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House of Straw

How Washington's tax system undermines our economic future – and how to fix it

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Executive Summary

Washington needs a new tax system. As a state, we have been ratcheting down the level of spending on education for at least two decades, depriving many of our children and young adults of the foundations they need to achieve their full potential. Even after we restore full employment and economic growth, we simply will not be able to wring enough revenue from the current tax structure to build the education system we have envisioned and our children deserve.

Washington's tax structure is out of step with today's economy. It was designed in the 1930s when agriculture, extractive industries, and manufacturing were the drivers of economic growth and wealth. While other states have modernized their systems, Washington has not. Washington's population and economy are growing, but with each passing year the gap grows wider between the revenues our tax system generates and the services state residents and businesses need.

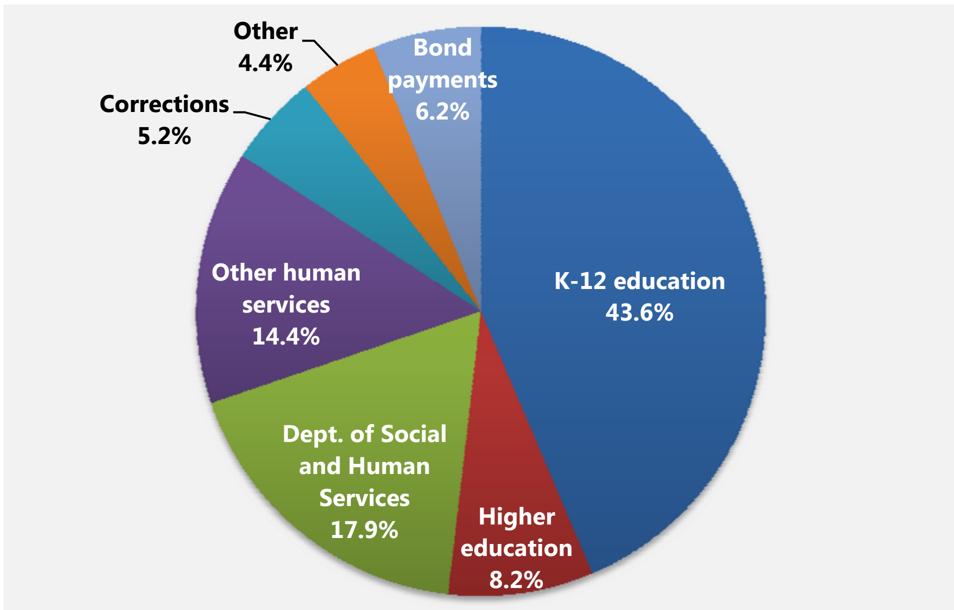
Americans enjoy access to education, mobility, public health and safety, clean air and water, a reliable food supply, and a functioning economy because of the activities of local, state, and federal governments. Taxes paid by previous generations as well as by us today, built, maintain, and staff the schools, roads, fire stations, regulatory agencies, and other public facilities that keep society ticking and provide the foundation for individual opportunity.

Washington needs a new tax structure that reflects today's economy and has built in flexibility to keep up with newer standards in education, health, transportation, and other core public functions, even as economic change continues. Reforms that add a personal income tax, lower the sales tax, and revamp business taxes would make Washington's system more sustainable and fair. Without these reforms, we will not have the tools to ensure that all state residents have the opportunity for a healthy and prosperous life.

Washington's current revenues and expenditures: A snapshot

Most of the taxes Washington State collects are devoted to the General Fund budget and closely related funds, which together finance education, social and health services, courts and prisons, parks and other services. The Legislature and Governor adopt 2-year budgets. In the 2011-2013 biennium, the two-year General Fund budget totals about $30 billion. The K-12 public education system receives the largest share of state revenues – about 44% in 2011-13.

WASHINGTON STATE 2011-13 GENERAL FUND BUDGET



Source: www.fiscal.wa.gov ("Near" General Fund, including closely related funds, before adoption of 2012 Supplemental budget)

How Washington pays for public structures and services

Sales Taxes: Washington's retail sales and use tax funds nearly half of the General Fund budget. The state collects 6.5% on sales of most goods, as well as construction and repair services. Local governments collect additional sales tax, so consumers pay rates ranging from 7.5% to 9.5% across the state.[1]

Food and prescription drugs are exempt from sales tax. The legislature has also adopted close to 180 other special exemptions or reductions from sales tax, on items ranging from manufacturing machinery to fertilizer, high tech construction to used-vehicle trade-ins.[2] Alcohol, tobacco, pop syrup, hazardous substances and other items have special higher tax rates.

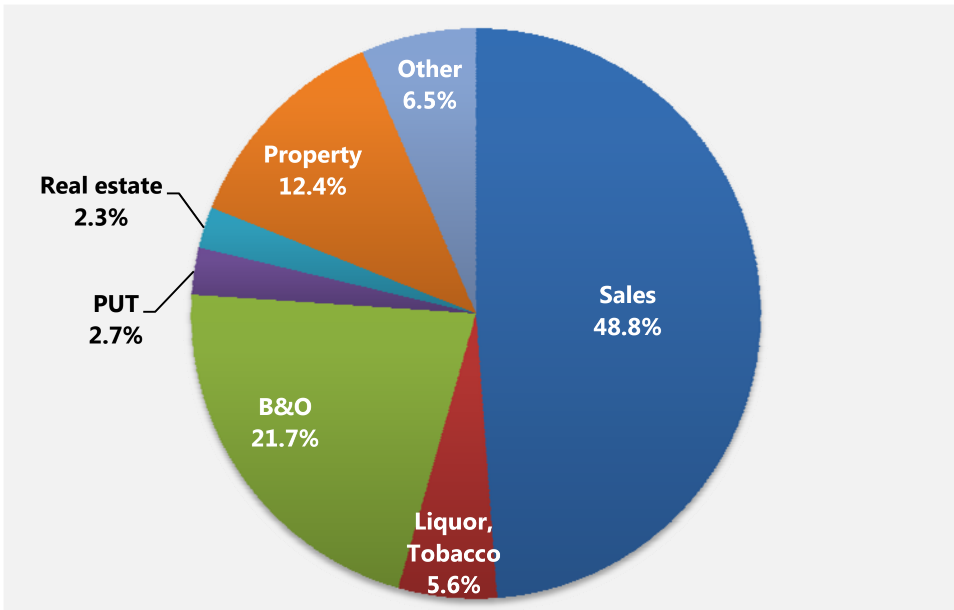
Property Taxes: Property taxes contribute 12.4% to the General Fund. This represents about 20% of the total property tax Washington residents pay. The rest stays in local communities, supporting schools, city and county services and other local facilities.

Business Taxes: Washington's main business tax is the Business & Occupation tax (B&O), which in most cases is paid on a company's gross (total) receipts without deductions for expenses, at rates ranging from less than 0.5% for manufacturing and retail, to 1.8% for most services, such as legal, medical, and financial, which are not subject to retail sales tax. The 1.8% service rate was adopted in 2010 and is scheduled to revert to 1.5% in July 2013.[3]

Over the past two decades, the Legislature has approved a number of special lower rates, deductions, and credits for specific industries within the B&O tax structure – at least 175 of them at the last tally – including tax breaks for aerospace manufacturing, seafood processing, agricultural production, and private school tuition.[4]

Some types of businesses have targeted taxes instead of or in addition to the B&O tax, including public utilities, insurance, parimutuel gambling, and oil companies. Other smaller sources of revenue include the estate tax, paid on the value of nonfarm estates over $2 million.[5]

WASHINGTON'S SOURCES OF REVENUE FOR THE GENERAL FUND, 2011-2013



Source: www.fiscal.wa.gov (before adoption of 2012 Supplemental budget)

Federal and other funds: The state's total Operating Budget includes the General Fund plus money received from the federal government and other sources for specific purposes such as Food Stamps, Medicaid, and children's health. There are also separate budgets for transportation, funded mostly by the gas tax, and capital construction, funded by bonds.

Problems created by Washington's tax structure

Washington adopted its current tax structure in 1935. Since then, the basic system has remained the same even as the economy has evolved to focus more on services and information than on tangible products. The Great Recession and its aftermath have slowed public revenues in all states, but Washington's problems go far deeper. Our state's tax structure has three fundamental flaws that create problems for our residents and our economy:

1. Shrinking tax base: Our tax base is focused on a part of the economy that is shrinking in importance – sales of goods. As the population and economy grow and change, tax revenues do not keep up with the needs for rebuilding public structures and services. A balanced system that includes multiple sources, covers most economic activities, and includes a personal income tax is most likely to remain relatively stable and produce natural revenue growth to match changing needs.

2. "Upside-down" tax rates: Low- and moderate- income residents pay far higher percentages of their income in state and local taxes than the wealthy. Business taxes also tend to fall more heavily on small and newer companies than on large and established firms. Growing income inequality exacerbates this problem.

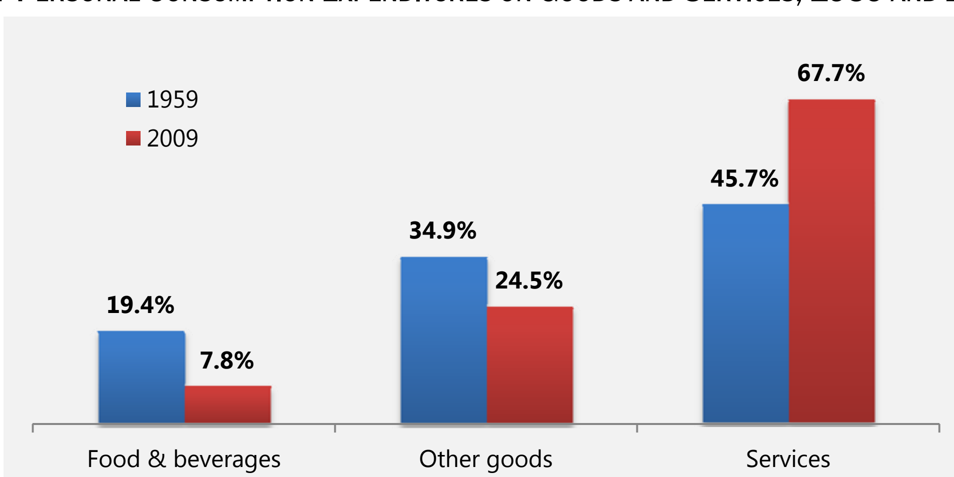
3. Inadequacy: Washington's shrinking tax base and upside down rates have left us without the resources to provide the early learning, K-12 schooling, and higher education that our people and businesses need to assure opportunity and the ability to compete. Health services, infrastructure, and other public goods all have unmet needs.

1. Washington's shrinking tax base: It's not just the recession

Washington's taxes no longer match household spending patterns

The sales tax is Washington's most important source of public revenue. For decades, people have been shifting their spending from goods – which are subject to sales tax – to services, which are mostly not taxed. Between 1959 and 2009, the share of U.S. consumer spending on services increased from 46% to 68%, while spending on goods other than food fell from 35% to 25%.[6]

SHARES OF PERSONAL CONSUMPTION EXPENDITURES ON GOODS AND SERVICES, 1959 AND 2009, U.S.



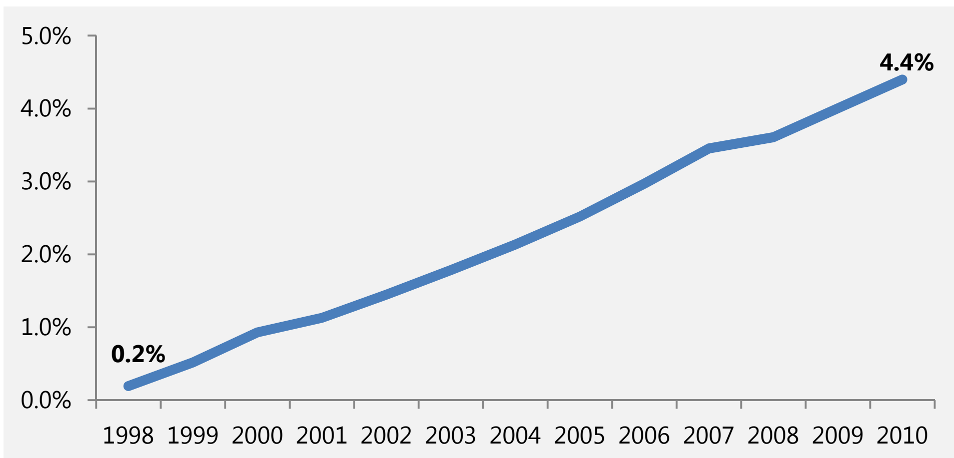
Source: US Bureau of Economic Analysis, Trends in Consumer Spending, June 2011

Consumers are also buying more of the goods they do purchase over the internet, often tax-free.[7] From 1998 to 2010, the percentage of US consumer spending going to e-commerce rose steeply, from just 0.2% to 4.4% of the total value of sales.[8] By 2011 that figure had reached 5%.

Experts expect rapid growth in e-commerce to continue, potentially undermining the viability of some Main Street brick and mortar businesses.[9] And while people of all income levels are turning to internet purchases, higher-income households have more access to the internet and upper middle and high income households shop more often online than lower-income households.[10]

These trends mean that Washington's most important source of public revenue comes from an ever smaller slice of the economic pie, and further exacerbate the inequities of the tax system.

E-COMMERCE AS PERCENTAGE OF ALL RETAIL SALES, U.S. 1998 TO 2010



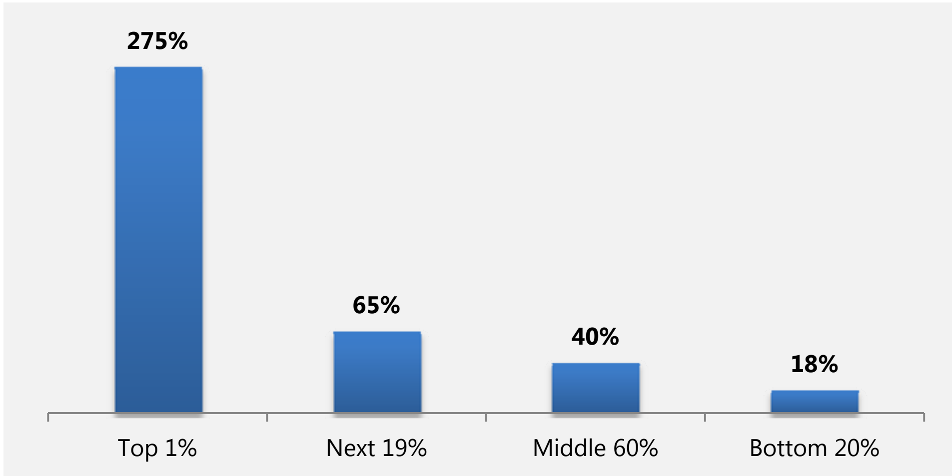
Source: US Census, 2010 E-commerce Multi-sector Data Tables

Growing income inequality contributes to revenue shortfalls

Another trend that contributes to Washington's shrinking tax base is growing income inequality. According to Internal Revenue Service data, the top 1% of American taxpayers more than doubled their share of national income between 1986 and 2007, while the share held by the bottom half fell by 26%. Altogether 95% of American taxpayers lost income share over those 3 decades, while 5% gained.[11] The Congressional Budget Office reported that between 1979 and 2007 the income of the top 1% of households increased by 275% after inflation, while middle income Americans saw only a 40% increase and the bottom fifth of households a meager 18%.[12]

The same trends played out in Washington. From the late 1980s to 2006, the incomes of the top fifth of Washington state households grew by 41.3% over inflation, while the bottom fifth only gained 5.5% and those in the middle grew 11.8%.[13]

Income Growth in U.S. Households, 1979 - 2007

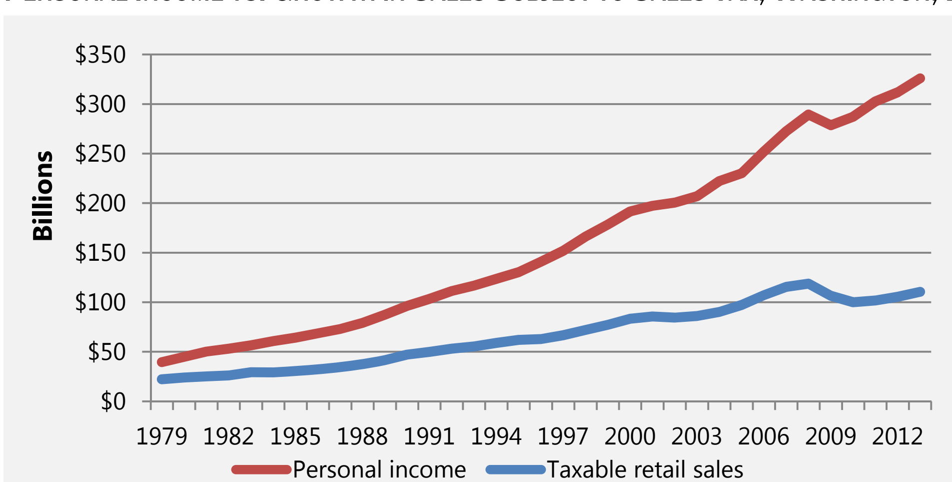


Source: Congressional Budget Office

Wealthy people may buy more expensive things and pay more total sales tax, but they also spend a much lower percentage of their income than do lower- and moderate-income households. The well-to-do also tend to purchase more services which are not subject to sales tax rather than things with tax – housekeeping services rather than cleaning supplies or accountant services rather than off-the-shelf software, for example.

Because of this top-heavy growth in wealth, the total personal income of Washington residents has risen at a much faster rate than taxable retail sales over the past 30 years. The gap is growing over time. With the onset of the Great Recession in 2008, total state personal income dipped slightly, and then resumed growth, while taxable retail sales have yet to recover. In 1979, taxable retail sales represented 56% of personal income in Washington. By 1990, the ratio was at 49% and in 2010 it was 35%. Even as population and incomes go up, sales tax revenue does not keep pace, leading to chronic shortfalls in state revenue.

Growth in Personal Income vs. Growth in Sales Subject to Sales Tax, Washington, 1979-2012



Sources: U.S. Bureau of Economic Analysis and Washington Economic and Revenue Forecast Council

Additional structural factors squeezing Washington's budget

Additional factors shrinking Washington's revenue base and squeezing the budget include:

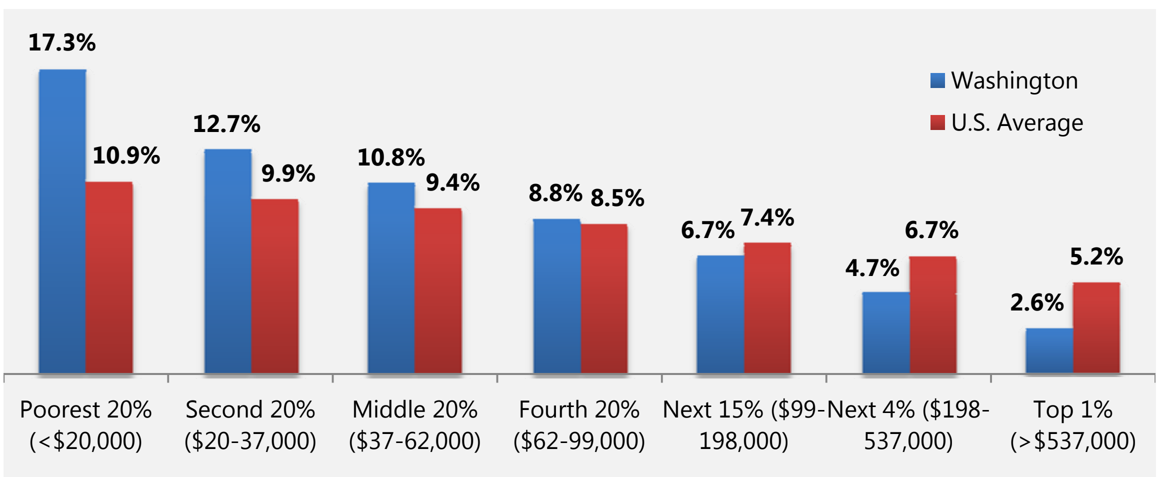
- Voter- and legislatively-approved measures that limit property tax growth. Since 2002 the limit has been 1% – less than the usual rate of inflation.[14] Since 80% of property taxes fund local services, city and county governments have been hit even harder than the state.
- Legislative actions to pass hundreds of new tax breaks – over 300 since 1990 and over 200 just since the year 2000.[15]
- The high rate of medical inflation, aggravated by an aging population and growing state responsibility for health coverage.[16]
- Economic and social changes that create needs for enhanced and expanded education and other public services.

2. Upside-down: Higher tax rates for lower incomes, smaller businesses

Individuals and Families

Because Washington relies so heavily on sales tax and lacks a state income tax, the state's tax structure is highly regressive: low- and moderate-income Washingtonians pay more in state and local taxes than in other states, while those with the highest incomes pay far lower rates. According to a national analysis by the Institute for Taxation and Economic Policy, Washington has the most regressive tax system in the country.

PERCENT OF INCOME PAID IN TAXES, WASHINGTON STATE AND U.S. AVERAGE, 2007

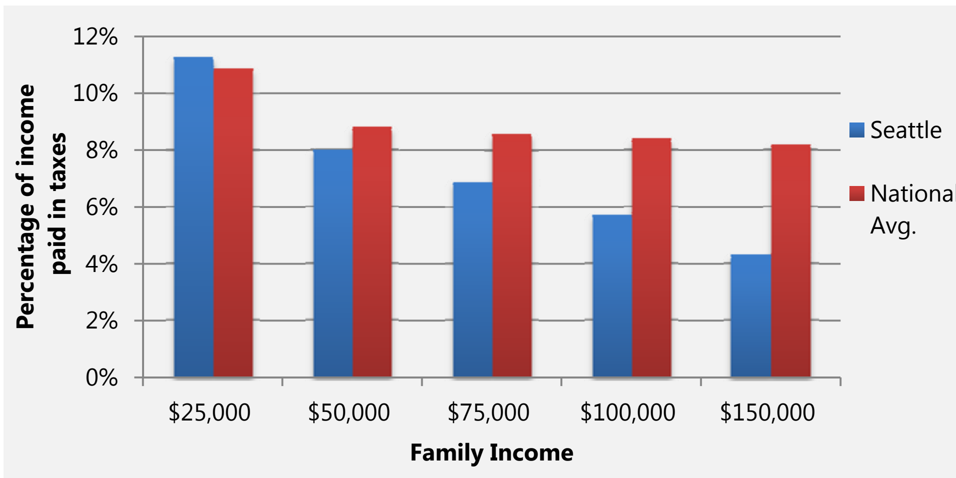


For non-elderly taxpayers. Source: Institute for Taxation and Economic Policy

Other studies of how state tax obligations are distributed across income groups using different methodologies have come up with somewhat different numbers, but the same overall conclusion – Washington asks its highest income residents to pay among the lowest tax rates in the country, while requiring lower-income residents to pay much higher rates. The Washington State Department of Revenue calculated that households with incomes under $20,000 pay 14.2% in state and local taxes, households with $50,000 to $60,000 pay 8.1%, and those above $130,000 pay 3.9%.[17]

The District of Columbia regularly compares taxes paid by its residents with taxes in the largest city in each state. According to the 2010 analysis, the total of state income, property, sales, and auto taxes paid by a Seattle family of 3 with an annual income of $25,000 amounted to 11.3% of income, while a family with $50,000 paid 8%, and one with $150,000 paid just 4.3%. The lowest income Seattleites paid more in major taxes than the average of their counterparts in other cities, while those with incomes over $150,000 paid among the lowest taxes in the nation, ranking 43rd among the states.[18]

ESTIMATED PERCENTAGE OF INCOME PAID IN STATE INCOME, PROPERTY, SALES, AND AUTO TAXES, BY INCOME FOR FAMILY OF 3, SEATTLE AND LARGEST CITY IN EACH STATE, 2010

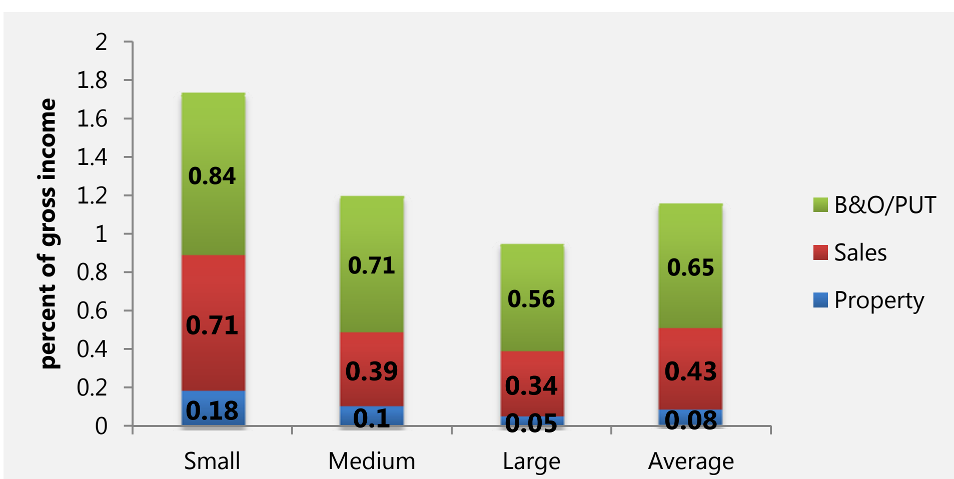


Source: Government of the District of Columbia, Tax Rates and Tax Burdens: A Nationwide Comparison

Businesses

Unequal treatment under Washington's tax structure also extends to businesses. Small companies pay on average a total of 1.73% of their total revenues on property, sales, and business taxes, while large firms pay on average just under 1%. New firms of all sizes typically pay more in sales tax than established firms, though often a little less in B&O or PUT taxes.[19]

PERCENTAGE OF TOTAL BUSINESS REVENUES PAID IN MAJOR WASHINGTON TAXES BY FIRM SIZE, 2009

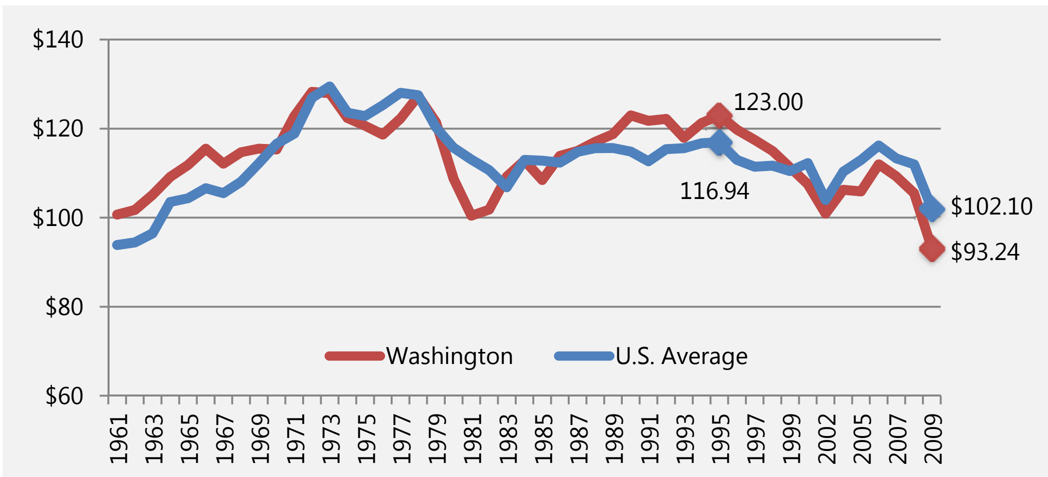


Small = gross receipts under $5 million; medium = $5 to $25 million; large = over $25 million.
Source: Washington Office of Financial Management and Department of Revenue.

3. Inadequacy: Support for education and other public funding in decline

Since the mid-1990s, state and local public revenues in Washington have fallen steadily relative to personal income in the state. A modest rebound from 2004 through 2006 barely brought Washington tax collections up to the level of the first Reagan administration in the early 1980s – still far below the typical rate of the past half century. In 2009, only $93.24 out of every $1,000 in the state was collected in state and local taxes, a lower figure than at any time in the past 50 years. That year Washington ranked 35th among the 50 states in state and local tax collections per $1,000 of personal income.[20]

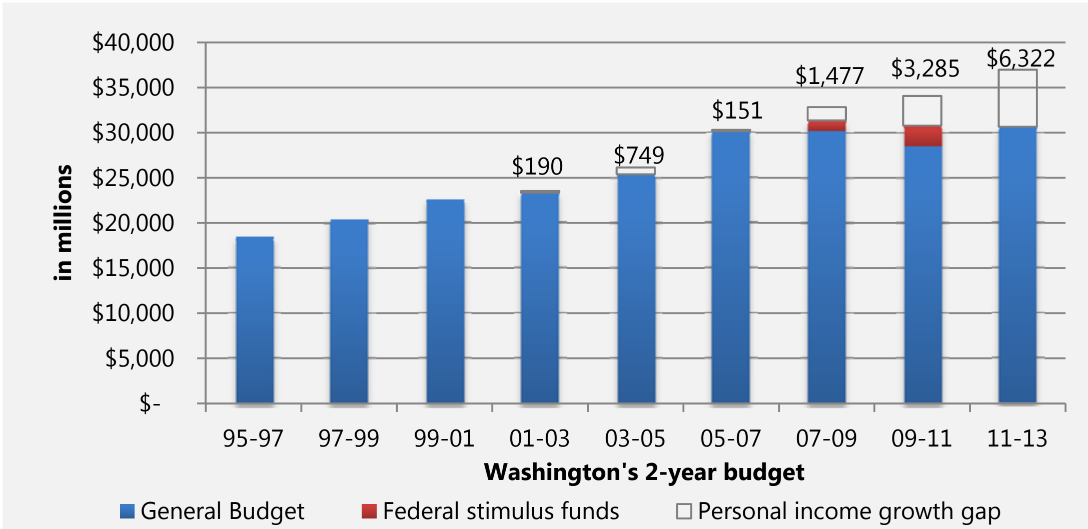
State and Local Tax Collections per $1,000 Personal Income, Washington and U.S. Average, 1961-2009



Sources: U.S. Census Bureau and Washington Department of Revenue

The state budget gap is compounded by the fact that over the past decade, local revenues have accounted for an increasingly large share of total state and local revenues in Washington.[21] If Washington's General Fund budget had grown at the same rate as personal income in the state since 2000, the state would have had an additional $6.3 billion to spend on education, health care, and other services during the 2011-13 biennium.

GAP BETWEEN GROWTH IN PERSONAL INCOME AND WASHINGTON'S NEAR GENERAL FUND BUDGET



Sources: US Bureau of Economic Analysis and WA Economic and Revenue Forecast Council.

Promises made to educate all kids – will they be kept?

Because of the weaknesses in Washington's tax structure, the state has failed to modernize and expand access to education, from early learning through higher education, to meet the needs of students and employers in today's economy. In 2009 and 2010, Washington adopted ambitious goals to increase student achievement by 2018, including funding full-day kindergarten statewide, reducing class size to a maximum of 17 in the lower grades, increasing the hours of instruction in higher grades, and other enhancements.[22]

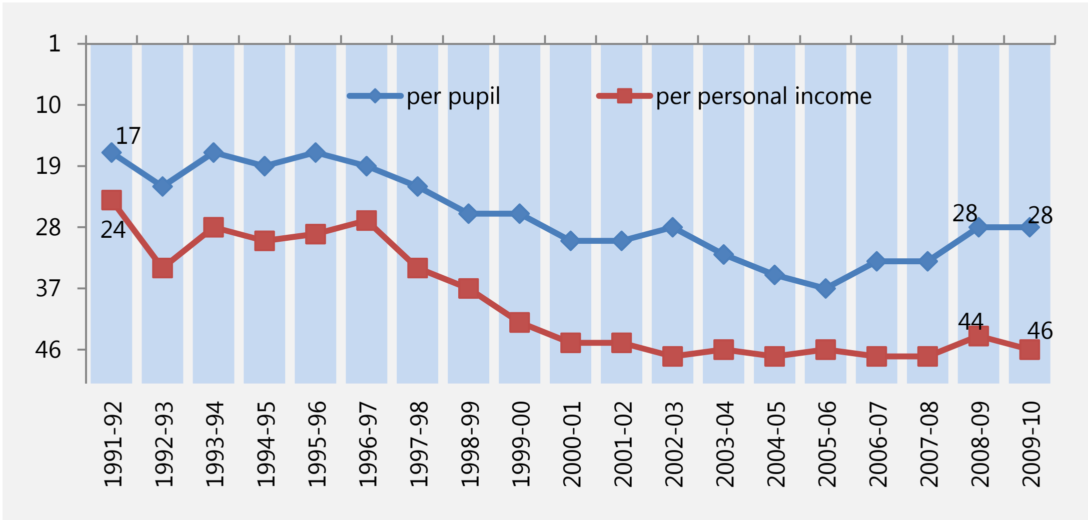
At a minimum, these education reforms will cost an additional $3.3 billion by the 2017-19 biennium, according to preliminary and incomplete estimates, and very likely considerably more.[23] That sum is in addition to the $1 billion or so needed in the 2016-17 biennium to restore K-12 cuts made in the current budget.[24] The most recently adopted state budgets reallocated some funding to make progress towards reform goals. However, overall K-12 spending reductions totaled about $3.5 billion of the $10.5 billion cut from state budgets from 2009 through 2011 in the wake of the Great Recession.[25]

Investing more in schools must be a top priority. Washington's constitution declares that it is "the paramount duty of the state to make ample provision for the education of all children residing within its borders."[26] In January 2012, the Washington State Supreme Court ruled in the McCleary decision that the state was failing in this constitutional duty to provide each and every child with an education that provided "the basic knowledge and skills needed to compete in today's economy and meaningfully participate in this state's democracy."[27] The State Supreme Court declared in McCleary that it would retain jurisdiction to ensure that the state followed through with "ample" funding by 2018.

K-12 funding woes preceded the recession

The state's national rank in K-12 public school funding has been falling for two decades. In the 1991-92 school year, Washington ranked 17th among the 50 states plus the District of Columbia in per pupil revenue. By 2009-10, that ranking had slipped to 32nd. Relative to the income of state residents, Washington ranked 24th in 1991-92 and 46th in the most recent tally – above only South Dakota, Arizona, Tennessee, Florida, and the District of Columbia.[28] Washington's average student to teacher ratio of 19.4 in elementary and secondary schools far exceeded the national average of 15.4 in the 2009-10 school year.[29]

WASHINGTON'S RANK AMONG THE STATES IN K-12 PUBLIC SCHOOL REVENUE



Source: U.S. Census Bureau

If Washington residents supported public schools at the average rate of people in all states – paying on average $49.82 per $1,000 in personal income rather than just $42.48, Washington school children would have benefited from $2.2 billion worth of additional resources in the 2011-2012 school year, or $4.7 billion for the current biennium.[30] Washington cannot achieve that higher level of support reached in many states because our tax system requires upper income households to contribute so little.

Early education starved and higher education moving out of reach

In addition to the need for more investment in K-12 education, limited state and federal funding keeps access to quality childcare and preschool sharply restricted, despite ample evidence showing the multiple benefits of quality early learning for children and society. Meanwhile, compensation for teachers of young children remains abysmally low, driving high rates of turnover and further reducing quality of care, while working parents struggle to find affordable care for their children.[31]

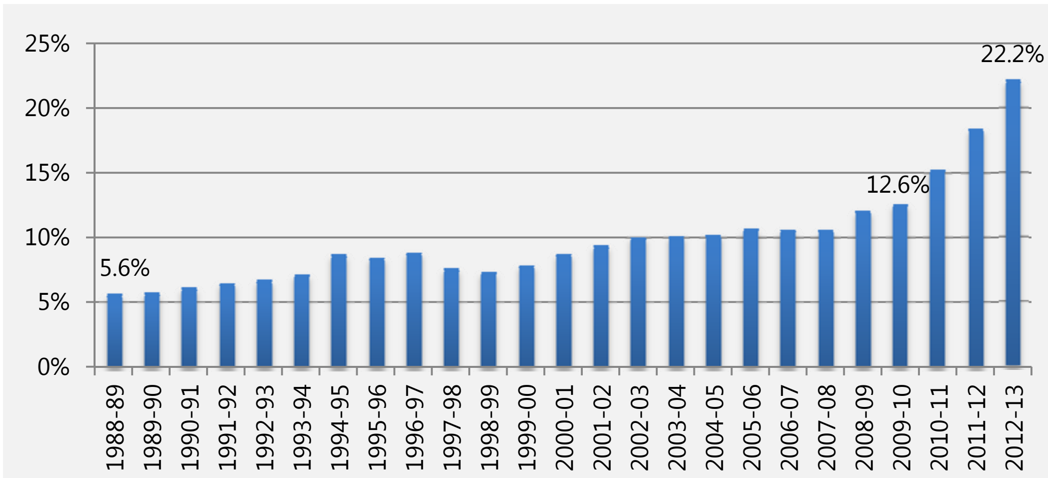
Washington also lags behind other states in access to college. In 2009, Washington ranked 47th in the percentage of 18 to 24 year olds in the state enrolled in higher education, with 29.6% of young adults in college compared with a national average of 36.2%.[32] College graduates far out-earn non-graduates, with median annual earnings 71% – $21,000 – above those with only a high school diploma in the state in 2010.[33]

Washington's major employers need more technically trained workers than our state produces. Washington residents are shut out of high earning careers because they lack a diploma, while employers import workers with degrees from other states and countries. Despite limited access to college, Washington ranked 10th among the states for the percentage of the population over 25 with a bachelor's degree or higher in 2007.[34]

This situation will only get worse without policy change. According to a study by Georgetown University Center on Education, the share of jobs in the United States requiring education beyond high school jumped from 28% to 59% between 1973 and 2008, and will climb to 63% by 2018.[35]

Since the 1970's when the state covered 90% of the cost of instruction for higher education, Washington has been shifting the cost of college to students and their families, to the point where a college degree is increasingly priced out of reach. By 2008, the state only covered 65% of instructional cost. Budget cuts and tuition hikes since then have reduced the state's share to just 35%.[36] Tuition at the University of Washington cost about 6% of a middle-income household's annual income in 1988. The relative cost doubled even before the most recent state budget crisis and large tuition hikes. In the 2012-13 academic year, a year of university tuition alone will require over 20% of state median household income.[37]

UNIVERSITY OF WASHINGTON TUITION AS A PERCENTAGE OF MEDIAN HOUSEHOLD INCOME IN WASHINGTON



Sources: Median Income from U.S. Census Bureau, Tuition from UW and Higher Education Coordinating Board

Other parts of the state's higher education system, while less costly, have undergone similar transfers of financial obligation from the state to individual students and their families. In addition to tuition increases, access to higher education has been constrained through cuts to classes and whole programs across the higher education system.[38] Since the majority of Washington's high school graduates who continue with post secondary education rely on in-state public schools, state funding is particularly important. A study of the 2004-05 high school graduating class found that 70% had enrolled in higher education after five years, and 71% of those young people were attending public 2- or 4- year institutions in-state.[39]

Other public needs to support health and prosperity

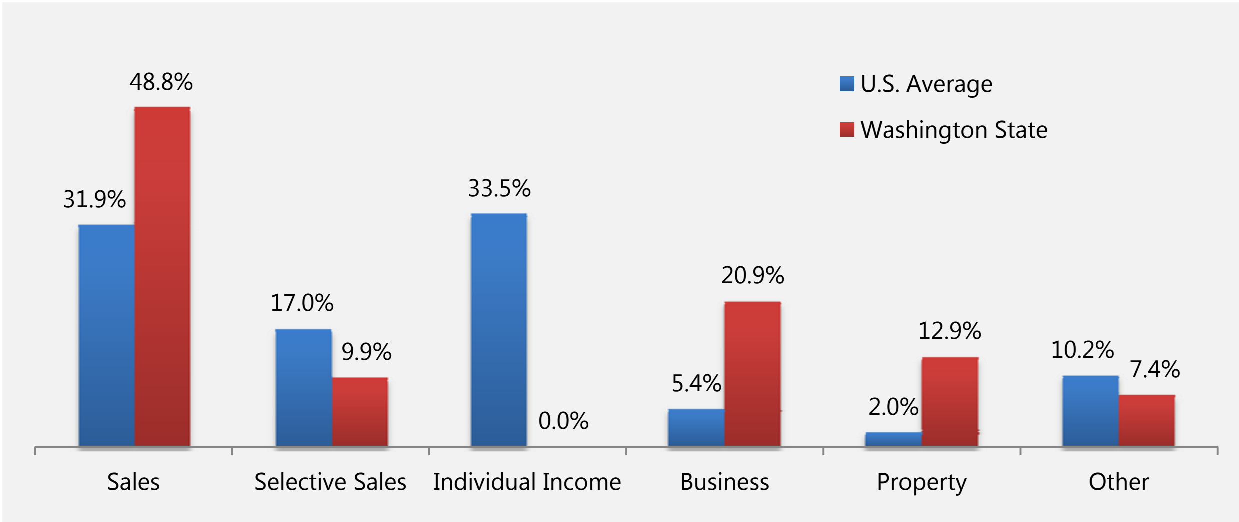
Education is not the only area of the state budget that will need additional resources in coming years. For example, the aging population will continue to drive increased demand for state-funded health and long-term care services. Projected "natural" growth of state revenues will not keep pace with demand for services, even after our economy has recovered from recession.[40]

Comparison with other states

Our tax structure is a major reason Washington's education system is falling behind. Most other states have a state income tax to balance out sales, business, and other taxes. On average, individual income taxes contribute about one third of state funds.[41] Unlike the sales tax, revenues from income taxes keep pace with economic growth over the long run, even when the underlying structure of the economy changes.

Without an income tax, Washington relies more heavily on general sales tax and business taxes than most states. Washington's state budget also receives more property tax revenue than the national average, even though Washington residents actually pay a little less than the national average in total state and local property taxes. That is because in many states all property taxes are allocated to fund local services, while in Washington about 80% stays in local communities and 20% goes to the state to support public schools statewide. In Washington, the state and local property tax totaled $1,217 per capita in 2009, compared to $1,381 across the U.S.[42]

SOURCES OF STATE REVENUE, WASHINGTON AND U.S. AVERAGE 2010



Selective sales category includes alcohol, tobacco, and gasoline taxes. Business tax for U.S. average reflects corporate income taxes; for Washington includes B&O and PUT taxes. Sources: Federation of Tax Administrators, Washington Economic and Revenue Forecast Council

Six states in addition to Washington do not have any individual income tax, but each also has another source of revenue that is either unavailable to or untapped by Washington. Texas, Wyoming, and Alaska have oil and other natural resources, Nevada has gambling revenues, Florida has tourism, and South Dakota collects sales tax on business and professional services.[43] Two additional states, New Hampshire and Tennessee, have a personal income tax limited to interest and dividend income.[44] Florida, South Dakota, and Tennessee rank even lower than Washington in school funding relative to personal income.[45]

Structural deficits across the States

Washington is not alone in suffering from a shrinking revenue base. A 2005 analysis by the Center on Budget and Policy Priorities concluded that Washington was among seven states in the 2nd highest risk category for structural deficit problems, topped by 11 states at even higher risk – Alaska, Arkansas, Colorado, Florida, Nevada, New Mexico, Pennsylvania, South Carolina, Tennessee, Texas and Wyoming. Notably, six of the 11 highest risk states have no or only a limited income tax.[46]

A number of factors contribute to the structural imbalance of income and revenue needs. Most states have a retail sales tax and have experienced an erosion of the relative value of that revenue source – although those states with a comprehensive income tax do not rely as heavily on the sales tax as Washington does.

The corporate income tax – which all but a handful of states rely on –has been declining as a share of state income as well. Corporate income taxes contributed 8.4% of state income in 1988, 6.1% in 2000, and 5.5% in 2010 and 2011.[47] The ability of corporations to shift resources among states and nations to minimize their tax obligations account for much of this decline, compounded by the propensity of states to hand out tax breaks to firms as an inducement to locate or stay within their borders.[48] Washington's B&O tax, while also riddled with special exemptions, has generally held up better than corporate income taxes as a source of state revenue.

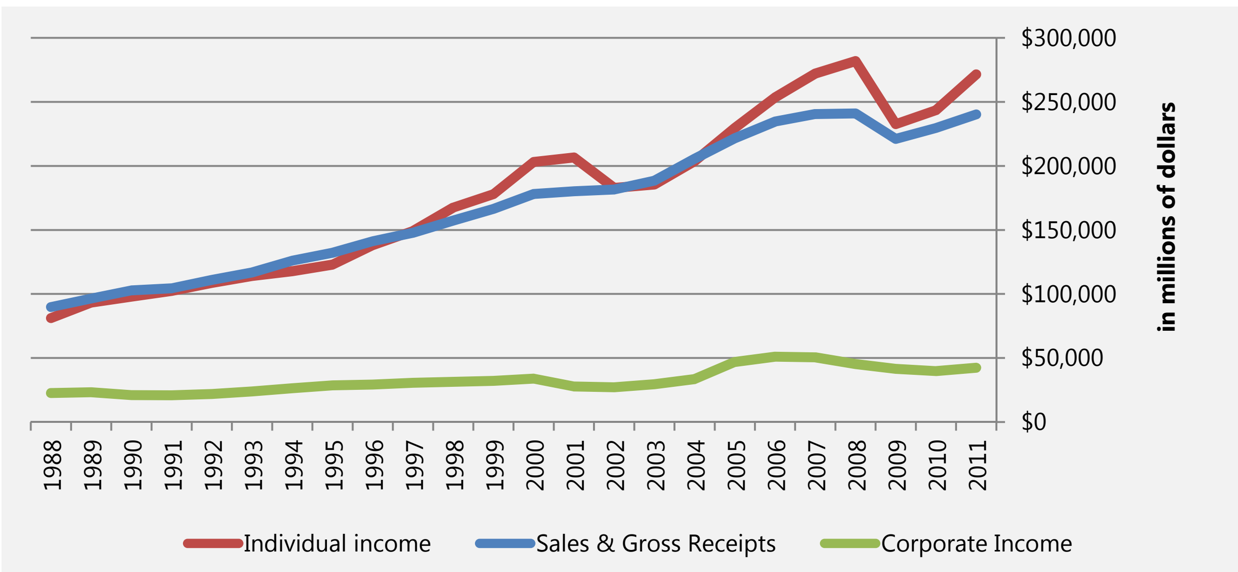
Income taxes vary in how well they keep up with economic growth. Flat rates with no exclusions will grow at the same rate as income growth overall. Graduated income tax receipts can increase faster than overall income growth, especially when the wealthy are gaining in income share, helping offset some of the slower growing revenue sources. Some states tax different sources of personal income differently, such as retirement or capital gains income, impacting how well revenues track economic growth.[49]

Impact of recession

States budgets across the country have taken a beating with the Great Recession. All forms of state revenue have fallen. Income taxes are more volatile than sales and property taxes, growing more steeply when the economy is growing and falling more sharply in downturns. By the fourth quarter of 2011, total state tax revenues nationally surpassed the nominal level of the last quarter of 2007, with 33 states posting higher collections, according to analysis by the Rockefeller Institute. However when adjusted for inflation, total state taxes were still 3.4% lower than at the end of 2007.[50]

While public revenues will likely fall (absent rate or policy changes) during a recession under any tax structure, a balanced system that includes multiple sources, covers most economic activities, and includes a personal income tax is most likely to remain relatively stable and produce natural revenue growth to match the growth in need.

NATIONAL ANNUAL TOTALS OF STATE INDIVIDUAL INCOME, CORPORATE INCOME, AND SALES & GROSS RECEIPTS TAXES, 1989 TO 2011, NOT ADJUSTED FOR INFLATION



Note: Washington's B&O tax and similar gross receipts taxes in a handful of other states are included with sales taxes by the Census Bureau. Source: U.S. Census Bureau, Quarterly Summary of State and Local Tax Revenue

Alternative tax structures for Washington

Recommendations of 2002 Washington State Tax Structure Study Committee

The inadequacies of Washington's tax system have been evident for decades. Tax advisory commissions appointed in the 1960s, 1970s, and 1980s recommended a number of changes, with a new state income tax a central component every time.[51] In 2001, the state legislature authorized a Washington State Tax Structure Study Committee to evaluate the functionality of our state tax system and propose alternatives for improvement. Bill Gates, Sr. chaired the committee, which was made up of state legislators and local experts in tax law, economics, accounting, and public finance. The final report, submitted in November 2002, concluded: *"the current structure is so flawed in meeting the most important criteria that it must be judged as unsatisfactory."*[52]

Among the chief problems the committee identified:

- **Inequity.** The Committee proposed that taxation should at least be proportional across the income spectrum, but found those with the lowest incomes paid a disproportionately large share in the current structure.

- **Lack of harmony with other states**. New and expanding businesses often pay higher tax rates in Washington than in competitor states. The uniqueness of Washington's system, including the high sales tax and reliance on taxes paid by businesses rather than households, provides opportunities and incentives for individuals and businesses to avoid taxes by moving purchases and business activities to other states.

- **Non-neutrality.** Washington's system provides opportunities to avoid taxes and treats equivalent purchases differently. Consumers can avoid the sales tax by purchasing services and internet goods. Businesses pay varying effective rates of the business and occupation (B&O) tax because of "pyramiding" – the compounding of taxes on the same goods and services as they are transferred among firms.

- **Inadequacy.** The need for state services grows at least as fast as the economy, but state revenues have grown more slowly. The exclusion of significant parts of the economy from the tax base – including consumer services, individual income, intangible assets, agricultural production, and investment income of nonfinancial businesses –compounds inadequacy of revenues even as the state population and economy grow.

The committee proposed a number of reform alternatives for the legislature's consideration, designed to make Washington's tax system more fair for low- to moderate-income households, equitable for businesses, sufficient for supporting the state's economy, and compatible with the federal and other state systems.

Over the last decade, some incremental alternatives recommended by the committee have been enacted, including: creating a rainy day fund; maintaining the state estate tax; joining the Streamlined Sales Tax Project (to pave the way toward equitable taxation of internet sales);[53] and establishing a schedule to review tax exemptions. Other incremental recommendations have not been adopted, including adding sales tax to consumer services and removing it from construction labor.

The two most substantive recommendations of the committee to improve Washington's tax system have not been followed:

1. Replace the business and occupation (B&O) tax with a value added tax (VAT) on business activity. A VAT can be structured in different ways, but in essence taxes only the amount a firm adds to the value of goods and services, allowing purchases from other firms to be deducted. A VAT would increase equity and neutrality compared to the B&O tax on gross receipts.

2. Establish a personal income tax, coupled with reductions in the sales tax and elimination of the state portion of the property tax. Most states and the federal government rely on a personal income tax because it is a broad base which grows naturally with the economy, and is based on ability to pay. Coupling an income tax with a reduction in other taxes would make Washington's tax system more equitable, neutral, and competitive relative to other states. It would also allow state residents to take larger deductions for federal income tax purposes.

The road to reform: Building blocks for a better tax system

Washington needs a tax structure that will provide sufficient public revenues to keep Washington's people and economy healthy and provide opportunity for the next generation. Fulfilling the requirements of the McCleary ruling on school funding, providing the early learning supports that prepare all young children for success in school, restoring affordability and expanding access to higher education, and making the pragmatic investments in health and infrastructure that our state's people will need going forward simply cannot be accomplished with a revenue system so out of synch with growing areas of the economy. Reforms need to focus on:

1. Including revenue from growing parts of the economy
2. Reducing regressivity
3. Addressing business tax inequities

Achieving those goals will require comprehensive reform of Washington's tax structure. The most stable system with the greatest ability to remain adequate in the face of on-going economic change includes a number of types of taxes and requires all individuals and businesses to contribute. Key elements for a sustainable system include:

1. A personal income tax
   Income tax rates and bases vary considerably among the states.[54] Washington could maximize stability by structuring the tax to be general – applying to most individuals and types of income. Adopting graduated rates would help both to assure natural growth of revenue and to offset the regressivity of most other taxes.[55] Most states start with Adjusted Gross Income from the federal income tax form and add their own deductions, simplifying preparation and minimizing state enforcement costs. Higher income individuals and those who itemize on their federal income taxes would be able to deduct the state income tax from their federal taxable income.

2. A lower sales tax
   Reducing the state portion of the sales tax will lower taxes for everyone, especially lower- and moderate-income individuals, and small and expanding businesses. It will fully or partially offset the impact of a new income tax for households, promote business tax equity, and reduce the overall regressivity of Washington's system.

3. More equitable business taxes
   Whether adopting a VAT as the Tax Structure Study Committee proposed or some version of a corporate income tax, Washington's business taxes could be made much more manageable for small, new, and expanding firms. Minimizing special tax breaks – and maximizing transparency and accountability for those that remain – would also add fairness and stability to the system. A new state business tax should take lessons from other state systems and be designed to minimize tax avoidance strategies.

Obstacles to overcome

Achieving major tax reform in Washington will require overcoming the reluctance of both voters and policymakers to grapple with major change – and likely face a constitutional challenge.

Voters and policymakers have been reluctant to make sweeping changes to Washington's tax structure since 1935. In 1932, voters approved a graduated state income tax with 70% of the vote. However, the State Supreme Court declared it unconstitutional in a 5 to 4 decision the following year. The court ruled that income was property and therefore any taxation must be at equal rates not exceeding 1%. While some legal scholars believe that ruling would no longer stand if challenged, most income tax proposals since that time have been introduced as constitutional amendments. After passing both chambers with the required two-thirds majorities, the Legislature submitted constitutional amendments and general personal income tax proposals to the voters in 1934, 1970, and 1973, and corporate income tax measures in additional year, but all those measures failed at the ballot box.[56]

More recently, in 2010, the majority of voters said no to an initiative (not a constitutional amendment) to establish an income tax on individual incomes over $200,000. Initiatives to restrict taxes have frequently been approved by state voters over the past two decades, including measures to limit growth in property tax revenues, decrease the motor vehicle excise tax, limit growth of the state budget and require super majorities in the state legislature to pass tax increases. At the same time, voters across the state have consistently approved tax increases to fund school levies, libraries, parks, and other specific local services and facilities.

Conclusion

The Great Recession and painfully slow recovery have resulted in four years of fiscal crisis for Washington. State policymakers have confronted growing needs for services and investment to combat impacts of the recession, with sharply reduced resources. The world economy remains unsettled and the state's fiscal outlook uncertain. The McCleary decision requiring major new investments in education and uncertainties about the state budget impacts of federal health reform add to the pressures on state policymakers.

Continuing an austerity approach to the state budget will condemn a whole generation of our youth to a lifetime of reduced opportunities. Each child who lacks health care and loving nurture in infancy, starts kindergarten unprepared, fails to read by second grade, struggles with math, leaves high school unprepared for the workforce or college, or finds the doors of our state higher education system slammed shut, may never achieve her full potential or a find the means to pursue her dreams. Each child who slips through the gaps represents a failure of us all as a society.

So long as our public revenue system is based on the economy of the 1930s, we will only be able to afford an education system suited to that era – when the typical worker could support a family with no more than a high school education. Restoring a growing and economically secure middle class and the promise of opportunity for all will require major new investments in education, health care, and infrastructure. Washington needs a new tax structure to allow all our people to thrive and prosper.

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