

# INITIATIVE 1077: THE RIGHT FIX FOR WASHINGTON'S FLAWED TAX STRUCTURE

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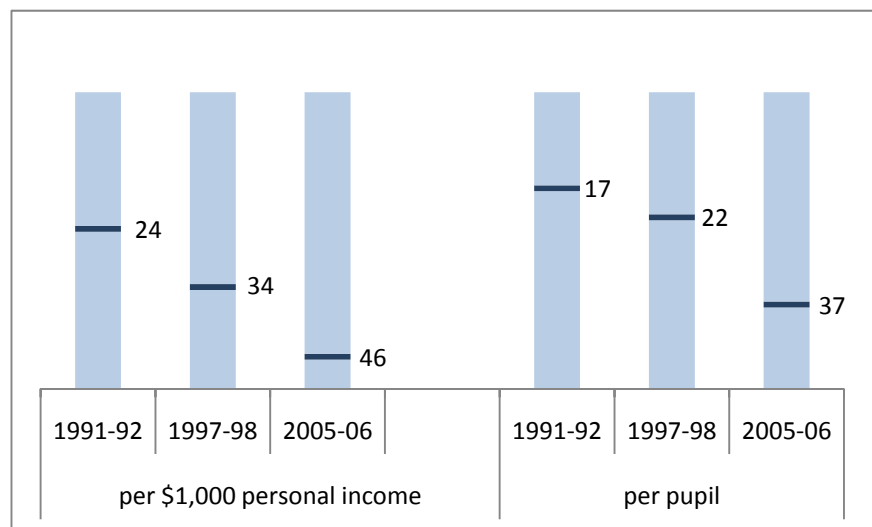
While the state's recession-driven budget deficit has received considerable attention, Washington's public revenue structure has more fundamental problems that will remain even when the economy has fully revived. Without reform, our state will continue to struggle to find sufficient funds to provide the kind of educational system our young people and businesses need to thrive in the global economy, while sustaining health and other basic services.

Initiative 1077 would improve Washington's tax structure, making it more fair and allowing public revenues to better keep pace with economic growth and the need for services. It would reduce taxes for the majority of Washingtonians by lowering property taxes and exempting small businesses from the business and occupation tax. And it would raise new revenue dedicated to education and health services by adding an income tax on the wealthiest 3% of households – the group that is now paying the lowest percentage of income in state and local taxes and has enjoyed the most dramatic income gains in recent years.

## Washington's Structural Deficit - It's Not Just the Recession

Even before the Great Recession devastated state budgets nationwide, Washington was losing ground in funding high priority public services. From the 1991-92 school year to 2005-06 Washington's rank among all the states in funding K-12 education fell from 17<sup>th</sup> to 37<sup>th</sup> on a per pupil basis, and from 24<sup>th</sup> to 46<sup>th</sup> relative to the state's personal wealth.<sup>1</sup>

### WASHINGTON'S RANK AMONG THE STATES IN K-12 SPENDING



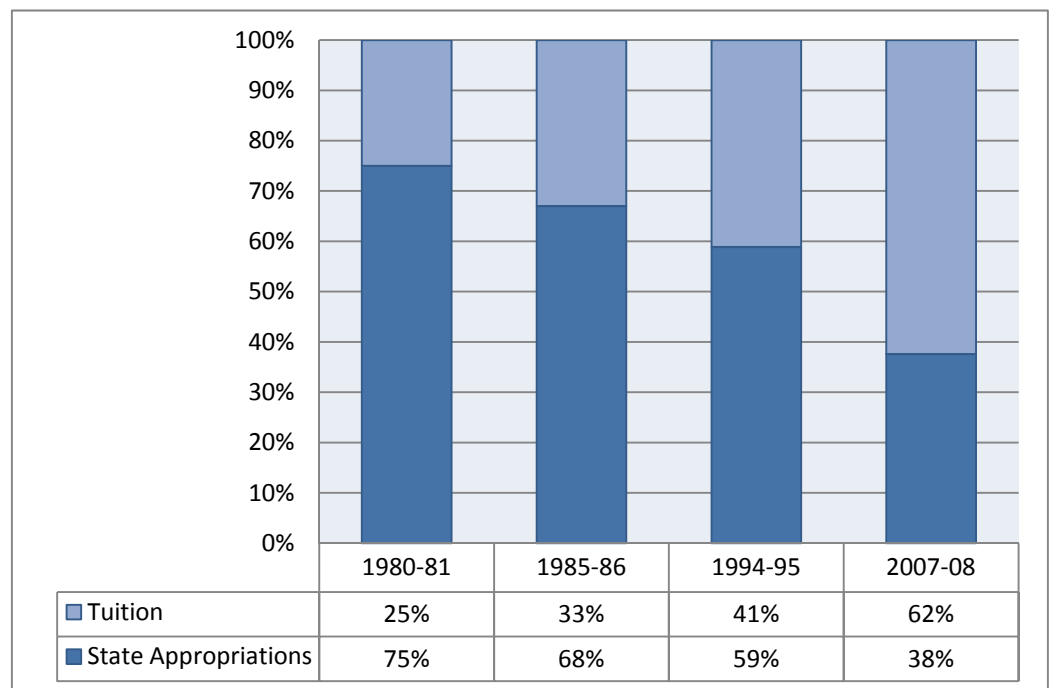
Source: U.S. Census, Annual Survey of Local Government Finance



For the past thirty years, Washington State has been reducing the level of appropriations to higher education. In 1980-81, undergraduate tuition accounted for 25% of the total costs of undergraduate instruction in research universities, while the state covered the remaining 75%. By the 2007-08 academic year, tuition covered 62% and the state only 38% (Figure 4). The trend of disinvestment is also evident in community and technical colleges, with the state decreasing its share from 77% in 1980-81 to 58% in 2007-08.<sup>2</sup>

Meanwhile, the traditional college-age population has been growing faster than overall growth, and more older adults are returning to school for job retraining. In addition, the number of seniors over age 85 is expected to increase more than twice as fast as the general population in coming years, raising the need for expensive long term care services.<sup>3</sup>

### STATE APPROPRIATIONS VS. TUITION AS A PERCENTAGE OF COSTS OF INSTRUCTION IN WASHINGTON RESEARCH UNIVERSITIES



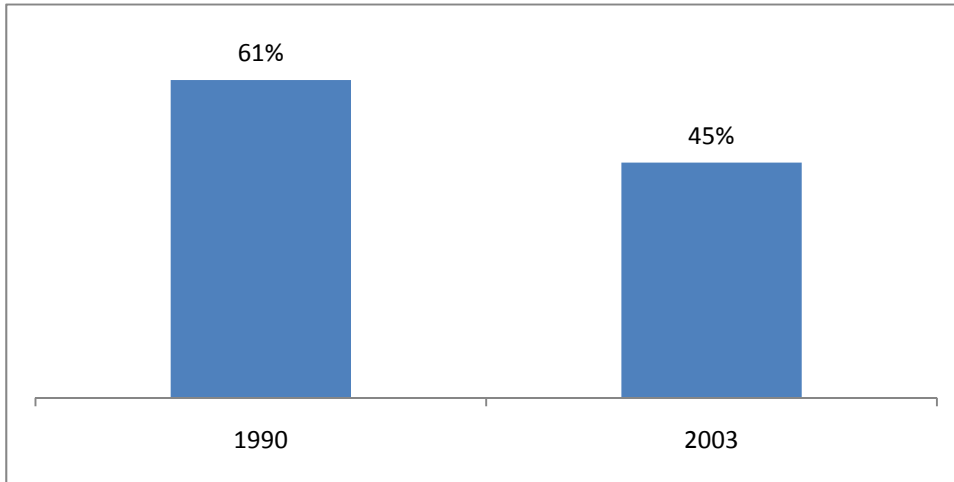
Source: Washington Higher Education Coordinating Board, "Key Facts About Higher Education in Washington"

### Over-Reliance on Sales Tax Is a Big Part of the Problem

Over half of Washington's general fund revenues come from the sales tax – 56.5% in the 2007-09 biennium. We pay sales tax on most goods other than food and prescription drugs and a few services such as car repair and construction. But more and more spending is on other types of services, including health care, beauty salons, veterinarians, and attorneys, and people are buying more goods over the internet – often without paying sales tax. From 1990 to 2003 alone, the percentage of sales subject to sales tax in Washington fell from 61% to 45%, according to an Indiana University study of sales taxes across the country.<sup>4</sup>

## PERCENTAGE OF SALES SUBJECT TO SALES TAX

WASHINGTON STATE, 1990, 2003



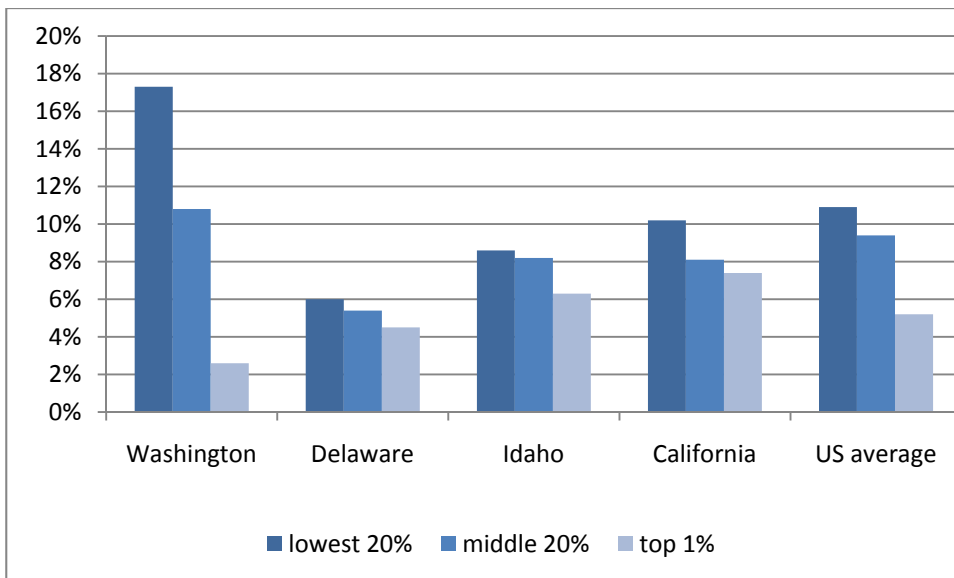
Source: John L. Mikesell, cited in Center on Budget and Policy Priorities, "Faulty Foundations."

## Washington's Tax Structure is Also the Most Regressive

In addition to the structural deficit, Washington over taxes low and middle income residents compared to other states and under taxes our wealthiest citizens. Repeated studies have found that Washington's system is the most regressive of any of the states.<sup>5</sup>

## PERCENTAGE OF INCOME PAID IN STATE AND LOCAL TAXES

NON-ELDERLY TAXPAYERS, 2007

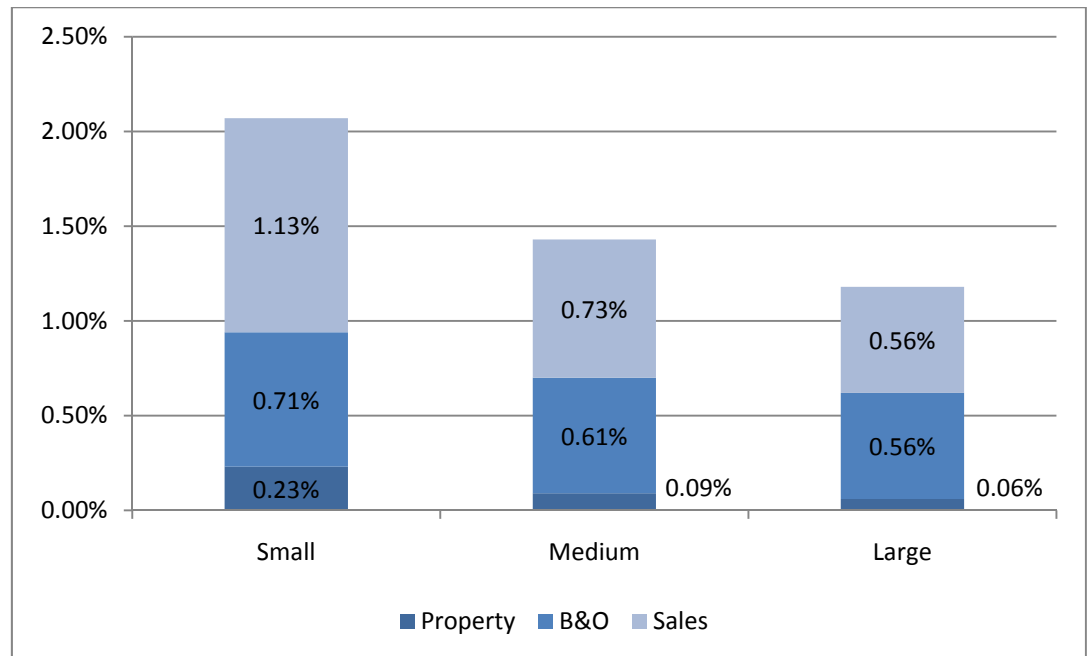


Source: Institute for Taxation and Economic Policy, *Who Pays?*, 2009

Washington's tax system also disadvantages small businesses and those just starting out. Small businesses pay a higher percentage of their gross income in both sales tax and the business and occupation tax (B&O) than do mid-size or large companies.<sup>6</sup> And because the B&O tax is on gross receipts, firms have to pay it even when they make no profit.

### STATE TAXES PAID BY WASHINGTON BUSINESSES

(AS A PERCENTAGE OF GROSS INCOME, BY FIRM SIZE)



Source: Washington Department of Revenue, 2002 data.

### Why Other States Do Better

Other states have been able to rise above Washington in funding education and have less regressive tax systems because most have an income tax. Washington is one of only seven states with no income tax. Most of those others (Alaska, Florida, Nevada, South Dakota, Texas, and Wyoming) have other major sources of revenue, including from oil, minerals, gambling, and tourism. On average in other states, individual income taxes contributed 34.4% of General Fund revenues in 2009.<sup>7</sup>

The states with an income tax have a general tax that applies to most households, except for Tennessee and New Hampshire which only apply income tax to interest and dividend income. Top rates range from 3% in Illinois (one of the 7 states with a flat rate) to 11% in Hawaii and Oregon. Five states have top rates above 9%, and an additional 4 have rates above 8% in 2010.<sup>8</sup>

## Initiative 1077 – The Right Reform for Washington

Initiative 1077 has been filed to appear on the November 2010 ballot in Washington. It would improve Washington’s tax structure by reducing both the structural deficit and regressivity. I-1077 proposes:<sup>9</sup>

- Adding an income tax on couples with incomes above \$400,000 and singles over \$200,000;
- Reducing the state portion of the property tax by 20%;
- Eliminating or reducing B&O taxes for many businesses by raising the small business credit from \$420 to \$4,800 per year;
- Dedicating net new revenues to education (70%) and health (30%);
- Requiring regular reporting on how revenues are spent and requiring that future changes in the income tax be approved by a vote of the people.

The combination of new tax and reductions would result in about \$1 billion in new revenue per year for education and health care.

### ESTIMATED ANNUAL REVENUE CHANGE FROM INITIATIVE 1077

	Annual Revenue Change
<b>Income tax:</b> 5% over \$200,000 singles/\$400,000 couples 9% over \$500,000 singles/\$1 million couples	\$1,700 million
<b>Property tax:</b> Reduce state portion 20%	(\$357 million)
<b>B&amp;O tax:</b> Increase credit from \$420 to \$4,800 annually	(\$249 million)
<b>Net New Revenue</b>	<b>\$1,094 million</b>

*Sources: Income tax- Institute for Taxation and Economic Policy estimates for 2009; Property tax – 20% of state receipts for 2009; B&O tax – Department of Revenue estimate for 2012.*

**Income tax.** The tax reform proposed by I-1077 will lower taxes for most Washington residents and raise taxes for about 3% of the state’s highest income households. The wealthiest now pay a far lower share of their income to support public services than do middle and lower income families. Washington’s well-to-do also pay far less than do their counterparts in almost every other state.<sup>10</sup>

The wealthiest households have also enjoyed the fastest growth in incomes over the past decade. In Washington State between the late 1990s and 2006, the top fifth gained 11.6% while the bottom fifth lost 4.2%.<sup>11</sup> Among Washington men, those in the top 90<sup>th</sup> percentile of hourly earnings enjoyed a 20.4% real increase, compared to 6.7% for those in the middle and a slight loss of real earnings for those in the 20<sup>th</sup> percentile.<sup>12</sup>

Washington residents paying the new tax would be able to deduct it from their taxable income. Federal deductions by the wealthiest tax payers in income tax states are far higher than those from non-income tax states who are only able to deduct sales tax. As a result, Washington State is contributing more than its share to federal revenues, compared to other states.<sup>13</sup>

**Property tax cuts.** Two thirds of Washington households own their homes. These households will receive a direct reduction of 20% of the state portion of the property tax. Currently on average 21% of total property taxes go to the state. The remainder stays in local communities and includes voter-approved school levies and support for other local services.<sup>14</sup> The 20% reduction in the state property tax translates into an annual tax saving of \$170 for the average homeowner in Seattle where the average residence value in 2010 is \$448,500. In Algona with an average residence value of \$193,700 the annual savings would be \$100.<sup>15</sup> Because the cost of property tax is typically included in rent, renters over time will also likely save. Of course, as the graph on page 4 illustrates, businesses of all sizes will also benefit from the property tax cut.

### EFFECTS OF I-1077 ON WASHINGTON HOUSEHOLDS

Family/ Income	Total State Income Tax	Reduced Federal Tax	Avg. Property Tax Reduction	Net New Tax	Percentage of Income Paid
Median single female/\$38,000	-	-	-\$153 (Kent)	-\$153	-
Median single family/\$70,500	-	-	-\$206 (Shoreline)	-\$206	-
Couple/\$500,000	\$5,000	\$618	-\$247 (Issaquah)	\$4,136	0.8%
Single/\$500,000	\$15,000	\$2,949	-\$181 (Seattle)	\$11,871	2.4%
Couple/\$1.2 million	\$48,000	\$8,924	-\$242 (Bellevue)	\$38,834	3.2%
Couple/\$3 million	\$210,000	\$46,184	-\$368 (Mercer Island)	\$163,449	5.4%

*Federal tax reduction assumes substituting state income for state sales tax in itemized deductions, with current sales tax deductions of \$2,315 for couples and \$2,180 for singles with incomes of \$500,000 (from 2010 IRS table), and of \$9,202 for higher income families, based on average deduction for wealthiest households. Sources: IRS Instruction for 1040 Schedule A, 2010; United for a Fair Economy, "Leaving Money on the Table"; U.S. Census Bureau American, Community Survey; Washington State Department of Revenue.*

**B&O tax cuts.** Businesses classified as services, such as hairdressers, pay 1.5% of their gross receipts in B&O tax. Those classified as retail pay 0.471%. The very smallest businesses are currently exempt under the small business tax credit. I-1077 raises the tax credit from \$420 to \$4,800 per year, phased out up to \$9,600. Retail businesses with gross receipts up to about \$1 million would be exempt from B&O taxes under I-1077, and those up to about \$2 million would see their taxes reduced. According to analysis by the Department of Revenue, of the 317,000 firms in Washington, 81% would be exempt from B&O taxes under I-1077. An additional 12% of firms would have their taxes reduced.

## EFFECTS OF I-1077 ON BUSINESS TAXES

	Gross Receipts Exempt Now	Gross Receipts Exempt with I-1077
Service business (1.5% rate)	\$28,000	\$320,000
Retail business (0.471% rate)	\$89,172	\$1,019,108

*Source: Department of Revenue*

### Conclusion

Initiative 1077 would be a big step in the right direction, reforming Washington's tax system to be more in step with the 21<sup>st</sup> century economy. It would create a more fair and balanced tax system, while providing badly needed revenue for education and health services.

## Endnotes

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- <sup>1</sup> U.S. Census Bureau, Public Elementary-Secondary Education Finances, <http://www.census.gov/govs/www/school.html>.
- <sup>2</sup> Washington Higher Education Coordinating Board, "Key Facts About Higher Education in Washington", Chapter 4, Higher Education Finances, p. 53, 2008, <http://www.hecb.wa.gov/keyfacts/>.
- <sup>3</sup> Washington Office of Financial Management, Washington Trends, Projected Change in Budget Driver Populations, December 2008, [www.ofm.wa.gov](http://www.ofm.wa.gov).
- <sup>4</sup> John L. Mikesell, "State Retail Sales Tax Burdens, Reliance, and Breadth," *State Tax Notes*, July 12, 2004, as cited in Iris Lav, et al, "Faulty Foundations: State Structural Budget Problems and how to Fix Them," 2005, Center on Budget and Policy Priorities, [www.cbpp.org](http://www.cbpp.org).
- <sup>5</sup> Institute for Taxation and Economic Policy, "Who Pays?: A Distributional Analysis of the Tax Systems in All 50 States," 3<sup>rd</sup> edition, 2009, <http://www.itepnet.org/whopays.htm>.
- <sup>6</sup> Small firms in this analysis have less than \$5 million in annual gross income, medium size firms have \$5 to \$25 million. Department of Revenue, "Incidence of Washington Taxes," presentation to the House Finance Committee, February 15, 2005. These numbers are for established firms.
- <sup>7</sup> Federation of Tax Administrators, "2009 State Tax Collections by Source," <http://www.taxadmin.org/fta/rate/09taxdis.html>.
- <sup>8</sup> Federation of Tax Administrators, "State Individual income Taxes," as of January 1, 2010, [www.taxadmin.org](http://www.taxadmin.org).
- <sup>9</sup> Washington Secretary of State, Initiative filed 2010, <http://www.sos.wa.gov/elections/initiatives/people.as> U.S. Census Bureau, Public Elementary-Secondary Education Finances, <http://www.census.gov/govs/www/school.html>.
- <sup>10</sup> Institute for Taxation and Economic Policy, "Who Pays?: A Distributional Analysis of the Tax Systems in All 50 States," 3<sup>rd</sup> edition, 2009, <http://www.itepnet.org/whopays.htm>.
- <sup>11</sup> Data comparisons are for the years 1998-2000 and 2004-2006. Center on Budget and Policy Priorities and Economic Policy Institute, "Pulling Apart: A State-by-State Analysis of Income Trends," 2008 edition, [www.epi.org](http://www.epi.org).
- <sup>12</sup> Economic Policy Institute analysis of Current Population Survey data, inflation adjusted using CPI-U-RS.
- <sup>13</sup> United for a Fair Economy and Institute for Taxation and Economic Policy, "Leaving Money on the Table," April 2010, [http://www.faireconomy.org/news/Leaving\\_Money](http://www.faireconomy.org/news/Leaving_Money).
- <sup>14</sup> Washington Department of Revenue, Tax Reference Manual 2010, [www.dor.wa.gov](http://www.dor.wa.gov).
- <sup>15</sup> King County Department of Assessments, Assessed Value and Taxes by City, 2009 and 2010, <http://www.kingcounty.gov/Assessor/Reports/AnnualReports/2010.aspx>.