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Washington State and Local Tax System: Dysfunction and Reform

Funding Basic Education

Washington's dysfunctional state and local tax system is badly in need of reform. Among other things, the current tax system is the root cause of our inability to fully fund basic education as mandated by the Washington State Supreme Court. The following analysis explains how we stumbled into this fix and how we can climb out.

1. In 1932, seventy percent of the Washington voters passed an initiative to enact a graduated income tax, but the Washington State Supreme Court ruled in a 5-4 decision that the graduated income tax was an "unconstitutionally non-uniform property tax." If one more judge had ruled that an income tax was not a property tax or the initiative had proposed a flat-rate income tax, Washington would have an income tax today. In 1987, the Washington State Economic Development Board, composed of business and government leaders, recommended that the state tax base be broadened and stabilized "by reducing the sales tax rate and instituting a flat-rate personal income tax." In 2002, the Washington State Tax Structure Study Committee recommended "a flat-rate personal income tax to reduce the sales tax rate and eliminate the state property tax."

2. How much should state and local governments tax? The state and local effective tax rate for all states (state and local tax revenue as a percent of personal income) has averaged 10.5 percent and been quite stable since FY 1970. After averaging 10.5 percent over the prior ten years, the national effective tax rate slipped to 10.2 percent in FY 2015.

3. In FY 2015, with personal income amounting to $365.0 billion, Washington state and local governments collected an estimated $34.1 billion in taxes. But the state and local effective tax rate was just 9.3 percent. Taxing below the 10.5 percent national norm, Washington state and local governments forfeited $4.2 billion in tax revenue in FY 2015 and $27.2 billion from FY 2005 to FY 2015.

4. Between FY 1995 and FY 2014 (the latest year for which there are data for individual states), the Washington state and local effective tax rate fell from 11.4 percent (eleventh highest in the nation) to 9.4 percent (thirty-sixth highest). The extraordinary decline was due to the inadequacy of the state's sales-based tax system—its inability to generate sufficient tax revenue for the growing economy—working in concert with Initiative 601. Enacted in 1993, I-601 was the first of several voter-approved initiatives requiring a two-thirds vote of the Legislature to raise taxes. Declared unconstitutional in 2013, the supermajority rule nevertheless thwarted tax increases for twenty years.

5. As a consequence of Washington's falling effective tax rate, current spending for public elementary and secondary schools per $1,000 of personal income declined from slightly above the national average ($44.07 versus $43.68) in FY 1992 to 15.2 percent below the average ($32.60 versus $38.46) in FY 2014. It would have taken an additional $2.0 billion to lift Washington K-12 spending up to the national norm in FY 2014.

6. Washington's current fiscal bind is further complicated by its regressive tax system, which is widely recognized as the most unfair in the nation. In 2015, the Institute on Taxation & Economic Policy estimated that Washington's lowest-income families paid 16.8 percent of their income on state and local taxes, while the one percent of families with the highest incomes paid only 2.4 percent. This meant that the lowest-income families had to work 8.7 weeks out of the year to pay their state and local tax bill, while the highest-income families had to work only 1.2 weeks.

7. If tax revenue is inadequate, the typical response is to raise tax rates or broaden the tax base, which in a sales-based tax system like Washington's exacerbates its unfairness. Since even property taxes are regressive, the only good alternative source of revenue is an income tax.

8 With no need for other taxes, a 10.5 percent single-rate personal income tax would be adequate (tax revenue would always be 10.5 percent of personal income, the national norm). It would also be fair (every household, no matter what its income, would have to work 5.5 weeks out of the year to pay its annual state and local taxes).

9. In FY 2015, a 10.5 percent personal income tax would have raised $38.3 billion in state and local tax revenue, $4.2 billion more than collected with the current tax system. The additional $4.2 billion would have covered the $2.0 billion plus shortfall in the funding for basic education with money left over for other priorities.

10. A major benefit of a personal income tax is the savings on federal income taxes due to the deductibility of state and local personal income, property, and general sales taxes. In FY 2015, when Washington citizens paid $34.1 billion in state and local taxes under the current tax system, they saved an estimated $1.1 billion on their federal income taxes due to the federal deduction offset. This was a small benefit—one-third of the average nationally—because Washington lacks a personal income tax.

11. If Washington had a 10.5 percent personal income tax in FY 2015, state and local governments would have raised $38.3 billion in taxes because of the higher effective tax rate. At the same time, the federal deduction offset would have jumped to an estimated $5.6 billion, since every dollar of state and local taxes would have been deductible. The $4.5 billion increase in the federal deduction offset would have "paid" for the $4.2 billion increase in state and local tax revenue. In other words, thanks to the generosity of the federal tax system, a 10.5 percent personal income tax would ensure adequate tax revenue for our schools and other public services without adding to our overall tax burden.

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