

# CHAPTER 2

## TAX POLICY

### 1. Guiding Principles of Taxation<sup>1</sup>

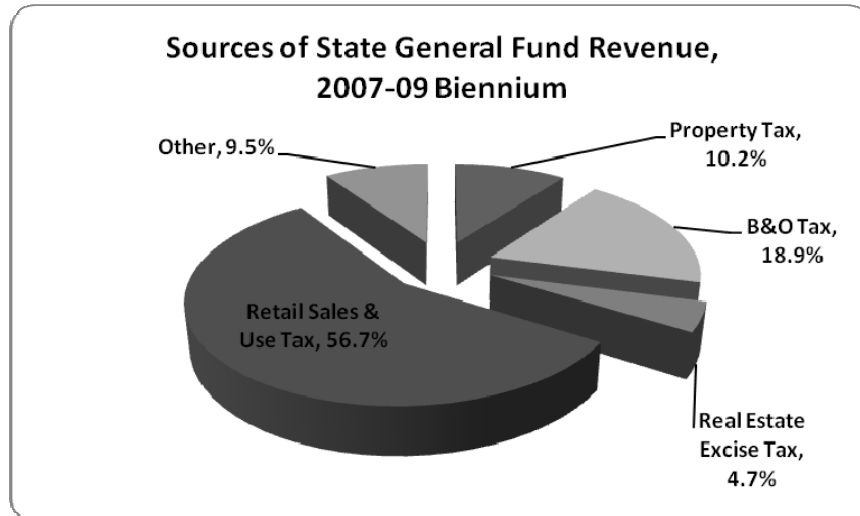
#### Recommendations

1. Adopt guiding principles based on equity and economic neutrality to shape changes in Washington's tax system, so the tax system is focused on raising needed revenue for core functions of government, not directing the choices and behavior of citizens.
2. Policymakers should seek to lower the overall tax burden to promote prosperity and opportunity for the benefit of all citizens.

#### Background

The people of Washington pay over 50 different kinds of taxes at the state and local level.<sup>2</sup> The largest single revenue source for state and local government is the general sales and use tax, representing about 55 percent of all taxes. The next largest revenue source is the Business and Occupation (B&O) tax. The chart shows the sources of state general fund revenue.

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“Other” includes revenue from liquor sales, tobacco taxes, lottery proceeds, insurance premiums, etc. Source: Office of Financial Management.

The proper function of taxation is to raise money for core functions of government, not to direct the behavior of its citizens. This is true regardless of whether government is big or small, and this is true for lawmakers at all levels of government. Many lawmakers think of the tax code as a way to penalize “bad” behaviors and reward “good” ones. They have sought incessantly to guide, micromanage and steer the economy by manipulating the tax laws.

Taxation will always impose some damage on an economy’s performance, but that harm can be minimized if policymakers resist the temptation to use the tax code for social engineering, class warfare and other extraneous purposes. A simple and fair tax system is an ideal way to advance Washington’s economic interests and promote prosperity for its residents.

### Policy Analysis

The fundamental principles presented here provide guidance for a fair and effective tax system; that is, one that raises needed revenue for core functions of government while minimizing the burden on citizens.

- **Simplicity** – The tax code should be easy for the average citizen to understand, and it should minimize the cost of

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complying with the tax laws. Tax complexity adds cost to the taxpayer, but does not increase public revenue. For governments, the tax system should be easy to administer, and should help promote efficient, low-cost administration.

- **Accountability** – Tax systems should be accountable to citizens. Taxes and tax policy should be visible and not hidden from taxpayers. Changes in tax policy should be highly publicized and open to public debate.
- **Economic Neutrality** – The purpose of the tax system is to raise needed revenue for core functions of government, not to control the lives of citizens. The tax system should exert minimal impact on the spending and business decisions of individuals and businesses.
- **Equity and Fairness** – Fairness means all taxpayers should be treated the same. The government should not use the tax system to pick winners and losers in society, or unfairly shift the tax burden onto one class of citizens. The tax system should not be used to punish success or to “soak the rich.”
- **Complementary** – The tax code should help maintain a healthy relationship between the state and local governments. The state should always be mindful of how its tax decisions affect local governments so they are not working against each other – with the taxpayer caught in the middle.
- **Competitiveness** – A low tax burden can be a tool for Washington’s economic development by retaining and attracting productive business activity. A high quality revenue system will be responsive to competition from other states.
- **Balance** – An effective tax system should be broad-based, without relying too heavily on a few sources of revenue. For the same reason, an ideal tax system should avoid special exemptions, preferring a low overall tax rate with few loopholes.
- **Reliability** – A high quality tax system should be stable, providing certainty in taxation and in revenue flows. It should

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provide certainty of financial planning for individuals and businesses.

While these guiding principles are important, there are inherent problems with any system of taxation. Basically, taxation reduces spending on private sector goods and services traded in the free market. The benefits of free exchange – to both the purchaser and seller – are reduced when trade is restrained by taxation. The way that taxes restrain private trade varies.

Income and property taxes reduce the incomes of taxpayers, lowering their demand for goods and services. Sales and excise taxes increase costs to suppliers, reducing their willingness to provide goods at any given prices. In any case, taxes reduce private trade and curtail job creation.

Since taxes lower the economic welfare of citizens, policymakers should try to minimize the economic and social problems that taxation imposes. Citizens then directly gain the benefits of a low tax burden. These benefits are summarized below:

### Benefits of a low tax burden

- **Faster economic growth** – A tax system that allows citizens to keep more of what they earn spurs increased work, saving and investment. A low tax burden will mean a competitive advantage for Washington over states with high-rate, overly progressive tax systems.
- **Greater wealth creation** – Low taxes significantly boost the value of all income-producing assets and help citizens maximize their fullest economic potential, thereby broadening the tax base.
- **End micromanagement and political favoritism** – A complex, high-rate tax system favors interests that are able to exert influence in Olympia, and that can negotiate narrow exemptions and tax benefits. “A fair field and no favors” is a good motto for a strong tax system.
- **Increased civic involvement** – A complex, high-rate tax system makes it nearly impossible for the average citizen to

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understand how and why the state is collecting money. Citizens become cynical and alienated from their government. At some point, most citizens come to feel the state government no longer represents their interests. A simplified, broad-based, low-rate system encourages citizens to become re-engaged with government and to seek greater civic involvement.

The people of Washington work hard for what they earn. Money paid in taxes is, by definition, not available to meet other needs. As a matter of respect to citizens, policymakers should work to keep the overall level of taxation to the absolute minimum needed to pay for the core functions of government.

### **Recommendations**

**1) Adopt guiding principles based on equity and economic neutrality to shape changes in Washington's tax system, so the tax system is focused on raising needed revenue for core functions of government, not directing the choices and behavior of citizens.**

Basic to the concept of a fair tax system is that the state should take no more from citizens than it needs to pay for the core functions of government. This consideration goes beyond the need to balance the budget; it is a matter of fundamental respect and trust between citizens and their government.

**2) Policymakers should seek to lower the overall tax burden to promote prosperity and opportunity for the benefit of all citizens.**

Washingtonians require and expect basic government services, and taxes must be collected to pay for these services. Government revenue should be limited to real public needs, so the tax system itself does not become one of the major problems of life. A fair and efficient tax system shows respect for the citizens of our state.

## 2. State Income Tax

### Recommendation

1. Avoid enacting a state income tax.

### Background

Washington is one of only seven states that does not tax citizens' incomes. Doing so would fundamentally alter the state's tax structure, changing it from one that mainly taxes consumption to one that also taxes productivity.

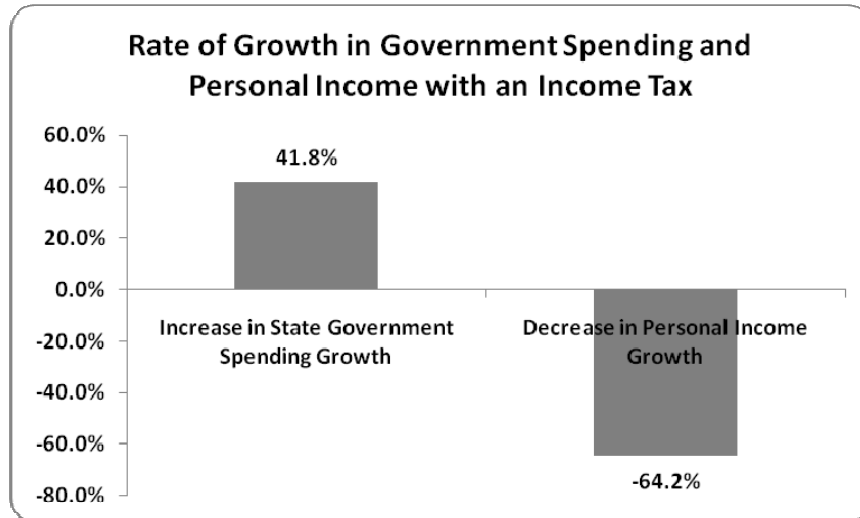
Each state levies a different combination of taxes on the people who live, do business or travel within its borders. These different types and levels of taxation have a profound impact on the actions of residents and businesses and can significantly impede economic growth. More than any other type of tax, an income tax can stifle a state's economic growth, create instability in public revenues and limit people's take-home income.

### Policy Analysis

Examination of long-term economic trends in states that have adopted income taxes indicate how a state tax on incomes may affect Washington. Since 1967, nine states have imposed an income tax.<sup>3</sup> In these states, government spending growth increased an average of 41.8 percent and personal income growth decreased an average of 64.2 percent after enacting the new tax.<sup>4</sup>

The following chart illustrates that the rate of government spending growth increases and personal income growth slows in states that impose an income tax, based on economic changes since adoption of an income tax through 1998.<sup>5</sup>

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Government spending grows faster and personal incomes rise more slowly in states with an income tax.

Why does personal income growth fall off faster in states that tax personal incomes? There are a number of reasons. Personal income growth is largely a function of market incentives. When government imposes a tax on earnings, individuals lose incentive to work harder and increase their wages. Similarly, when a share of interest earnings from savings is lost each year to taxation, individuals have less reason to save in the first place.

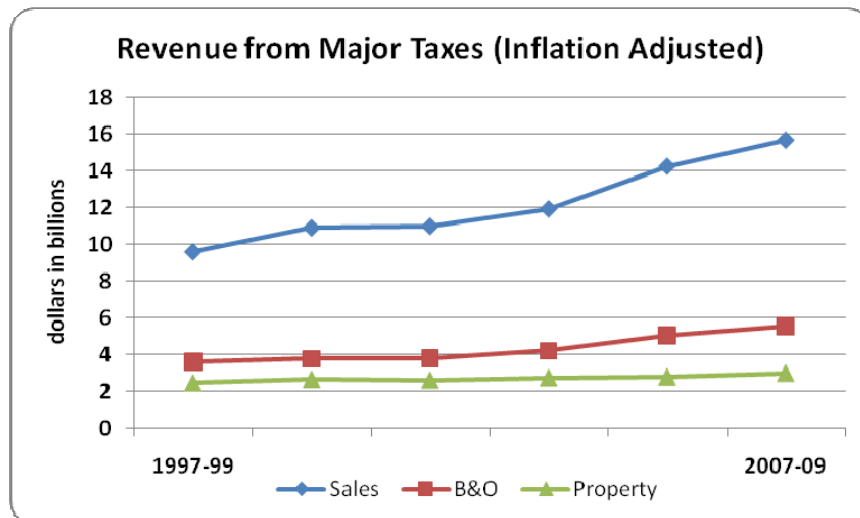
Why does government spending tend to increase faster in states that tax personal incomes? There are two primary reasons. First, an income tax adds one more way policymakers can incrementally increase tax revenues to fuel a faster rate of government growth. But over time, even small increases combine to stifle economic growth, transferring more money out of the productive economy and into the government sector.

Second, an income tax is not as transparent as other taxes. The tax is automatically deducted from workers' paychecks each month. The only time citizens may be aware of how much they pay in income tax is when they complete a tax return once a year, and even then they may be more interested in any refund they might receive than in the amount of tax they paid in the first place. The obscure nature of an income tax increases the temptation for elected

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officials to increase the tax rate with less chance of provoking a negative public reaction.

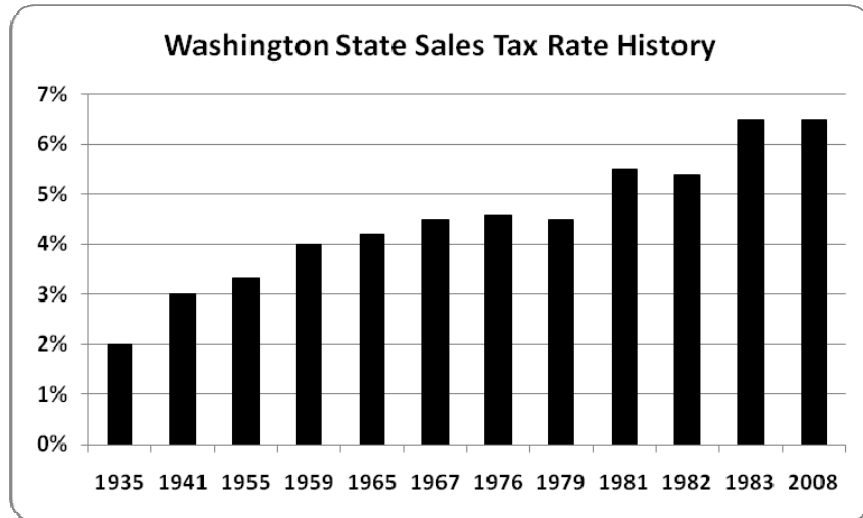
Often lawmakers and special interest groups that rely on government spending say a state income tax is necessary because the growth of revenues from existing taxes are insufficient. But as the following charts show, money collected from Washington's major taxes – property, Business and Occupation and sales – are growing steadily and outpacing inflation. In addition to increases in tax rates, revenues have grown sharply due to the natural expansion of the economy.



In most years, state revenue from major taxes grows faster than inflation.

The sales tax rate has grown since its inception in 1935 from two percent to 6.5 percent today. The following chart shows the growth of the sales tax rate. This upward trend contributed greatly to the growth in state revenues.

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The state sales tax rate has more than tripled since 1935

State income taxes tend to reduce personal income growth, increase the rate of government spending and lower the competitiveness of the business climate. Avoiding an income tax allows people to spend more time working for themselves and their families, and less time working to pay for government.

### **Recommendation**

**1) Avoid enacting a state income tax.** A state income tax would have a negative effect on the Washington economy. Comparisons among states show that income taxes reduce state competitiveness, add cost and complexity to the tax code, and reduce the incentive for people to work, save and invest. The absence of an income tax is one of the few clear advantages Washington's business climate has over those of other states.

### 3. Sales Tax Deductibility

#### Recommendation

1. Encourage Congress to promote equal tax treatment among states by making state sales tax deductibility permanent.

#### Background

In 1986, as part of a major overhaul of the tax code, Congress ended the deductibility of state sales taxes. For eighteen years, as residents of one of the seven states without a state income tax, Washington residents were unable to deduct what they pay in state sales taxes from their federal income tax. Since state income taxes are fully deductible, residents of other states received more favorable treatment under the code.

#### Policy Analysis

In 2004, Congress and the President resolved this inequity with passage of H.R. 4520, the American Jobs Creation Act.<sup>6</sup> A provision of the bill again made state sales tax deductible from the amount of personal income subject to the federal income tax. The deduction saves Washington residents an estimated \$500 million per year.<sup>7</sup>

In practice, Washingtonians do not have to keep track of all their sales receipts through the year to calculate how much they pay in state taxes. The IRS issued a table that estimates, based on income, what dollar amount taxpayers can claim as sales tax costs on federal income tax forms. Additional deductions are allowed for sales tax paid on major purchases, such as automobiles.

The sales tax deductibility provision enacted in 2004 was only in place for tax years 2004 and 2005.<sup>8</sup> Congress has since temporarily extended the exemption for 2006 and 2007, but has not made the credit permanent.

**Recommendation**

**1) Encourage Congress to promote equal tax treatment among states by making state sales tax deductibility permanent.** The temporary sales tax deductibility provision is scheduled to expire once again. Unless Congress extends the provision or makes it permanent, residents in Washington and six other states will again be subject to unequal treatment under the federal tax code.

## **4. Property Tax Limitation**

### **Recommendations**

1. Enact property tax relief to reduce the financial burden government places on citizens to promote economic growth, homeownership, job creation and greater personal freedom.
2. Maintain Washington's uniformity principle when taxing property, so all classes of property owners are treated the same under the law.

### **Background**

Many people believe their property value alone determines how much property tax they must pay, and when the county assessor updates home values to reflect market trends, their taxes automatically go up. This is not the case.

County assessors do not levy property taxes. Elected state legislators and the local board and council members of Washington's 39 counties and more than 1,720 cities and other taxing districts decide how much property tax citizens must pay.

Once elected officials in each taxing district decide the total dollar amount they feel they need to fund public operations for the following year, the assessor apportions that amount among the district's property owners, based on each land parcel's assessed value. It is a budget-based tax system, and that is the source of most of the confusion over who is responsible for rising property taxes.

Most people are familiar with rate-based tax systems, like the state sales tax or the federal income tax. Under a rate-based system elected officials first set a percentage rate which determines the fraction of each dollar of a given tax base that must be paid to the government. The revenue the government will receive from such a tax cannot be known in advance; it can only be estimated.

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A budget-based system, like the property tax, begins at the other end. Elected officials *first* decide how much money they feel is needed for their government budget, then divide this among the tax base to determine what rate is needed to raise that amount of revenue.

The rate is expressed as so many dollars per \$1,000 of assessed value. Under this system, the amount of revenue the government will collect is known from the beginning. It is the tax *rate* that is unknown until the assessor calculates it. The difference between the two systems can be expressed this way:

- **Rate-based system:  $\text{rate} \times \text{tax base} = \text{revenue}$**
- **Budget-based system:  $\text{revenue} \div \text{tax base} = \text{rate}$**

Once the rate is determined, the county assessor applies it to the value of each owner's property. One piece of land may fall under the jurisdiction of as many as ten separate taxing districts.<sup>9</sup> The assessor adds the budget demands of the different districts together, calculates the tax rate, and then mails the final bill to each property owner. Property tax payments are due twice a year.

### *Voter-approved tax limitation*

In recent years Washington voters have approved three popular measures to ease the growth of the property tax burden state and local governments place on their citizens.<sup>10</sup> Each measure set progressively more stringent limitations on how much state and local elected officials could increase the basic property tax each year. The relatively easy passage of these measures indicates public support for limiting property tax increases has remained stable over time.

The latest of these measures to become law was Initiative 747, passed by voters in 2001. It provides that a taxing district may not increase the total amount it collects in regular property taxes by more than one percent from one year to the next. Initiative 747's one percent limit replaces the earlier Referendum 47 limit, which held annual property tax increases to the lower of the rate of inflation or six percent.<sup>11</sup>

*Judges overturn, and legislature re-enacts, Initiative 747*

In June 2006, King County Superior Court Judge Mary E. Roberts struck down Initiative 747, saying the underlying law it was supposed to amend was ruled unconstitutional between the time Initiative 747 was filed in January 2001 and when it went to the voters that November. As a result, she said, voters were “incorrectly led” about what they were voting on.<sup>12</sup>

Judge Roberts’ ruling was wrong on two counts. First, the voters were not misled. The ballot title clearly states what Initiative 747 would do: limit property taxes to 1 percent per year.<sup>13</sup> Second, Judge Roberts said the initiative didn’t accurately reflect the law it sought to amend. But a separate court ruling changed the underlying law *after* Initiative 747 was filed, so initiative sponsors had no way of updating the text of the initiative before it appeared on the ballot.

Under Judge Roberts’ hyper-technical legal reasoning, it is impossible to file a valid ballot initiative in Washington state, since initiative sponsors have no way of knowing how the legislature or a judge may change the law the initiative seeks to amend in the 10 months between the filing deadline and election day.

Judge Roberts’ ruling, though flawed, was upheld by a sharply-divided state supreme court in 2007. The public reaction was so strong that lawmakers quickly convened a one-day special session for the purpose of re-enacting the Initiative 747 property tax limitation. Since Judge Roberts and the state supreme court justices had struck down Initiative 747 on a procedural technicality, the legislature’s re-enactment of the measure makes it immune to further legal challenge.

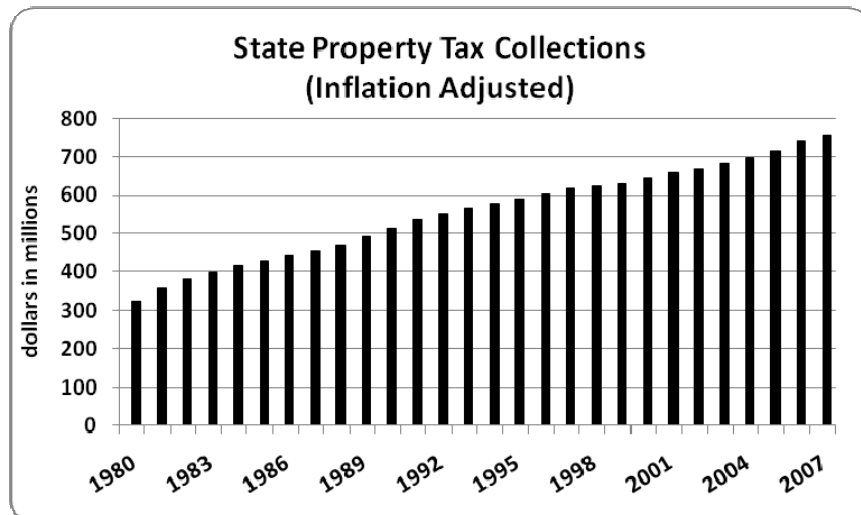
Under the Initiative 747 law, local officials have three options when considering whether and how much to increase yearly property tax collections: 1) they can increase the amount collected by up to one percent; 2) they can increase the amount collected by more than one percent by drawing on unused taxing authority they banked in previous years; or 3) they can ask voters to approve a higher increase. There are no statutory limits on tax increase proposals sent to the voters. Such proposals need only a simple majority to pass.

**Policy Analysis**

Washington Policy Center research staff have tracked the results of voter-enacted property tax legislation for ten years. Our annual studies examine the extent to which elected leaders in Washington’s 39 counties and 22 major cities restrict increases in regular property tax collections to voter-approved limits, or whether they choose to enact higher increases.

Our research finds that voter-passed initiatives have been successful in restricting how much the regular property tax burden grows each year. Well over 90 percent of Washington counties and major cities now limit their annual increase in regular property tax collections to one percent or less. This is a considerable change from 1998, when only six counties and two cities did so.

Yet while the annual rate of property tax increase has slowed, the amount of money collected by the state from this revenue source has sharply increased since 1980.



Property tax collection report from the Washington State Department of Revenue. 1980 base year using IPD inflation calculations from Washington’s Legislative Evaluation & Accountability Program Committee (LEAP).

Because of tax limitation, property taxes are much lower today than they would have been under previous law. Limits on increases have brought well over \$1.1 billion in tax savings for

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Washington citizens, although the overall rate of property taxation remains high and taxpayers are demanding additional relief.

### *Maintaining property tax fairness*

Some tax-relief bills introduced in the legislature seek to create a “split roll,” in which, for the first time, different classes of property owners would be treated differently under the law. For example, some bills offer tax relief to homeowners, but not to business properties. If state tax collections remain the same, the result would not be broad-based tax relief at all, but merely an unfair shift of part of the existing tax burden from one group of property owners to another.

Efforts to provide property tax relief to Washingtonians should maintain the longstanding constitutional principle of treating the same class of taxpayers equally and uniformly. Lawmakers should avoid proposals that promise tax relief, but instead just shift the tax burden from one group of citizens to another, thus using tax policy to create winners and losers in society.

The simplest way lawmakers can ease the financial burden they place on citizens is to phase out the state property tax levy. Permanently phasing out the state property tax would not reduce local taxes collected by county and local governments. It would, however, induce state elected officials to set clear priorities in state spending.

### **Recommendations**

**1) Enact property tax relief to reduce the financial burden government places on citizens to promote economic growth, homeownership, job creation and greater personal freedom.** Initiative 747 sought to limit but not reduce the overall property tax burden. Lowering the current level of property taxation would reduce the existing financial burden on citizens, free up money for investment in economic growth and job creation, and give Washingtonians greater personal freedom. One way to do this without impacting local government financing would be to reduce or phase out the state property tax levy.

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**2) Maintain Washington's uniformity principle when taxing property, so all classes of property owners are treated the same under the law.** Washington tax law contains a fundamental principle of fairness: all property owners are treated equally when being taxed by state and local officials. Policymakers should defend this principle and resist proposals to create a so-called "split roll," in which separate classes of property owners are created and then taxed at different rates.

## 5. General Tax Limitations

### Recommendations

1. Adopt a constitutional amendment requiring a two-thirds legislative vote to raise state or local taxes.
2. Give tax increases an expiration date.
3. Like gas-tax revenue, toll revenue should be constitutionally protected.

### Background

The voters have consistently voiced a desire to restrict the ability of government officials to unduly raise their tax burden. Initiative 601, passed by voters in 1993, required not only a two-thirds vote of the legislature to raise taxes, but also voter approval of any tax increase in excess of the state spending limit.

Despite this clear directive by the voters, lawmakers have suspended the two-thirds vote requirement twice (in 2002 and 2005) and the Democratic leader in the Senate, Senator Lisa Brown, has recently filed a lawsuit asking the State Supreme Court to declare the two-thirds vote requirement unconstitutional.

Instead of attacking and ignoring the will of the voters, government officials should enact meaningful restrictions on tax increases to help provide a restraint on excessive government spending and future tax increases.

Restrictions will help prioritize government spending and provide a legislative climate in which further increases in the government's financial burden are difficult to pass. Under such a restriction, if lawmakers felt they really needed to collect more money from people, tax increase proposals could be submitted directly to voters for approval.

## **Policy Analysis**

### *Constitutional taxpayer protections*

Since the legislature has repeatedly suspended the voter-approved requirement that tax increases require a two-thirds vote for approval, constitutional protections are needed. These protections, however, should not be limited to state taxpayers, but should extend to local taxpayers as well.

To encourage government officials to build a strong public consensus on the need for any proposed tax increase, a two tiered approach should be adopted. Government officials should utilize two different options to raise the tax burden:

1. with a two-thirds vote of the legislative body or;
2. with a simple majority vote pending ratification by the voters via a referendum.

Either option would help assure that a broad consensus is reached and the taxpayers are included on any policy decisions that would result in an increase in their tax burden.

### *Tax increase sunsets*

Often, when Congress enacts a tax cut or a tax exemption, it includes a sunset clause, meaning the cut or exemption will expire on a certain date. Inevitably, a sharp political debate ensues when an expiration date nears, as lawmakers grapple with whether to vote to extend the tax reduction or to let it terminate. Often a tax break quietly expires without lawmakers having to vote it up or down.

Temporary tax cuts and exemptions create financial unpredictability for taxpayers from one year to the next. Ultimately, when tax cuts and exemptions are set to expire automatically, it is the same as building automatic future tax increases into the law.

In contrast, tax increases are rarely set to expire or “sunset” on a certain date. They tend to be permanent, thus allowing lawmakers to avoid addressing them or having to take an official position. Often taxes are created or increased for specific projects, but

they do not expire automatically when the project is paid for or completed. Lawmakers then channel the revenue into the general fund or mark it for future spending. It becomes tax revenue in search of spending.

Citizens and businesses pay more than 50 different taxes in Washington.<sup>14</sup> Lawmakers routinely increase these taxes incrementally or create new ones, even during times when the natural expansion of the economy is pouring additional money into state coffers. For example, during the 2005 session, the legislature permanently raised taxes by \$500 million, even though state revenues were growing by seven percent, due to normal economic growth.

By the time the legislature convened in 2006, the state economist was forecasting a \$1.6 billion surplus. It turned out that the \$500 million in new taxes was completely unnecessary. The new taxes became revenue in search of new spending, and lawmakers were more than happy to oblige.

If the 2005 tax increase had included a sunset provision, Washington citizens would be enjoying significant tax relief today, since the subsequent budget surplus showed that these additional taxes were not needed.

Instead of creating a permanent new expansion of the budget in order to spend away the surplus, lawmakers could simply have allowed the 2005 tax increase to expire. Washington citizens would have benefited by being allowed to keep more of their own money.

#### *Protect toll revenue*

State lawmakers are gradually adopting a system of funding transportation projects with toll revenue. Unlike gas-taxes, toll revenue is not constitutionally directed to be used only on public highways. The toll revenue can be redirected to any purpose, including non-transportation government spending, such as entitlement programs.

To ensure that vital transportation infrastructure needs are met, toll revenue should be protected from being tapped for general spending or other non-highway purposes. Toll revenue should receive the same protection that gas-tax revenue receives under the state

constitution. If constitutionally protected, drivers would be more willing to accept a broad-based system of road tolls to help pay for and manage traffic congestion relief.

### **Recommendations**

**1) Adopt a constitutional amendment requiring a two-thirds legislative vote to raise state or local taxes.** Since public officials often refuse to honor voter-approved taxpayer protections, the constitution should be amended to require a two-thirds vote of a state or local legislative body, or voter approval through a referendum, before any state or local tax increase takes effect.

**2) Give tax increases an expiration date.** When new taxes and tax increases are set to expire, lawmakers will have the opportunity to look at the facts and determine if the tax is serving its intended purpose. If collecting revenue from the tax is still justified, lawmakers can reauthorize it for a further period of time. If the project or goal for which the tax was imposed in the first place has been accomplished, citizens should be permitted to keep their money. If the legislature had followed this recommendation in 2005, the Washingtonians today would be benefiting from \$500 million in tax relief.

**3) Like gas-tax revenue, toll revenue should be constitutionally protected.** To gain public support for funding transportation projects with road tolls and to ensure that road revenues are actually spent on reducing traffic congestion, toll revenue should receive the same constitutional protection afforded to gas-tax revenue.

## 6. Tax Advantages of Tribal Businesses

### Recommendations

1. State leaders should negotiate an agreement with tribal casino owners so that a portion of Indian gambling profits are paid into the state general fund in lieu of taxes, as is common in most other states.
2. Policymakers should set up a review of the relationship between the state and tribal businesses, especially in new areas of commerce in which tribes compete with non-Indian citizens.

### Background

For decades, tribal businesses (including casinos and hotels) have benefited from a system of rules and regulations that gives their owners significant competitive advantage over non-tribal citizens. Whether in the form of exemptions from unemployment insurance, business and occupation taxes, or workers' compensation taxes, many tribal businesses are able to take advantage of a reduced regulatory environment. Nowhere is this exemplified more than in the gaming industry.

In Washington there are 29 federally recognized Indian tribes. These tribes operate 27 casinos, with at least one additional major casino under construction, which together generated \$1.33 billion in gross revenue in 2007.<sup>15</sup>

The total combined membership of the 29 tribes in the state is just under 55,000 people, or .009 percent of the people in the state. Some tribes have fewer than 200 members, while the largest have more than 9,000. Tribal membership is defined as the certified number of people who are officially recognized by tribal leaderships, based on their racial identity.

*Who is an Indian?*

There is no legal definition of who is an American Indian. Each tribe decides on and enforces its own membership rules. The National Indian Gaming Commission describes federal policy this way:

“Indian tribes have the authority to determine membership requirements. Many tribes have a blood quantum requirement (i.e., one-fourth) and may have additional requirements relating to residency, place of birth, or enrollment deadlines. The Federal Government generally requires a person to be a member of a federally recognized tribe to be eligible for federal benefits.”<sup>16</sup>

For example, leaders of the Snoqualmie Tribe, in a dispute over control of the tribe’s anticipated casino profits, recently expelled 60 members because they “don’t have the required one-eighth tribal blood to be members.”<sup>17</sup> At the same meeting of designated “preferred voters,” tribal leaders banished eight members, depriving them of all tribal benefits, including the right to be on tribal land, and the right to claim Indian identity.<sup>18</sup>

For purposes of the U.S. Census, the definition of who is an Indian is based on self-identification. In 2000, 2.4 million people identified themselves as American Indian or Alaska Native.<sup>19</sup> Only a small portion of people who self-identify, however, are registered members of a recognized Indian tribe.

*Tribal businesses’ tax status*

In Washington, state and local governments are specifically prohibited by federal law from taxing any aspect of tribal gaming, whether it is a business and occupation tax on operations, or sales and use taxes for equipment. Also, no taxes are allowed on tribal gaming itself.

Some tribal businesses make limited impact mitigation payments to local governments to help cover the cost of community services. Unlike regular taxes paid by other citizens, however, these payments are voluntary, and the amount is negotiated between the tribal business owners and local governments.

Tribal business owners only make revenue-sharing and impact mitigation payments *after* their businesses have made a clear profit. In contrast, non-tribal business owners must pay the state Business and Occupation tax whether they make a profit or not.

### **Policy Analysis**

Non-tribal card rooms and mini-casinos are subject to the full array of business taxes: sales tax on food and beverages, business and occupation tax, sales tax on construction and equipment purchases, etc. Additionally, local governments can levy a tax of up to 20 percent on gross receipts from gambling. More than half of local jurisdictions that tax non-tribal card rooms impose a tax rate of around 10 or 11 percent.

Some tribes are moving beyond their traditional core business of operating casinos and game rooms and branching out into other industries. Proposals for future tribal businesses include selling gasoline without collecting the 36 cents-per-gallon state gas tax, operating hotels and shopping malls without collecting state taxes, and opening a tax-exempt oil refinery to produce even cheaper gas for non-tribal consumers.

In 2006, the Squaxin and Swinomish tribes won a case in U.S. District Court (Judge Thomas Zilly) allowing them to keep revenue from gas taxes rather than forward them to the state.<sup>20</sup> Other Washington tribes could assert the same right and use their added profits to lower the price they charge drivers at the pump.

#### *The Indian Gaming Regulatory Act*

In 1988, Congress passed the Indian Gaming Regulatory Act prohibiting states from taxing tribal gaming revenues. However, tribes sometimes negotiate a voluntary profit-sharing agreement with states. This allows tribal leaders to mute public criticism about unequal tax treatment among businesses without giving up a valuable tax exemption.

In Washington, however, there is no profit-sharing agreement between the state and Indian tribes, as there is in most other states.

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In 2005, the Washington State Gaming Commission reached a tentative agreement with the Spokane Tribe under which the Tribe would pay a percentage of its gaming profits, based on a sliding scale, to the state general fund.<sup>21</sup>

This agreement never took effect. On October 27, 2005, Governor Gregoire sent a letter to the Gaming Commission canceling the proposed agreement and instructing state negotiators to start over.<sup>22</sup>

In 2007, she signed a new agreement with financial terms far more generous to the Spokane Tribe.<sup>23</sup> Under the new compact, the tribal members will retain between \$60 million and \$90 million over ten years, which, under the canceled agreement, would have been paid to the general fund and used to fund state programs.

The canceled 2005 Spokane Tribe agreement could have served as a model for agreements with the state's other casino-owning tribes. If the state had such profit-sharing agreements with these tribes, the state general fund in 2006 alone would have received between \$42 million and \$490 million, depending on the net profits of individual casinos.

The following table summarizes the legal and regulatory advantages of tribal-owned businesses.

**TAX POLICY****Comparison of Washington state regulations and taxes that apply to tribal businesses and non-tribal businesses**

	Tribal Businesses	Non-Tribal Businesses
Must obey smoking ban	No	Yes
Must obey 1964 Civil Rights Act	No	Yes
Must obey voter- passed initiatives	No	Yes
Pay gaming taxes	No	Yes
Pay B&O tax	No	Yes
Pay sales tax	No	Yes
Pay tobacco tax	No	Yes
Pay workers' comp. taxes	No	Yes
Pay unemploy. tax	No	Yes
May offer slots	Yes	No
May offer keno	Yes	No
May offer craps	Yes	No
May offer roulette	Yes	No
May offer baccarat	Yes	No
Higher betting limit	Yes	No

### Recommendations

**1) State leaders should negotiate an agreement with tribal casino owners so that a portion of gambling profits are paid into the state general fund in lieu of taxes, as is common in most other states.** By not following through with the model agreement negotiated with the Spokane Tribe in 2005, state leaders are depriving the state of important additional revenue that could supplement spending on essential public services, like public education and health care.

They are also missing an opportunity to serve the public interest, because there is no policy in place to redress some of the imbalance between the favorable tax treatment enjoyed by tribal businesses, and the high-tax environment in which all other business owners must operate.

**2) Policymakers should set up a review of the relationship between the state and tribal businesses, especially in new areas of commerce in which tribes compete with non-Indian citizens.** Policymakers should request a study to measure the economic and competitive impact of tax-free tribal businesses on non-tribal businesses in areas of commerce other than gambling. An objective assessment is needed to determine whether the special tax and regulatory treatment granted to tribal businesses is exceeding its intended purpose.

**Additional Resources from Washington Policy Center**

“Learning from the Past and Creating our Future” (keynote address at WPC’s 2008 Government Reform Conference), by David Walker, April 2008.

“Assessing the Impact of the 1% Property Tax Limit,” by Paul Guppy, February 2008.

“Review of Homestead Property Tax Proposals,” by Jason Mercier, February 2008.

“Citizens Guide to Initiative 960, The Taxpayer Protection Act,” by Jason Mercier, Policy Notes, 2007-16.

“New Tax Deferral Program Offers Little Hope to Hard-Pressed Homeowners,” by Paul Guppy, December 2007.

“The Taxpayer Protection Act, Take 2,” by Jason Mercier, September 2007.

“Failure to Enact Permanent 1% Limit Could Lead to \$1.5 Billion Property Tax Increase,” by Paul Guppy, March 2007.

“The Washington Policy Center Tax Cut Plan,” by Paul Guppy, January 2007.

“Getting to the Bottom of Initiative 920 (Death Tax Repeal),” by Carl Gipson, October 2006.

“Relying on Sin Taxes Reveals the Contradictions in the State Budget,” by John Barnes, June 2005.

“New Research Shows Voter-Passed Property Tax Limitation is Working,” 2005.

“Property Tax Limitation in Washington State,” by Paul Guppy, August 2003.

“The Economic Case against an Income Tax in Washington State,” by David G. Tuerck, John S. Barrett, Sorin Codreanu, May 2003.

“A Policy Guide for Budget Reform: Strategies for Improving State Government Services and Reducing the Deficit,” by Eric Montague, January 2003.

“Guiding Principles of a Fair and Effective Tax System,” by Paul Guppy, January 2002.

“State Income Taxes Increase Government Spending and Reduce Personal Income Growth,” by Eric Montague, June 2002.

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<sup>1</sup> The text in this section is adapted from “Principles of Sound Tax Policy,” by Dan Mitchell, Heritage Foundation, Washington, D.C., November 2001, “Guiding Principles of Taxation,” Tax Policy and Research, Montana Department of Revenue, October 2001, and “Some Underlying Principles of Tax Policy” by Richard K. Vedder and Lowell E. Galloway, Joint Economic Committee, United States Congress, Washington, D.C., September 1998.

<sup>2</sup> “Tax Reference Manual, Information on State and Local Taxes in Washington State,” Revenue Research Report, Department of Revenue, Olympia, January 2007, p. 1, at [www.dor.wa.gov/Content/AboutUs/StatisticsAndReports/2007/Tax\\_Reference\\_2007/default.aspx](http://www.dor.wa.gov/Content/AboutUs/StatisticsAndReports/2007/Tax_Reference_2007/default.aspx).

<sup>3</sup> These states are Connecticut, Illinois, Maine, Michigan, Nebraska, New Jersey, Ohio, Pennsylvania and Rhode Island.

<sup>4</sup> “Economic Impact of the Adoption of a State Income Tax in Washington,” by Dr. Thomas R. Dye, Lincoln Center for Public Service, published by the National Taxpayers Union, Washington, D.C., June 2000.

<sup>5</sup> Ibid.

<sup>6</sup> H.R. 4520, “To amend the Internal Revenue Code of 1986 to remove impediments in such Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad,” passed by Congress and sent to the President, October 11, 2004, at [www.thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.04520](http://www.thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.04520).

<sup>7</sup> Les Blumenthal, “State sales tax deduction cut from federal measure,” *The News Tribune*, Tacoma, May 11, 2006. See also “Promoting State Sales Tax Deductibility,” Office of Congressman Brian Baird, October 2003, at [www.house.gov/baird/tax.htm](http://www.house.gov/baird/tax.htm).

<sup>8</sup> Conference Report on H.R. 4520, “The American Jobs Creation Act of 2004,” Committee on Ways and Means, United States House of Representatives, October 7, 2004, at [www.waysandmeans.house.gov/media/pdf/hr4520/hr4250confreptshortsummary.pdf](http://www.waysandmeans.house.gov/media/pdf/hr4520/hr4250confreptshortsummary.pdf).

<sup>9</sup> Examples of taxing districts include: the state, county, city, road, school, public utility, library, port, water, fire, sewer, parks, flood zone, hospital, airport, ferry, cemetery, mosquito control, park-recreation, emergency medical, irrigation, cultural-arts, agricultural pest and urban apportionment. In all there are 1,744 taxing districts in Washington.

<sup>10</sup> The three measures are: Referendum 47, passed November 1997 by 64 percent to 36 percent; Initiative 722, passed November 2000 by 56 percent to 44 percent (this

initiative was later invalidated by the courts); and Initiative 747, passed November 2001 by 58 percent to 42 percent.

<sup>11</sup> The measure of inflation required under Referendum 47 was the Implicit Price Deflator reported by the United States Treasury every October.

<sup>12</sup> *Washington Citizens Action of Washington et. al. v. State of Washington and William Rice, Director of the State Department of Revenue*, King County Superior Court, Judge Mary E. Roberts, No. 05-2-02052-1 SEA, June 13, 2006.

<sup>13</sup> “Proposed Initiatives to the People – 2001,” text of Initiative 747, filed January 8, 2001, Index of Initiative and Referendum History and Statistics: 1914 – 2005, Office of the Washington Secretary of State, at [www.secstate.wa.gov/elections/initiatives/statistics.aspx](http://www.secstate.wa.gov/elections/initiatives/statistics.aspx).

<sup>14</sup> “Tax Reference Manual: Information on State and Local Taxes in Washington State,” Washington State Department of Revenue, January 2008, at [www.dor.wa.gov](http://www.dor.wa.gov).

<sup>15</sup> “Net Gambling Receipts for Gambling in Washington State in Fiscal Year 2007,” Tribal Gaming (estimated), Washington State Gambling Commission, Agency Overview, December 2007, at [www.wsgc.wa.gov/newsletters/brochure.pdf](http://www.wsgc.wa.gov/newsletters/brochure.pdf).

<sup>16</sup> “Who is considered a tribal member?” National Indian Gaming Commission, Frequently Asked Questions, Tribal Members, at [www.nigc.gov/AboutUs/FrequentlyAskedQuestions/tabid/57/Default.aspx#q\\_01](http://www.nigc.gov/AboutUs/FrequentlyAskedQuestions/tabid/57/Default.aspx#q_01), accessed May 29, 2008.

<sup>17</sup> “Snoqualmies banish eight, disenroll 60,” by Linda V. Mapes, *The Seattle Times*, April 28, 2008.

<sup>18</sup> *Ibid.*

<sup>19</sup> “Table 1: Total Population by Age, Race, Hispanic Origin or Latino Origin for the United States, 2000,” Census 2000 Briefs and Special Reports, U.S. Census Bureau, at [www.census.gov/population/www/cen2000/phc-t9.html](http://www.census.gov/population/www/cen2000/phc-t9.html).

<sup>20</sup> See also, “Tribes could escape gas tax,” by Joseph Turner, *The News Tribune*, Tacoma, May 14, 2006, and “Tribes take over gas tax from state,” *The Associated Press*, May 30, 2006.

<sup>21</sup> Spokane Tribe and the State of Washington Class III Gaming Compact 2005, Appendix.

<sup>22</sup> Letter from Governor Christine Gregoire to Mr. Curt Ludwig, Chairman, Washington State Gaming Commission, October 27, 2005.

<sup>23</sup> “Governor Signs Spokane Tribal Gaming Compact, Washington State Gambling Commission, February 16, 2007, at [www.wsgc.wa.gov/docs/press\\_releases/spokane\\_compact\\_021607.pdf](http://www.wsgc.wa.gov/docs/press_releases/spokane_compact_021607.pdf).