

Economic Vitality

Analysis of the current tax system found three problems with economic vitality that should be addressed.

- Washington State's tax system differs considerably from other states' tax systems.
- For most types of businesses, total tax burden in Oregon is less than in Washington.
- Washington's tax system is burdensome to businesses in their unprofitable years, such as when they are expanding.

The alternative to exempt construction labor from retail sales tax addresses each of these problems. Washington is one of only seven states that imposes sales taxes on construction labor. Exempting labor construction from sales tax would make our treatment of construction activity consistent with other states, including Oregon.

Construction costs can be a large component of expansion costs. Exempting construction labor would considerably decrease the cost of this type of expansion.

The alternative to increase the B&O credit from \$35 to \$70 provides tax relief for some new businesses.

Descriptions of the Alternatives Intended to Primarily Address Economic Vitality

Exempt construction labor from sales tax

Description: Washington is one of only a few states that impose sales tax on the labor portion of a construction contract. Currently, the retail sales tax is imposed on the entire contract price for a custom-built home, including labor, materials, and other overhead.

This proposal would provide an exemption for that portion of the contract attributable to labor. Contractors would separately account for labor and overhead by separate invoices or some other mechanism. Sales tax would only apply to the overhead and materials portion of each contract.

Proposed Tax Base: Sales tax would only apply to overhead, materials, and other non-labor costs for construction contracts.

Proposed Tax Rate: 6.5 percent state sales tax, appropriate local sales taxes.

Estimated Revenue Loss: CY 2005: \$400 million

Problems Addressed:

Economic vitality – Exempting construction labor would make our treatment of construction consistent with other states, including Oregon.

Regressivity – Exempting construction labor on home construction would lower the price of building new homes. Higher income households spend a smaller percentage of their income on homes.

Home ownership – This proposal covers both commercial and residential construction. Decreasing the cost of building homes could encourage home ownership.

Volatility – This would decrease the tax on a very volatile portion of the economy.

Tax harmony with other states – Washington would be consistent in taxation of construction compared to most other states.

Simplicity – Exempting construction labor from retail sales tax could allow contractors to pay sales tax on materials at the time of purchase instead of at the end of the project. This would help both retailers and contractors by eliminating the need for resale certificates and complex record-keeping.

Problems Created:

Adequacy – One of the reasons that Washington's sales tax base is broader than other states is because of the high reliance on sales tax. This alternative would significantly decrease the sales tax base. If implemented, alternative revenues would have to be provided.

Other States with Similar Programs: As of 1994, only seven states including Washington taxed labor construction. These states are Arizona, Hawaii, Kansas, Mississippi, New Mexico, South Dakota and Washington.

A majority of the Committee recommends that the Legislature exempt construction labor from retail sales tax if the exemption is revenue neutral (i.e. the loss of revenue is offset by another source of revenue).

Increase the B&O tax credit from \$35 to \$70

Description: Currently, small businesses are entitled to a credit against their B&O tax. The maximum credit available is \$35 per month. The credit is phased out for larger businesses; as a business' tax liability increases beyond \$35 per month, the