

# CHAPTER 6

## BUSINESS CLIMATE

### 1. Improving the Business Climate

#### Recommendations

1. Amend or repeal laws and regulations that impede business innovation and entrepreneurship.
2. Repeal laws and regulations that no longer serve a public purpose and only work to keep competitors out of the marketplace.
3. Require the governor to review and approve new agency regulations.

#### Background

While the United States has experienced a troubled economy recently, Washington state seems largely immune to the national trend. The smaller impact of a national downturn on our region, however, can lead to a deceptive impression about the state's long-term economic prospects. Not everything is rosy for business in Washington – particularly for small businesses. Fewer small businesses (those with fewer than 50 employees) are able to afford health insurance for their workers.

There is a lack of qualified employees willing to work in certain industries. The state-imposed regulatory environment is more complex and difficult than ever. Washington has a relatively hostile business climate, which limits job creation and imposes a drag on general economic prosperity.

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While the overall business climate is important to the economic vitality of the state, policymakers should pay special attention to smaller firms.<sup>1</sup>

- Of the state's 198,200 employer firms, 98 percent (194,600) are small businesses;
- In addition, about 387,500 people in Washington are self-employed;
- Small firms employed 55.8 percent of the non-farm private workforce in 2004 (the latest data available);
- About 1.3 million people work for small businesses in Washington;
- Washington has the highest business start up rate and the highest business failure rate in the country;
- Washington's recovery from the 2000–2001 recession was led by a surge of new jobs created by small businesses, and they contribute significantly to annual job creation today.

While larger businesses play an important role in creating and sustaining a viable economic climate, small businesses are a major catalyst for job growth and revitalization.

### **Policy Analysis**

Entrepreneurs and businesses face numerous challenges every day. Some of the strongest threats to their economic survival come not from competitors, but from the confusing tangle of state, county and municipal regulations.

State and local regulators place significant barriers between entrepreneurs and their dreams. The staggering amount of regulatory red tape amounts to more than 100,000 requirements that a small business owner must know, understand and follow in order to run a business legally. The regulatory structure strangles small businesses, drives up the cost of entering the market and increases the cost of living for consumers.

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Washington Policy Center's Center for Small Business and Entrepreneurship has identified several issues small business owners say are the primary barriers to their success. Those issues are:

- the rising cost of health insurance;
- a clogged transportation system;
- the high business tax burden;
- high-cost unemployment insurance;
- the state workers' compensation monopoly;
- confusing and complex regulations;
- tort and liability expenses;
- access to affordable water and energy.

Many of these issues are discussed in other chapters of this policy guide. Other sections in this chapter provide recommendations regarding the overall business climate, affordable health care for small businesses, unemployment insurance, regulatory reform and estate tax repeal.

State and local policymakers should reduce government-imposed barriers for Washington entrepreneurs, which would expand economic opportunity for all citizens, and promote a vibrant business climate today and for future generations.

### Recommendations

**1) Amend or repeal laws and regulations that impede business innovation and entrepreneurship.** During the state's 119 year history, literally thousands of laws have been enacted that make it more difficult to start and run a small business in Washington. Policymakers should initiate a systematic review process to identify outdated laws in need of amendment or repeal.

**2) Repeal laws and regulations that no longer serve a public purpose, and only work to keep competitors out of the marketplace.** Such laws harm consumers by keeping competitors out of the marketplace. The for-hire vehicle, taxicab, hair care and moving industries provide examples of antiquated or overly-strict regulations that work against the public interest by reducing price competition and consumer choice.

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**3) Require the governor to review and approve new agency regulations.** New agency laws hugely affect the business community. Submitting any new significant rule to review and approval by the governor would help slow the incessant flow of new regulations from state bureaucrats, and would create clear accountability when new business restrictions are put in place.

## **2. Small Business Access to Health Insurance**

### **Recommendations**

1. Legalize the sale of basic health insurance plans to small businesses.
2. Allow small business owners to purchase health plans in any state, just like other types of insurance.
3. Freeze health care mandates until the cost and benefit of current mandates are studied.
4. Encourage affordable access to Health Savings Accounts.

### **Background**

The steadily-rising cost of health insurance is a major problem for the business community. Small business owners who participated in Washington Policy Center's Small Business Project identified the cost and availability of health care as their number one concern. Business owners voiced particular concern about the way state imposed mandates drive up health insurance costs for small firms.

The sale of health insurance in Washington is governed by an amazingly complex combination of state laws, rules and regulations, and small businesses have few resources for dealing with the confusing web of red tape. Increases in health insurance costs are forcing many small business owners to reduce or eliminate health care coverage for their workers.

According to a National Federation of Independent Business (NFIB) survey of small business owners throughout Washington, the number of employers who offer health care coverage for all employees has dropped from 65 percent in 1993 to less than 50 percent today.

## **Policy Analysis**

Health insurers in Washington are required by law to obey 53 state imposed mandates covering a broad range of providers, illnesses and treatments.<sup>2</sup> A mandated benefit is a requirement that an insurance company cover (or offer coverage for) common health care providers, benefits and patient populations.

Employers must often pay for coverage their employees do not want or need. Each mandate may only add one-quarter or one-half a percent to the cost of buying health coverage, but added together their impact is enormous. Conservative estimates show mandates add at least 15 to 20 percent to the price of a health insurance policy.<sup>3</sup>

The large number of mandates, combined with the heavy taxes and regulations placed on all insurance policies, means economical low-cost health coverage is not available in Washington. It is like a hotel market with all Hiltons and Sheratons, but no Motel 6.

Because they are forced to buy expensive “Cadillac” insurance plan or no plan at all, plus yearly double-digit premium increases, the business community is scrambling for health plan alternatives.

Business owners deal with competition every day. They understand that reducing barriers to entry for new health insurance products would increase competition in the marketplace. Small business owners support a package of reforms that would streamline state regulations, reduce mandates, increase competition among insurers and encourage low cost Health Savings Accounts (HSAs).

HSAs offer small employers a cost-effective way to provide health coverage to their employees when traditional coverage is too expensive. Money placed in HSAs is tax free and belongs to individual workers. The money is theirs to keep if they switch jobs, are unemployed for a time or decide to retire. HSA funds can be used tax free to pay any qualified medical expense. An accompanying catastrophic insurance policy covers medical costs in case of major illness or injury.

**Recommendations**

**1) Legalize the sale of basic health insurance to small businesses.** In recent years, the legislature has considered a number of bills trimming mandates and regulations that would open new opportunities for small businesses to obtain health insurance. The Senate in particular has made progress in this direction. Though none of these bills became law, lawmakers should allow insurers to again offer low-cost, economical health plans to Washington residents.

**2) Allow small business owners to purchase health plans in any state, just like other types of insurance.** Health insurance is less heavily regulated in most other states, and coverage is often less expensive in those states than in Washington. Allowing small business owners to shop for coverage across state lines would lower costs and create more options for small business employees and their families. In addition, the resulting competition would lower prices and improve service for all businesses and citizens in Washington.

**3) Freeze health care mandates until the cost and benefit of current mandates are studied.** Health care plans offered by insurance companies in Washington must include 53 mandated benefits in order to be legally offered in the market. Health care mandates in Washington include options such as mental health, acupuncture and massage therapy. Together, these mandates add 15 to 20 percent to the cost of health insurance in Washington.

**4) Encourage affordable access to Health Savings Accounts.** Reducing state imposed mandates and streamlining insurance regulations would reduce the cost of insurance plans that must accompany Health Savings Accounts. Lowering the cost of HSAs would allow many small business owners to offer affordable health benefits to their workers.

### 3. Regulatory Reform

#### Recommendations

1. Regulate for results, not for process.
2. Reorganize the Office of Regulatory Assistance into an Office of Regulatory Reform that would identify regulations that duplicate or contradict each other, are outdated or do more harm than good.
3. Include a regulatory sunset provision for new regulations, and submit all existing regulations to review by the legislature every five years.
4. Create a regulatory fast track for companies and individuals with a good record of complying with regulations.

#### Background

The right to live where we choose, the right to own property, the right to make a living and the right to enter into voluntary agreements are all fundamental aspects of a free society. Respect for our natural rights is essential to maintaining civil life, and the central function and purpose of government is to protect the basic freedoms of its citizens.

Yet government itself often poses a grave and immediate threat to these rights. One of the most pressing public issues today is the ever-expanding scope and burden of government regulations, and the implications of this trend for people's economic liberties.

The overall problem is summarized by a statement in an editorial from *The Seattle Times*, "Sometimes, the government simply doesn't know when to leave the marketplace alone."<sup>4</sup> Today, Washington citizens, small businesses and major industries face an expanding array of regulations at all levels of government.

*The burden of regulation*

Very small firms, that is, those with fewer than 20 employees, spend 45 percent more per employee than larger firms in order to comply with just federal regulations. A firm with fewer than 20 employees might spend \$7,647 per employee to comply with federal regulations, whereas a firm with over 500 employees would spend only \$5,282 per employee.<sup>5</sup>

Total state regulation has expanded to fill 32 phonebook-sized volumes, which together form a stack of paper over five feet high. These rules have the force of law, and they strictly control and limit the day-to-day activities of every person in the state.

The fundamental policy question facing the people of Washington and their elected representatives is: What is the right balance of government intervention versus economic freedom? The answer is that government power should be limited to the rules needed to assure public health and safety, help the needy and protect consumers, so that over-regulation does not choke off the oxygen the economy needs to thrive.

The drafters of Washington's constitution provided guidance by recommending "a frequent recurrence to fundamental principles," which is "essential to the security of individual rights and the perpetuity of free government."<sup>6</sup>

Within the limits of ordered liberty it is the right of citizens to live their lives as they see fit, not as the government directs. When state government oversteps its bounds by regulating the smallest details of lawful activities, it hinders the vibrant economic and social life of the community.

*Government is the largest employer*

Government as a whole is now one of the largest industry classifications in the state. Washington ranks among the highest states in the per capita tax burden, and is among the highest in the overall cost of government it places on its citizens. One national study ranked Washington as one of the most regulated state.<sup>7</sup> Another study ranked Washington at only 31st in economic freedom, well below top-ranked Kansas.<sup>8</sup>

## **Policy Analysis**

The numbers provide ample warning that state government is becoming too large and expensive, and is moving too slowly to adapt to the changing world around it. In combination with the burgeoning cost and size of government, the regulatory burden on Washington residents has increased substantially. As small business owners, non-profit groups, homeowners, farmers and other ordinary citizens work to realize their dreams, they find they are increasingly frustrated by government regulators.

One builder of affordable housing calls the detailed permit reviews required by the Growth Management Act “ridiculous,” and says the process plods slowly and adds significant costs. Added costs include inventory carrying charges, fees for sophisticated engineering and extensive legal fees.

In the end, costs must be passed along to homebuyers in the form of higher prices, pushing many low-income families out of the housing market. One Vancouver builder found that government taxes and regulations added 22 percent to the sale price of his homes.<sup>9</sup>

A recent study by the University of Washington found that state and local land use restrictions add \$200,000 to the cost of a home in Seattle, helping push the median inflation-adjusted home price in the city to \$447,800.<sup>10</sup> The study’s author noted that, “The state is intervening to restrict supply. It’s not that there’s no land at all.”<sup>11</sup>

### *Examples of easing regulations*

In New York, the governor created a Governor’s Office of Regulatory Reform (GORR) to work with all agencies to reduce the number and complexity of state regulations. The Office’s message to citizens is explicit: “If you’re getting the runaround or being unnecessarily hounded by one of our state agencies call us.”<sup>12</sup> GORR officials say they will intervene and take care of the problem – fast. The Office’s goal is to make New York more attractive to business growth, and it has been credited with helping to create thousands of new jobs.

Another idea taking root among several states is the creation of a small business ombudsman for state government. The idea is based on the U.S. Small Business Administration's Office of the National Ombudsman (ONO). Like the federal office, a state-level ombudsman would be someone who is empowered to represent business owners as they navigate the confusing maze of state agencies and their thousands of pages of requirements.

The state ombudsman could listen to citizen complaints and investigate regulatory problems on their behalf. The federal office has saved small businesses across the country thousands of dollars. A state ombudsman would provide a similar benefit to Washington businesses.<sup>13</sup>

In streamlining regulations, Washington leaders do not need to reinvent the wheel. By following the successful example of New York, or similar efforts in states such as Texas, Massachusetts and New Jersey, policymakers can reform and modernize the state's Byzantine regulatory system.

### **Recommendations**

**1) Regulate for results, not for process.** Measuring the results of the regulatory process, rather than the process itself, would enable policymakers to know whether state agencies are accomplishing their core mission, or simply spending their budgets. Focusing on measurable outcomes would free agencies, businesses and individual citizens to find the best way to achieve desired public goods.

**2) Reorganize the Office of Regulatory Assistance into an Office of Regulatory Reform that would identify regulations which duplicate or contradict each other, are outdated or do more harm than good.** Currently, the Office of Regulatory Assistance only tries to help citizens through the complex maze of existing state regulations. It does not ask whether those requirements are in any way useful or needed. Reorganized as an Office of Regulatory Reform, it could actively review all state regulations and determine which ones duplicate or contradict each other, are no longer needed, or do more harm than good to the public interest.

**3) Include a regulatory sunset provision for new regulations, and submit all existing regulations to review by the legislature every**

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**five years.** Under the current system most state regulations are written to last forever. Policymakers should require all agency rules and regulations to carry a sunset provision, every five years be reviewed and, if still needed, reauthorized by the legislature.

**4) Create a regulatory fast track for companies and individuals with a good record of complying with regulations.** To focus enforcement where it is needed, state regulatory agencies should authorize companies and individuals who have a good record of following environmental and regulatory rules to approve their own applications and permits. The results would be periodically audited by state oversight agencies. Companies and individuals that did not follow regulations voluntarily would be penalized and their self-monitoring authorization would be revoked.

## 4. Unemployment Insurance Reform

### Recommendations

1. Bring state benefits more in line with the national average.
2. Allow workers to have personal unemployment accounts.
3. Increase benefit compliance audits.
4. Require training or community service as a condition of receiving benefits.

### Background

Washington's unemployment insurance system imposes the second-highest per employee cost in the nation.<sup>14</sup> While the tax *rate* is not higher than most states, businesses in Washington must pay that rate on the first \$31,400 of salary for each employee.<sup>15</sup> In contrast, businesses in most other states only pay unemployment taxes on the first \$7,000 to \$10,000 of salary.

#### *Generous benefits*

A primary cost-driver of Washington's state-run system is the high level of benefits it pays out. The maximum unemployment benefit, a generous \$515 per week, is close to the highest in the nation. Washington's average weekly benefit payout is \$325, 12 percent higher than the nationwide average of \$290.

Lawmakers make it easy for workers to receive tax-funded unemployment benefits. Among the ten reasons a person can use to get state unemployment benefits are, "to accept other work," a pay reduction of 25 percent, or a reduction in work hours of 25 percent.<sup>16</sup>

A person must work just 17 weeks to qualify for benefits. Employers, especially in the arts and seasonal businesses, often specifically design temporary employment positions so that a worker will receive unemployment payments once the employer has no

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further need of the employee. The level of benefits paid out is not based on financial need.<sup>17</sup>

In 2008 the legislature further expanded the unemployment insurance program. Lawmakers made employees who voluntarily leave their current work to join an apprenticeship program eligible to receive tax-funded benefits.<sup>18</sup>

### *Effort at reform*

In an effort to slow cost increases and promote job creation, the legislature passed major reforms to the system in 2003, most of which went into effect January 2004. The reforms included holding the maximum weekly benefit at \$496, reducing the maximum time an employee can collect unemployment benefits from 30 to 26 weeks, and changing the benefit calculation to reflect a full year of work, not just the two highest-paid quarters.

In 2005, however, the legislature reversed itself and repealed several key improvements from 2003 – just when many of these reforms were beginning to have an effect. The legislature’s sudden repeal of unemployment insurance reforms added an unexpected burden to the business climate and angered many small business owners.

In 2006, the state legislature enacted a broad unemployment insurance package, making permanent the 2005 changes, key among them:

- Businesses would be taxed according to a four-quarter scale while worker benefits would be paid out by the two-quarter scale, therefore, most businesses would get some tax relief in their unemployment insurance premiums.
- The general unemployment insurance trust fund would pay the difference between the taxes collected from individual businesses and the benefits paid out to workers.

### **Policy Analysis**

Today, Washington’s unemployment benefits are among the most generous in the nation, and the average unemployment payroll

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tax imposed on workers is the second-highest in the nation, at \$803 per worker.

High unemployment benefits increase unemployment because the incentive to collect unemployment is often greater than the incentive to work. Many people will try to collect the maximum they can from the system, waiting until their benefits are almost exhausted before seriously seeking new employment.

In addition to discouraging work, the current employment tax system is fundamentally unfair. Despite a lifetime of paying in, workers receive no refund when they retire, and workers who have not been unemployed never receive any benefit.

Washington's high unemployment tax burden has four primary negative effects on the state economy:

1. It discourages job growth and deprives the people of Washington of new work opportunities;
2. It encourages existing businesses to outsource jobs to other states;
3. It has a smothering effect on start-up businesses, and punishes successful businesses that attempt to hire more workers;
4. It discourages businesses in other states from relocating or expanding their operations to Washington.

Given the high costs of Washington's unemployment benefits system, policymakers should consider an alternative system based on personal, portable worker benefit accounts.

Such an approach has worked in other countries. In 1981, Chile pioneered a new system in which workers pay 10 percent of their wages into a personal account administered by a private fund. Employers contribute an additional 2.4 percent. A portion of the funds go into the general fund to cover young workers and those who cannot contribute enough into their account to meet the minimum level of benefits.<sup>19</sup>

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Key to the success of Chile's program is individual control of personal benefits. In contrast to the Washington system, unemployed workers in Chile can collect benefits whenever they are out of work for any reason, whether they are laid-off, fired or choose to leave their job. Strict qualification limits and punitive enforcement are not required because workers control their own benefits.

One of the best features of Chile's system is the built-in incentive for saving long-term. At retirement, workers keep all the money in their unemployment account. Washington's system has no such provision – employees here receive nothing from the system at retirement.

### **Recommendations**

**1) Bring state benefits more in line with the national average.**

When carried too far, high unemployment benefits increase unemployment. At a certain point, the incentive to remain on subsidized unemployment is greater than the incentive to work. Studies show that job-finding activities and formal job placement rises dramatically in the final few weeks of benefit eligibility. Bringing benefits in line with the national average would reduce the cost of unemployment taxes and help ensure a competitive business climate, while maintaining worker protections.

**2) Allow workers to have personal unemployment accounts.** Under the current system, Washington workers receive no refund or benefit when they retire, and workers who have not been unemployed receive no benefits at all. A system based on individual accounts returns fairness and equity to the system. Personal accounts promote individual responsibility, provide workers with a financial asset, encourage saving for retirement, and would relieve the state of most of the administrative cost and complication of the current system.

**3) Increase benefit compliance audits.** In a recent performance audit, the State Auditor praised the Employment Security Department for its fraud protection practices, pointing to the Department's automated claims management system as a model of efficiency. Ironically, many employers feel it is this system that encourages workers to avoid seeking a job. Increasing audits of people who are on unemployment would help ensure that they are

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really complying with job search requirements, rather than simply waiting for their benefits to run out.

**4) Require training or community service as a condition of receiving benefits.** Many people view unemployment benefits as a kind of paid vacation from the state. Job search requirements are minimal and unenforced, so people often pursue personal interests while receiving unemployment checks. Weekly training and community service would help prepare unemployed people for a return to work, and would provide a reasonable incentive to accept a job when one is available.

## **5. Estate Tax Repeal**

### **Recommendation**

1. Repeal the Washington estate, gift and inheritance tax.

### **Background**

In 1981, Washington voters approved Initiative 402 to repeal the state estate tax. It passed by a greater than two-to-one margin.<sup>20</sup> State lawmakers then instituted a “pick-up tax” by taking a portion of federal estate taxes levied on deceased Washington residents.

In 2001, Congress enacted a ten-year phase out of the federal estate tax. However, the Washington state legislature did not take action to conform state law to that change. As the federal tax was reduced year by year, the state Department of Revenue began collecting estate tax revenues at a rate higher than the legally allowed tax rate.

Currently, the federal estate tax rate is scheduled to fall to zero in 2010, but will skyrocket to 55 percent in 2011, unless Congress acts to make the phase out of the federal tax permanent. Legislation to accomplish this is pending in Congress.

The Washington Supreme Court ruled in February 2005 that, because of Initiative 402, the Department of Revenue is only entitled to a portion of federal estate taxes due, and that Congress’ action in 2001 eliminated the ability of Washington to collect a portion of the soon-to-expire federal tax. The court’s decision meant that, if the legislature did nothing, Washington’s estate tax would end in 2010 when the federal tax expired.

In 2005, however, state legislators enacted a new estate tax. The new tax law “de-couples” Washington’s estate tax law from the federal government’s tax laws.<sup>21</sup> The 2005 law repeals Initiative 402 and re-instates a stand-alone Washington estate tax law. Washington’s estate tax will continue unchanged after the federal tax ends in 2010.<sup>22</sup>

### **Policy Analysis**

The rate at which an estate is taxed varies from 10 percent to 19 percent, depending on the size of the estate. Estates in Washington are taxed if the assessed value exceeds \$2 million. Family farms are exempt, but there is no exemption for family owned small businesses.

The impact of the 2005 estate tax law is growing. The Washington Department of Revenue estimates it will collect tax from just over 200 estates in 2006, 220 in 2007, and 240 in 2008. The Department estimates the estate tax will bring about \$235 million to state coffers during the 2007-09 budget cycle, more than double what the state collected in 2005-07.<sup>23</sup>

Tax officials expect the amount of revenue they collect to increase even more over time, as more families are affected. Total revenue from estate tax collection equals about four percent of Washington's operating budget.

### **Recommendation**

**1) Repeal the Washington estate, gift and inheritance tax.** The estate tax is counterproductive because it impedes economic growth and discourages family businesses from remaining in or relocating to this state. Most importantly, it is unfair, because it targets family-owned businesses that can least afford to pay it, while their larger, incorporated competitors are exempt.

## **6. Business and Occupation Tax Reform**

### **Recommendations**

1. Reduce the harmful effects of B&O tax pyramiding.
2. Reduce taxes for all businesses; do not just shift the tax burden among businesses.
3. Increase the transparency of the B&O tax.
4. Provide B&O tax relief for new and small businesses.

### **Background**

The Business and Occupation (B&O) tax is Washington's second-largest source of tax revenue; only the general sales and use tax generates more money for state government. The B&O tax is a gross receipts tax, which means that the tax is levied on businesses' gross income, gross sales, or value of products. There are no deductions allowed for the cost of doing business, such as payments for raw materials, rent, or wages paid to employees.<sup>24</sup>

As a gross receipts tax, even business owners who lose money must pay the tax, based on the total volume of their annual sales.

The B&O tax was first imposed in 1935 and today consists of ten major tax rate categories. The rates themselves are relatively low in comparison to most other states' corporate income taxes. For example, Washington's manufacturing and wholesaling tax rate is 0.484 percent; the retailing tax rate is 0.471 percent.

Business owners are taxed according to their commercial activities, and one company may be subject to more than one tax rate.

The first \$28,000 in yearly gross income is not taxed. Firms that do this amount of business or less pay no B&O tax and are not required to file.

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The legislature has also enacted several small business tax credits that relieve a portion of B&O tax liability. The Tax Reference Manual states, “a [small business] subject to the 0.484 percent tax rate would incur no B&O tax liability until annual income exceeds \$86,777.”<sup>25</sup> SB 6407, introduced in the 2008 session, would have increased the small business tax credit by seven percent, thus providing greater tax relief for small firms, but this bill did not pass.

Washington is one of the few states in the nation that relies so heavily on a gross receipts tax. The pros and cons of the tax are often debated, and while policymakers recognize the harmful effect the tax has on small, new and unprofitable businesses, they disagree about whether and how to alleviate the tax burden they impose on those businesses.

### **Policy Analysis**

#### *Pyramiding tax system*

The B&O tax is a broad-based tax system. The tax base to which the tax is applied is much larger than the gross state product (GSP). This means that the economic activity that state leaders are taxing is much greater than the value of what businesses are actually producing. The GSP is the total value of all goods and services produced by Washington businesses in a single year. Washington’s B&O tax base is approximately 177 percent of the GSP.

The B&O tax base is broader than the GSP because lawmakers apply the tax to every transaction for any single product, from the time of production until final sale to the consumer. Each time a transaction takes place, say, between a wholesaler and a distributor, the product is subject to taxation, even though the inherent value of the product remains the same.

This broad base explains why very low B&O tax rates bring in so much money for the state. However, taxing the many stages of production and distribution creates unique problems for high volume, low profit margin businesses.

A high volume, low profit margin business (for example, a retailer) generates a high number of transactions, each involving a small amount of profit. Therefore the B&O tax system imposes a

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higher effective tax rate. This is in contrast to a low volume, high profit margin business that handles few transactions, but makes more profit per transaction. Washington's B&O tax system ends up favoring this second type of business, while financially punishing the first kind.

This problem is inherent in what are called "pyramiding" or "turnover" tax systems. A large business that has centralized and vertically integrated its operations has a tax advantage over a competitor, often a small business, that must contract out to help produce its product. The state taxes work that is contracted out, but not work that is moved from one company division to another.

The B&O tax system rewards big companies that do most production in-house, and makes it much harder for small, innovative competitors to break into markets already dominated by large firms.

### *Tax exemptions increasing*

A Department of Revenue (DOR) report on tax exemptions lists 567 "exclusions, deductions, preferential tax rates, deferrals and credits," and runs over 300 pages.<sup>26</sup> The number of different tax breaks changes every year during the legislative session. Not all 567 exemptions are geared towards industry and commerce. Many of them apply to property taxes.

However, as described by DOR, 246 exemptions are aimed at "business incentive," "other business," and "agriculture." If the "commerce" and "services" categories are included, that number rises to 272. Forty-eight percent of the total tax exemptions target the business community, whereas the other exemptions focus on individuals and property owners.

Since 2001, the legislature passed 147 exemptions, deductions or credits to the tax code. This is an average of 21 per year. Over the previous 25-year period, 1975-2000, the legislature averaged just over nine exemptions per year. In the period 1950-1974, there were fewer than four averaged exemptions per year.<sup>27</sup>

This situation creates a system in which state lawmakers pick winners and losers in particular industries. Each year, more exemptions, deductions or credits are enacted into the state's tax

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code. Most of them give a benefit to certain industries, or even subsets of industries. This practice, while perhaps well-intentioned, becomes a game of “What industry can finagle the most tax exemptions?” Lawmakers respond to special interest requests, instead of providing broadly-applied tax relief for all Washington businesses and industries.

### *Lack of transparency*

The B&O tax is a stealth tax. Consumers are not aware of the role the gross receipts tax plays in increasing the cost of a product. Sales taxes are always displayed as a line item on a bill of sale, but the B&O tax portion is not reported to consumers; it is built into the purchase price.

### *Tax relief for new and small businesses*

Washington state ranks seventh in the nation for business start ups (after ranking first and second earlier this decade), but still ranks worst in the nation in business terminations. The state does not keep track of why Washington firms fail, but businesses owners routinely cite the state’s burdensome tax structure as one major cause.<sup>28</sup>

In 2007, legislation was introduced to exempt new businesses from the first year of B&O tax, and to reduce B&O taxes for a firm’s first few years.<sup>29</sup> However, the bill failed to gain enough votes for passage.

## **Recommendations**

**1) Reduce the harmful effects of B&O tax pyramiding.** The pyramiding effect, taxing every transaction in the production process, is a major source of the economic problems caused by the state’s B&O system. The system’s lack of transparency rewards large, high profit margin companies and disproportionately harms high volume, low profit margin businesses.

**2) Reduce taxes for all businesses; do not just shift the tax burden among businesses.** Policymakers should enact broad tax relief for all businesses, instead of continuing to increase the hundreds of tax exemptions, credits and deductions that benefit favored industries.

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**3) Increase the transparency of the B&O tax.** Consumers are paying a stealth tax they rarely see. This creates a sense that consumers do not play a role in B&O transactions when, in reality, they end up footing most of the cost of the tax. Like the sales tax, consumer tax receipts should show the estimated cost of the B&O tax and how it contributes to the final purchase price.

**4) Provide B&O tax relief for new and small businesses.** Policymakers should exempt new businesses, regardless of industry, from B&O tax liabilities for an introductory period of one year. After getting established, a new business' B&O tax liability could steadily increase until it is paying the full amount within a few years of startup.

**Additional Resources from Washington Policy Center**

“24 Ways to Improve the State’s Small Business Climate,” by Carl Gipson, January 2008.

“Lawmakers Have Time to Fix Feel-Good, Do Nothing Legislation,” by Carl Gipson, January 2008.

“Washington Policy Center Comments on WAC 296-62-095 – Heat-related Illness Rule,” by Carl Gipson, April 2008.

“The Streamlined Sales and Use Tax Agreement: A Primer on the New Law,” by Hallie Hostetter and Carl Gibson, Policy Note 2007-03.

“An Overview of Washington's Emergency Heat Stress Rule,” by Carl Gipson, Policy Note 2007-21.

“2007 Legislative Session: Some Problem-Solving Legislation Tends to Create Further Headaches for Small Businesses,” by Carl Gipson, May 2007.

“Proposed State-Mandated Warranty Would Increase Costs to Homebuyers,” by Paul Guppy and Christopher Fox, March 2007.

“Small Business May Need a Good Defense this Legislative Session,” by Carl Gipson, January 2007.

“A Citizens’ Guide to Initiative 920: A Measure to Repeal the Estate Tax,” by Carl Gipson, October 2006.

“Punishing Targeted Businesses Hurts Us All,” by Carl Gipson, September 6, 2006.

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