

Is Washington a High-Tax State?

Facts and Figures on Washington State and Local Revenues

Institute on Taxation and Economic Policy
February 2007

Executive Summary

Legislators and advocates in Washington often debate whether the state's taxes are "too high" or "too low" based on a simplistic and misleading view of tax data. This report delves deeper into the data and finds that rudimentary measures of Washington tax levels can conceal more than they reveal about the true burdens facing Washington taxpayers. When the actual impact of state and local taxes on Washington families is accounted for, the state's taxes are clearly among the lowest in the nation.

Washington's tax system is also notable for its extreme imbalance. Washington is one of only nine states with no broad-based tax on personal income, and makes up for this by imposing sales and excise taxes that are among the highest in the nation. Washington also relies more heavily than almost any other state on sales tax revenues.

Upper-income Washingtonians experience Washington as a low-tax state—but the reality is far different for lower-income working families. The poorest Washingtonians pay four times more of their income in state and local taxes than the wealthiest Washington families must pay—and actually face a tax load that is fourth highest in the nation, on average.

There has been growing concern about the rapid growth of local property taxes throughout the state. The report suggests that efforts to curb the growth of Washington taxes should focus on improving the fairness of the state's tax structure. A key component of a fairness-enhancing reform could be the use of a property tax "circuit breaker" credit.

Notwithstanding the state's below-average tax levels, Washington policymakers are missing an important opportunity to make the state's taxes even lower. By not levying a personal income tax, the state fails to take full advantage of the ability to write off certain state taxes on federal income tax forms.

Washington State voters have frequently been asked to vote up or down on a variety of tax cuts—and, more recently, on tax hikes to fund public transportation. Lawmakers of both parties have promised substantial tax cuts without endangering transportation and other public services, arguing that the current tax system is too punitive to Washington families.

But little critical attention has been paid to the question of just how high Washington taxes are right now in a national context—and how that might change under various reform proposals.

This report aims to help inform the tax and spending debate by taking a close look at trends in Washington state and local taxes. The report gives special attention to the dramatically different tax rates paid by poor and wealthy Washingtonians. The report also highlights the distinction between overall tax levels and the levels of specific Washington taxes, and also discusses the critical difference between the taxes paid to the state of Washington and the taxes actually paid by Washington residents.

Washington Taxes: Below Average By Any Measure

The most frequently cited measure of a state’s overall tax level is total state and local tax collections expressed as a share of some measure of a state’s economy. Much of the comparative data presented is from the Census Bureau and Bureau of Economic Analysis, the most recent data available is for fiscal year 2004. The chart below shows how Washington stacks up by these various measures.

- Expressed as a share of statewide Gross State Product (a measure of all the economic activity in the state), Washington’s taxes were 8.7 percent in 2004, 29th highest nationally and 3 percent below the national average.

- As a share of statewide personal income, Washington taxes were 10.2 percent, 34th highest nationally and almost 5 percent below the national average.

Total State & Local Taxes in 2004: Three Measures							
	% of Pers. Inc.		Per Capita		% of GSP		
		Rank		Rank			Rank
California	10.9%	14	\$ 3,730	11	9.1%		21
Idaho	10.5%	22	\$ 2,732	42	9.3%		17
Montana	9.8%	42	\$ 2,623	45	9.2%		19
Oregon	9.8%	41	\$ 2,914	32	8.2%		38
Utah	10.6%	19	\$ 2,772	39	8.3%		37
Washington	10.2%	34	\$ 3,454	18	8.7%		29
ALL STATES	10.7%		\$ 3,433		9.0%		

- On a per capita basis, Washington taxes were \$3,454 in 2004, slightly above the national average, and were 18th highest nationally.

Addendum: Washington Compared to National Average		
	-4.6%	+0.6%
		-3.4%

SOURCE: Bureau of Economic Analysis; Bureau of the Census

Tax-by-Tax Variation in 2004

While Washington taxes are below average overall, there is wide variation in the levels of particular Washington taxes: some taxes are quite low, while others are unusually

high. In particular:

- Washington is one of only nine states without a broad based income tax.
- Washington’s sales and excise taxes, by contrast, are second highest in the nation. At 6.2 percent of personal income, Washington’s consumption taxes were 62 percent above the national average in fiscal year 2004.
- Washington property taxes were 10 percent below the national average in 2004, and ranked 28th highest nationally.
- Washington was 37th highest, and 21 percent below the national average, in its reliance on all other taxes.

Washington Taxes as a % of Personal Income in 2004									
	Personal		Sales & Gross		Property		Other		
	Income Tax	Rank	Receipts Taxes	Rank	Taxes	Rank	Taxes	Rank	
California	3.0%	11	3.7%	26	2.8%	35	1.5%	15	
Idaho	2.5%	19	4.0%	20	3.0%	30	1.1%	26	
Montana	2.4%	22	1.8%	46	3.9%	14	1.7%	9	
Oregon	4.1%	2	0.9%	50	3.2%	22	1.5%	13	
Utah	2.7%	16	4.4%	14	2.7%	38	0.8%	43	
Washington	—	45	6.2%	2	3.0%	28	1.0%	37	
All States	2.3%		3.8%		3.4%		1.2%		
Addendum: Washington Compared to National Average									
	-100%		+62%		-10%		-21%		

Source: Bureau of Economic Analysis; Bureau of the Census

In other words, Washington’s tax system does not rely evenly on the “big three” taxes (income, sales and property) that typically make up the bulk of state and local tax collections. Instead, Washington makes up for the absence of an income tax by imposing above-average sales taxes.

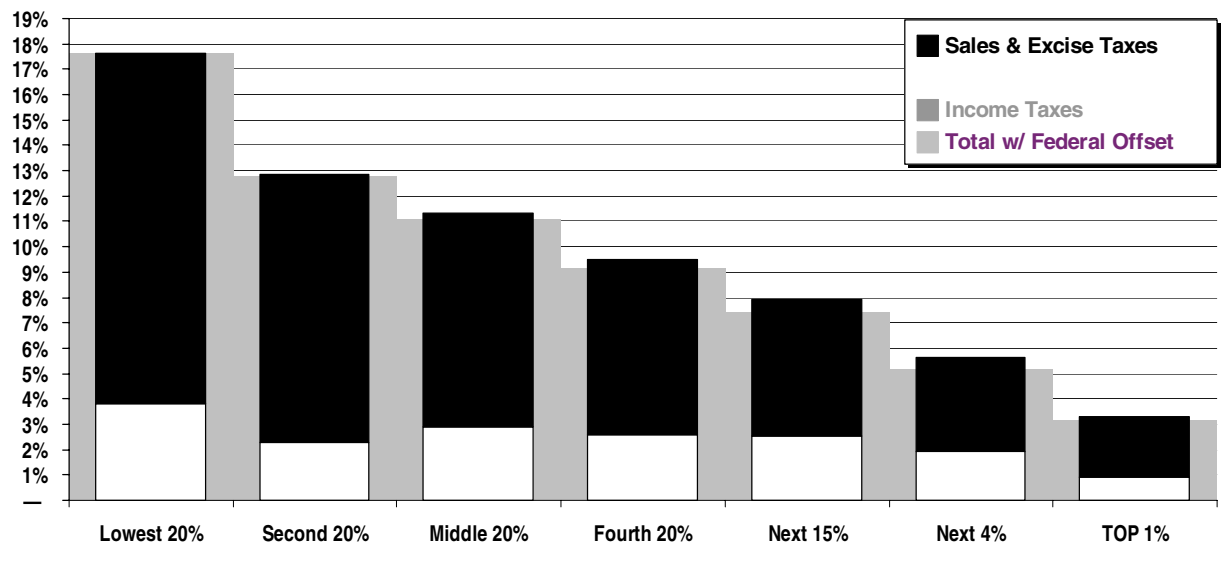
Many Washington Taxes Are “Exported”

The main problem with the aggregate tax comparisons presented so far is that they don’t tell us whether specific groups of taxpayers experience Washington as a low-tax or high-tax state. Taxes can affect different taxpayers very differently depending on their income level and other factors.

A second, especially important problem with aggregate tax comparisons is that they include all taxes collected in the state, regardless of whether state residents actually pay those taxes. For example, because of the importance of tourism to Washington’s economy, an especially large percentage of Washington tax revenues come from out of state visitors. In addition, much of the taxes paid by businesses to the state of Washington do not ultimately come out of the pockets of Washington residents at all, but are instead “exported” to non-Washingtonians.

Washington State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



Tax Fairness in Washington: The Poor Pay More

The Washington state and local tax structure is *regressive*—that is, it requires low- and middle-income Washingtonians to pay higher shares of their incomes in taxes than the wealthiest taxpayers have to pay. In other words, Washington’s tax laws actually redistribute income away from ordinary families and towards the richest Washingtonians. A January 2003 report by the Institute on Taxation and Economic Policy¹ found that:

- The poorest twenty percent of Washingtonians paid, on average, 17.6 percent of their income in Washington taxes, while the wealthiest one percent of taxpayers paid only 3.3 percent of their income in state and local taxes.
- After taking into account the deductibility of state taxes on federal tax forms, the effective tax rate on the wealthiest 1 percent of taxpayers was an average of 3.1 percent—less than a fifth of the tax burden on the very poorest Washingtonians.
- According to ITEP’s January 2003 report, Washington has the most unfair tax system in the nation.

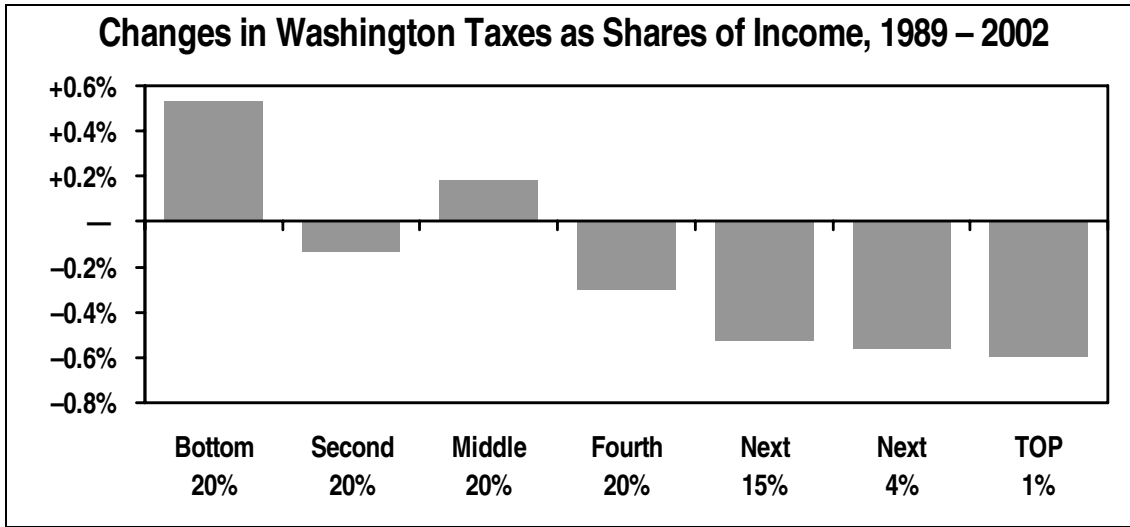
The ITEP report also showed that the Washington tax system became even more unfair as a result of tax changes enacted in the 1990s. Growth in property taxes has made the Washington tax system more regressive in 2002 than it was in 1989.

- Each Washington income group paid more of their income in state and local taxes in 2002 than the same group did in 1989—but the poorest 80 percent of

¹*Who Pays? A Distributional Analysis of the Tax Systems in All 50 States.* McIntyre, Denk, Francis, Gardner, Hsu and Sims (Institute on Taxation and Economic Policy, 2003). The findings of this study do not reflect tax increases, reductions, or other tax changes (including either tax increases or tax cuts) enacted after 2002. Recent tax changes imposed do not impact this report’s basic findings.

Washingtonians experienced the biggest tax increase as a share of income.

- The wealthiest 20 percent of non-elderly Washington taxpayers—those earning more than \$67,000 in 2002—saw a much smaller increase in their effective tax rate over this same period.

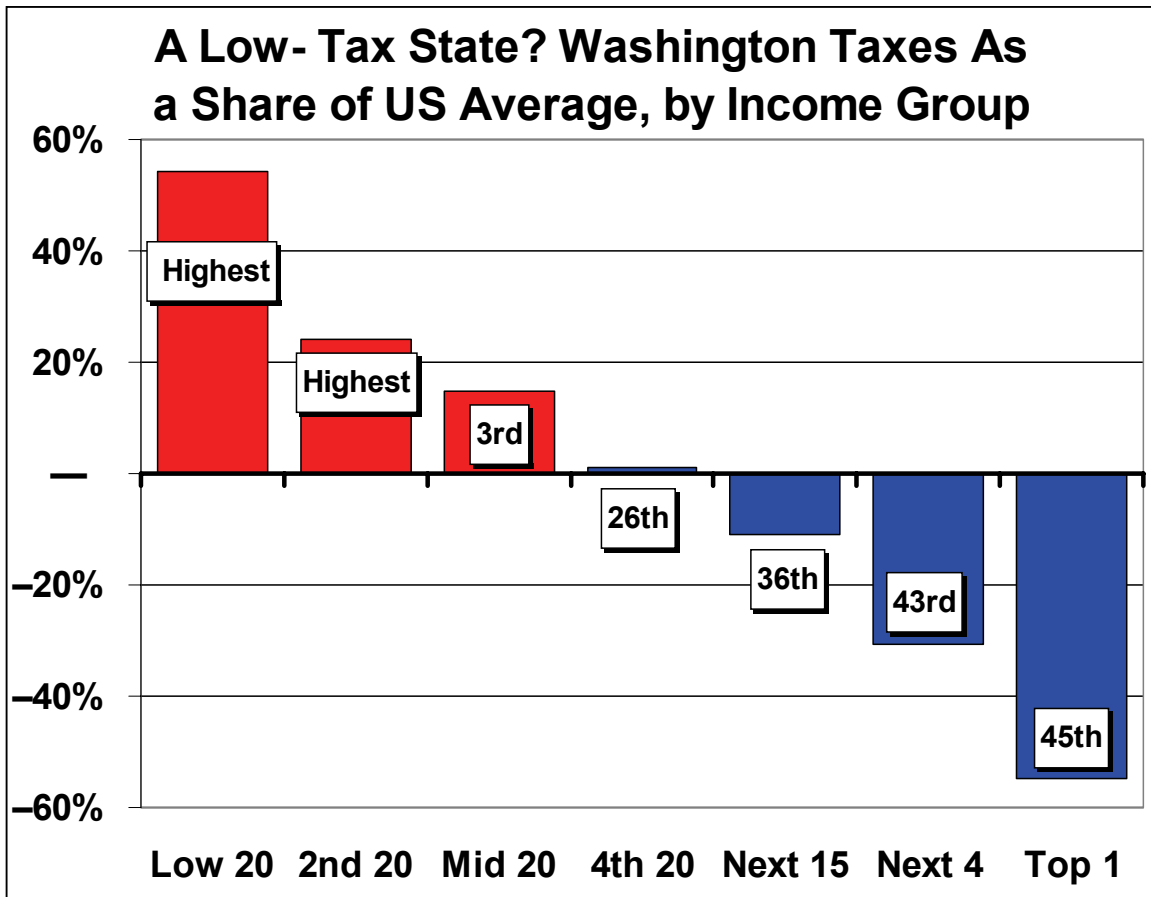


Washington is a Low-Tax State—But Only If You’re Wealthy

The results of the *Who Pays* report also allow us to compare the overall levels of taxes on state residents across the nation—which gives us more useful information than the Census data presented previously. As the following chart shows, the state and local taxes paid by Washingtonians at every income level are among the lowest in the nation:

- The taxes paid by the poorest 20 percent of Washingtonians were the highest in the nation, and were more than 50 percent below the national average as a share of income.
- By the same measure, the Washington state and local taxes paid by middle-income Washingtonians were 3rd highest in the nation, almost 20 percent above the national average.
- At the other end of the income spectrum, the taxes paid by the wealthiest 1 percent of Washingtonians were just 45th highest, almost 60 percent below the national average.
- In other words, only five states require their wealthiest taxpayers to pay less of their income in state and local taxes than does Washington.

By comparison to the aggregate Census data presented above, the more detailed *Who Pays* report tells a dramatically different story about Washington’s “low tax” legacy. Despite the state’s low tax ranking, many low- and middle-income Washingtonians actually experience Washington as a high tax state—and only the wealthiest residents of the Evergreen state truly enjoy the benefits of Washington’s low-tax status.



Recent Changes and Future Opportunities

This report reveals that despite Washington’s overall below-average tax rankings, the cost of funding Washington public services falls disproportionately on the very poorest Washington families. One reason for this is Washington’s property tax. Property taxes have been in the sights of Washington anti-tax activists for over a decade. But the outcome of anti-property tax sentiment has been a series of tax caps and assessed value caps that restrict the growth of property taxes for all families.

However, if tax relief for fixed-income homeowners and renters is the goal, assessment caps are among the least effective tax strategies available. Caps give tax breaks to anyone whose home value increases rapidly, reserving the biggest tax breaks for those (typically wealthy) homeowners whose home values grow fastest, and provide nothing at all for low-income homeowners whose assessed values are stagnant. This makes assessment caps very expensive and very poorly targeted.

Circuit breakers protect taxpayers from property tax “overload” like an electric circuit breaker: when a property tax bill exceeds a certain percent of a taxpayer’s income, a circuit breaker reduces property taxes in excess of the “overload” level.

Legislators should be applauded for trying to curb a growing reliance on property taxes. Yet, there are other policy avenues available like a property tax circuit breaker which are much less expensive than “across the board”

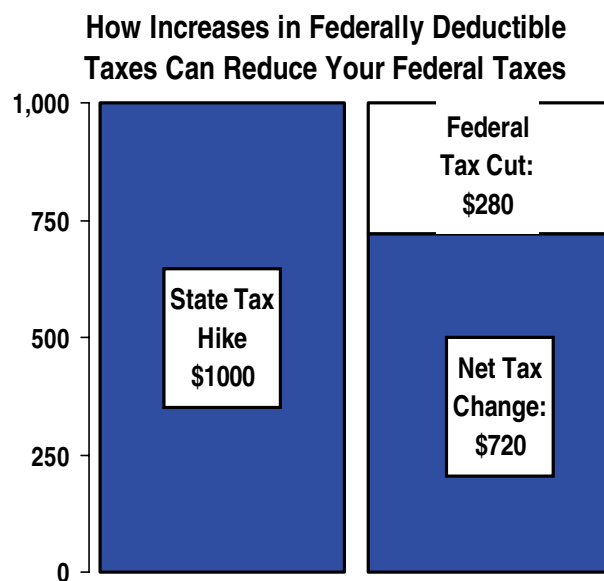
property tax breaks—and the benefits are targeted to taxpayers for whom property taxes are most burdensome.

The “Federal Offset”: A Missed Opportunity to Reduce Washington Taxes

The importance of Washington’s sales tax ensures that out-of-state visitors pay an unusually large share of the cost of funding Washington public services. Yet the Washington tax system is also unusual in that it fails to take advantage of another opportunity to export the cost of funding public services—the ability to write off state income taxes on federal tax returns. Residents of any state who itemize deductions on their federal tax returns are allowed to deduct the state and local income taxes and property taxes they pay—which directly reduces their federal taxable income and their federal tax bill. Sales and excise taxes, by contrast, are generally not deductible on federal tax forms.² Thus, for every dollar in income or property taxes paid to a state or local government, taxpayers who itemize get a offsetting federal tax cut of up to 35 cents, depending on which federal tax bracket they are in. This is commonly known as the “federal offset.”

The chart below shows this effect. Suppose that under a hypothetical Washington income tax, an itemizing Washington taxpayer in the 28 percent federal tax bracket is subject to a \$1,000 state income tax hike. Her federal itemized deductions will increase by \$1,000 as a result—which means that \$1,000 less of her income will be subject to federal income tax. Since this last \$1,000 of income was originally taxed at 28 percent, this person’s federal income taxes will go down by \$280 (28 percent of \$1,000). So the state of Washington receives the full \$1,000—but only \$720 comes out of the wallet of the Washington taxpayer. The remaining \$280 is effectively paid to the state of Washington by the federal government. This “federal offset” amounts to a federal subsidy for states that rely on personal income taxes, through which the federal government effectively helps a state’s itemizers to pay their state income taxes.

The federal offset has clear implications for proposals to increase state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents’ wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for Washington itemizers. Because the federal offset is most useful for wealthy taxpayers



²Federal legislation passed in 2004 allowed a temporary tax deduction for itemizers (mostly living in states without an income tax) who pay more sales tax than income tax. This optional deduction was only available in 2004 and 2005.

who are more likely to itemize, the state can maximize its “bang for the buck” from state income tax hikes by targeting these tax hikes to the wealthy Washingtonians who will enjoy the largest federal tax cuts as a result.

The federal offset is not limited to the income taxes paid by individuals. Corporations can export up to 35 percent of their state corporate income taxes to the federal government. This means that by not levying a corporate income tax, Washington lawmakers are passing up a chance to export part of the state’s business tax burden to the federal government in the form of lower federal corporate income taxes for Washington businesses.

Federal deductibility means that the differences in tax levels between income-tax and non-income-tax states are never really as large as they appear to be. Federal deductibility is a good deal for states like California and Oregon that rely heavily on income taxes, because it allows states with progressive income taxes to export part of their tax to the federal government. Conversely, the federal offset is an especially *bad* deal for non-income tax states like Washington, because the state is unable to take advantage of the federal offset’s matching grant for state income taxes.

The general inapplicability of the federal offset to sales and excise taxes makes these regressive taxes a bad deal for Washington residents, since virtually every dollar of a sales tax hike that is paid initially by state residents will ultimately come out of their pockets.

Conclusion

Measured as a share of statewide personal income, Washington taxes are actually below average overall. But as this report has shown, the simplest measures of Washington tax levels can actually conceal more than they reveal about the actual taxes paid by Washington families at different income levels. When the actual incidence of Washington state and local taxes on Washington taxpayers is accounted for, the state’s taxes are clearly among the lowest in the nation—but only for the wealthiest Washingtonians. In fact, low-income Washingtonians experience Washington as a high-tax state—and pay much more of their income in state and local taxes than the wealthiest Washingtonians must pay. Efforts to reform the state’s tax structure should focus on remedying this basic inequity.

APPENDIX : ITEP TAX MODEL METHODOLOGY

The Institute on Taxation & Economic Policy has engaged in research on tax issues since 1980, with a focus on the distributional consequences of current law and proposed changes. ITEP's research is frequently used by other groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating the yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed changes. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

The ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the Joint Committee on Taxation, the U.S. Treasury and the Congressional Budget Office (although each of these models differs as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and its capabilities:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemptions and standard deductions,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the yield and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in consumption taxes. There are more than 250 base items available to amend in the model.

The Property Tax Model analyzes revenue yield and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue yield and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Data Sources

The ITEP model is a “microsimulation model.” That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department, the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:

IRS Individual Public Use Tax File, Level III Sample; IRS Individual Public Use Tax File; Current Population Survey; Consumer Expenditure Survey; U.S. Census, 1990.

Partial List of Aggregated Data Sources:

Miscellaneous IRS data; Congressional Budget Office and Joint Committee on Taxation forecasts; other economic data (Commerce Department, WEFA, etc.); state tax department data; data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.); state specific consumption and consumption tax data (Census data, Government Finances, etc.); state specific property tax data (Govt. Finances, etc.); American Housing Survey 1990; 1990 Census of Population Housing; etc.

A more detailed description of the ITEP Microsimulation Tax Model can be found on ITEP’s website at www.itepnet.org.