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Washington's Business Tax Structure

Written Testimony for the Washington House Tax Structure Working Group

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Chairwoman Frame and Chairman Nealey:

Thank you for this opportunity to submit testimony on behalf of the Tax Foundation, where I am a senior policy analyst. The Tax Foundation is the nation's oldest tax policy research organization, and we would be pleased to offer our assistance to this commission, and to Washington policymakers generally, as you weigh options for structural reform.

In an era when broad bipartisan agreement often feels like a pipe dream, it's particularly notable that there is a near-universal embrace–at least in theory–that a well-structured tax code should have broad bases and low rates. In practice, states all fail, in varying degree, to achieve this aim. Each divergence from the principle has a set of justifications, but the end product is often a swiss cheese tax code that no one can be proud of.

Washington's Business & Occupation (B&O) tax comes with a catalogue of tax exemptions, deductions, and other preferences, and they merit careful scrutiny. Their sheer number, however, owes in significant degree to two things that aren't deductible in Washington, but are in almost every other state: employee compensation and cost of goods sold, the hallmarks of a tax on corporate net income.

Corporate income taxes are on net income (essentially profits)—income after expenses, like employee compensation and production or acquisition costs. Corporate income taxes have an "ability to pay" component, as they're (imperfectly) levied on what's left after expenses. A gross receipts tax, like Washington's B&O tax, is based on gross revenue, meaning that not only can it fall heavily on marginal or even unprofitable companies, but that it penalizes businesses with longer production cycles, where the same income is taxed multiple times over (called tax pyramiding).

Most states go overboard with tax exemptions. In our *State Business Tax Climate Index*, which measures tax structure, we penalize states which lean heavily on tax incentives. These targeted preferences are nonneutral and shift burdens to companies, industries, and activities which aren't similarly favored with incentives. Ultimately, moreover, tax incentives are often a way to paper over bad policy. That's true in states with poorly designed or high-rate corporate income taxes, but it's especially true in Washington, where the fundamental structure of the B&O tax is antiquated, nonneutral, and distortionary.

Washington's B&O has so many exemptions in large part because it is levied on gross receipts, not net income, and its worst effects can only be mitigated by almost endless tinkering. It's a case of trying to cope with a flawed fundamental policy with another set of flawed, but largely countervailing, policies.

Reviewing the state's Tax Exemption Study, one is struck by the exemptions whose stated purpose is to provide relief to low-margin firms that would otherwise experience outsized burdens under a gross receipts tax, or to counter the effects of pyramiding or otherwise bring effective rates more in line with those faced by other industries. Many of these exemptions are more narrowly tailored efforts to do what the different rates are supposed to accomplish: keep the tax from becoming an impossible burden for businesses with low margins or long production chains.

Some tax exemptions and deductions exist to approach a proper definition of income. Others exist to favor certain industries or economic activities. Occasionally the lines blur—but that's more frequently the case under a high-rate gross receipts tax like Washington's. (By way of comparison, Ohio's tax is imposed at a uniform 0.26 percent rate and Nevada's gross receipts tax has a 0.111 percent tax on retail and a 0.181 percent rate on most services, compared to a 0.471 percent rate on retail and a 1.5 percent rate on services in Washington.)

In examining exemptions, therefore, Washington policymakers must ask themselves whether a particular exemption is designed to enhance or undermine the tax's neutrality. Is it designed to bring the taxation of one industry more in line with the taxation of other industries or to give it a particular tax advantage? This is not an optimal way to do tax policy–optimally, states would not have gross receipts taxes–but given the practical and legal realities, the prudential rule must be *first, do no harm*. Tax preferences which function as incentives merit close scrutiny, while those that attempt to rectify fundamental inequities may have greater justification. It is a balancing act.

The B&O's shortcomings notwithstanding, however, Washington has a highly competitive tax code—and while addressing legitimate concerns within that code, it is important to preserve the features that make it stand out.

There is, I know, a desire to address the regressivity of the state's tax code, driven largely by the absence of an individual income tax. In evaluating these issues, though, policymakers should be very wary of the analysis from the Institute on Taxation and Economic Policy (ITEP). No model is perfect, but a few major issues stand out here:

1. The use of 1988 federal taxpayer data grossed up to the present. (Because of a change in federal data collections, ITEP's model has to continue to use this outdated dataset.) The economy has changed a lot since 1988, and using 30-year-old data can yield highly unreliable results.
2. Only including select taxes in the analysis. ITEP's model ignores major swaths of Washington's tax code, including the estate tax, leasehold tax, severance tax, insurance premium taxes, transit authority taxes, and public utility taxes, most of which have a progressive effect.
3. Although ITEP does make some effort to account for the B&O being a gross receipts tax rather than a sales tax, its methodology is unclear, and it is likely represented as being more regressive than it is in practice.
4. It includes the state and local tax deduction, a federal provision, as part of the state tax structure in an effort to make state tax codes look more regressive. Incidentally, this means that under ITEP's methodology, every state's tax code moved in a progressive direction with the

adoption of the federal Tax Cuts and Jobs Act, which capped the state and local tax deduction at $10,000.

5. It does not acknowledge that the totality of federal, state, and local tax burdens is progressive due to the highly progressive nature of federal taxes.

Still, it's perfectly legitimate to be concerned about regressivity. Generally, however, it is far more effective and efficient to focus on progressive *spending* policies. A pro-growth tax structure favors the economic activity necessary to sustain such policies, which cautions against rethinking too many of the tax policies which are responsible for Washington's strong business climate. The relative revenue stability of the state's current system of taxation, when compared to other possible tax mixes, also merits consideration, particularly if the state intends to address issues of equity

Tax exemptions which serve only to advantage favored industries, and not to help approach a proper definition of taxable income, tend to be regressive as well as economically inefficient. The Tax Foundation is always available to work with policymakers to help identify ways to streamline the tax code.

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