

Sales and Use Tax

*Overview of Seattle's retail sales and use tax
March 2003*

INTRODUCTION

The purpose of this document is to provide a basic overview of Seattle's retail sales and use tax and its role in City finances. This is not a comprehensive review of the sales tax; many details and technical issues are not addressed.

The retail sales and use tax is Seattle's second largest source of revenue for general government purposes, accounting for 20% of Seattle's general fund revenue in 2002. The state administers and collects the tax, and sends Seattle its share each month.

Tax base

The retail sales tax is levied on the selling price of goods and certain services purchased at retail by final consumers. Consumers include individuals, businesses, and nonprofit or government agencies. A purchase of goods for resale is considered a wholesale sale, and is not subject to the sales tax. In general the tax applies to:

- Sale of goods
- Construction including labor
- Repair of tangible personal property
- Lodging for less than 30 days
- Telephone service
- Participatory recreation services
- Physical fitness services
- Landscape maintenance

Some items that fall within the above listing have been exempted from the sales tax. Examples include food purchased for off-site consumption, prescription drugs, and local residential telephone service.

The use tax, which has the same tax base and rate as the sales tax, applies to purchases on which the sales tax is not collected by in-state businesses. Examples include vehicles sold by private individuals and some purchases from out-of-state businesses. Purchasers are expected to pay use tax on all out-of-state transactions, but the tax is difficult to enforce at the consumer level.

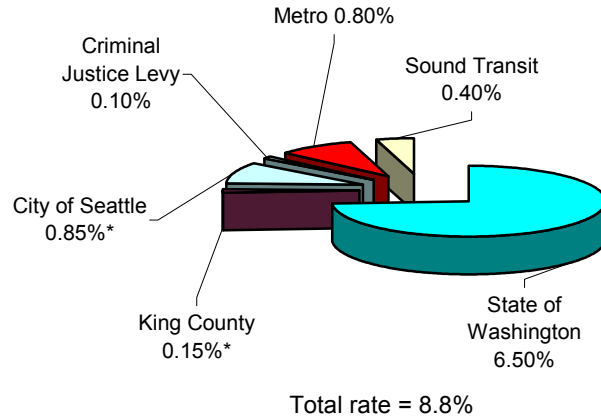
Distribution of sales tax collections

The retail sales tax has both a state and a local component. The tax base, which is established by the state, is the same for both. However, there are separate rates for state government, local governments (cities and counties), and a variety of special purposes, including transit, criminal justice, and stadiums. Some of the special purpose taxes can be levied only with voter approval.

The sales tax rates that apply within the city of Seattle are shown in Figure 1. The total sales tax rate in Seattle is 8.8%, with the exception of a 9.3% rate that applies to food and beverages purchased in restaurants and bars. The extra 0.5% is used to pay for construction of the baseball stadium. Local sales tax is collected at a 1.0% rate, and the revenue is split between the City of Seattle, which gets 85%, and King County, which gets the remaining 15%. Thus city government receives approximately 10% of the

total sales tax revenue collected within Seattle. The state, with a rate of 6.5%, gets nearly three-quarters of the revenue collected in Seattle.

Figure 1. Sales and use tax rates in Seattle



*Local tax rate is 1.0%: revenue is split between Seattle (85%) and King County (15%).

Grouping the components of the sales tax rate by type of recipient (see Figure 2) reveals that local transit (Metro and Sound Transit) receives a larger share of the tax collected in Seattle than does general purpose local government (City of Seattle and King County).

Figure 2. Sales and use tax rates by recipient

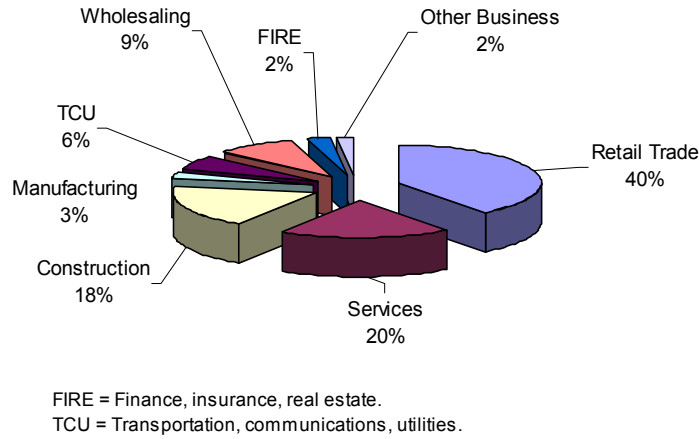
State government	6.5%
Local government	1.1%
Local transit	1.2%

Local sales tax collections are distributed to local jurisdictions based upon the location of the retail outlet at which the purchase is made. For retail transactions involving construction, repair, or other service activity, the tax revenue goes to the jurisdiction in which the service is performed. For purchases from out-of-state businesses and lease or rental of goods, the jurisdiction in which the goods are first used receives the tax revenue.

Taxable retail sales by industry

In 2002, the retail trade sector accounted for the largest share of Seattle's sales tax base, 40%. Other large sectors were services, construction, and wholesale trade (see Figure 3). Within the retail trade sector, the largest industries were auto dealers and service stations, eating and drinking places, and miscellaneous retail, a category that includes a variety of specialty retailers such as jewelry stores and toy stores.

Figure 3. Seattle taxable retail sales by industry, 2002



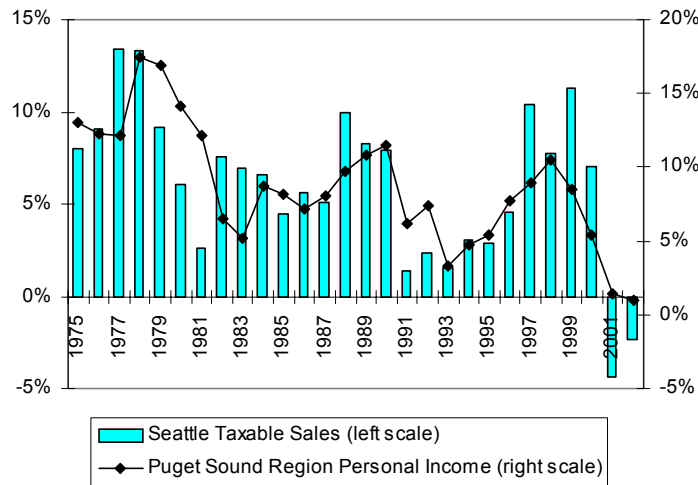
Over time the composition of the sales tax base has changed, as retail trade's share of total taxable sales has dropped from the 50% range in the mid-1970s to 40% in 2002. Wholesale trade and manufacturing have also seen their share decline. Offsetting these drops has been an increase in the share of taxable sales from services, construction, and communications.

Revenue from the sales tax

In 2002, the City of Seattle received \$126.2 mil. from sales tax sources, \$115.3 mil. from its local sales tax levy and \$10.9 mil. from the King County criminal justice levy. Revenue from the county criminal justice levy, which must be used for criminal justice purposes, is shared between county government and King County cities.

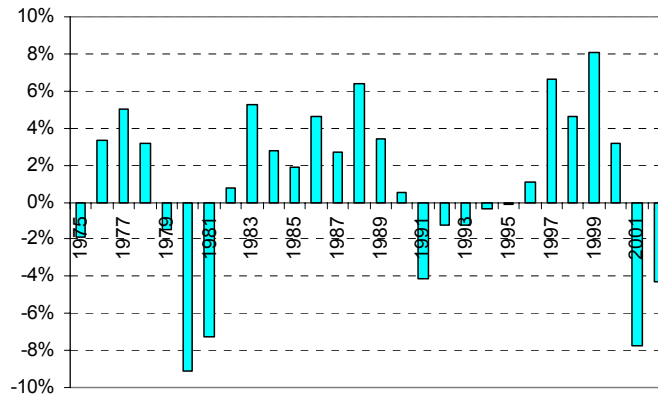
The growth of sales tax revenue over time is determined by economic conditions. Tax revenue grows rapidly when the economy expands and grows slowly or declines when the economy is stagnant or in recession. This relationship is reflected in Figure 4, which shows the historical growth of Seattle taxable retail sales and Puget Sound region personal income. 2001 and 2002 are the only years since at least the early 1970s in which revenue declined from the previous year.

Figure 4. Annual growth of Seattle taxable retail sales and regional personal income



Removing the effects of inflation from the taxable sales data yields a data series that shows the real (i.e., inflation-adjusted) growth of taxable retail sales (see Figure 5). Real taxable sales growth has turned sharply negative during recessions (1980-82 and 2001-02), and was also negative in the early 1990s when the region's economy was stagnant and the nation was in recession. The highest growth rate of the past 28 years occurred in 1999, at the height of the internet, stock market, and high-tech booms. Average annual real growth over the period 1974-2002 was 0.8% (i.e., 0.8% above the rate of local inflation).

Figure 5. Annual growth of real (inflation-adjusted) Seattle taxable retail sales

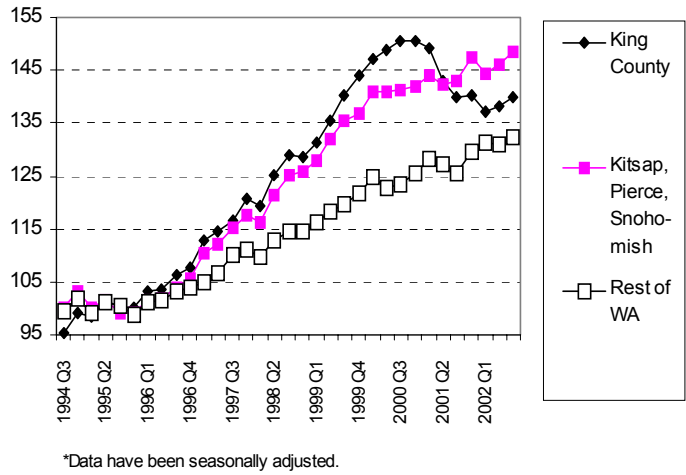


Recent trends in taxable retail sales

Seattle's sales tax revenue has moved through a very volatile period since the mid-1990s. Seattle and the Puget Sound region were strong participants in the high-tech, internet, and stock market booms of the late-1990s. Rising employment and very strong income growth, particularly at many high-tech and internet firms, led to robust growth in taxable retail sales.

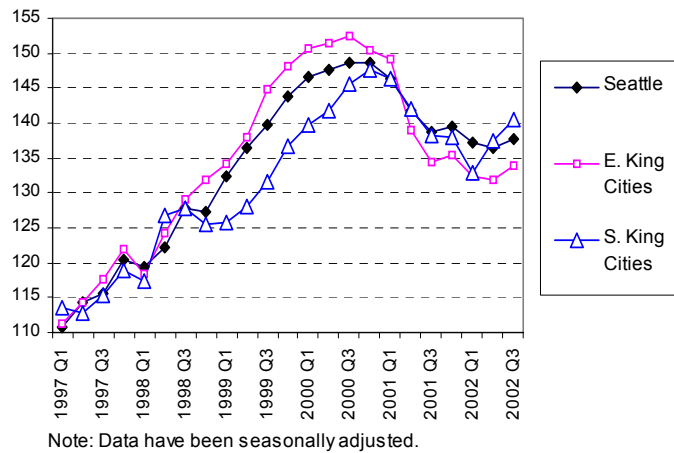
The recession that followed the boom has hit the Puget Sound region much harder than most areas of the nation. Regional employment has fallen by more than 5% from its pre-recession peak in late 2000, compared to a drop of less than 1½% nationally. The impact of the September 11 attacks has been particularly devastating due to its effects upon air travel and the Boeing Company. Figure 6 makes use of taxable retail sales data to illustrate the extent to which the current downturn has been focused in King County.

Figure 6. Taxable retail sales for regions within Washington: 1995=100



Within King County, cities in the eastern part of the county experienced the sharpest increase in taxable sales during the late-1990s boom, as well as the biggest drop during the current recession (see Figure 7). Compared to east King County, Seattle and south county cities experienced greater stability over the recent cycle. Nevertheless, Seattle's taxable retail sales declined by 8.4% from its peak in the 3rd quarter of 2000. If the effects of inflation are removed, the decline increases to 12.6%. Industries experiencing the sharpest drops include wholesale trade, communications, auto dealers, and furniture stores.

Figure 7. Taxable retail sales, King County cities: 1995 = 100



Forecasting sales tax revenue

For budgeting purposes, the City needs to forecast sales tax revenue two years into the future. For longer-term financial planning, forecasts are made over a 10 year time horizon.

Since the growth of sales tax revenue over time is determined by the growth of the local economy, the City uses economic models to make forecasts of sales tax revenue. These models identify historical relationships between economic activity and taxable retail sales. These relationships are then used, along with a forecast of future economic activity, to develop a forecast of future taxable sales. The forecast is

developed at an industry level because individual industries react differently to changing economic conditions.

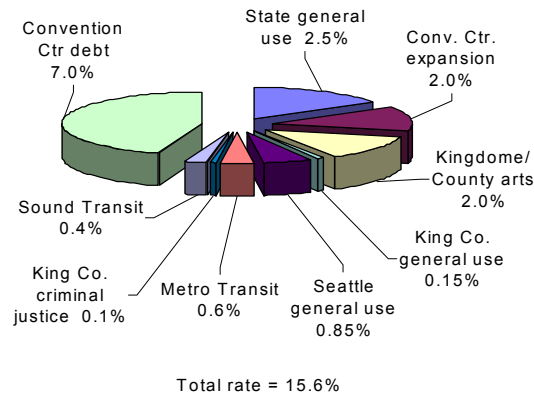
The City's most recent forecast of sales tax revenue, which was prepared in November 2002, anticipates a return to growth in 2003. Sales tax revenue is expected to increase by 2.4% in 2003 and 3.0% in 2004.

The hotel/motel and rental car taxes

In addition to the general sales taxes described above, there are selective sales taxes which are imposed on the purchase of specific items. Two that are relevant to Seattle are the hotel/motel and rental car taxes.

Within the City of Seattle, the tax rate for hotel and motel facilities with 60 or more units is 15.6%. This rate includes the 7.0% convention center tax; the remaining 8.6% represents the regular state and local sales tax rate - with the exception that the rate for Metro Transit is 0.6%.* In addition, the state takes only 2.5% of its 6.5% levy. The remaining 4.0% of the state's levy is used to finance convention center expansion, pay off Kingdome debt, and support arts activity in King County (see Figure 8). After the Kingdome debt is paid off in 2015, the 2% that is currently used for Kingdome debt and arts activity will be redirected to pay off debt on the Seahawks Stadium through 2020.

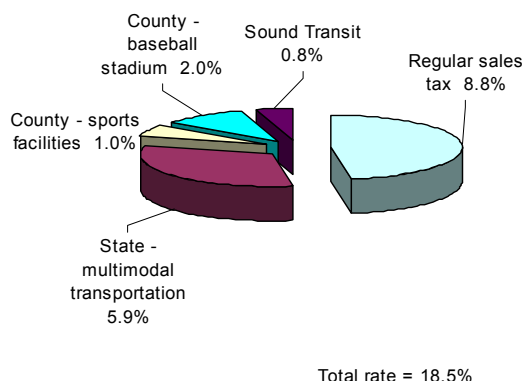
Figure 8. Hotel/motel tax



*The 0.2% rate increase for Metro Transit that went into effect in April 2001 does not apply to lodging facilities subject to the convention center tax.

The rental car tax rate of 18.5% consists of the 8.8% regular state and local sales tax rate as well as the additional components shown in Figure 9. Revenue from the 1.0% county rate for sports facilities is used to retire Kingdome debt and support youth sports activity.

Figure 9. Rental car tax



Taxation of internet and catalog sales

With the rise of sales made via the internet, taxation of remote (i.e., internet, catalog, and mail order) sales is an increasingly important sales tax issue. One major concern is loss of revenue. The Washington Dept. of Revenue estimates that \$257 million in Washington state and local sales tax revenue is currently lost to remote sales. This figure will only grow larger over time.

A second concern is equity. Under current practices, a sale made by a traditional retailer will result in the sales tax being paid, while the purchase of the same product from a remote seller often goes untaxed. The result is that different types of retailers (traditional vs. remote) are treated differently, as are different types of purchasers (in-person vs. remote).

Under current law, Washington residents owe sales and use tax on purchases made from out-of-state sellers. However, as a result of U.S. Supreme Court decisions, out-of-state retailers are not required to collect the tax, unless they have a physical presence or “nexus” within the state. The court’s reasoning was that requiring out-of-state sellers to collect the tax was too burdensome given the complexity of the sales tax system across the nation’s cities and states in terms of composition of the tax base, tax rates, exemptions, etc.

To address the court’s concerns regarding the sales tax’s complexity, 39 states (including Washington) have joined in a project to simplify and modernize the tax. The goal of the project is to provide states with a streamlined sales tax system that includes the following features:

- Uniform definitions within state tax laws
- Tax rate simplification
- State level administration of local sales taxes
- Simplified exemption rules
- Uniform audit procedures

Once a significant number of states implement the streamlined sales tax system, the states will petition Congress to grant the states the power to require remote sellers to collect the tax.