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. POLICY BRIEF . JANUARY 12, 2010

Increasing and Modernizing the Sales Tax

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Introduction

Now more than ever, Washingtonians need basic public structures like health care and education. At the same time as the need for these investments has grown, the recession has greatly reduced the resources available to meet the need. In sum, the national recession has caused a critical imbalance in Washington State.

So far, the response to this imbalance has included $3.5 billion in deep cuts that will harm our ability to have an educated workforce, a strong health care infrastructure, and economic security. Now state policymakers face another $2.6 billion shortfall and the Governor's first budget proposal outlines a solution that depends heavily on making even deeper cuts. These proposed cuts would, among other things, eliminate health insurance for tens of thousands of workers and children, eliminate child care assistance for thousands, and curtail toxic clean-up efforts. A more balanced approach is needed. In order to maintain our shared investments in health care, education, the environment, and communities, one option is to modernize and temporarily increase our state's major revenue instrument: the sales tax. Elements of the proposal include:

- A temporary (3-year) increase in the state sales tax rate to 7.5 from 6.5 percent combined with fully funding the Working Families Tax Rebate (WFTR), which would offset much or all of the cost of the sales tax increase for over 350,000 Washington working households.
- Permanently modernizing the sales tax by extending it to include consumer services. This would bring the sales tax more in line with the modern economy, making it a more adequate and equitable instrument for financing public services.
- Extend the sales tax to candy, gum, and bakery products and eliminate a tax break for shoppers from out-of-state.

Together, these three elements would generate an additional $1.2 billion in resources that could be used to prevent further economically damaging cuts. The remaining deficit could be closed through a combination of additional revenue strategies, an extension of federal recovery funds, and one-time transfers and changes (including accessing the Rainy Day Fund).

The economy's impact on the budget

During the last session, the Legislature faced a $9 billion deficit. After making deep budget cuts, the Governor signed a budget that was expected to leave an ending fund balance of nearly half a billion dollars plus $250 million in the rainy day fund.

Since then, the Great Recession has continued to wreak havoc on state budgets across the country; 39 states are currently facing deficits.[1] The economy has had an impact on both sides of the budget equation:

- On the spending side, the downturn means that struggling families face a heightened need for state services, such as health care. Upon losing employer sponsored health coverage, laid off workers and their families often must rely on state health insurance programs. For example, since the current budget was passed, the number of children expected to access children's medical assistance programs has risen by 11 percent.[2]
- While the need for public structures has grown, the continued economic malaise has also meant that the state is taking in too little revenue to meet the growing needs of vulnerable families and maintain our long-term investments and economic competitiveness. The amount of revenue expected to be raised from fiscal year 2009 through fiscal year 2011 has fallen by $1.68 billion, since the current budget was passed.[3]

Last year, policymakers dealt with effect of the recession on Washington by cutting vital programs and services – such as kicking tens of thousands of struggling workers off the state's Basic Health Plan, eliminating class-size reduction initiatives, and increasing tuition at state colleges and universities. This one-dimensional, cuts-only approach jeopardized our state's economic recovery by slashing investments in health care, education, the environment, and communities.

An imbalanced approach

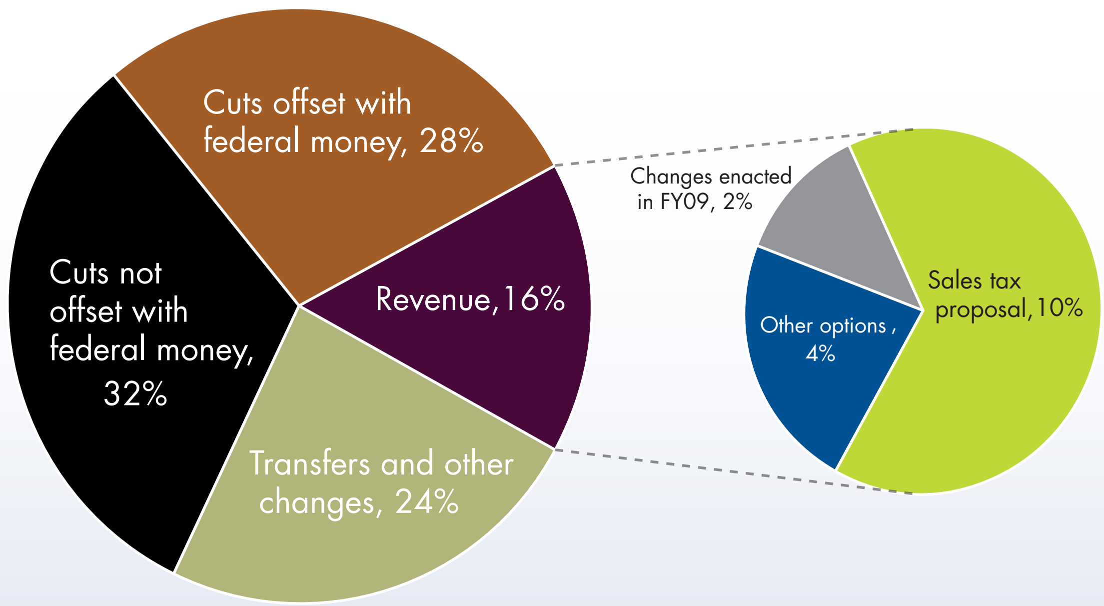
The Governor's supplemental budget proposal that was released on December 9th follows in the same vein as the budget passed last year. Combined with those already-enacted cuts, the Governor's supplemental budget proposal would result in a historic 14 percent reduction in the state's near-general fund.[4]

This approach would jeopardize our state's economic recovery by slashing investments in important public priorities like health care, education, environmental protection, and safer communities. It would also create immediate harm for many. For example:

- Over 65,000 people will lose access to affordable health insurance;
- 16,000 children will lose health insurance coverage;
- Over 20,000 people who are unable to work due to disability will lose financial and medical assistance;
- 12,300 students from lower income families will lose an important source of financial aid;
- 2,400 working families per month will lose child care assistance;
- 1,500 three-year-olds will lose access to early learning opportunities.

The Governor has expressed distaste for this all-cuts budget approach. She has indicated that some of the cuts proposed in her first budget would be unacceptable, such as elimination of Basic Health, which provides affordable health insurance to over 65,000 people. She plans to release a second budget which will avoid about $700 million of the cuts proposed in the first version. However, many important services would still be slashed under the second version of the Governor's budget, such as programs that help working families pay for child care, prevent costly health problems by supporting at-risk pregnant women, and clean up toxic sites.[5]

Figure 1: FY2009-11 budget solutions with sales tax proposal



Source: BPC calculations of data from LEAP, OFM, DOR, and ITEP

A balanced approach

Instead of taking another, deeper, round of budget cuts, policymakers should consider a more balanced approach that would include revenue strategies. Specifically, by modernizing and temporarily increasing the state sales tax, we can quickly and efficiently raise $1.2 billion in resources needed to preserve services for struggling Washingtonians and maintain long-term investments.

This strategy would include: 1) a temporary (3 year) increase in the state sales tax rate to 7.5 from 6.5 percent coupled with full funding for the Working Families Tax Rebate; 2) modernizing the sales tax to include currently untaxed consumer services such hair and nail salons, massage services, and travel arrangement services; and 3) eliminating costly exemptions for candy and gum, bakery products prepared and sold on-site, and nonresident shoppers (Table 1).

Combined with additional revenue strategies, an extension of federal recovery funds, and one-time transfers and changes, further cuts such as those proposed in the Governor's budget can be avoided.

Tax increases under this proposal would remain a modest share of total actions taken to close shortfalls during the FY2009-11 biennium. Figure 1 shows that tax increases under the proposal would account for barely one-sixth of total measures taken to balance the budget over the course of the biennium. This assumes that 1) the Legislature enacts the $650 million in transfers and changes proposed by the Governor, 2) that no additional federal recovery funding is received, and 3) the remainder of the shortfall is closed through revenue options such as those listed in Table 2, below. An extension of federal recovery funds could further reduce the needed role of revenue increases.

TABLE 1: MODERNIZING AND TEMPORARILY INCREASING THE STATE SALES TAX

PROPOSED CHANGES	FY2011 Revenue ($ millions)
Temporary (3-year) sales tax increase & Working Families Tax Rebate	
Increase the sales tax rate to 7.5 from 6.5 percent	1,044
Full funding for the Working Families Tax Rebate	-77
Subtotal	967
Modernizing the sales tax to include consumer services[1]	
Satellite and cable TV services	34
Personal care services (hair, nail, skin, massage, and other services)	20
Travel agent commissions	20
Investment advice	19
Admissions (movie theaters, racetracks, sporting events, etc.)	17
Instructional lessons (sports)	4
Tax preparation services	3
Travel arrangement and reservation services, and fees related to non-sporting events	2
Subtotal	118
Other sales tax actions	
Repeal the exemption for nonresidents	37
Extend the sale tax to purchases of candy and gum	28
Extend the sales tax to purchases of bakery products sold on-site	16
Subtotal	81
GRAND TOTAL	1,166

1. Revenue estimates include a reduction in the B&O tax rate to the rate applied to retail sales businesses. Some consumer services are also purchased by businesses.

Source: Department of Revenue

Increasing the sales tax and funding the Working Families Tax Rebate

The Budget & Policy Center recommends temporarily increasing the state sales tax rate to 7.5 from 6.5 percent, and permanently funding the Working Families Tax Rebate -- a tax rebate for low-income working families with children. This approach would:

- Generate about $1 billion per year in new resources;
- Result in minimal administrative and compliances costs for the government and businesses;
- Be relatively equitable, as the Working Families Tax Rebate (WFTR) would reduce much of the added costs for low-income working families.

Revenue Potential

Increasing the state sales tax is the simplest and most direct method of generating revenues sufficient to offset damaging cuts in health care, education, child care, and other state services that assist struggling Washingtonians. Temporarily increasing the sales tax rate to 7.5 from 6.5 percent could be implemented quickly and efficiently, and would generate over $1 billion in new resources for use in the current FY2009-11 biennium.[6]

Minimal Compliance Costs

Policymakers have a sixty-day legislative session to close a $2.6 billion shortfall. Any revenue solution must be simple to implement and administer. Raising the sales tax rate meets that criterion. It would be straightforward for the Department of Revenue to administer. Similarly, a sales tax increase would not entail burdensome compliance costs for businesses, which would only have to make small adjustments to current procedures to account for the new rate. While the state sales tax rate has not changed in over 25 years, businesses are accustomed to dealing with local rate changes.

Mitigating the impact for working families

Implementing and fully funding the Working Families Tax Rebate (WFTR) would refund a portion of the state retail sales tax to the 350,000 Washington households who qualify for the federal Earned Income Tax Credit (EITC). By doing so, the WFTR will provide an income boost to hard-working Washingtonians.

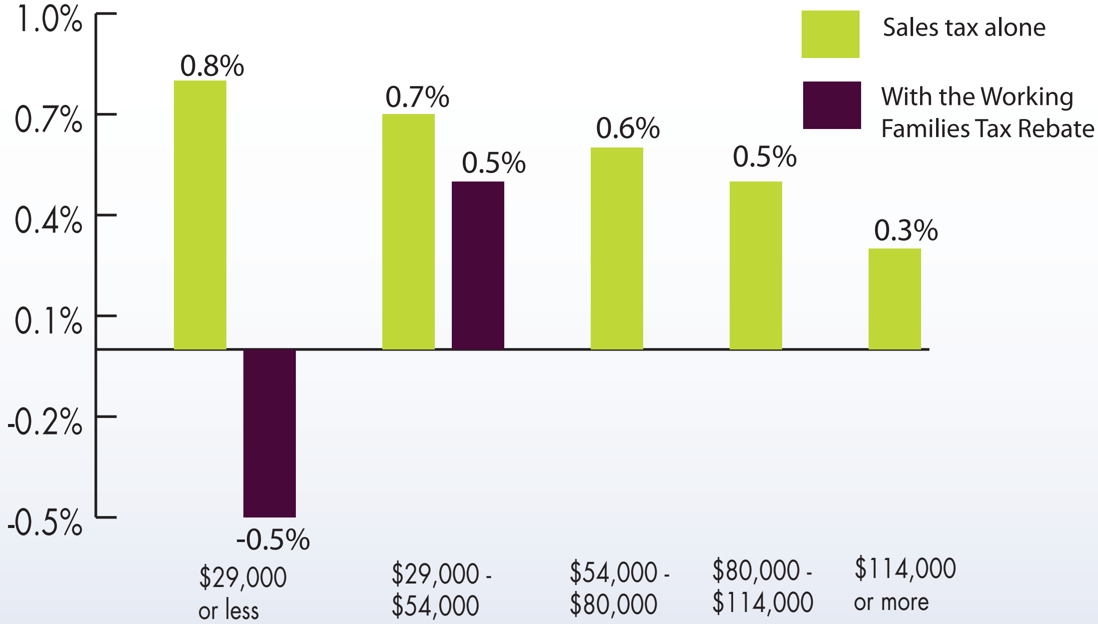
The groundwork for implementation of the WFTR has already been laid. The measure was signed into law in 2008. Since then, the Department of Revenue has begun to establish an efficient system to administer and distribute rebates to low-income working families.

The WFTR would be calculated as a flat percentage of the EITC – a federal tax credit that provides tax refunds to low-and moderate-income working families. A rebate set at ten percent of the federal EITC would provide a tax break of up to $500 for lower income working families.[7] In total, it would return over $70 million annually to working families in Washington.[8]

Raising the sales tax would generate a sizable amount of revenue, but without the WFTR it would also increase costs for vulnerable families in Washington. While upper income families would pay more in absolute terms, an increase in the sales tax would cost lower income families more as a share of their income. As shown in Figure 2, the sales tax increase would amount to 0.8 percent of income for lower income families, compared to 0.3 percent for upper income families.

The Working Families Tax Rebate is an important tool for revenue policy because it can offset the impacts of a tax increase for families who are struggling to make ends meet during the recession. Figure 2 also shows the net impact of a sales tax increase combined with a Working Families Tax Rebate. The bottom fifth of Washington families (those earning under $29,000) would actually see a net decrease in sales tax. The rebate would also significantly lower the cost of the sales tax increase for the next bracket of earners (those earning between $29,000 and $54,000).[9]

Figure 2: Annual cost of a one-percentage-point increase in the state sales tax as a share of personal income, by 2009 income group



Source: Institute on Taxation and Economic Policy

For more information on the Working Families Tax Rebate, read the Budget & Policy Center report "The Working Families Tax Rebate" (http://budgetandpolicy.org/reports/the-working-families-tax-rebate).

Modernizing the sales tax

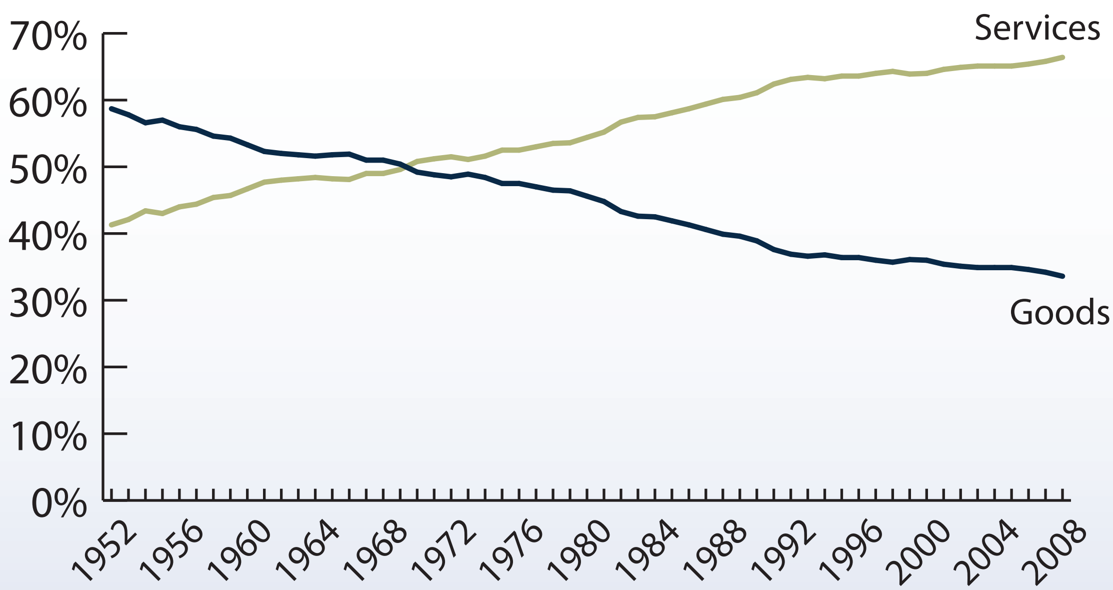
As part of a balanced approach, Washington's sales tax should be modernized to include consumer services that are not currently subject to the sales tax -- such as hair and nail salons, admissions to movie theaters and sporting events, and travel arrangement services. In addition, the sales tax should be extended to include candy, gum and bakery products and an exemption for nonresident consumers should be eliminated. This approach would:

- Raise a significant amount of revenue in the current biennium;
- Bring the sales tax more in-line with the modern economy;
- Ensure the sales tax is applied more equitably across different types of products and services.

Revenue Potential

Extending the sales tax to include a broad range of consumer services would generate a substantial amount of new revenue needed to preserve our public investments. Table 1 provides estimates of the amount of revenue that could be raised by extending the sales tax to eight common household services that are identified by the Department of Revenue as administrable. In total, extending the sales tax to these services would generate about $120 million in the 2011 fiscal year.[10] Other common services such as veterinary services, pet grooming, self storage, private club memberships, and private limo services, could also be considered.[11]

Figure 3: Goods and services in the U.S. as a share of personal consumptions expenditures, 1952-2008



Source: BPC calculations of data from the U.S. Bureau of Economic Analysis (NIPA 1.1.5)

Improving adequacy

Since it was first enacted in 1935, the sales tax has become a less effective and less adequate instrument for funding public priorities. One reason is that the tax has failed to keep pace with changes in the economy and consumer spending. Extending the sales tax to services would help bring the tax more in-line with the modern economy, making it a more adequate source of revenue.

The sales tax was enacted at time when consumers spent most of their money on tangible, manufactured goods. Since then, the economy has changed significantly, and consumers now spend a greater share of their incomes on services. Figure 4 illustrates the change in national personal consumption patterns over the last six decades. As the graph shows, in 1952 purchases of goods accounted for about 59 percent of personal consumption expenditures, while services accounted for 41 percent of expenditures. By 2008 this pattern had reversed. In that year, purchases of services made up for 67 percent of expenditures, while goods accounted for only 34 percent.[12]

Washington's sales tax has not kept pace with this shift in consumer preferences, however. As a result, the tax – which is intended to be a general tax on consumption – now generates revenue from a smaller portion of total consumer purchases. This shift toward greater consumption of services is likely to continue for the foreseeable future.[13] Without extending the sales tax to include currently untaxed services, the tax is likely become an increasingly less adequate source for financing state services.

Improving equity

Extending the sales tax to include consumer services would also reduce fundamental inequities in

TABLE 2: OTHER REVENUE OPTIONS

REVENUE OPTION	FY2011 Revenue ($ millions)
Business and Occupation (B&O) Tax	
Apply a 10 percent surcharge to all existing rates	270
Repeal the deduction for interest paid on first home mortgages	85
Other taxes	
Increase the cigarette tax to $3.025 from $2.025 per pack	85
Enact a new tax on bottled water of 1 cent per oz. at wholesale	183
Enact a new tax on nonfountain soft drinks of 5 cents per 12oz at wholesale	102
Increase the Syrup Tax to $2 from $1[1]	15

1. Includes a repeal of the B&O Syrup Tax credit

Source: Department of Revenue

Washington's tax system. Under current law, an individual who prefers to spend his or her money on goods, such as electronic massaging devices, is likely to pay more in sales tax than a person who prefers to purchase services, such as a massage from a therapist. Extending the sales tax to consumer services would ensure that the sales tax treats consumers and businesses equitably, irrespective of their personal preferences or the types of products or services they provide.

Other sales tax actions

To generate additional revenues, policymakers should consider eliminating at least three costly sales tax exemptions. Repealing the exemption for candy and gum and the exemption for bakery products would increase sales tax revenues by about $44 million in FY2011. Repealing the sales tax break given to shoppers from states with low or no sales tax would generate about $37 million per year.[14]

The remaining gap

Modernizing and temporarily increasing the state sales tax would generate enough resources to close about $1.2 billion of the $2.6 billion dollar shortfall that lawmakers must close for the remainder of the 2009-11 fiscal biennium. The Governor has proposed transferring $650 million from the rainy day fund and other state funds. To fill the remaining gap, we have also provided a list of other revenue enhancement options. Detailed in Table 2, these actions include closing costly business tax exemptions, increasing the cigarette excise tax, and creating new "sin" taxes on soft drinks and bottled water.

Long-term reforms needed

In order to remain a prosperous and competitive state, it is crucial that we continue to make further investments after the economy recovers that foster a quality education system, adequate and affordable health care, a healthy environment, and greater safety in our communities.

The revenue enhancements proposed in this report are designed to provide a short-term solution to the budget shortfalls caused by the national recession. Future investments will require altering our revenue structure in a way that provides more resources, reduces taxes for low and moderate income families, and improves long-term stability. The conversation about short-term strategies should include long-term thinking about structural reform, including a state income tax.

Policymakers should also take a holistic look at costly expenditures made through the tax code. There are at least 567 individual state and local tax expenditures in Washington. Collectively, this assortment of credits, exemptions, preferential rates, deferrals, and other types of expenditures will cost $13 billion in forgone tax revenue in the current biennium, according to the Department of Revenue.[15] Yet unlike other types of spending, the cost of Washington's numerous tax expenditures are not routinely considered during the state's budget process. Policymakers should integrate tax expenditures into the standard budget-development process. Doing so would allow legislators to eliminate wasteful or ineffective tax expenditures, fostering greater transparency and accountability.

Raising taxes to preserve services is sound economic policy

Raising revenue as a response to the current fiscal crisis reflects sound economic policy, according to prominent economists, both nationally and here in Washington State.

During the recession of early 2000s, Nobel Prize winning economist Joseph Stiglitz and Peter Orszag -- now Director of the Office of Management and Budget -- wrote "a reduction in government spending on goods and services is thus likely to be more harmful to the economy in the short run than an increase in taxes or a reduction in transfer program spending."[16]

Because cutting state services entails cancelling state contracts and vendor payments, laying off workers, and cutting benefit payments for struggling workers and families, Stiglitz and Orszag reasoned that budget cuts immediately remove demand from state economies on a dollar-for-dollar basis, causing greater economic damage during a recession. By contrast, raising taxes would result in less economic damage because some of the money used to pay the additional taxes would come from reduced savings and out-of-state consumers. As such, state tax increases cause less short-term damage to the economy than deep budget cuts.

Mainstream economists here in Washington State agree. Last year, the Budget & Policy Center released a letter signed by over 20 economists and public policy experts from Washington State urging lawmakers to take a balanced approach, including revenue increases, when addressing the state's budget deficit. "Implementing deep cuts in government spending and declining to raise revenue through tax increases is not an effective strategy to guide Washington State out of this recession," the letter states.[17]

Using tax increases to help close state budget shortfalls is a common practice. During the recession of the early 1990s, 44 states increased taxes to help maintain services. Similarly, following the dot-com bust of the early 2000s, 30 states generated new resources through tax increases, and 30 have already done so in the current downturn.[18]

Of all the options available, closing our budget shortfalls with an unbalanced, cuts-only approach would cause the most short-term damage to Washington's economy. Preserving services through tax increases, on the other hand, would cause less economic damage, and would leave us well-positioned once prosperity returns.

Conclusion

As a result of the national recession, Washington faces inadequate resources to meet the cost of maintaining our shared investments in education, health care, and economic security. To resolve the current $2.6 billion shortfall, it is crucial that lawmakers take a balanced approach that includes revenue increases. Raising taxes now would allow us to maintain vital services through the recession, and would leave us well situated to grow and prosper again once the economy recovers.

A revenue package that would be administratively straightforward and raise significant revenue must include modernizing and temporarily increasing the state retail sales tax. Full funding of the Working Families Tax Rebate would offset most or all of the added costs for low-income, working families. In addition, to ensure a prosperous future for all Washingtonians, policymakers should also consider long-term reforms to our state's revenue structure.

Acknowledgements

The Budget & Policy Center gratefully acknowledges the support of the Annie E. Casey Foundation, Bill & Melinda Gates Foundation, Paul G. Allen Family Foundation, Marguerite Casey Foundation, Campion Foundation, and the Seattle Foundation. Matt Gardner for the Institute for Taxation and Economic Policy provided data and analysis. The findings and conclusions presented in this report are those of the authors alone, and do not necessarily reflect the opinions of these organizations.

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