

Business & Occupation Tax Reform, Part IV

New tax pyramiding data for Washington State: Pyramiding occurs more frequently than thought, resulting in broader tax base

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Introduction

In 2001, the state legislature created the Washington State Tax Structure Committee, also known as the Gates Commission, headed by William H. Gates, Sr. The mandate given to the Commission by the state legislature was to conduct “a systematic analysis of Washington’s existing tax structure and provide recommendations for alternatives to improve the tax system.”

The Committee focused on several aspects of the state’s tax system, ranging from the property tax to the sales tax and more. But it also zeroed in on the effects the Business and Occupation tax has on the business community. What they found was of great concern to the committee and to policymakers.

Washington state’s Business and Occupation (B&O) tax is a gross receipts tax levied upon businesses in the state. The tax applies to all business transactions—as opposed to only the final sale of the product. Therefore, all transactions to produce the final product are taxed, including business-to-business purchases of supplies, raw materials and equipment. In Washington state there are no B&O deductions for the cost of doing business.

One of the consequences of the gross receipts tax policy is the extra layer of taxation applied at each stage of production, an effect called “pyramiding.” Pyramiding, according to the Committee, is the payment of taxes by different companies to produce the same good or service. The B&O tax is similar to a sales tax, yet it is applied to all inputs (raw material needed to produce a good) as well as to the final sale.

Updated Data Shows Increased Tendency of Pyramiding

Using the latest data available at that time, from 1998, the Committee discovered that the B&O tax was applied an average of 2.5 times to each good or service, even though the rate varies considerably across industries. Among the industries listed in the Committee’s report, the B&O pyramided anywhere from 1.4 times (computer services) to 6.7 (manufactured food).

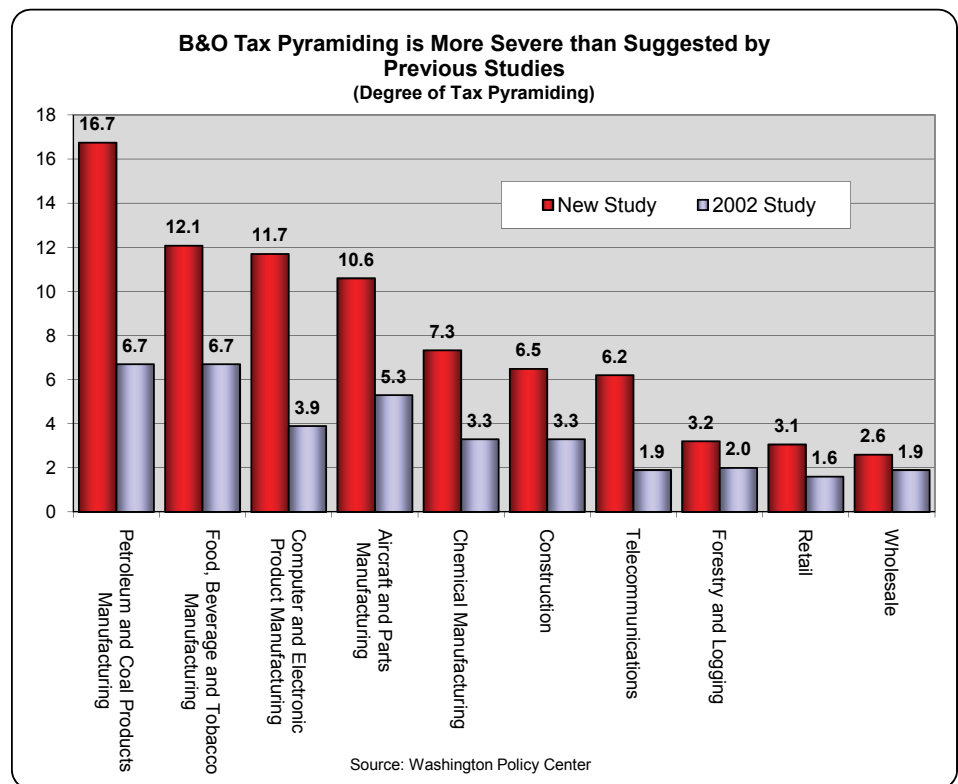
The data used took into account out-of-state imported products. When the data only takes into account Washington state production, along with updated data tables released in May 2008, we see that the overall average of pyramiding rose from 2.5 to 3.0—a 20% rise in how often the B&O tax is applied.

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The Tax Commission's 2002 report relied on data that blended out-of-state imports into the same industry categories as Washington state products. Washington Policy Center's new model treats them separately, because out-of-state companies do not face the pyramiding problem that in-state companies face. For instance, if a car is produced in Michigan and is only sold in Washington state as a final product, there is no tax pyramiding. When the two products are mixed together (out-of-state imports and in-state production) as the 2002 study did, a bias is introduced that pushes the pyramiding down substantially.

When out-of-state product imports are ignored, true pyramiding of Washington state products can be determined. As a result, the 2002 study was masking some very high tax pyramiding in import-heavy industries like petroleum products refining.

As the graph below illustrates, the degree to which industries are subjected to pyramiding is far worse when using data that excludes imported products. The telecommunications industry now pyramids 6.2 times versus 1.9 in the 2002 report—a 226% increase. Both computer and electronic product manufacturing and aircraft and parts manufacturing industries see a 200% increase when compared with the data from the 2002 report.¹



Washington state's tax base is 190% larger than the gross state product—a 25% increase in two years.

This results in a broader tax base from which the B&O system extracts revenue. Because a gross receipts tax applies to each business transaction, it also encompasses the entire production of the state and includes all transactions that lead to the final product. Therefore the tax base is far larger than the gross state product.

In 2007, the total base of the B&O tax was about \$591 billion.² Washington's gross state product that same year was only \$311 billion. This means the tax base

¹ For a full comparison table of estimated B&O Tax Pyramiding by Industry please visit: <http://www.washingtonpolicy.org/Centers/smallbusiness/B&OPyramid.xls>

² Washington State Department of Revenue, *Quarterly Business Review: Calendar Year 2007*, and 2009 *Competitiveness Redbook*, WashACE, table 7.

was 190% larger than the total economic product of the state, due to the taxation of intermediate transactions in the chain of production.

A January 2007 Tax Foundation/Council of State Taxation report using 2005 numbers found that the tax base was 177% larger than gross state product.³ This means the tax base grew 25% in two years while the value of gross state product grew 16% in the same two years.

Policy Analysis

As stated in “[Business and Occupation Tax Reform Part II – The Pyramid Problem](#),” the economic consequences of a gross receipts tax results in the potential for modifying business’ behavior. Businesses are incentivized to bring in out-of-state material during production to cut costs. Businesses may also take the more radical step of vertically integrating their operations to cut down on the number of business-to-business transactions during production. Both practices reduce economic growth, jobs and business opportunities in the state.

The question then becomes: Is it wise to rely on such a large base to pay for government when the economic ramifications of pyramiding, along with other inherent problems in the B&O system, make the system so burdensome to businesses?

Washington Policy Center and the 2002 Tax Commission agree that the Business and Occupation tax violates several sound principles of a responsible taxation system. Both the Commission and WPC point out that the B&O tax violates the principles of economic neutrality, transparency, and simplicity.⁴

The B&O tax incentivizes imports and vertical integration. Both practices reduce economic growth and jobs in Washington state.

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³ John L. Mikesell, “Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance,” Tax Foundation and Council on State Taxation. January 2007.

⁴ See “[Business and Occupation Tax Reform: Characteristics of a Responsible Business Tax System](#),” Washington Policy Center Policy Note, June 2008. Also see, *Tax Alternatives for Washington State: A Report to the Legislature*, Department of Revenue, November 2002.