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Revenue Trends 2013.3: Washington State's 1930s Tax System Doesn't Work In A 21st Century Economy

By Andrew Nicholas

Revenue Trends, a quarterly analysis of data and projections that impact public investments in Washington state.

Washington state tax revenues are projected to be slightly higher in the coming years than previously forecasted, but total resources will continue to fall far short of the amount needed for a strong economy. Fixing Washington state's antiquated 1930s tax system is the only way to ensure our children receive a state-of-the-art education, and that our state remains an attractive place to do business in a 21st century economy.

This third edition of Revenue Trends examines data from the September 2013 revenue forecast from the state Economic and Revenue Forecast Council (ERFC) and other sources.

While revenue is moving in the right direction as the economy maintains a slow but stable path to recovery, the state is still reeling from the devastating effects of the Great Recession. Our analysis of recent revenue data shows:

- **Revenue is still well below pre-recession levels:** Despite positive news in the September 2013 forecast, state tax collections in the current fiscal year are projected to remain about $1.2 billion below 2008 levels, after adjustment for inflation. State revenues are not projected to reach pre-recession levels for the foreseeable future.
- **New tax break transparency requirements are a good step forward, but more needs to be done:** A new law enacted this year will bring greater accountability and transparency to future tax breaks by ensuring they all have an expiration date, a well-defined public purpose, and metrics to assess whether they indeed benefit Washingtonians and the state economy. The new law is necessary given that the number of tax breaks on the books in Washington state has nearly doubled over the last two decades, rising from 333 in 1990 to 648 in 2013.
- **Washington state's revenue recovery trails the rest of the country:** Revenue collections in other states are recovering much more rapidly in comparison to Washington state. States with more balanced revenue systems that include an income tax, instead of relying so heavily on sales taxes, have seen significant boosts in revenue. Many states have seen recent growth in income and capital gains tax revenue, neither of which Washington state is able to take advantage of in our antiquated tax system.
- **Flaws in our revenue system are preventing a stronger recovery:** Washington state's 1930s-era revenue system is not suited for a 21st century economy and no

longer allows for adequate investment in important public services. Revenue collections have lost considerable ground compared to the state economy, falling 30 percent between 1995 and 2013. This trend is projected to continue, threatening Washington state's long-term economy and well-being.

The good news is that solutions to both our current and long-term revenue issues exist. Closing ineffective or outdated tax loopholes would generate significant resources that could be used to invest in public priorities, such as safety, economic security, and education. In the long-term, policymakers should address the flaws of our revenue system, starting with enacting an excise tax on capital gains, expanding the sales tax to a broader range of consumer services, and more heavily scrutinizing tax breaks.

Revenue Still Far Below Pre-Recession Levels

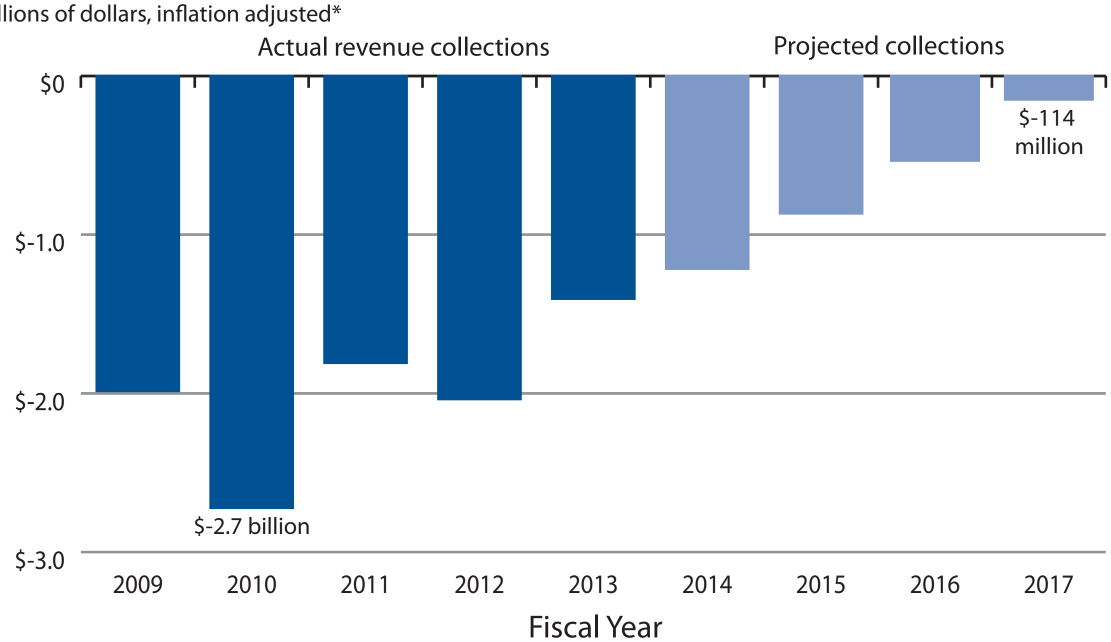
The September 2013 forecast showed positive signs of economic growth, with anticipated revenue collections increasing by $345 million in the current 2013-15 budget cycle.[1] While the economy and tax receipts continue to grow at a slow but steady pace, the state is still reeling from the chaos caused by the Great Recession. The sheer depth of the last economic downturn means that revenues remain well below pre-recession levels, and will continue to do so for much of the current decade.

Figure 1 shows that revenues remain depressed once adjustments are made to reflect price increases that have occurred since 2008. As the graph shows, inflation-adjusted tax receipts will still be $1.2 billion (seven percent) below 2008 levels. State tax revenues are projected to remain below 2008 levels at least through 2017, the extent of ERFC's projections.

The recovery of state tax revenues in Washington state following the Great Recession has been very slow by historical standards. Figure 2 shows the pace of recovery following both the Great Recession and the so-called "dot com bust" recession of the early 2000s. Five years after the deepest part of the dot com bust recession, tax revenues had recovered to 20 percent above pre-recession levels, after adjustment for inflation. In stark contrast, five years after the depth of the

FIGURE 1. Revenues Remain Below Pre-Recession Levels

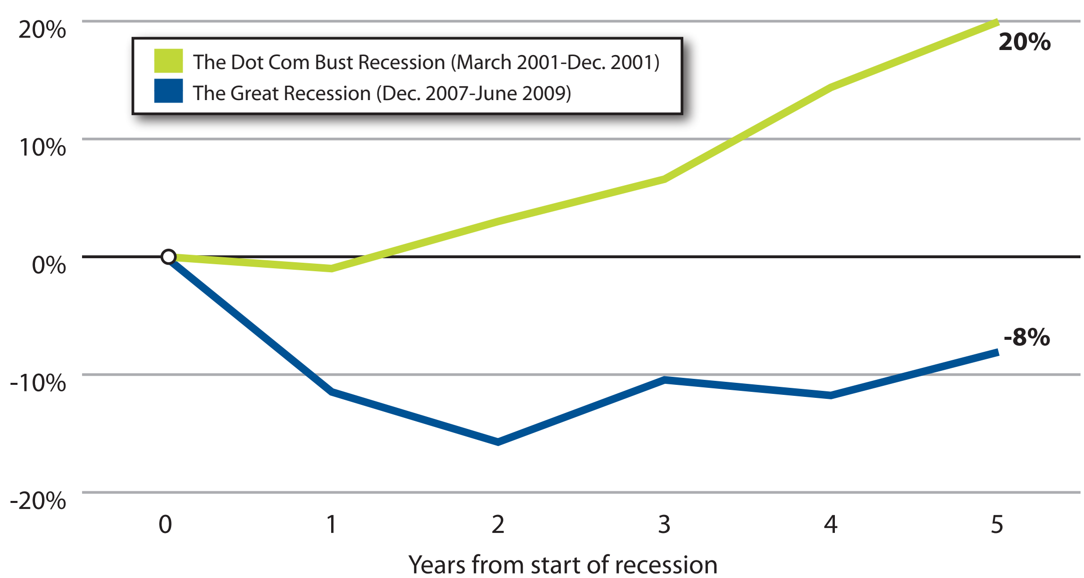
Change in state revenue collections from previous economic peak (2008), billions of dollars, inflation adjusted*



Source: BPC analysis; data from ERFC - Near General fund, state-only revenue. *Real (2013) dollars adjusted using the CPI.

FIGURE 2. Revenue Recovery Lags Previous Recession

Percent change in near-general fund revenue since start of recession, adjusted for inflation



Source: Budget & Policy Center Analysis; data from ERFC and BLS

Great Recession, revenues remain eight percent below their pre-recession peak.

Washington State Trails Nation in Revenue Recovery

Washington state ranks in the bottom third of states for the return of state tax revenues to pre-recession levels. As of March 2013, nationwide state tax collections have recovered to about nine percent above pre-recession levels. In Washington state, however, they have recovered to only two percent above 2008 levels (see Appendix Figure A).

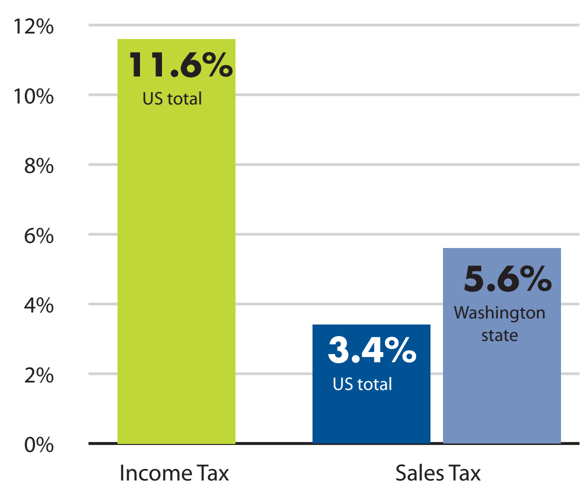
More Robust Tax System = Faster Recovery

States with a more diverse mix of taxes have been quicker to recover from the recession than Washington state, which does not have an income tax and relies too heavily on sales taxes.

Nationwide, state personal income taxes for the first three quarters of the 2013 fiscal year were up 11.6 percent relative to the same time period a year ago (Figure 3). In contrast, state sales tax revenue grew much more slowly - up only 3.4 percent nationally, and just 5.6 percent in Washington state.[2]

FIGURE 3. Washington State Missing Key Components of a Robust Revenue Recovery

Year-over-year change in state tax collections by type, first three-quarters of fiscal year 2013



Source: Budget & Policy Center calculations; data from Nelson A. Rockefeller Institute of Government

New tax break reforms are a good start, but more needs to be done

During the 2013 legislative session lawmakers approved necessary reforms that will enhance the transparency and accountability of future Washington state tax breaks. Under Senate Bill 5882 all new tax breaks are required to include a clear public purpose along with specific data and metrics for state auditors to use in evaluating whether or not they are performing adequately. SB 5882 also establishes that any new tax break will expire after 10 years unless another date is specified.

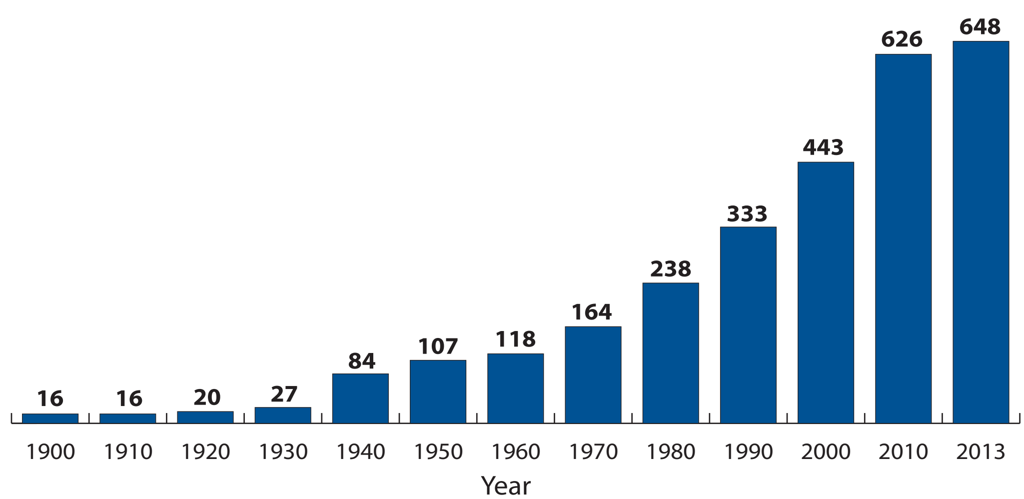
While these reforms represent an important step in the right direction, far more must be done to ensure tax breaks are scrutinized routinely by policymakers and balanced against other important priorities. Most state tax breaks lack transparency and accountability. Every year, policymakers pour over the state budget, carefully examining expenditures on health care, education, public safety, and other important investments. Yet, hundreds of state tax breaks with little or no proven benefit to Washingtonians remain on the books for years or decades without receiving any review or assessment from lawmakers. And, even though tax breaks are often costly and inefficient tools for meeting public objectives, they have become very popular among lawmakers over the past few decades.

Figure A shows that the number of tax breaks on the books in Washington state has nearly doubled since 1990, rising from 333 to 648. In just the last three years our investment in schools, health care and other important services have been dramatically cut, while lawmakers adopted 22 new tax breaks.

The unrestrained growth of state tax breaks cannot continue if policymakers are to build the modern education, community safety, and health care systems needed to make Washington state competitive in the 21st century. In the coming legislative session, policymakers should work to apply the sensible transparency measures included in SB 5882 to all 648 existing tax breaks on the books in Washington state.

FIGURE A. Unchecked Growth In Tax Breaks Will Continue Without Reforms

Cumulative number of tax breaks in Washington state by decade, 1900-2013.



Source: Budget & Policy Center calculations; data from Department of Revenue

A recent report from the Center on Budget and Policy Priorities sums it up. "... *[S]tates without income taxes are missing out on revenue. Part of the recent revenue boost reflects the fact that income taxes are better at growing with the economy than sales or other taxes.*"[3]

States with more balanced revenue systems have also fared better over the long-term. Revenues as a share of the economy in Washington state have declined by 26 percent since 1992, while neighboring Idaho experienced a significantly smaller drop of 18 percent and Oregon's revenue fell by only about one percent (Appendix Figure B).[4]

Systemic Flaws Undermining Our Recovery

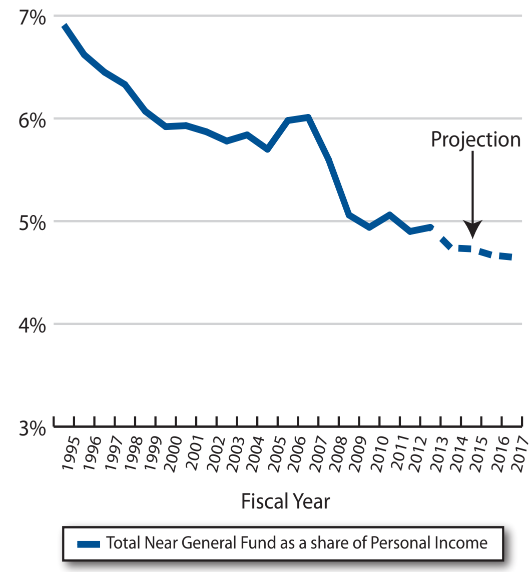
Washington state's outdated and flawed tax system is one of the main reasons for the state's poor revenue recovery. Without a personal income tax or a tax on capital gains, the state is failing to benefit from significant and rapidly growing portions of the economy, such as the stock market. As a result, the state's revenue system has been unable to keep up with rising needs, the higher cost of providing services, and a growing population. This has led to shrinking resources for many important public priorities.

Figure 4 shows that revenue as a share of the economy has fallen dramatically since the mid-1990s. Revenue collections as a share of total state personal income fell to less than 5 percent this year from about seven percent of the state economy in 1995. If nothing is done, state revenues will continue to lose ground, falling to 4.7 percent by 2014 – a historic low. By 2017, revenue as a share of the economy will only be just 67 percent of what it was in 1995.[5]

The major driving force is the state's overreliance on the retail sales tax. When the sales tax was enacted in 1935, consumers spent most of their incomes on tangible goods such as household items and tools. In the modern economy, consumers spend most of their incomes on services like health care, financial advice, and cable and satellite TV, which are not taxed in Washington state and did not exist when the sales tax was put in place. Consumers also purchase many goods from out-of-state

FIGURE 4. Revenue System Cannot Keep Pace With State Economy

Total Near General Fund as a share of personal income from fiscal year 1995 to 2017*



Source: BPC analysis; data from ERFC. *Projected values for fiscal year 2013 through 2017.

sellers via the Internet, but the state is barred by federal law from requiring the sellers to collect sales tax on these transactions.

Figure 5 shows the tax consequences of this dramatic shift in consumer behavior. In 1980 the scope of products subject to the state sales tax amounted to about 60 percent of Washington state's total economy. Today, they amount to less than 35 percent of the economy, and will continue to decline unless the sales tax is applied to the things Washingtonians now spend their money on.[6]

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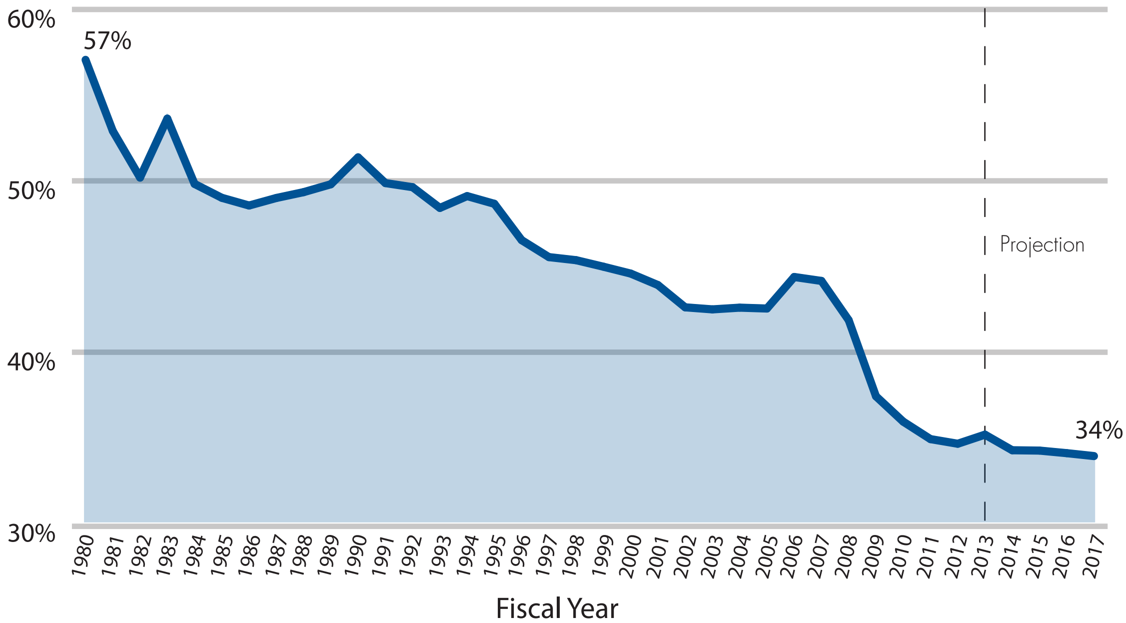
The second edition, June 2013: Revenue Trends 1.2 can be found here.

FIGURE 5. Taxable Retail Sales Have Plummeted as a Share of the Economy

Taxable retail sales as a percent of state personal income for fiscal year 1980 to 2017*



Source: BPC analysis; data from ERFC. *Projected values for fiscal year 2013 through 2017.

Acknowledgments

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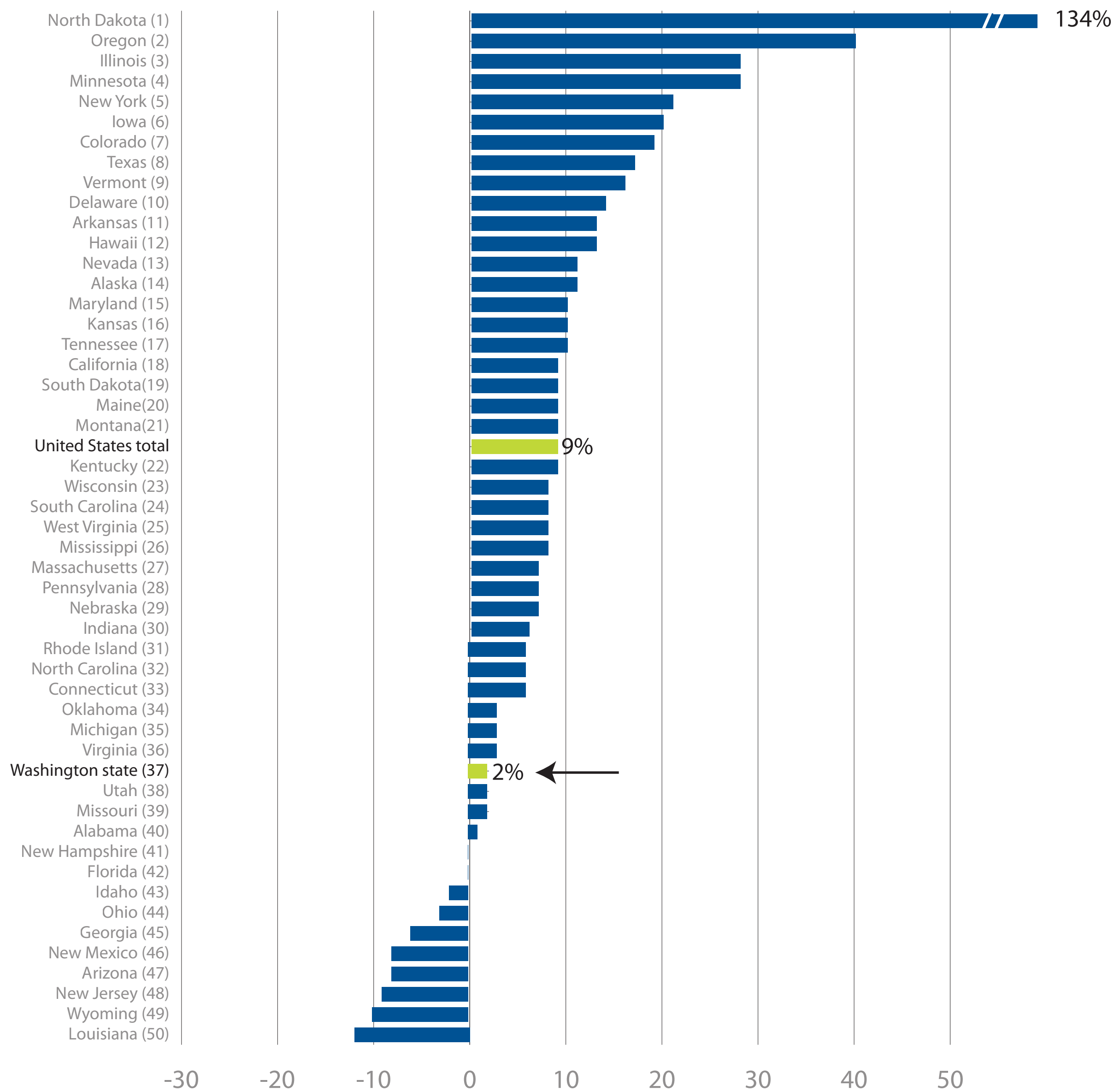
Endnotes

1. Economic and Revenue Forecast Council (ERFC), September 2013, Economic and Revenue Forecast. Near-general fund tax revenue..
2. Budget & Policy Center calculations; data from The Nelson A. Rockefeller Institute of Government, "State Government Tax Revenue by State" http://www.rockinst.org/government_finance/revenue_data.aspx
3. McNichol, Elizabeth "States Should React Cautiously to Recent Income Tax Growth: April Surge Provides Opportunity to Invest in Infrastructure, Boost Reserves" Center on Budget and Policy Priorities, http://www.cbpp.org/cms/?fa=view&id=3972; Jun 13, 2013
4. Budget & Policy Center calculations; state revenue data from the U.S. Census Bureau; State total personal income data from the Bureau of Economic Analysis (BEA).
5. Budget & Policy Center calculations; revenue data from ERFC, June 2013; State total personal income data from the BEA. Taxes as a share of total state personal income is commonly used by economists as a measure of revenue adequacy.
6. Budget & Policy Center calculations; data from ERFC, June 2013.

Appendix Figures

Appendix Figure A: Washington State Trails Nation in Revenue Recovery

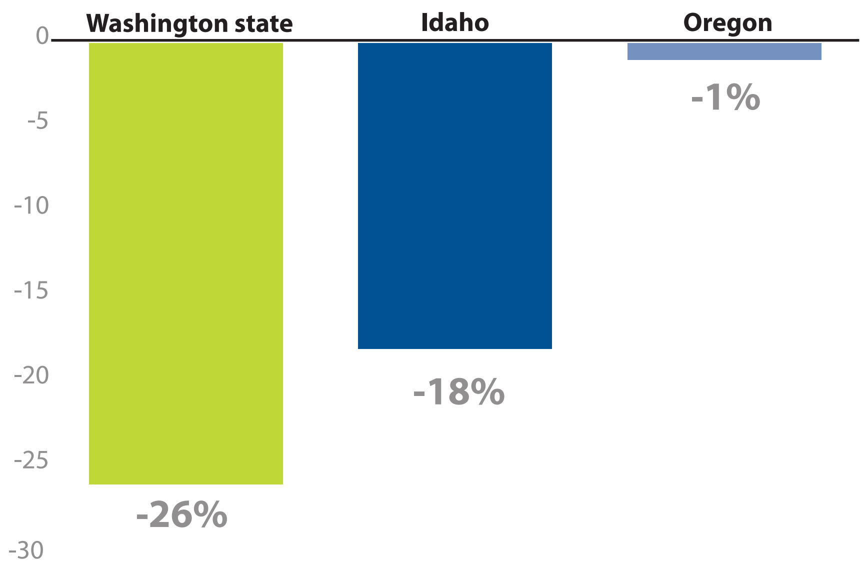
Percent change in state tax collections by state and rank, 2008 - present



Budget & Policy Center analysis; data from the Rockefeller Institute of Government

Appendix Figure B. Neighboring States' Tax Systems Are More Robust

Percent change in state revenue collections as share of total state personal income, 1992-2012, Washington state, Idaho, and Oregon.



Source: Budget & Policy Center Analysis, data from the US Census Bureau and BEA.