



POLICY BRIEF

How to reform Washington's tax structure

By Jason Mercier,
Director, Center for Government Reform

March 2019

Key Findings

1. The proper function of taxation is to raise money for core functions of government in a neutral way.
2. Though there is no recession-proof tax structure, Washington has consistently ranked as having relatively stable tax collections compared to other states.
3. One part of our tax code in need of serious reform is the "temporary" Business and Occupation tax.
4. Lawmakers should take advantage of the U.S. Supreme Court's recent ruling in the Wayfair case to provide people with sales tax relief.
5. According to the Internal Revenue Service a tax on capital gains is an income tax.
6. States without income taxes don't tax capital gains income.
7. Voters have rejected a state income tax ten straight times (including six proposed constitutional amendments) most recently voting it down by a nearly two-to-one margin in 2010.
8. Another important principle for elected officials to embrace is tax transparency.



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Introduction

On January 24, 2019, the House Finance Committee held a work session on the state’s tax structure and recommendations for reform.¹ I was invited by lawmakers and made a presentation on tax principles and volatility, reforming the “temporary” Business and Occupation tax, providing a sales tax cut, why a capital gains tax is an income tax, and the need for a state tax transparency website. Here is a summary of the information I presented on these issues.²

Tax principles and volatility

The proper function of taxation is to raise money for core functions of government in a neutral way. A “fair field and no favors” is a good motto for a strong tax system. Elected officials should not use the tax system to favor special interests, to punish business activities they don’t like, or otherwise to reward or harm people for the reasonable choices they make in their own lives.

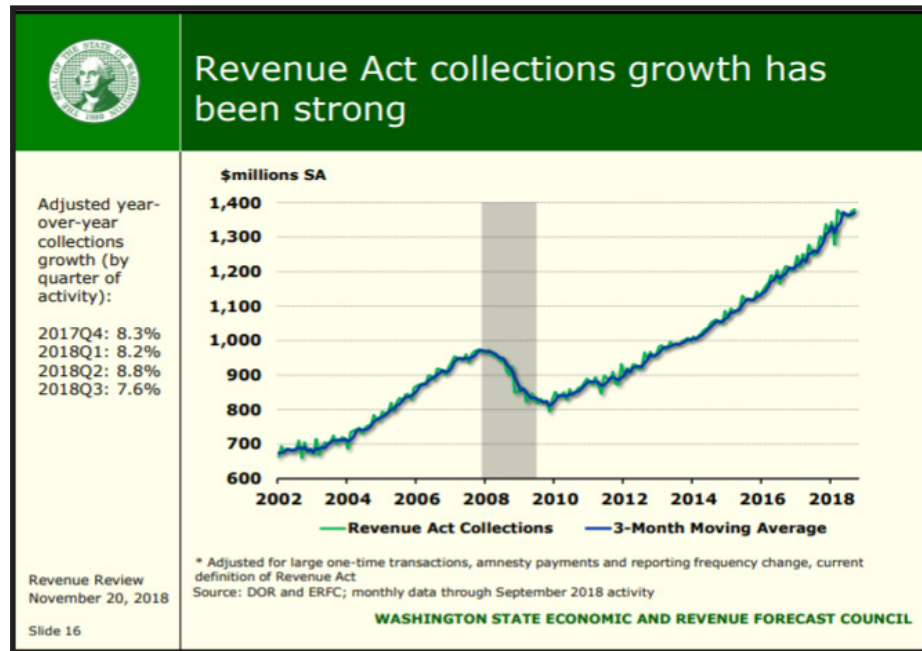
The following fundamental tax principles provide guidance for a fair and effective tax system; one that raises needed revenue for core functions of government, while minimizing the financial burden elected officials place on citizens. A healthy tax system should have:

- Simplicity
- Accountability
- Economic Neutrality
- Equity
- Complementary components
- Competitiveness
- Reliability
- Transparency

¹ “House Finance Committee Work Session,” TVW video archive, January 24, 2019, at <https://tinyurl.com/y7d3czsg>

² “Washington State Tax Structure,” by Jason Mercier, Washington Policy Center, January 24, 2019, at <https://www.washingtonpolicy.org/library/docLib/Tax-structure-presentation-.pdf>

Washington's tax system provides reliable revenue growth



Though there is no recession proof tax structure, Washington has consistently ranked as having relatively stable tax collections compared to other states. The reason for this is Washington's three major tax sources (sales, gross receipts, and property) are among the least volatile taxes. Progressive income taxes, however, are the most volatile and unpredictable sources of tax revenue.

The relative stability of Washington's tax collections has also been noted by Standard & Poor's. From S&P's August 2018 bond rating for the state:

Good recent economic growth relative to that of the nation and a sales tax-based revenue structure that has demonstrated less sensitivity to economic cycles than income tax-reliant states . . . The state's reliance on retail sales, and business and occupation taxes for a combined 69% of general fund revenues (on a budgetary basis) typically affords Washington more revenue stability than other states that rely on personal income tax revenues.³

Reforming the "temporary" Business and Occupation (B&O) tax

One part of our tax code in need of serious reform is the "temporary" Business and Occupation tax. The following is from the conclusion of the 1933 state Supreme Court ruling allowing the tax:

"This law is, perhaps, not perfect. No tax law yet devised has been entirely fair and just to all in its practical workings. This is an emergency measure, limited by its terms to a two-year period. If it works injustice to some, it will be but temporary, and such temporary injustice, if any, must be borne for the common good." – 5-4 majority in *State ex rel. Stiner v. Yelle*⁴

³ "State of Washington; Appropriations; General Obligation," S&P Global Ratings, August 16, 2018, at <https://tre.wa.gov/wp-content/uploads/2019/08/ABT-SP-2018.08.16-Report.pdf>

⁴ "*State ex rel. Stiner v. Yelle*, 174 Wash. 402, 25 P.2d 91 (1933), at <http://courts.mrsc.org/washreports/174WashReport/174WashReport0402.htm>

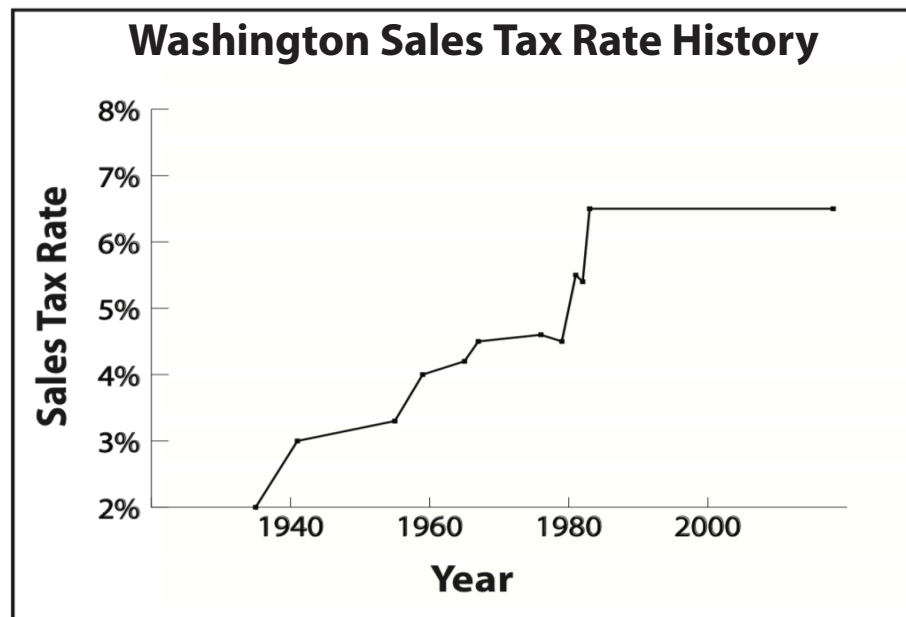
Washington Policy Center proposes replacing the B&O tax with a simple, fair Single Business Tax.⁵ Under this type of tax, the business owner would have a choice of three ways by which to calculate the tax owed and would be allowed to choose the one that results in the lowest tax burden. A uniform discount would also be applied. Calculating the taxable margins could be based on either the business’

1. Total gross receipts minus labor cost;
2. Total gross receipts minus all production costs except labor; or
3. 60% of total gross receipts.

Providing a sales tax cut

Lawmakers should take advantage of the U.S. Supreme Court’s recent ruling in the *Wayfair* case to provide people with sales tax relief. In *Wayfair*, the court ruled that states can collect sales tax when their citizens buy goods over the internet from out-of-state businesses.

When it was first imposed in 1935, Washington’s sales tax rate was just two percent. It is currently at 6.5% and citizens have not seen a rate reduction since 1982, as shown below.



Washington’s sales tax started out low, but it is now 6.5%. State officials have provided no sales tax relief since 1982.

Washington’s growing economy, the continued increases in state revenue growth (with over 9% forecasted increase for the 2019-21 state budget), and the new money from the U.S. Supreme Court’s *Wayfair* ruling, provides the opportunity to make tax relief for Washington families a priority during the 2019 Legislative Session.

⁵ “Replacing the Business and Occupation Tax with a Single Business Tax,” by Jason Mercier and Carl Gipson, Washington Policy Center, May 2010, at https://www.washingtonpolicy.org/library/docLib/May_2010_BOPB.pdf

There is no debate that a capital gains tax is an income tax

What type of tax is a capital gains tax? It is an income tax. According to the Internal Revenue Service (IRS):

This is in response to your inquiry regarding the tax treatment of capital gains. You ask whether tax on capital gains is considered an excise tax or an income tax? It is an income tax. More specifically, capital gains are treated as income under the tax code and taxed as such.⁶

Every state revenue department in the country describes capital gains as income. Those states that tax capital gains do so through their income tax codes. No state taxes capital gains as a separate “excise tax.”

What do states without a capital gains tax have in common? They have no personal income tax. As officials from these states explain:⁷

- Alaska Department of Revenue: “No personal capital gains tax. Alaska currently does not have a personal income tax.”
- Florida Department of Revenue: “There is currently no Florida income tax for individuals and, therefore, no Florida capital gains tax for individuals.”
- Nevada Department of Taxation: “Nevada does NOT have a capital gains tax similar to federal income tax.”
- New Hampshire Department of Revenue Administration: “No capital gains tax in New Hampshire.” *Note: NH does not have general income taxes.*
- South Dakota Department of Revenue: “South Dakota does not have an income tax and does not tax capital gains income.”
- Tennessee Department of Revenue: “Tennessee does not have a general income tax. Instead, the Hall income tax is imposed only on bond interest and dividends from stock. Capital gains are therefore generally not subject to taxation in Tennessee.” *Note: TN is phasing out the Hall tax by 2022.*
- Texas Comptrollers Office: “No capital gains tax. Texas does not have a state income tax.”
- Wyoming Department of Revenue: “No capital gains tax because Wyoming does not have an income tax.”

There is also the fact that the text of capital gains tax bills introduced in the Legislature this year refer to income taxes (text of HB 1343 and SB 5129):⁸

- Bill definition of taxable capital gain: “Federal net long-term capital gain’ means the net long-term capital gain reportable for federal income tax purposes.”

⁶ “IRS: Capital gains tax ‘is an income tax,’” by Jason Mercier, Washington Policy Center, September 25, 2018, at <https://www.washingtonpolicy.org/publications/detail/irs-capital-gains-tax-is-an-income-tax>

⁷ “Which states don’t have a capital gains income tax?,” by Jason Mercier, Washington Policy Center, December 14, 2018, at <https://www.washingtonpolicy.org/publications/detail/which-states-dont-have-a-capital-gains-income-tax>

⁸ “Nonpartisan legislative staff summarizes Governor’s capital gains tax proposal,” by Jason Mercier, Washington Policy Center, January 16, 2019, at <https://www.washingtonpolicy.org/publications/detail/nonpartisan-legislative-staff-summarizes-governors-capital-gains-tax-proposal>

- State reporting requirement: “In addition to the Washington return required to be filed under subsection (1) of this section, taxpayers owing tax under this chapter must file with the department on or before the date the federal return is required to be filed a copy of the federal income tax return along with all schedules and supporting documentation.”

The state Supreme Court has repeatedly made it clear that lawmakers cannot call an income tax an “excise tax” simply to avoid the state’s graduated income tax ban.

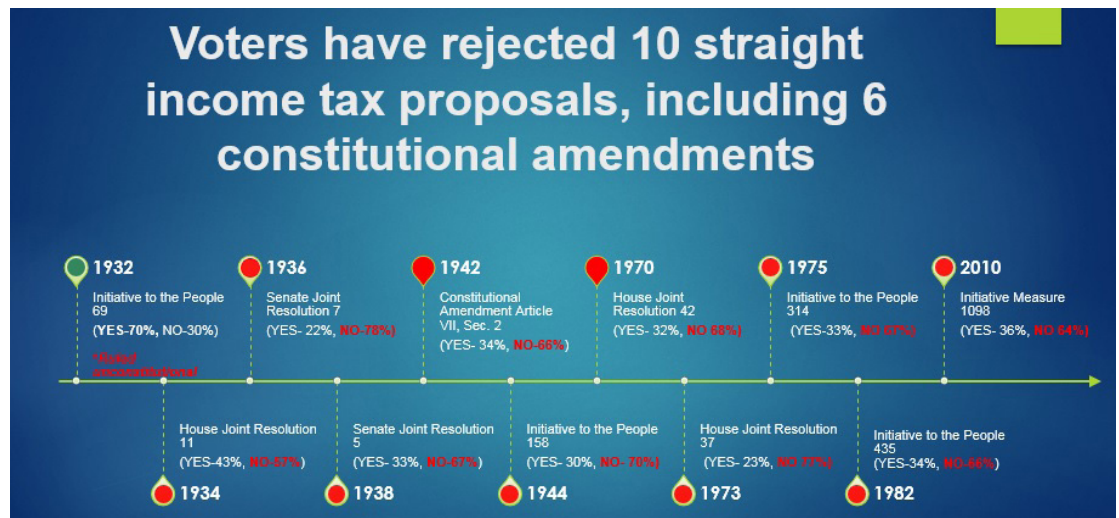
As explained by former Justice Talmadge:⁹

The Legislature attempted to describe the income tax as an excise tax on the ‘privilege of receiving income’ in the State of Washington. The Supreme Court was unmoved.

The Jensen court stated that the 1935 Legislature’s effort to rename the tax did not make it an excise tax . . . Subsequently, in *Power, Inc v. Huntley*, the Legislature enacted what it described as a corporate excise tax, which was actually a graduated new income tax on corporations. Again, the Supreme Court indicated that legislative labels for a tax are not controlling.

A state income tax is unpopular

Imposition of a state income tax in Washington state has been consistently unpopular over the years, sparking strong bi-partisan opposition. In all, the people have rejected a state income tax ten straight times (including six proposed constitutional amendments) most recently voting it down by a nearly two-to-one margin in 2010.¹⁰



⁹ “HB 1730 and SB 5111 would impose a capital gains income tax in Washington state,” by Jason Mercier, Washington Policy Center, March 2017, at <https://www.washingtonpolicy.org/library/doclib/Mercier-LM-HB-1730SB5111.pdf>

¹⁰ “Income Tax Ballot Measures,” Washington Secretary of State, at <https://www.sos.wa.gov/elections/research/income-tax-ballot-measures.aspx>

Capital gains income tax revenue is unreliable

As warned by former California Governor Jerry Brown, income taxes on capital gains are extremely volatile and unreliable. Heeding Governor Brown’s warning about the volatility of capital gains, California voters in 2014 approved a constitutional amendment to restrict the use of capital gains for state spending in order to reduce the state’s dependence on this source of revenue.

Explaining the effect of the constitutional amendment, the California Legislative Analyst’s Office (LAO) said: “This constitutional amendment separates state spending from the rollercoaster of revenue volatility.”¹¹

More from the California LAO analysis:

Probably the single most direct way to limit the state’s exposure to the kind of extreme revenue volatility experienced in the past decade would be to reduce its dependence on the source of income that produced the greatest portion of this revenue volatility—namely, capital gains and perhaps stock options.¹²

There was also this warning from analysts at the Washington Department of Revenue (DOR) on the 2012 capital gains income tax proposal (House Bill 2563):¹³

“Capital gains are extremely volatile from year to year. Revenue from this proposal will depend entirely on fluctuations in the financial markets and can be expected to vary greatly from the amounts presented here.”

If enacted, Washington would be the only state in the country with a stand-alone income tax on capital gains.

Doing this would throw away what the state Department of Commerce says is not only a “competitive advantage” for the state but also “is great marketing” for Washington.

If a Washington state income tax were imposed, Commerce officials warn it would mean “one less tool that we have in our economic development tool box.”¹⁴

The need for a state tax transparency website

Another important principle for elected officials to embrace is tax transparency.

Individuals and business owners should be able to quickly and easily learn about how much officials in each taxing district add to the total tax burden they impose on citizens. This is especially true when one considers there are nearly 1,800 taxing districts in the state.

11 “ACA 1 X2 – Bill Analysis,” California Legislative Analyst Office, May 2014, at http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0001-0050/acax2_1_cfa_20140515_091436_asm_floor.html

12 “Revenue Volatility In California,” California Legislative Analyst Office, January 2005, at https://lao.ca.gov/2005/rev_vol/rev_volatility_012005.htm

13 “HB 2563: Establishing a state tax on capital gains,” Washington State Legislature, January 17, 2012, at <https://app.leg.wa.gov/billsummary?BillNumber=2563&Year=2011&Initiative=false>

14 “WA Department of Commerce: No state income tax “is great marketing” for Washington,” by Jason Mercier, Washington Policy Center, September 21, 2018, at <https://www.washingtonpolicy.org/publications/detail/wa-department-of-commerce-no-state-income-tax-is-great-marketing-for-washington>

Increasing the ease of public access to state and local tax rates would enhance trust in government and increase the public's understanding of the real cost of government services. Improved transparency would also facilitate meaningful tax competition among taxing districts, because taxpayers could compare different tax burdens based on where they decide to live or locate their businesses.

SB 6032, Sec 135 (4) of the 2018 supplemental state operating budget would have created a tax transparency website.¹⁵ The provision, however, was vetoed by the Governor.

To help improve the transparency of state and local taxation, state lawmakers should act again on this popular bipartisan proposal to create an online searchable database of all tax districts and tax rates in the state. Hopefully, the governor would sign it into law this time.

Conclusion

The people of Washington have a right to be informed about the taxes they are required to pay, and to know which elected officials impose this financial burden on them each year. Such information is fundamental to democratic self-government and is essential to maintaining public trust in office-holders at the state, county and local level.

The principles presented in this study show how officials can adopt fair standards of taxation, avoid imposing an unpopular state income tax, end and replace the inefficient and “temporary” B&O tax and provide sales tax relief.

These reforms would help lower the tax burden, provide greater tax transparency and predictability, and maintain stable revenue to fund public services, all to the benefit of everyone living in the state.

¹⁵ SB 6032 incorporated the text of SB 6590, which provided for the creation of a state tax-transparency website that was accessible to the public.

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