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The Impact of the Ron Sims Tax Plan On Washington Tax Fairness

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Washington's tax system is regressive, requiring low- and middle-income families to pay far more of their income in tax than wealthier Washingtonians. A tax reform plan recently proposed by gubernatorial candidate Ron Sims would change the state's tax system by repealing the state's general business tax and the state sales tax, creating a $100,000 homeowner's exemption from the state property tax, and introducing a personal income tax. This analysis looks at the factors shaping tax fairness in Washington, and estimates the impact of the Sims proposal on the overall regressivity of the tax system.

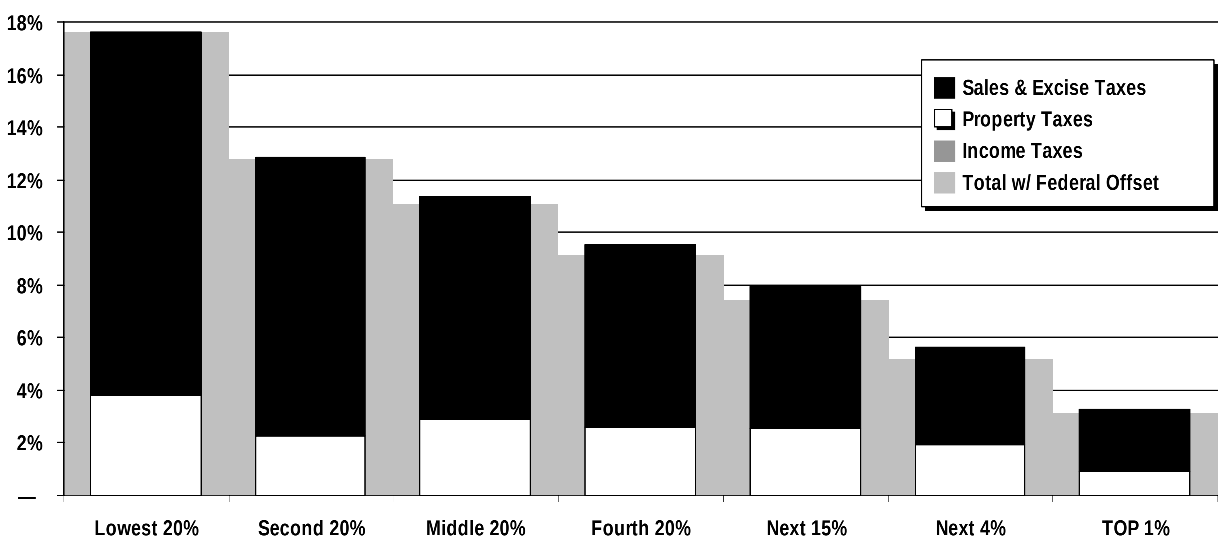
What Makes the Washington Tax System Regressive?

A January 2003 ITEP report, *Who Pays*, found that Washington had the most regressive tax system in the country. The report showed that the poorest twenty percent of non-elderly Washington families paid, on average, 17.6 percent of their income in state and local taxes. By contrast, middle-income Washingtonians paid 11.3 percent of their income in tax, while the very wealthiest 1 percent of Washington taxpayers paid just 3.3 percent of their income in state and local taxes. In other words, the poorest Washingtonians paid five times more of their income in tax than did the very wealthiest families.

The ITEP report identified two principal reasons for this unfairness in the Washington system. First, Washington is one of only nine states that do not currently levy a personal income tax. Second, Washington relies more heavily on sales taxes than any other state. Because sales taxes hit low-income taxpayers heaviest as a share of income, and personal income taxes generally require wealthier taxpayers to pay more of their income in tax, this extreme imbalance makes the tax system especially unfair.

Washington State & Local Taxes in 2002

Shares of family income for non-elderly taxpayers



What the Sims Plan Would Do

The Sims plan would make the following changes to the Washington tax system:

- **Repeal the Business and Occupation Tax**. The B&O tax is the state's only general business tax. Unlike the business taxes used by most states, the B&O tax is based on a business' gross receipts, rather than corporate profits. As a result, the B&O tax is ultimately passed through to consumers as a hidden sales tax.
- **Repeal the State Sales Tax**. The plan would eliminate the current 6.5 percent state sales and use tax, while leaving local sales taxes intact.
- **Property Tax Swap.** The plan would introduce a $100,000 homestead exemption from the state portion of the property tax, which would be paid for by increasing the state property tax rate on all remaining taxable property. Overall statewide property tax collections would remain unchanged.
- **Enact a Personal Income Tax.** The tax would exempt the first $30,000 of income for married couples ($15,000 for singles) and would allow an additional $10,000 exemption for each dependent. Income would be taxed at rates ranging from 4 to 10 percent; families with incomes over $100,000 would pay at the top rate.

The following table shows the distributional impact of the Sims plan:

- The poorest 80 percent of the income distribution would see, on average, a cut in state and local taxes under the Sims plan, with the largest tax cuts going to the very poorest taxpayers.
- The wealthiest 20 percent of Washingtonians would, on average, see an increase in state and local taxes under the Sims plan.
- The total amount of state and local taxes paid by Washington residents would increase by $272 million if these changes were enacted in 2003.

Impact of Ron Sims Tax Plan
All Washington Taxpayers, 2003 levels

2003 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%	
Income Range	Less Than $17,000	$17,000 – $30,000	$30,000 – $47,000	$47,000 – $72,000	$72,000 – $134,000	$134,000 – $361,000	$361,000 – Or More	**$ Impact on State Residents**
Average Income in Group	$10,000	$23,000	$38,000	$59,000	$95,000	$188,000	$1,210,000	
Tax Change as % of Income								
Repeal B&O Tax	–2.5%	–1.8%	–1.5%	–1.2%	–0.9%	–0.6%	–0.3%	$ –1,601,000
Eliminate State Sales Tax	–6.3%	–5.2%	–4.6%	–4.0%	–2.9%	–1.8%	–0.8%	$ –4,847,000
$100,000 HSE-Prop Swap	–0.4%	–0.2%	–0.2%	–0.2%	–0.1%	+0.0%	+0.1%	$ –127,000
Graduated PIT	+0.0%	+0.7%	+1.4%	+2.4%	+4.2%	+6.8%	+8.7%	$ +6,847,000
Total State Tax Change	**–9.2%**	**–6.6%**	**–4.9%**	**–2.9%**	**+0.3%**	**+4.5%**	**+7.7%**	**$ +272,000**
Associated Federal Tax Change	—	–0.0%	–0.1%	–0.3%	–0.7%	–1.2%	–3.0%	$ –1,523,000
Net Distributional Impact of Sims Tax Plan After Federal Tax Changes								
Tax Change as % of Income	**–9.2%**	**–6.6%**	**–5.0%**	**–3.1%**	**–0.4%**	**+3.4%**	**+4.7%**	**$ –1,251,000**
Average Net Tax Change	–924	–1,541	–1,884	–1,850	–347	+6,360	+56,629	

SOURCE: Institute on Taxation and Economic Policy, August 2004

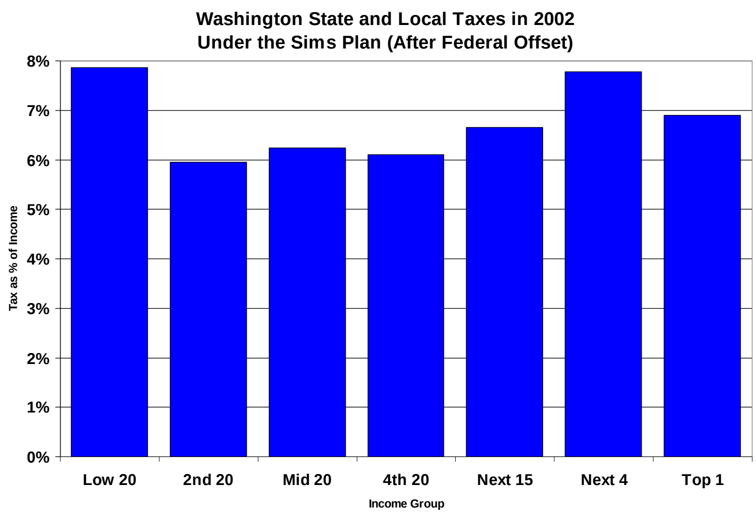
How the Sims Plan Affects Federal Income Taxes

The Sims plan would also have a substantial impact on the *federal* income taxes paid by Washingtonians. Taxpayers itemizing their federal income taxes can write off their state and local income and property taxes as an itemized deduction. But taxpayers living in no-income-tax states (like Washington) are unable to take advantage of this write-off. If the Sims plan were implemented, federal itemizers living in Washington would be able to deduct their state income tax payments from their federal income. As a result:

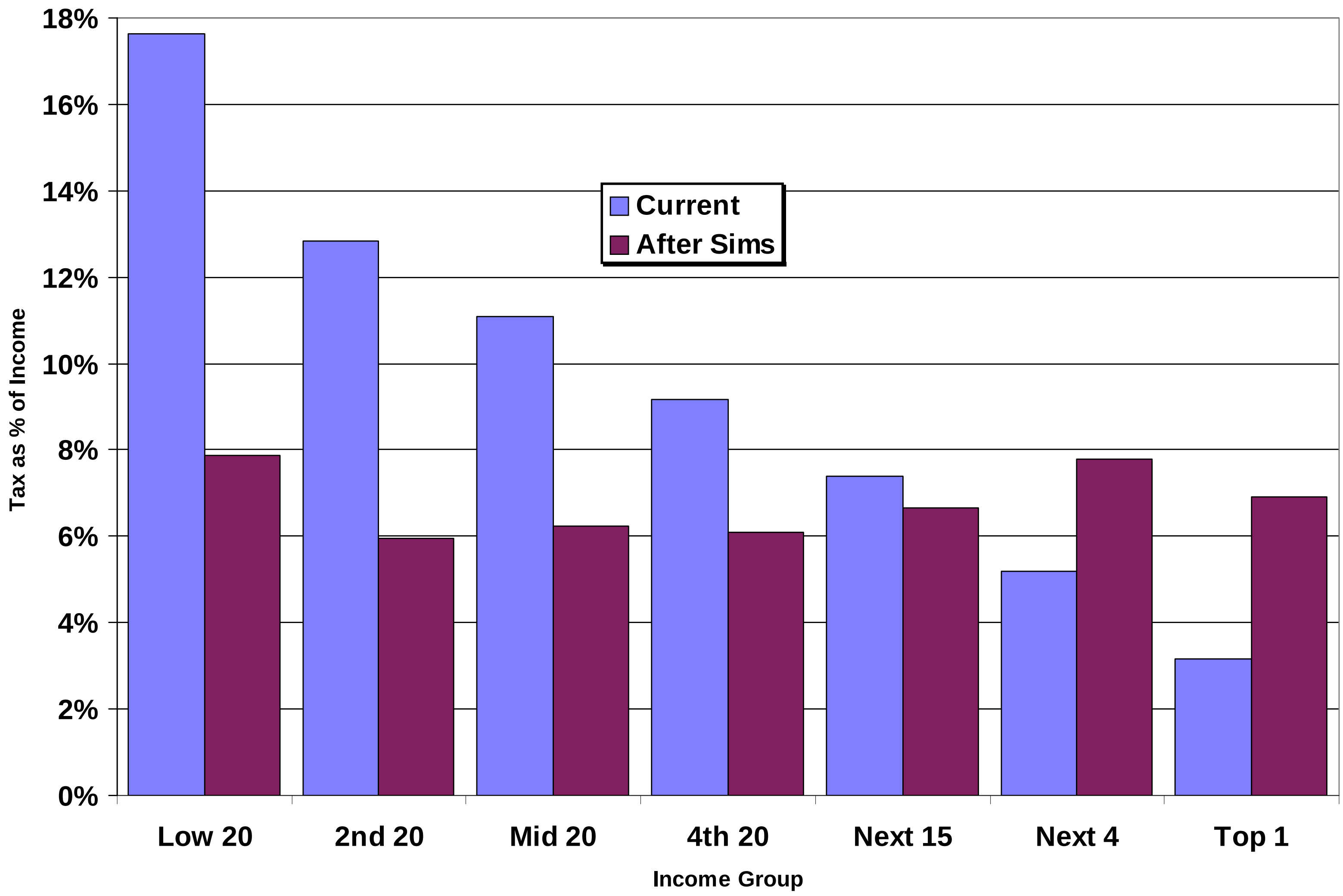
- Wealthier Washington itemizers would be able to reduce their effective state income tax liability by up to a third.
- Federal taxes paid by Washington State residents would go down by over $1.5 billion.
- This means the overall impact of the Sims plan on federal and state taxes paid by Washingtonians is a $1.25 billion tax cut.
- When federal tax changes are taken into account, only the wealthiest five percent of the income distribution would, on average, see a net tax increase from the Sims plan.

How the Sims Plan Would Affect Tax Fairness in Washington

The Sims tax plan would drastically change the incidence of state and local taxes in Washington. If the Sims plan had been fully implemented in 2002, Washington would rank not as the most unfair tax system in the nation, but as the *least* unfair tax system. The chart at right shows the incidence of the Washington tax system (including the "federal offset") in 2002 after implementing the Sims plan. As the chart shows, the Washington tax system would be much less regressive if the Sims plan were enacted. However, low-income Washingtonians would still pay more of their income in taxes than taxpayers in all higher income groups, on average, if the plan were fully implemented. In other words, the Sims plan would go a long way toward reducing the unfairness of the Washington tax system—but even if these ambitious reforms were enacted, the very poorest Washingtonians would still pay more of their income in tax than wealthy Washingtonians.



APPENDIX: STATE AND LOCAL TAXES IN 2002 BEFORE AND AFTER IMPLEMENTING THE SIMS TAX PLAN (AFTER FEDERAL OFFSET)



About ITEP: ITEP is one of the leading research and education organizations in the country working on government taxation and spending policy. Since its founding in 1980, ITEP's work has played a key role in educating the public and informing federal and state tax policy. ITEP's website is http://www.itepnet.org .

The analysis presented here was conducted using the ITEP microsimulation tax model. Since 1996 ITEP has used this model to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data that is extrapolated to the year being analyzed. This is the type of tax model used by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, the Congressional Budget Office, and many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. Included in the sample are federal tax returns, with statistically valid samples from every state and the District of Columbia. A sampling of records from the U.S. Decennial Census five percent sample (which contains a random sample of five percent of all census forms received by the Census Bureau) are also included, and statistically matched with the tax return records. Other data sets are used to impute detailed expenditures for each record and other information. The data on the records is extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and government and other widely respected macro data sources. (A complete description and methodology for the ITEP model is available on request.)