REVENUE

80-year-old tax and revenue system hampers state's ability to meet vital needs

Washington's overall economy is one of the strongest and most diverse in the nation. Yet over the years, our state and local governments have become increasingly hamstrung by an inability to meet the rising demands placed on services by a growing population.

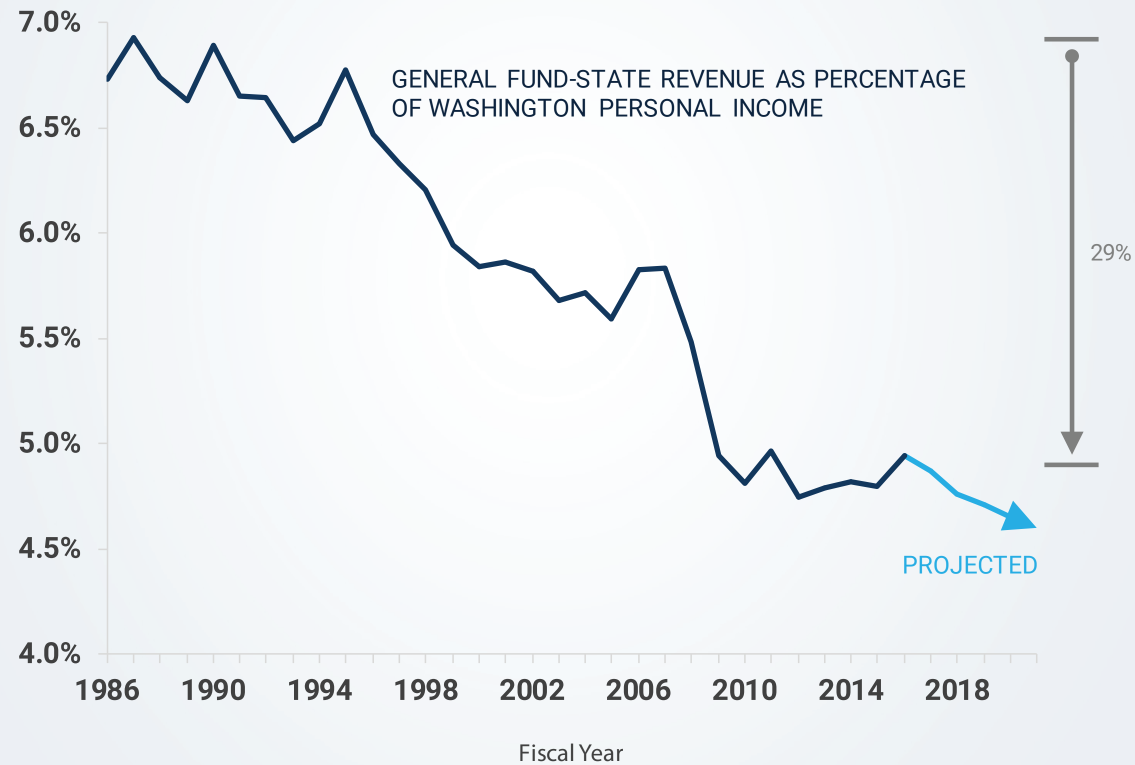
Our tax system — put in place in the 1930s, when rotary phones and manual typewriters were the norm — does not reflect the state's modern, service-based economy. That is partly why our state and local tax systems no longer keep pace with the growth of our economy.

Each year, as our tax revenues fall further behind, we face a growing structural imbalance in our state budget.

Consider this: In the early 1990s, State General Fund revenue collections equaled nearly 7 percent of the overall economy (as measured by total personal income). But today, revenue collections as a share of the economy have declined steadily, to less than 5 percent.

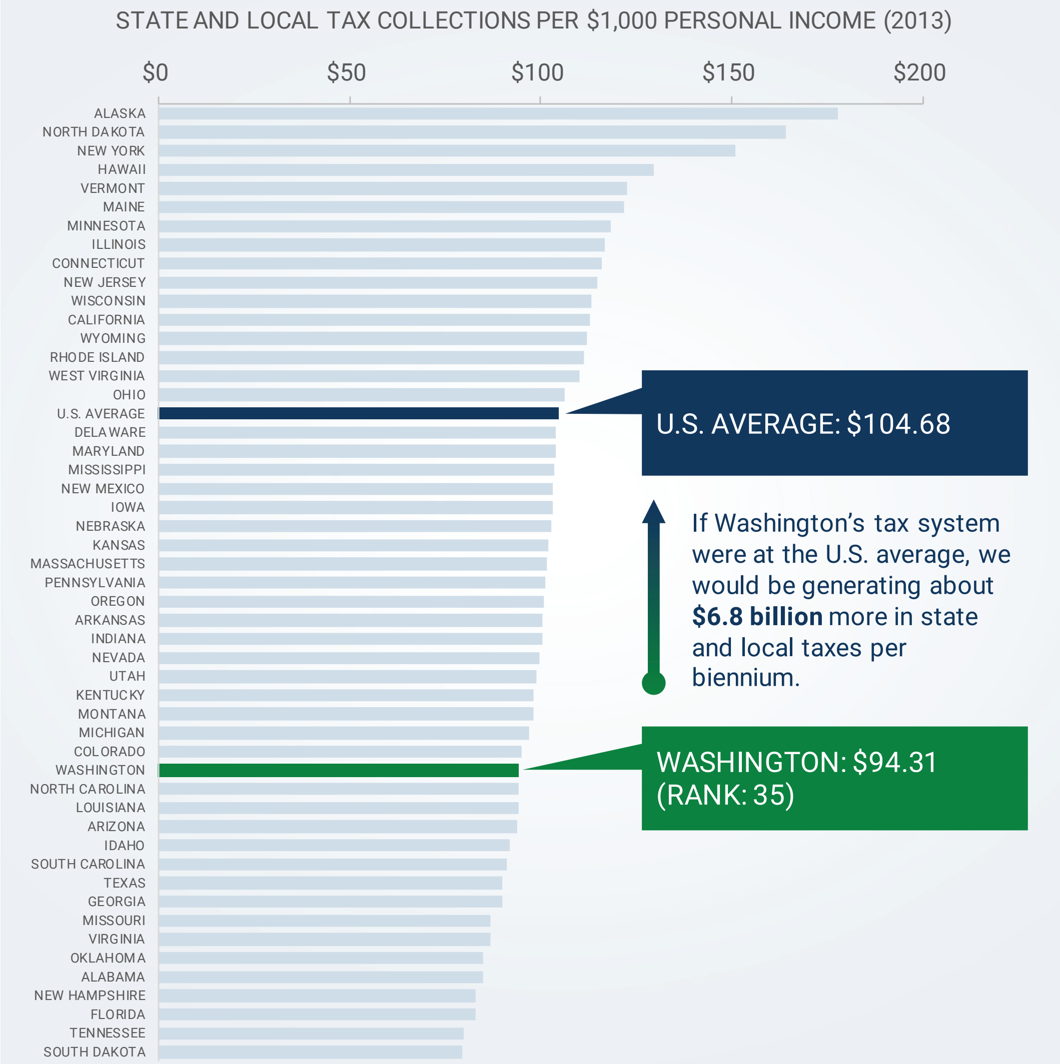
Washington is falling behind other states as well. During the mid-1990s, Washington ranked 11th nationwide in state and local taxes as a share of the economy. By 2013, the state's ranking had fallen to 35th — well below the average for all states.

Over the past 30 years, state revenue collections as a share of the economy have fallen by nearly 30%



Source: Washington State Economic and Revenue Forecast Council, Nov. 2016

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. 2016

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How significant is that? If Washington's tax system were at the U.S. average, we would be generating about $6.8 billion more in state and local taxes per biennium.

As economy shifts to services, Washington's tax system falls further behind

A multitude of factors have been stripping the gears of the state's tax and revenue system, the bulk of which was put in place 80 years ago, when the state economy looked much different than it does today.

Washington gets nearly half its revenue through retail sales taxes, primarily on goods. Besides making the state's tax system the most regressive in the nation, our heavy reliance on a goods-based sales tax also helps explain why we continue falling behind in revenue collections.

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. Yet people today are spending a smaller share of their disposable income on goods and a greater share on services such as those provided by accountants, architects, attorneys, consultants and real estate agents. In fact, over the past 40 years, services have more than doubled as a share of the total economy.

Since the mid-1930s, Washington has adopted more than 650 state and local tax exemptions, worth billions of dollars. Nearly a third of those were put in place during the past 15 years. While many tax exemptions are well-targeted at providing needed tax relief or creating jobs, many others are outdated or no longer serve their original purpose.

What's more, consumers today are doing more of their shopping online instead of in local stores. But because many out-of-state businesses do not collect sales taxes, Washington loses hundreds of millions of dollars each year in potential revenue, and our brick-and-mortar businesses are placed at a competitive disadvantage.

Saddled with a flawed and inefficient tax and revenue system, the state in recent years has too often relied on “one time” money — such as through fund shifts or tapping reserves — to solve budget shortfalls. As a result, budget shortfalls reappear at the start of each biennium.

While it will be necessary to once again tap reserves, given the enormity of the challenges the state faces in the next biennium and beyond, Gov. Inslee understands the state cannot rely too heavily on one-time solutions or temporary revenue sources.

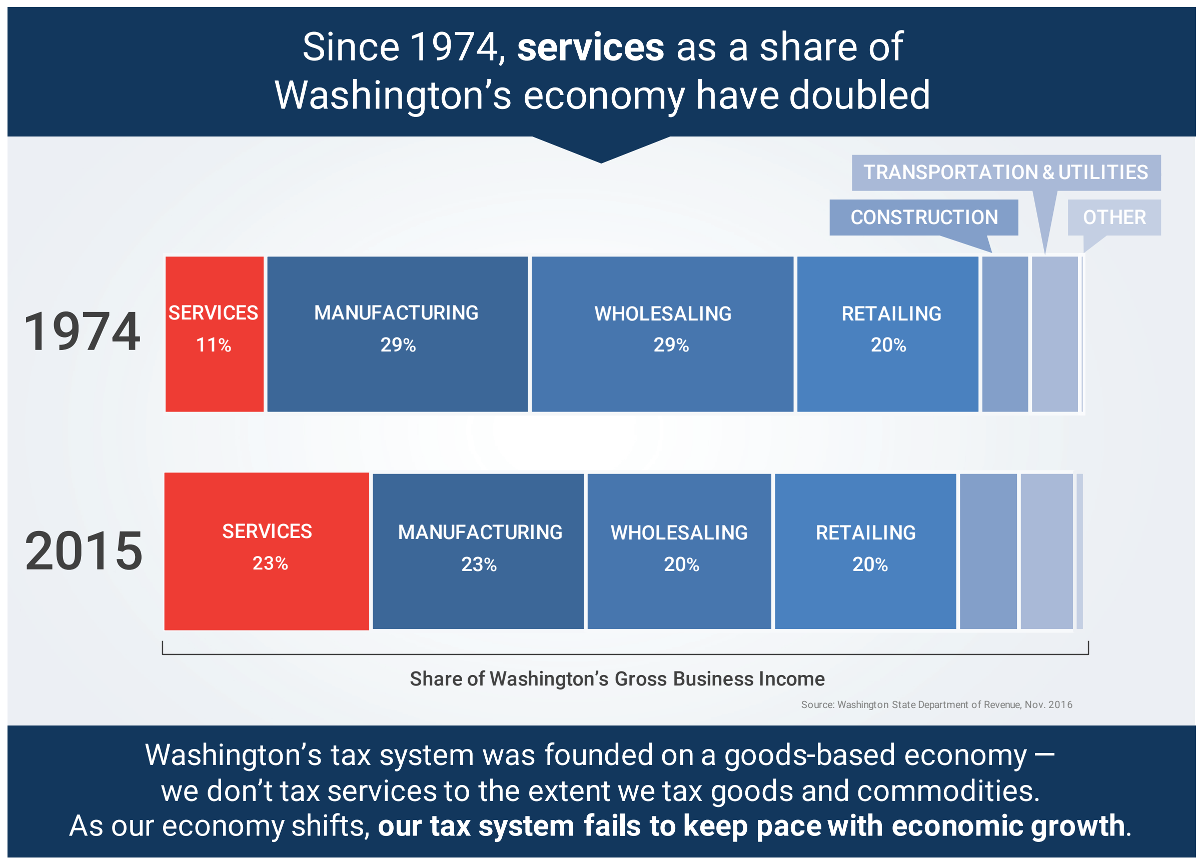
Proposed revenue changes will fully fund education, provide local property tax relief

The governor’s proposed 2017–19 operating budget calls for a balanced mix of revenue changes that will address the state’s immediate needs and create a sustainable revenue system better designed to keep pace with needs as our economy grows. His revenue plan is rooted in fairness for working families.

Overall, the governor is proposing nearly $4.4 billion in net new revenue for the 2017–19 operating budget. The vast majority of that will go toward ensuring sustainable full funding for education, significantly expanding community services for mental and behavioral health services, and supporting investments in homelessness, public health and other key priorities. The governor is proposing about $800 million in additional new revenue to fund projects in his capital budget.

Importantly, the governor’s revenue package would reduce local property taxes. School districts now fund a significant portion of the state’s basic education obligations through local property taxes — a practice the state Supreme Court has ordered the Legislature to fix.

Under the governor’s plan, every school district would receive more money from the state. The infusion of state funding would reduce local school district property tax levies. Initial estimates indicate that local school taxes during the next biennium would be reduced by at least $250 million per year and that more than three-fourths of households and businesses statewide would get a property tax cut.



The governor also proposes increasing the state business and occupation tax on services and other activities from 1.5 percent to 2.5 percent, which would generate nearly $2.3 billion in the next biennium. The tax is applied to a broad range of personal and professional services, such as those provided by accountants, architects, attorneys, consultants and real estate agents.

To make sure very small businesses aren't impacted, the governor's plan more than doubles the B&O tax filing threshold to $100,000 and increases the small-business tax credit to $125 per month for all businesses. These changes would mean 38,000 more small businesses statewide would receive relief.

The governor is also 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 are not capital gains and would not be taxed at all.

The proposal is similar to one he put forward two years ago to increase the share of state taxes paid by Washington's wealthiest taxpayers. The state would apply a 7.9 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, only a tiny fraction of the state's wealthiest taxpayers would be affected.

Washington is one of just nine states that do not tax capital gains. A 7.9 percent tax would put the state's rate well below Oregon's (9.9 percent) and California's (13.3 percent).

The tax would raise an estimated $821 million in fiscal year 2019. To address concerns about the volatility of a capital gains tax, the governor proposes creating a school investment reserve fund. Any year in which the state collects more than $900 million in capital gains taxes, the excess amount would be directed to the reserve fund. The tax is projected to generate more than $900 million by the second year it is in place.

The governor is also proposing a new tax on carbon pollution associated with the production and consumption of fossil fuels. The carbon tax would take effect in fiscal year 2018, generating about $1.9 billion in the next biennium. About half the revenue generated by the carbon tax would be directed to the state's education needs. The rest would be reinvested in clean energy and transportation projects to lower consumer fuel bills and reduce greenhouse gas emissions. Revenue will also support major projects to build water infrastructure and improve forest health. Some funds will offset taxes to businesses and low-income households especially vulnerable to increased energy costs.

Major Components of Operating Budget Revenue Plan	2017–19 Total
Increases	*$ in millions*
B&O tax on services – Increase rate to 2.5% (all services)	$2,276
Carbon tax (net revenue) – $25/ton plus inflation plus 3.5%	$1,069
Capital gains tax – 7.9% ($25,000/$50,000 threshold, exempt all residential property)	$821
Limit trade-in exclusion to $10,000	$91
Limit REET foreclosure exemption	$59
Repeal bottled water sales tax exemption	$57
Repeal extracted fuel (except hog fuel)	$52
Refund nonresident sales tax exemption	$49
Extend economic nexus to retailing B&O activities	$12
Decreases	
Cigarette smoking to age 21	$(16)
High-technology R&D tax incentives	$(30)
Increase small business B&O tax credit and tax filing threshold	$(92)

Finally, the governor's budget calls for closing five outdated tax exemptions, which would generate more than $300 million in revenue during the next biennium. Here are the exemptions the governor proposes closing and the revenue each would generate in the next biennium:

Repeal sales tax exemption on bottled water – $57 million

This proposal repeals the sales tax exemption for bottled water. Refunds are provided for those with a medical prescription for bottled water or for those who do not have access to potable water.

Sales of bottled water were subject to tax before 2004. But the tax was removed when Washington joined the nationwide Streamlined Sales and Use Tax Agreement. The agreement no longer requires Washington to exempt bottled water from sales tax. Bottled water is a discretionary purchase, and the vast majority of states collect tax on these sales.

Refund state portion of sales tax to nonresidents – $49 million

This proposal converts the current nonresident sales tax exemption to a refund program for the 6.5 percent state portion of the sales tax. The exemption was created in the 1960s and provides a tax advantage to out-of-state residents over Washington residents.

Repeal use tax exemption for extracted fuel – $52 million

This proposal limits the use tax exemption for fuel produced by an extractor or manufacturer when the fuel is directly used in the same process. Only wood byproducts, referred to as "hog fuel," would continue to be eligible for the exemption.

The biggest beneficiaries of this exemption are oil refineries that did not exist when this exemption was created. Other industries pay tax when they use materials they manufacture themselves.

Repeal sales tax exemption for trade-ins valued over $10,000 — $91 million

This proposal would limit the exclusion of trade-in value from retail sales and use tax to $10,000 for motor vehicles, recreational vehicles, boats and other items. The current unlimited deduction primarily benefits high-income earners, who have the state's lowest tax burdens.

Limit REET exemption on foreclosure sales by lenders – $59 million

This proposal requires banks and other lenders to pay real estate excise tax, or REET, if one of the following is met:

- A lender or creditor receives property through a foreclosure proceeding or by enforcing a judgment.
- Property is sold at a foreclosure or sheriff's auction.
- Property is transferred by order of the court in a foreclosure or a judgment enforcement proceeding.

This is a matter of fairness. The average homeowner pays REET when selling or in some cases when refinancing a mortgage. A bank should pay the same when selling the property.