Revenue

Improving Washington's outdated, unfair tax system

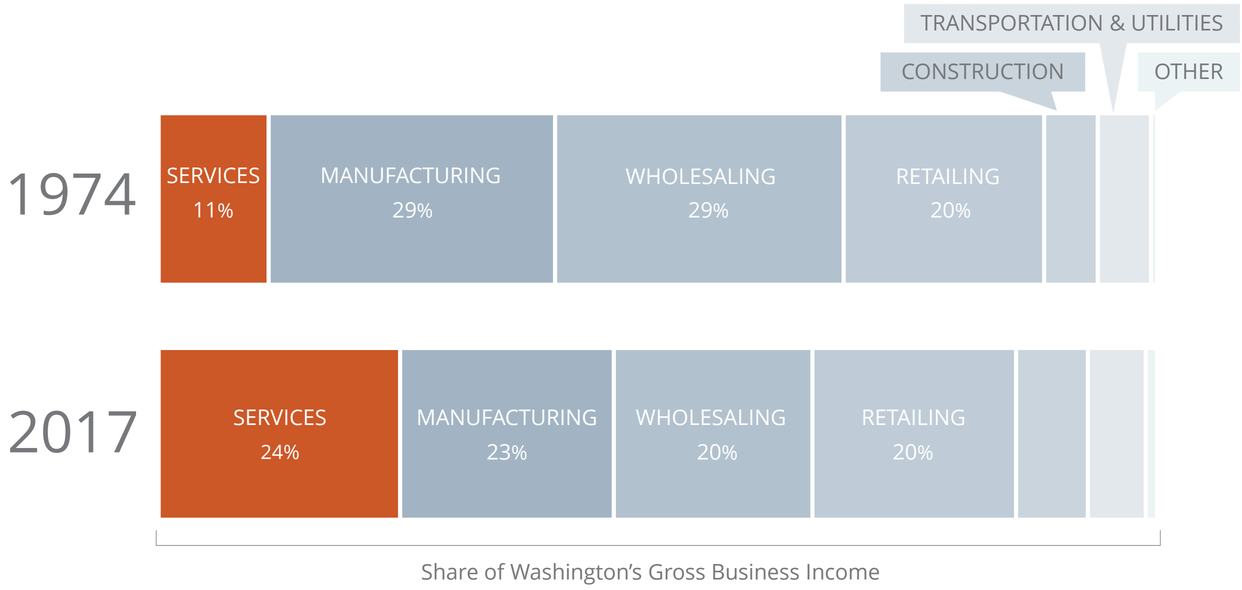
Washington has one of the most diverse and resilient economies in the nation. And, like much of the country, the state is in the midst of one of the longest-ever stretches of continuous economic growth. Even so, our state and local governments still struggle to find enough revenue to sustain their budgets.

This is partly due to the rising cost of providing services to a growing and aging population. But it is also the result of an outdated and inefficient state tax system that fails to keep pace with the growth of our economy — a tax system that puts too much of the burden on people at the lower end of the economic scale and does not require the very wealthiest to pay their fair share.

The bulk of Washington's tax system was put in place in the 1930s, when our economy was largely goods based. Today, however, we spend a smaller share of our disposable income on goods and a greater share on services such as those provided by accountants, architects, attorneys, consultants and real estate agents. In 1974, services made up a little over one-tenth of the overall state economy. By last year, services had grown to nearly a quarter of the economy. Washington's service economy also disproportionately caters to higher-income residents.

Here's the rub: Washington gets nearly half its revenue through retail sales taxes, primarily on goods. That may have worked well 50 years ago, but

Since 1974, services as a share of Washington's economy have more than doubled



Source: Washington State Department of Revenue, Nov. 2018

Washington's tax system was founded on a goods-based economy — we don't tax services to the extent we tax good and commodities. As our economy shifts, **our tax system fails to keep pace with economic growth.**

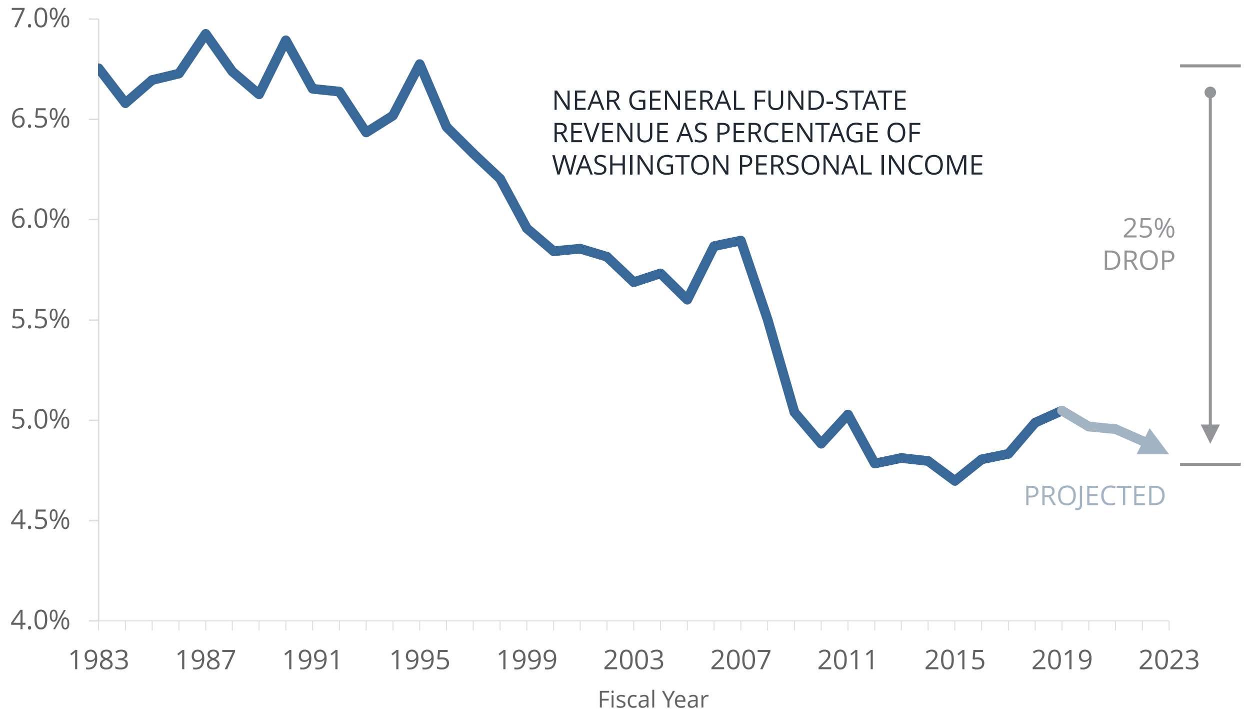
not anymore. Besides making the state's tax system the most regressive in the nation, our heavy reliance on a goods-based sales tax also makes it all but impossible for our revenue collections to keep pace with our growing economy.

Unlike some states, Washington does not impose a sales tax on most services. While Washington assesses a modest business and occupation tax on some services, in general we do not tax services to the extent we tax goods.

As a result, each year, Washington's tax system falls farther behind. In the early 1990s, General Fund-State revenue collections equaled nearly 7 percent of the overall economy (as measured by total personal income). But revenue collections as a share of the economy have declined steadily — to less than 5 percent today — and are projected to keep falling.

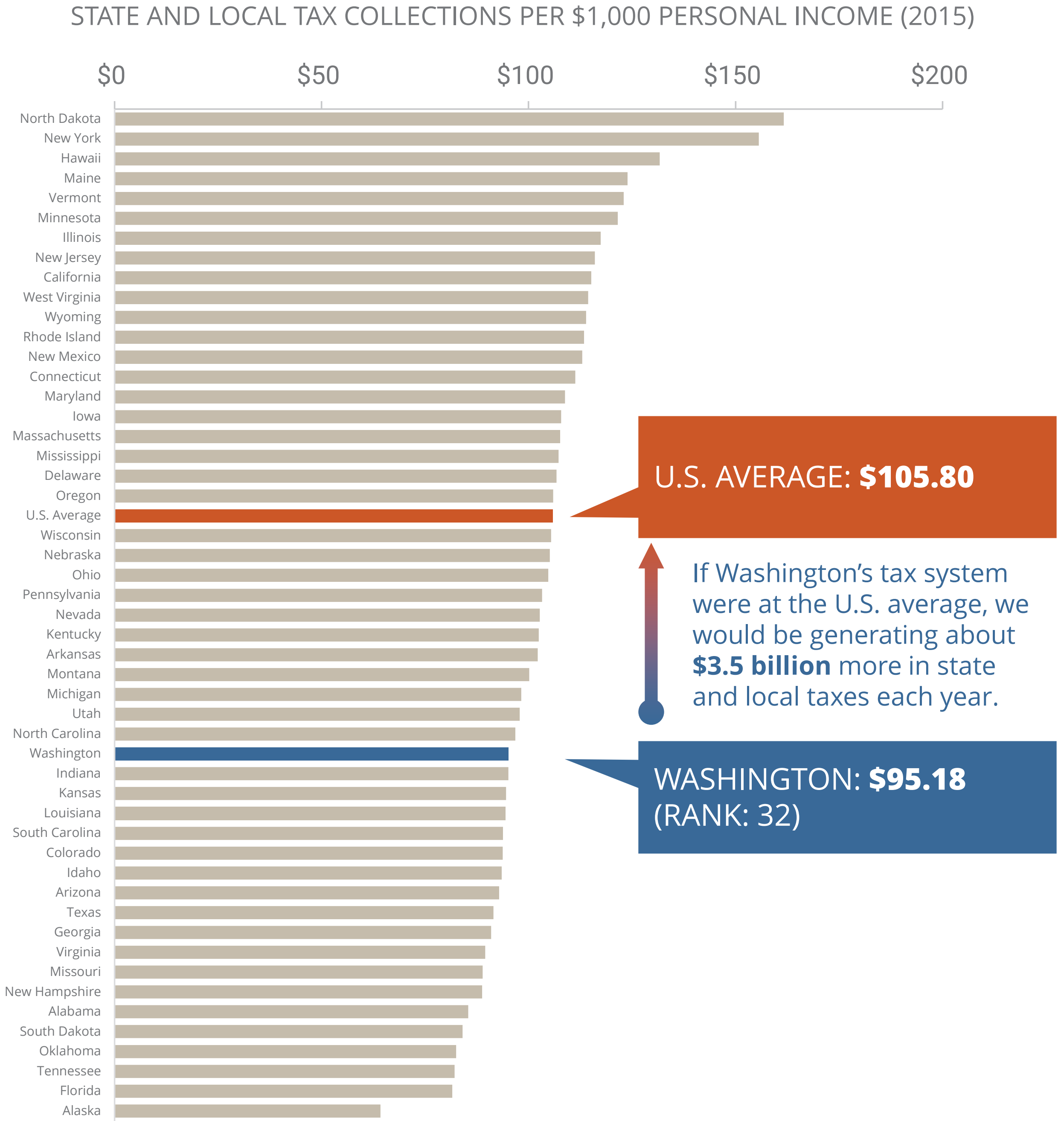
Washington is falling behind other states as well. As recently as the mid-1990s, Washington ranked 11th nationwide in state and local taxes as a share of the economy. Just two decades later, we ranked 32nd — well below the average for all states. If Washington's tax system were at the U.S. average, we would be generating an estimated $3.5 billion more in state and local taxes per year.

Over the past 23 years, state revenue collections as a share of the economy have fallen by 25 percent



Source: Washington State Economic and Revenue Forecast Council, Nov. 2018

Washington has fallen behind other states in revenue as a share of the economy



Source: Bureau of Economic Analysis and Census Bureau, U.S. Dept. of Commerce, Dec. 2018

In the mid-1990s, Washington ranked 11th nationwide. In the most recent ranking, our state was 32nd.

Proposed tax changes would help revenue keep pace with economy

With a tax system that does not keep pace with the growth of our economy, the state has too often had to rely on "one time" money — such as through fund shifts or tapping reserves — to solve budget shortfalls. As a result, budget shortfalls often reappear at the start of each biennium.

While it will be necessary to once again tap reserves, Gov. Inslee understands the state cannot rely too heavily on one-time solutions or temporary revenue sources to fund ongoing priorities.

The governor's 2019–21 operating budget calls for a mix of tax and revenue changes that will help address the state's immediate needs and create a more sustainable revenue system that is better able to keep pace with future needs as our economy grows.

Overall, the governor's plan would generate nearly $4 billion in additional revenue during the next biennium for the state operating, capital and transportation budgets. Besides helping the state meet its commitment to fully fund basic education, the additional revenue will enable the state to pay for vital improvements to our behavioral health system, expand early learning opportunities and fund recovery efforts for the region's critically endangered Southern Resident orca population. It will also support investments in homelessness, financial aid for college students, public health and other key priorities.

Even with the revenue increases the governor is proposing, Washington's tax collections as a share of the economy will remain below the national average.

Key revenue proposals

The governor proposes increasing the **state business and occupation tax** on services and other activities from 1.5 percent to 2.5 percent, which would generate about $2.6 billion in the next biennium.

The state has increased the B&O tax on services in the past. The most recent change was in 2010, when the tax was increased temporarily to help fund state services after revenue collections crashed during the recession.

As he has previously, the governor is calling for a new **capital gains tax** on the sale of stocks, bonds and other assets. Exemptions are provided for retirement accounts, homes, farms and forestry. Earned income from salaries and wages is not capital gains and would not be taxed at all.

Washington is one of just nine states that do not tax capital gains.

The proposal is designed to increase the share of state taxes paid by our state's wealthiest taxpayers. The state would apply a 9 percent tax to capital gains earnings above $25,000 for individuals and $50,000 for joint filers, starting in the second year of the biennium.

At those earnings thresholds, the tax would primarily affect very wealthy households. In fact, if the tax had been in place in 2016, the average total income of affected households would have been nearly $660,000.

And the tax will only affect a tiny fraction of taxpayers — about 1.5 percent of households in the first year.

The capital gains tax would raise an estimated $975 million in fiscal year 2021.

To help the state pay for court-ordered removal of fish passage barriers, the governor also proposes changing the state's **real estate excise tax** from a flat rate to a graduated rate. Currently, the state tax on all property sales is 1.28 percent, regardless of the sale price. Under the new graduated approach, the rate on lower-valued properties (under $250,000) would be 0.75 percent, while the rate would be 2 percent for property sales over $1 million and 2.5 percent for sales over $5 million. The rate would stay at 1.28 percent for sales between $250,000 and $1 million.

The graduated rate would increase state real estate excise tax collections by about $400 million in the next biennium.