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POLICY NOTES

The Economic Case Against an Income Tax in Washington State

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Washington is one of just a handful of states that do not levy a state income tax. However the Washington Tax Structure Study Committee, convened by the legislature in 2001 to study the state's tax structure and recommend changes, argues that the state would be better served with an income tax, enabling the state to reduce its heavy reliance on sales taxation and to eliminate the state property tax.

The Tax Study Committee's recommendations have sparked heated debate. Proponents of an income tax claim the new tax would be less regressive than the existing system. Opponents say an income tax will drive up government spending and hurt our already struggling economy.

Simulating the Effects of an Income Tax

Ultimately the debate about the desirability of an income tax cannot be settled by invoking theoretical or even moral arguments, because it is largely an empirical issue. One method that provides the required level of detail needed to analyze sweeping changes in the tax system is a Computable General Equilibrium (CGE) model. We have constructed a CGE computer model called the State Tax Analysis Modeling Program, or STAMP, which allows us to simulate the introduction of an income tax and trace its effects on Washington's economy.

For the purpose of this study, we consider the effects of introducing one of the Tax Structure Study Committee's recommended tax scenarios: Introducing a flat state income tax rate of 3.8%, reducing the state sales tax from 6.5% to 3.5% and eliminating the state property tax.

When we enter these changes into Washington-STAMP, and compare the new results with the baseline situation, a very interesting conclusion emerges: the tax change would hurt employment in the state and reduce the disposable income of those who remain employed. In other words, *the case for introducing a personal income tax in Washington is not economically compelling*.

Having stated the conclusion, we turn to the detailed results. The first point to note is that the combination of a state income tax, a lower sales tax and removal of the state property tax leads to an increase in the wage rate of 6.6%. This does not necessarily leave workers better off; it occurs because workers expect to be compensated for the increase in the income tax that they now have to pay.

The higher wage rate in turn leads firms to cut back the number of workers, so employment falls by 134,180. This represents a reduction of almost 3.75% in the number employed in Washington. As employment opportunities decrease, 71,000 formerly working, taxpaying households migrate out of Washington State to pursue other opportunities.

Alternatively one might look at real disposable income, which is earnings plus transfers (such as pensions) less taxes paid, adjusted for any change that occurs in the price level with an income tax. Total real disposable income in Washington would fall by 2.58%, while per capita real disposable income would also shrink by 1.40%. These results provide no justification for a major overhaul of the tax structure of the state.

Conclusion

The combination of a state personal income tax, reduction of the state sales tax and elimination of the property tax would lead to less employment, a smaller state population, and a larger number of non-working households. Working households from across all income groups leave the state and migrate elsewhere. Real disposable income falls for all income groups except those few making less than $10,000 per year. As a result of the detrimental impact the new tax will have on the economy, middle-income families, which make up the largest portion of the state's population, find themselves worse off.

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STAMP Computer Simulation Results

Economic effects of introducing a flat-rate personal income tax of 3.8%, reducing the state sales tax from 6.5% to 3.5% and eliminating the state property tax.

(m = million, bn = billion)	**Economy under Current Tax Policy**	**Economy with Income Tax**
	2004	**2004**
Employment	jobs	jobs
Number of jobs	3,579,196	3,445,018
Change in employment		-134,178
% change in employment relative to baseline		-3.75%
Gross wage rates	$/wkr/yr	$/wkr/yr
Baseline wage rate, $/person/yr, nominal $	34,239	36,488
Change in wage rate, nominal $		2249
% change in wage rate relative to baseline		6.57%
Investment	$m	$m
Baseline investment, $m, nominal $	36,785.411	48,717.830
Change in nominal investment ($m)		11,932.419
% change in capital stock relative to baseline		32.44%
State Personal Income, nominal	$bn	$bn
SPI ($bn)	210.771	215.415
Change in nominal SPI ($bn)		4.644
% change in nominal SPI		2.20%
Disposable Income, real	$bn	$bn
DI ($bn)	167.931	163.598
Change in real DI ($bn)		-4.332
% change in real DI		-2.58%
Disposable Income per capita, real	$	$
DI/capita ($)	26,668	26,296
Change in real DI/capita ($)		-372
% change in real DI/capita		-1.396%