use Tax to 0%, State Property Tax to 0%	6.7%	$1,790		

Note: Top federal marginal rate in tax year 2001 is 39.1%.

Federal tax savings from a personal income tax are considerably higher than the sales tax savings for two main reasons. First, households pay 64 percent of the sales tax in Washington, whereas they would pay 100 percent of the personal income tax. Note that a portion of the household tax savings is shifted from business tax savings. Since businesses pay less tax, they also export less to the federal government. Second, the sales tax is regressive. Therefore, a sales tax is borne more heavily by the poor who typically do not itemize, whereas a personal income tax is borne more heavily by itemizers. There are more itemizers at the higher income levels. In the option to completely replace the state sales tax with a flat rate 5.5 percent personal income tax, itemizers account for over two-thirds of the base taxable income.

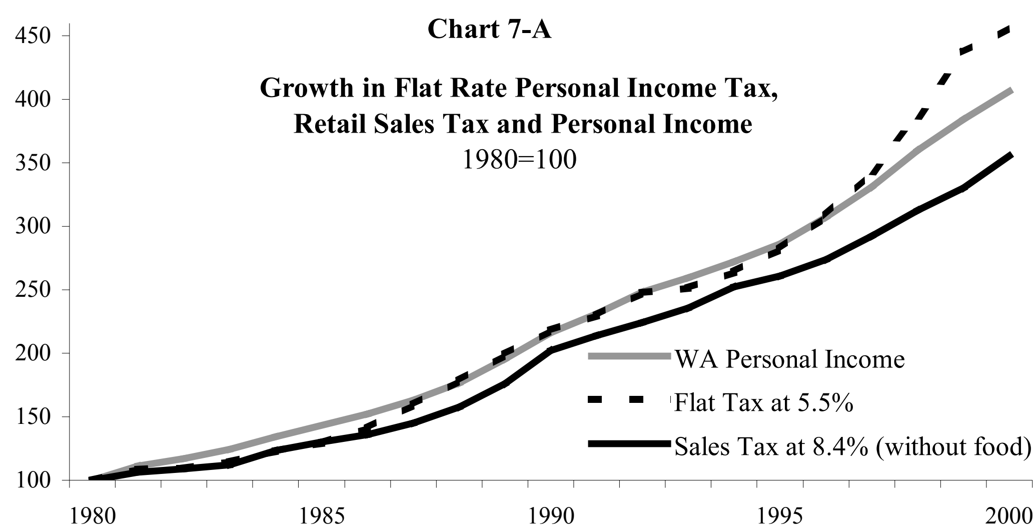
Table 7-2

Percent of Washington Households That Itemize
CY 1999

Adjusted Gross Income	Percent Households That Itemize	Adjusted Gross Income	Percent Households That Itemize
$0-10,000	2.7%	$60,000-80,000	66.3%
$10,000-20,000	10.0%	$80,000-100,000	77.6%
$20,000-30,000	17.0%	$100,000-200,000	81.9%
$30,000-40,000	28.5%	$200,000-500,000	79.7%
$40,000-50,000	42.5%	> $500,000	61.7%
$50,000-60,000	56.1%	Average	32.9%

Adequacy

Historical evidence from all 50 states analyzed by Committee member Dick Conway shows that state and local spending, net of federal transfers, tends to rise as fast as state income, or faster. Department of Revenue research indicates that, with a constant rate and base definition, retail sales tax revenue grows at a slower rate than state income (a measure of the size of the state economy), posing adequacy problems. Evidence indicates that revenue from a state income tax would grow at a rate comparable to the growth rate of state income over the long run.



Stability

Investors generally agree that a balanced and diversified portfolio of assets is less risky and more stable than a concentrated portfolio. Similarly, a tax structure that includes a variety of taxes will provide for a more stable source of revenue for state government over the long run. Although many of the taxes typically move together over a business cycle, they do not move in lock step, hence a combination of tax sources is more stable than either one alone.

Also, research shows that a sales tax base that exempts food is less stable than one that includes it (Holcombe and Sobel, 1997, p. 158). Because of Washington's heavy reliance on the retail sales tax, groceries are exempted from tax in order to reduce the regressivity of the state tax burden. An income tax is not regressive, hence policy makers have latitude to include groceries in the sales tax base if a more stable sales tax revenue stream is desired. For estimates of the volatility (short-run elasticity) of existing tax types, the flat rate income tax, and combinations of the tax mix, see Appendix C.

Competitiveness

Currently, businesses pay 46 percent of state and local taxes in Washington, as compared to 30 percent for the average of the seven Western states. This share is one of the highest in the nation. The Committee agrees that high business tax burdens reduce the economic vitality of the state, discourage firms from locating their operations here, and invite firms already located in Washington to consider other locations. Furthermore, to the extent that businesses in Washington are able to shift part of this burden to the buyers in the form of higher prices, such taxes represent a hidden burden on the buyers and contribute to a nontransparent tax structure.

Without an alternative tax base, the state has few options for reducing this business tax burden. The business and occupation tax, for example, is the second largest source of state tax revenue, and it would be difficult for the state to raise this revenue by increasing the unpopular state property tax or increasing the retail sales tax rate, which is already one of the highest in the nation. With a personal and corporate income tax system, the B&O tax burden can be reduced to bring the share of tax revenues collected from households and firms in Washington in line with shares in other states.

Fairness

Personal income taxes can be structured to address the problem of equity or fairness of the overall tax system. The Committee considered standard deductions, personal exemptions, and graduated rates to achieve progressivity in the personal income tax alternatives. Thus, depending upon the degree of reliance upon this type of tax, income taxes can offset the regressive impact of other state and local taxes.

States such as Washington that do not impose income taxes have particularly regressive tax systems when viewed apart from the federal tax burden. The municipal government of the District of Columbia conducts an annual study of household tax burdens in the largest city of each state as a proxy for the entire state. The study for Calendar Year 2000 indicates that the six states with the most regressive tax systems are Alaska, Texas, Washington, Wyoming, Nevada, South Dakota, and Tennessee. Analysis by the Committee confirmed that when evaluating the total tax system–local, state and federal–all states have progressive taxes and the differences among states are not as great.

Corporate net income taxes may be considered to be more equitable than gross receipts business taxes because the tax liability is linked to the firm's profitability. However, the corporate tax would introduce non-neutral tax treatment of corporations compared to unincorporated businesses and of equity financed investments compared to debt financing. Replacing the B&O tax with a corporate net income tax would eliminate the pyramiding of our tax system and the resulting non-neutral tax treatment of businesses.

Mechanics of Income Taxes

Personal Income Taxes

Forty-three states have personal income taxes. State individual income taxes are usually tied in varying degrees to the federal Internal Revenue Code (IRC) personal income tax statutes. This creates a number of administrative efficiencies for states and it makes it simpler for taxpayers to comply. A state income tax scheme can vary from the federal tax code by excluding certain income, providing different personal exemptions or deductions, and by fixing a different amount for the standard deduction.

Since most state income taxes are based on the federal tax, most states adopt the federal definitions as contained in the IRC and base their state tax on the amount of adjusted gross income (AGI) as calculated for the federal individual income tax. Some states then allow a personal exemption and/or standard or itemized deductions as defined by state law rather than federal definitions before the state tax rates (either flat or graduated) are applied. The state tax rates are substantially lower than the federal rates. However, the bracket break points for a graduated income tax may be based on the federal tax.

Some states simplify their tax computations by imposing their state tax as a percentage of federal income tax liability. This, in effect, incorporates all of the federal definitions, exemptions, and rate structure. The only decision made by the state legislature under this type of state income tax is the tax rate.

Basing state taxes at least partially upon the federal tax helps to reduce the cost of administering the state income tax. Nonetheless, the costs at the state level can be significant. The actual cost to administer a state income tax would depend upon the type of tax. Initially, there would be significant expenditures for development of computer systems and preparation of tax forms. Subsequently, the principal expenditures would shift to processing of returns, follow-up audit and compliance activities. Further analysis would be necessary to develop a cost-of-collection estimate.

The Department of Revenue collects state and local excise taxes principally from business entities. Presently, there are approximately 375,000 firms that submit tax returns on a monthly, quarterly, or annual basis. Under an income tax system the number of taxpayer accounts would increase by at least 2.3 million, as almost all households would be required to submit annual income tax returns (plus quarterly estimated payments for some), and employers would have to make monthly withholding payments on behalf of their employees.

Corporate Net Income Taxes

Corporate net income tax is currently levied in 46 states. All of these states either adopt or heavily refer to the federal Internal Revenue Code for definitions of taxable income, although most states allow additional items to be deducted and also require certain federally deducted items to be added back. The application of corporate income tax by states is complicated by multistate firms that derive income in more than one state and by the intricacies of corporate organization.

By federal law, a firm generally must have both a permanent physical presence and employees within a state to be subject to tax when the corporation is subject to tax in more than one state. Attribution of profits among those states may be done through "separate accounting" at the establishment level within a state. It may also be done through "apportionment" based on payroll, property, and sales. Apportionment methods are not uniform–some states double-weight sales or more heavily weight sales. Further complications are caused by the complexities of corporate organizations, with holding companies and parent-subsidiary relationships. Some states tend to treat corporations within a holding company as separate entities. Others have pursued a "unitary" approach, viewing the overall corporation as the taxable entity.

Income Tax Alternatives

#4. Flat Rate Personal Income Tax

Proposal: Significantly reduce or replace the state retail sales/use tax and possibly replace the state property tax levy with a single rate personal income tax. The purpose is to reduce Washington's extreme reliance on these regressive taxes. Broadening the tax base to include income would create a diversified tax system that grows at a rate more comparable to the growth in the economy. The business and occupation tax would remain in place for all business entities organized in corporate, partnership, or sole proprietorship form.

Description:

Incidence: All individuals and households residing in Washington would be subject to the income tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income.

Tax Base: Adjusted gross income of individuals calculated for federal tax purposes, less the following state standard deduction (amounts to be indexed for inflation):

- Single taxpayers, $5,000
- Head of household, $7,000
- Married, filing jointly:
  - $7,000 if one spouse is employed
  - $10,000 if both persons are employed
- Elderly or disabled, an additional $1,000

Also, this model would allow a personal exemption of $2,900 (amount to be indexed for inflation) for taxpayers and each dependent. Further, it would allow credit for any state B&O tax paid (noncorporate businesses) and for any state income tax paid to another state.

An option to this proposal would be to allow additional targeted tax relief to the working poor (as a percentage of the federal earned income credit) and families with child care needs (as a percentage of the federal tax credit).

Rate and Yield: The income tax rate would depend upon the amount of existing state revenue to be replaced. Three options are illustrated below:

Table 7-3

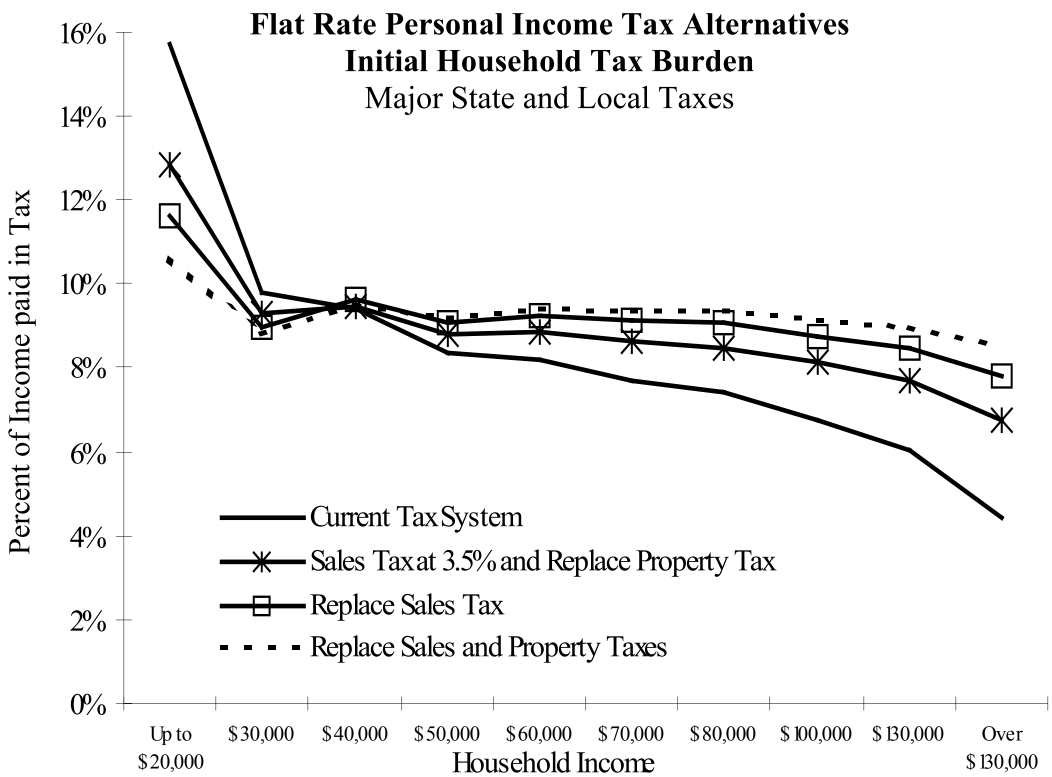
Flat Rate Personal Income Tax Alternatives
CY 2005

	Existing Taxes Reduced or Replaced	**Revenue Neutral Income Tax Rate**
A	Reduce state sales/use tax from 6.5% to 3.5%	2.6%
B	Reduce state sales/use tax to 3.5% and replace state property tax	3.8%
C	Replace state sales/use tax	5.5%
D	Replace state sales/use tax and state property tax	6.7%

Problems Addressed: Even with a flat rate income tax, some degree of progressivity would result from the personal exemptions and standard deductions. Flat rate income taxes would make our tax system less regressive and, with complete elimination of the state retail sales tax, nearly proportional. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved.

Washington's tax system changes from regressive to proportional depending on the extent to which sales tax is reduced and property tax is replaced with a flat rate income tax structure.

Chart 7-B



Source: Washington State Excise and Property Tax Simulation Model

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

There is no evidence that a flat rate personal income tax is less volatile than the retail sales tax. However, a tax structure that contains a personal income tax and a retail sales tax with food in the base can be less volatile than Washington's current tax structure.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

A major shift of tax burden from businesses to individuals would occur under this proposal. This is because corporations would experience a significant reduction in state sales/use tax (and the state property tax levy in Option B) but would pay no income tax. They would continue to pay the B&O tax, however, which is based on gross income. Reduction in reliance upon the retail sales/use and property taxes would improve Washington's business climate, since the current sales and property taxes are viewed by prospective firms as deterrents to investment in this state.

Chart 7-C
Flat Rate Personal Income Tax
Share of Tax by Households/Businesses

Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

Problems Created: Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and continue to administer an income tax. The costs would not be significantly different whether the income tax rates were flat or graduated. The administrative burden would also extend to individuals, who would have to file tax returns.

Even though the proposal is estimated to be revenue neutral overall, there would be a very major shift of tax burden from businesses to individuals. This is because corporations pay a significant share of the retail sales/use tax and the state property tax levy.

Under each of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax, even with the complete elimination of the state sales and use tax. As well, coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based state income tax with state-defined exemptions and deductions. Eight of these states employ a flat tax rate: Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania, Rhode Island, and Vermont. To varying degrees the options would make our tax mix more like other states because most states impose a personal income tax.

Chart 7-D

Percentage Reliance on Major State and Local Taxes

Source: U.S. Census Bureau, Government Finances, 1999

A majority of the Committee recommends the adoption of a flat rate personal income tax to be used to reduce the state sales and use tax rate and eliminate the state portion of the property tax. The state portion of the property tax should be made available to local governments and/or schools.

A majority of the Committee considers the use of the proceeds of an income tax appropriate for any of the following:

- **To reduce the state sales and use tax rate,**
- **To eliminate the state sales and use tax,**
- **To reduce business taxes, and/or**
- **To eliminate the state property tax and share all or part of it with local governments and/or schools.**

#5. Graduated Rate Personal Income Tax

Proposal: Significantly reduce or replace the state retail sales/use tax and possibly the state property tax levy with a graduated rate personal income tax. The purpose is to reduce Washington's extreme reliance on these regressive taxes and raise the same amount of revenue via an income tax. This proposal features the same three revenue reduction options as in #4, but the income tax rate structure differs. The replacement of both the state retail sales and property taxes is not proposed.

Description:

Incidence: All individuals and households residing in Washington would be subject to the tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income.

Tax Base: Same as under Proposal #4 above.

An option to this proposal would be to base the state tax on federal taxable income, rather than AGI. The difference between the two measures of base are itemized deductions such as interest and charitable contributions. This would eliminate the need for state determination of personal exemptions and standard deductions. Instead, the Legislature would implicitly adopt these elements as provided in federal law. This would allow a deduction for any state taxes paid by taxpayers who itemize deductions for their federal tax return. This proposal, as in Proposal #4, allows a credit for state income taxes paid to other states and B&O taxes paid within Washington.

Rate and Yield: The graduated rate structure would be patterned after the brackets for the federal income tax. Three sets of taxable income brackets and income tax rates would be provided for (1) single taxpayers and married couples filing separately, (2) heads of households, and (3) married couples filing jointly. The taxable income amounts for each of the three brackets would be indexed for inflation and therefore would be adjusted each year.

The actual tax rates would depend upon the amount of existing state revenue to be replaced. Three of the options in proposal #4 are illustrated below:

Table 7-4

Graduated Rate Income Tax Alternatives
CY 2005

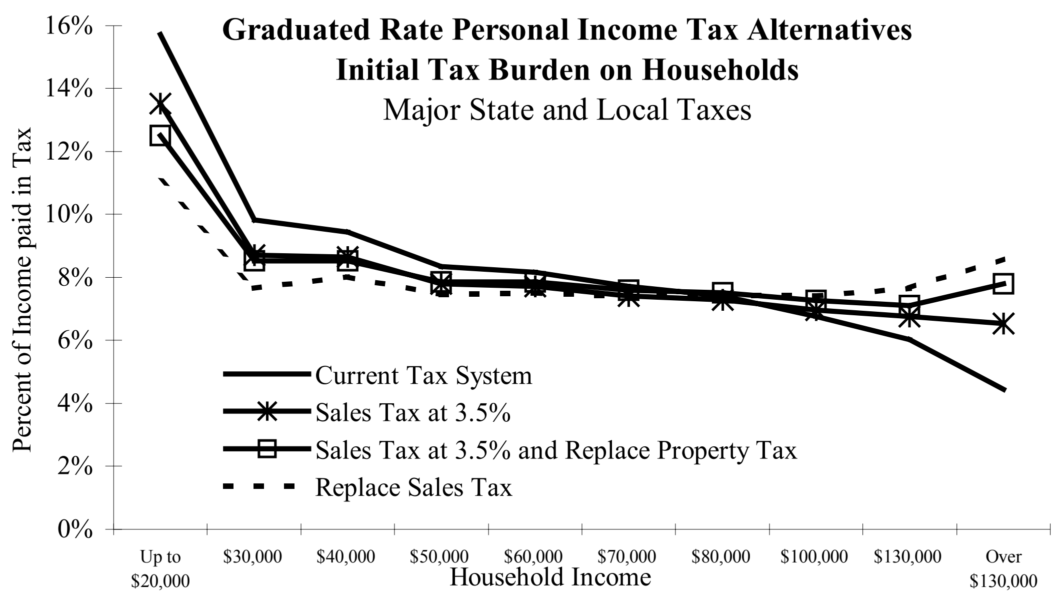
Existing Taxes Reduced or Replaced		Revenue Neutral Rates for Joint Returns: $0 to 49,900	$49,900 to 120,650	$120,650 and over
A	Reduce state sales/use tax from 6.5% to 3.5%	1.0%	2.7%	4.5%
B	Reduce state sales/use tax from 6.5% to 3.5%and eliminate state property tax	2.2%	3.5%	6.0%
C	Eliminate state sales/use tax	2.7%	5.7%	8.7%

Note: The income break points for single filers are $0 to 24,950, up to $60,325 and over $60,325.

Problems Addressed: Any of these options would significantly reduce the retail sales tax burden in Washington and decrease the regressivity of the state tax structure. With a graduated rate structure there would be a greater degree of progressivity than under Proposal #4. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved.

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

Chart 7-E



Source: Washington State Excise and Property Tax Simulation Model

Reduction in reliance upon the retail sales/use or property tax would improve Washington's business climate, since the current sales and property taxes are viewed by prospective firms as deterrents to investment in this state.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

A major shift of tax burden from businesses to individuals would occur under this proposal, increasing competitiveness. This is because corporations would experience a significant reduction in state sales/use tax (and the state property tax levy in Option B) with no corresponding income tax liability.

Chart 7-F
Major State and Local Taxes Paid Directly by Households and Businesses

Source: Utah State Tax Commission, Western States' Tax Burdens FY 1999-2000

Problems Created: Graduated personal income tax is more volatile than sales tax or property tax. It is also more volatile than a flat rate personal income tax.

Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and continue to administer an income tax. The costs would not be significantly different whether the income tax rates were flat or graduated.

The administrative burden would also extend to individuals, who would have to file tax returns.

Even though the proposal is estimated to be revenue neutral overall, there would be a major shift of tax burden from businesses to individuals. This is because corporations pay a significant share of the retail sales/use tax and the state property tax levy.

Under each of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax, even under Option C in which the entire state tax would be eliminated. Coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based state income tax with state-defined exemptions and deductions. Thirty-three of these states employ a graduated rate structure. To varying degrees the three options would make our tax mix more like other states because most states impose a personal income tax.

Chart 7-G

Percentage Reliance on Major State and Local Taxes

Source: U.S. Census Bureau, Government Finances, 1999

A majority of the Committee recommends the adoption of a graduated income tax, but more members favor the flat rate personal income tax.

#6. Flat Rate Personal and Corporate Income Tax

Proposal: Significantly reduce the state retail sales/use tax, eliminate the state B&O tax, and possibly eliminate the state property tax levy. These revenues would be replaced with a flat rate personal and corporate income tax. The purpose is to reduce Washington's extreme reliance on the regressive sales tax and the pyramiding problem caused by the B&O tax.

Description:

Incidence: All individuals and households residing in Washington would be subject to the tax. In addition, nonresidents who earn income in Washington would be subject to the tax on that income. Corporations doing business in Washington would be subject to tax on their net income, which would be apportioned to this state.

Tax Base: Same as under Proposal #4 above. The personal income tax would be based on AGI less the following deductions, personal exemptions, and credits:

Standard deduction (amount indexed for inflation):
- Single taxpayers, $5,000
- Head of household, $7,000
- Married, filing jointly:
  - $7,000 if one spouse is employed
  - $10,000 if both persons are employed
- Elderly or disabled, additional $1,000

Allow a personal exemption of $2,900 (amount indexed for inflation) for taxpayers and each dependent.

Allow credit for any state income tax paid to another state.

An option to this proposal would be to allow additional targeted tax relief to the working poor (as a percentage of the federal earned income credit) and families with child care needs (as a percentage of the federal tax credit).

The corporate net income tax would be based on federal taxable income as defined in the IRC. Thus, it would implicitly adopt all of the deductions as allowed under the federal corporate net income tax. For corporations doing business in multiple states, income would be apportioned to Washington using a standard three-factor formula. The ratios of in-state sales, property, and payroll compared with the firm's totals would each account for one-third of the apportionment. An alternative apportionment formula would double-weight the sales factor.

Rate and Yield: The flat rate income tax would be the same for both individuals and corporations. There are two options for this proposal. Both would reduce the state retail sales/use tax by 3 percent and totally eliminate the state business and occupation tax. The first would also eliminate the state property tax levy. The personal and corporate income tax rates necessary to accomplish these reductions would be as follows:

Table 7-5

Personal and Corporate Income Tax Alternatives
CY 2005

	Existing Taxes Reduced or Replaced	Revenue Neutral Tax Rates: Personal Income Tax Rate	Revenue Neutral Tax Rates: Corporate Income Tax Rate
A.	Reduce state sales/use tax from 6.5% to 3.5% Eliminate the B&O and state property tax	5.0%	5.0%
B.	Reduce state sales/use tax from 6.5% to 3.5% Eliminate the B&O	3.8%	3.8%

Problems Addressed: Either of these options would significantly reduce the retail sales tax burden in Washington, and some degree of progressivity would result from the personal exemptions and standard deductions. When combined with the reduction in regressivity resulting from the sales tax reductions, the overall equity of the tax system would be significantly improved. Reduction in reliance upon the retail sales/use tax would also improve Washington's business climate, since the current sales tax is viewed by prospective firms as a deterrent to investment in this state.

A portion of household tax burden could be exported because of deductibility of personal income tax from federal income taxes.

Exportability of corporate income tax is not an issue because corporations can export any state or local tax.

Eliminating or reducing the sales tax would alleviate the revenue loss to border cities and counties from cross-border shopping.

Elimination of the state B&O tax would shift taxation of business from the volume of activity (i.e., gross sales) to reflect profitability. This would particularly help new and expanding firms and could encourage these types of businesses to locate in Washington.

The shift from B&O to corporate income tax would eliminate pyramiding.

Problems Created: Replacing B&O with a corporate income tax would increase the volatility of the tax structure because corporate income tax is more volatile than B&O.

This proposal creates a problem for households who will see their tax burden increase as it shifts from corporations. This is because corporations pay a significant share of the retail sales/use tax and the state property tax levy, as well as the majority of the B&O tax. While this could make business taxes more similar to those levied in other states, it would entail a significant increase in the share of state/local taxes borne directly by individuals.

Imposition of an income tax may require a constitutional amendment. (See Appendix B.)

As discussed previously, it would be costly for the state to set up and administer a new income tax. The costs would not be significantly different whether the income tax rates were flat or graduated. Further, auditing of corporate net income tax returns would be much more complex than auditing the B&O tax, as firms are allowed to deduct their costs of doing business. On the other hand, the Department of Revenue would be able to piggyback its audit efforts on the federal audits of corporations since state and federal income taxes would be on the same base.

The administrative burden would also extend to individuals, who would have to file tax returns.

Under both of these options, local sales taxes would remain in place. While this is beneficial in terms of local government finance, there would be no savings in state costs of administering the retail sales/use tax. Coding of local sales taxes is one of the most onerous features of the sales tax for vendors, and this proposal would not address this problem.

Similar Taxes Imposed Elsewhere: There are 41 states that levy a broad-based personal income tax and a corporate net income tax. Five states levy a corporate income tax but no personal income tax. In nearly all of these states with the combination, the rates for the personal income tax are graduated. Further, only Colorado levies the same flat rate income tax rate on both sectors.

The majority of the Committee recommends, in addition to a personal income tax, a corporate income tax to replace the B&O tax.

Net Changes in Taxes Initially Paid by Businesses and Households

The personal income tax alternatives outlined in this chapter result in overall net decreases in tax paid by Washington taxpayers. While personal income taxes increase the taxes initially paid by households, there are offsetting benefits. The benefits are reductions in existing taxes and tax savings due to the ability to deduct personal income tax from the federal return. Taxes paid initially by businesses decrease overall with some offsetting loss in the ability to deduct existing taxes as business expenses.

The net tax changes for both businesses and households are summarized in the following tables. Tables 7-6 and 7-7 show the overall net tax changes for both businesses and households. Table 7-8 summarizes the net tax change for typical households. The household tax calculations in these tables are based on the assumption of initial incidence (i.e., the tax is borne by the entity that pays it). A significant fraction of retail sales and property taxes is paid initially by businesses, who may in fact pass on the tax to customers in the form of higher prices. No attempt has been made to determine the reduced indirect tax burdens on households that may result from the substitution of a personal income tax for sales and property taxes paid by businesses.

Table 7-6

Overall Net Taxes Initially Paid by Washington Businesses and Households
Washington Tax Structure Study Alternatives

	FLAT RATE PERSONAL INCOME TAXES ($MILLIONS)			
BUSINESSES	**Option A 2.6% Rate Reduce State RST**	**Option B 3.8% Rate Replace State Prop Tax, Reduce RST**	**Option C 5.5% Rate Replace State RST**	**Option D 6.7% Rate Replace State Prop Tax and State RST**
State Taxes Paid by Businesses				
Sales Tax	-$1,037	-$1,037	-$2,334	-$2,334
Property Tax	$0	-$654	$0	-$654
Federal Tax Savings / Loss				
Due to loss in deduction for state taxes as business expenses	$363	$592	$817	$1,046
Net Change in Taxes Initially Paid by Business	-$674	-$1,099	-$1,517	-$1,942
HOUSEHOLDS				
State Taxes Paid by Households				
Sales Tax	-$1,864	-$1,864	-$4,197	-$4,197
Property Tax	$0	-$919	$0	-$919
Personal Income Tax (includes non corp businesses)	$2,946	$4,490	$6,678	$8,222
Federal Tax Savings / Loss				
Due to deductibility of personal income tax	-$680	-$999	-$1,450	-$1,790
Due to loss in deductions for state property tax	$0	$129	$0	$129
Net Change in Taxes Initially Paid by Households	$402	$837	$1,031	$1,445
Net Tax Savings to WA Taxpayers	$272	$262	$486	$497

Table 7-7

Overall Net Taxes Initially Paid by Washington Businesses and Households
Washington Tax Structure Study Alternatives

	GRADUATED PERSONAL INCOME TAX OPTIONS ($MILLIONS)		
	Option A **1.0, 2.7, 4.5%** **Reduce RST**	**Option B** **2.2, 3.5, 6.0%** **Replace State Prop Tax, Reduce RST**	**Option C** **2.7, 5.7, 8.7%** **Replace State RST**
BUSINESSES			
State Taxes Paid by Businesses			
Sales Tax	-$1,037	-$1,037	-$2,334
Property Tax	$0	-$654	$0
Federal Tax Savings / Loss			
Due to loss in deductions for state taxes as business expenses	$363	$592	$817
Net Change in Taxes Paid by WA Business	-$674	-$1,099	-$1,517
HOUSEHOLDS			
State Taxes Paid by Households			
Sales Tax	-$1,864	-$1,864	-$4,197
Property Tax	$0	-$919	$0
Personal Income Tax (including non corp. businesses)	$2,938	$4,511	$6,575
Federal Tax Savings / Loss			
Due to deductibility of personal income tax	-$725	-$1,046	-$1,542
Due to loss in deductions for state property tax	$0	$129	$0
Net Change in Taxes Paid by WA Households	$349	$811	$836
Net Tax Savings to WA Taxpayers	$325	$288	$681

Table 7-8

Net Change in Taxes Initially Paid by Average Households
Washington Tax Structure Study Alternatives

	Household Income				
	$25,000	**$50,000**	**$75,000**	**$100,000**	**$200,000**
FLAT RATE PERSONAL INCOME TAX OPTIONS					
A 2.6 % Personal Income Tax	-$97	$143	$358	$749	$1,922
Reduce state RST to 3.5%					
B 3.8% Personal Income Tax	-$133	$213	$592	$1,239	$3,142
Reduce state RST to 3.5% and replace state Property Tax					
C 5.5% Personal Income Tax	-$224	$269	$712	$1,526	$3,981
Replace state RST					
D 6.7% Personal Income Tax	-$260	$339	$947	$2,015	$5,202
Replace state RST and replace state Property Tax					
GRADUATED PERSONAL INCOME TAX OPTIONS					
A 1, 2.7, 4.5% Personal Income Tax	-$275	-$284	-$192	$415	$2,452
Reduce state RST to 3.5%					
B 2.2, 3.5, 6% Personal Income Tax	-$311	-$223	$11	$801	$3,616
Reduce state RST to 3.5% and replace state Property Tax					
C 2.7, 5.7, 8.7% Personal Income Tax	-$537	-$473	-$247	$919	$4,748
Replace state Retail Sales Tax					

Notes: The options change household taxes as follows: (1) Household taxes increase by personal income taxes and the reduction of federal tax savings due to elimination of the state property tax. (2) Household taxes decrease by retail sale tax and property tax reductions. They also decrease by federal tax saving due to the deduction of state personal income tax.