



POLICY BRIEF

Citizens' Guide to Initiative 1098 *To Establish a State Income Tax*

by Paul Guppy
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Key Findings

1. I-1098 would enact a 5 percent tax on incomes over \$200,000 for individuals and \$400,000 for couples.
2. I-1098 would reduce the state's portion of the property tax by 20 percent (amounting to a 4 percent overall reduction in property taxes) and increase the B&O tax exemption to \$4,800.
3. If voters approve I-1098, after two years lawmakers can increase the tax rates and extend the income tax to anyone.
4. By enacting an income tax, Washington would be giving up a significant competitive advantage in relation to other states.
5. Passage of I-1098 would instantly raise Washington's income tax rate from zero to the fourth highest in the country.
6. Under I-1098, a person could donate 100 percent of his yearly income to charity, and still owe income tax to the state.

Introduction

In November the people of Washington will again vote on whether to impose a state income tax. The income tax proposal will appear on the ballot as Initiative 1098. Currently Washington is one of only nine states that do not impose a general income tax on citizens.¹

The people of Washington first considered an income tax in 1932, when it was enacted by a large majority. In 1933 the measure was struck down by the state supreme court as a violation of the constitution's uniformity clause (discussed below). In the years since 1932 Washington voters have rejected a state income tax four times, and the supreme court has invalidated income tax bills passed by the legislature.²

Initiative 1098 is different from past proposals. In the past, an income tax was presented to voters in the form of a constitutional amendment, in order to avoid the uniformity clause violation identified by the supreme court. Initiative 1098 is different in three ways.

- It is presented to voters as a proposed state law, not as a constitutional amendment
- As a "high-earners" tax, it would impose a two-tier tax on residents above a certain income level, not a graduated tax directed at most income earners
- It includes cuts in two existing taxes, in addition to the creation of a new tax

This Citizens' Guide describes the main provisions of Initiative 1098, how much revenue it would raise, and how a new tax on high-earners would affect charitable giving. The study explains the impact Initiative 1098 would have on the business climate and Washington's competitiveness compared to other states. It also examines whether Initiative 1098 is constitutional, describing past state supreme court income tax rulings and whether they are relevant today. Finally, this study examines the arguments made by Initiative 1098 proponents, particularly those involving fairness, revenue stability, funding for public schools, and whether the legislature would keep the tax limited only to higher-income people once it were in place.

¹ The other states are Alaska, Florida, South Dakota, Nevada, New Hampshire, Tennessee, Texas and Wyoming. New Hampshire and Tennessee tax interest and dividend income, but do not tax wages and salaries.

² Voters rejected income tax proposals in 1934 (House Joint Resolution 11), 1970 (House Joint Resolution 42), 1973 (House Joint Resolution 37), and 1975 (Initiative to the People 314), "Income Tax Votes," Office of the Secretary of State, Elections and Initiatives, at www.wei.secstate.wa.gov/osos/en/Pages/incometaxvotehistory.aspx.

Description of Initiative 1098

The ballot title and summary for Initiative 1098 reads:

“Initiative Measure No. 1098 concerns establishing a state income tax and reducing other taxes.”

“This measure would establish a tax on ‘adjusted gross income’ (as determined under the federal internal revenue code) above \$200,000 for individuals and \$400,000 for married couples or domestic partners filing jointly; reduce the limit on statewide property taxes by 20%; and increase the business and occupation tax credit to \$4,800. The tax revenue would replace revenues lost from the reduced levy and increased credit; remaining revenue would be directed to education and health services.”

“Should this measure be enacted into law? Yes [] No []”

As the summary indicates, the text of Initiative 1098 has three main parts:

1. It would reduce the state portion of the property tax by 20 percent (Section 301).

The state portion of the average property tax bill is 21 percent, so the total reduction for most property owners would be about 4 percent. For individual property owners the net annual reduction would be modest; the average homeowner in King County would save about \$180 per year. The provision does not limit increases imposed by counties, cities and junior taxing districts. After two years state lawmakers could increase the state portion of property taxes by a simple majority vote.

2. It would increase the Business and Occupation (B&O) tax credit to \$4,800 per year (Section 302).

This represents a large change in the allowable B&O tax credit. The B&O tax obligation of about 118,000 small businesses would fall to zero. A further 39,000 businesses would see their yearly B&O tax reduced. All business owners would benefit from a slightly improved tax environment, and the increased tax credit would modestly improve the business climate by spurring new investment and job creation.

3. It would create a state income tax (Section 501).

Initiative 1098 would impose an income tax of 5 percent on adjusted gross income over \$200,000 for individuals and \$400,000 for couples. The tax rate would rise to 9 percent on adjusted gross income over \$500,000 for individuals and \$1 million for couples. Because the tax applies to adjusted gross income, the usual deductions used to lower federal taxable income would not be allowed when calculating the state income tax.

The tax and income levels would also apply to out-of-state residents, who would be required to pay taxes to Washington on adjusted gross income “derived from sources within this state” (Section 701).

The income limits mean the tax would be targeted to 1.2 percent of state residents, although after two years the legislature could expand the application of the tax by a simple majority vote.

To illustrate how the income tax would work, an individual with annual adjusted gross income of \$300,000 would pay the state 5 percent on the amount

over \$200,000, or \$5,000 in tax. A couple with adjusted gross income of \$1.2 million would pay 5 percent on the amount between \$400,000 and \$1 million, plus 9 percent on the amount over \$1 million, for a total tax payment of \$48,000.

Initiative 1098 would go into effect on January 1, 2012 (Section 1003). On that date employers would be required to begin withholding estimated income tax payments from employee paychecks (Section 801). The initiative makes the employers personally liable to the Department of Revenue for these payments (Sections 802 and 804). State income taxes for 2012 would be due on April 15, 2013. After that date the state would add interest and penalty charges to the amount of unpaid tax, and failure to pay would make a person subject to prosecution under state law (Section 805).

The increased B&O tax credit would go into effect in 2012. Property taxes for 2012 are collected in 2013, so property owners would see no reduction in their taxes until then.

The net additional revenue collected each year (after deductions for revenue devoted to B&O and property tax cuts) would be divided between new spending on public education and health programs. Education programs would receive 70 percent of the additional revenue; health programs would receive 30 percent (Section 201).

The Financial Impact of Higher Taxes

Total revenues for the first year are estimated at \$2.2 billion. Below is a description of how the revenues from the first year's collections would be divided.³

Table 1: Washington State Estimated Income Tax Collections in 2012

Total estimated collections: \$2.2 billion
11% (\$250 million) to increasing the B&O tax credit
17% (\$383 million) to lowering the state portion of the property tax
50% (\$1.106 billion) to new spending on public education
22% (\$474 million) to new spending on health care programs

Nearly three-quarters, (72 percent, or \$1.58 billion) of the revenue from the increased tax burden would be directed to expanding state programs, while a little over one-quarter (28 percent, or \$633 million) would be devoted to reducing business and property taxes. The state Office of Financial Management estimates collections from the income tax would increase by 3 percent per year.⁴ Over the first five years the tax is expected to bring in \$11.16 billion to the state treasury, to be allocated in about the same proportions as shown in the table above.

At first about 64,400 Washingtonians, or 1.2 percent of the population, would have to pay the new income tax. The tax would be reported on 12,400 individual tax returns and 26,000 married couples, heads of household and widow returns.⁵ The tax rates in Initiative 1098 are not indexed to inflation.

³ "Fiscal Impact for Initiative 1098," Washington State Office of Financial Management, August 2010, at www.ofm.wa.gov/initiatives/2010/1098.pdf.

⁴ "Fiscal Impact for Initiative 1098," Washington State Office of Financial Management, August 2010, at www.ofm.wa.gov/initiatives/2010/1098.pdf.

⁵ Ibid.

Policy Analysis

Initiative 1098 would have a number of wide-ranging effects on the people of Washington state. This section analyzes these effects and examines the claims of income tax proponents.

1. Initiative 1098 Creates a New Way to Tax

Income tax proponents describe Initiative 1098 as “real tax reform” that is needed to change the state’s “unfair and inadequate tax system.”⁶ Yet Initiative 1098 would make no fundamental changes in the current tax code, beyond modest reductions in two existing taxes – changes that could easily be reversed by legislative action.

The tax system is currently based on three main revenue sources: the property tax, the B&O tax and the sales tax. Initiative 1098 leaves these taxes in place while adding a fourth way for the state to tax its citizens – an income tax.

Initiative 1098 would leave the sales tax unchanged, even though income tax proponents cite the sales tax as one that is “...regressive and stunts business growth.”⁷ They say the sales tax is a primary reason for enacting tax reform and note that low-income families pay a larger share of their income than other families to the state in sales tax. Passage of Initiative 1098 would do nothing to change that. This point will be addressed further in the section on tax fairness.

2. The Income Tax would Likely be Extended to More People

Unlike past efforts, Initiative 1098 is drafted as an ordinary law, not as an amendment to the state constitution. This makes it easier for the income tax to be extended to more people in the future. The legislature could change Initiative 1098 in the short-term with a two-thirds vote, and after two years could change it by a simple majority vote, just like any other part of the legal code. Both approaches would require the governor’s signature.

The initiative text says no changes could be made without a vote of the people (Section 1004), but this provision has no binding effect, and is itself subject to amendment or repeal by the legislature. Initiative 1098 contains no taxpayer protections against lawmakers increasing income tax rates to collect more revenue, or lowering the income thresholds to apply the tax to more people.

The reason the income tax, once in place, would likely be expanded is lawmakers in Olympia have repeatedly demonstrated their willingness to increase the rate and broaden the application of a new tax in the years following its enactment. Examples include:

- The first state sales tax was 2 percent, today the state tax is 6.5 percent
- The first state gas tax was one cent per gallon, today the state tax is 37.5 cents per gallon
- The payroll tax for unemployment compensation started at 1.8 percent, today can be as high as 5 percent

⁶ “A Message from Bill Gates Sr. upon the Certification of I-1098 for the November Ballot,” Yes on 1098 campaign, at www.yeson1098.com, accessed August 19, 2010.

⁷ Initiative 1098, Section 1001.

- Property tax rates started at under \$1 per thousand dollars of assessed value, today rates are closer to \$10 per thousand dollars of assessed value
- This year lawmakers extended the sales tax to certain foods and beverages, such as candy, soda and bottled water.

Americans experienced a similar pattern after the federal income tax was enacted. The initial federal income tax rate started at 1 percent and applied only to the very wealthiest people in the country; less than 1 percent of the population.⁸ In the years following, however, Congress progressively increased tax rates and lowered income thresholds, until paying the income tax became a permanent part of monthly expenses for most working households.

Because Initiative 1098's income levels are not indexed to inflation, the tax would automatically be extended to more people every year even without changes by the legislature. For this reason federal income tax rates are indexed to inflation, so people are not required to pay higher taxes if their incomes have not increased in real terms.

It is impossible to know whether lawmakers would vote to expand the income tax after it was created. The historical data indicate, however, that in Washington new taxes usually start out small and grow over time, and the same trend would likely occur with an income tax. The legislature's past actions are the best indicator of its future performance.

3. Income Tax Revenue May Not Go to Promised Purposes

Income tax proponents say Initiative 1098 would "...provide a stable, dedicated funding source for education and health care,"⁹ but there is no assurance the new funds would actually be devoted to these purposes. Lawmakers routinely shift money among accounts, to preserve favored programs, in response to political pressures, or to pay for wage and benefit increases negotiated under the 2002 collective bargaining law.

As noted, after two years a majority of lawmakers could change Initiative 1098's provisions in any way they like. There are numerous examples of the legislature amending, suspending and repealing voter-passed initiatives. Earlier this year lawmakers suspended the tax limitation and public disclosure provisions of Initiative 960.¹⁰ In recent years lawmakers have reduced education spending under voter-approved Initiative 728 (class size reduction) and Initiative 732 (teacher pay increases).¹¹ The Secretary of State reports that over the years the legislature has altered or suspended more than 30 voter-approved initiatives.¹²

Lawmakers often divert tax revenues from their intended purposes. This year the legislature transferred tax revenue totaling more than \$1 billion from 33

⁸ "History of the U.S. Tax System," Fact Sheets: Taxes, U.S. Department of the Treasury, at www.ustreas.gov/education/fact-sheets/taxes/ustax.shtml.

⁹ "We're a coalition of Washington State businesses, labor and respected civic leaders like Bill Gates, Sr." Yes on 1098 campaign, accessed June 11, 2010, at www.yeson1098.com/about.html.

¹⁰ Senate Bill 6130, passed February 22, 2010 and signed by Governor Gregoire on February 24, 2010.

¹¹ "Governor's office projects \$3 billion shortfall for 2011-2013," by Andrew Garber, *The Seattle Times*, June 17, 2010.

¹² "Suspending initiatives? Controversial but common," by David Ammons, From Our Corner, Office of the Secretary of State, February 25, 2010, at www.blogs.sos.wa.gov/FromOurCorner/index.php/2010/02/suspending-initiatives-controversial-but-common/.

dedicated trust accounts, some created by voter initiative, and spent those funds on general programs.¹³

Following are examples of trust accounts from which funding was taken in 2010:¹⁴

- The School Construction Account (\$193 million)
- The Education Savings Account (\$51 million)
- Aquatic Lands Enhancement Account (\$10 million)
- Washington Graduate Fellowships Trust (\$1.4 million)
- Energy Freedom Account (\$6 million)
- Savings Incentive Account (\$9 million)
- Tobacco Prevention and Control Account (\$20 million)
- Life Sciences Discovery Account (\$26 million)

Once in place, the income tax would function like any other part of the tax code, and the revenue from it would be subject to the same legislative oversight and appropriations authority that control other state funding sources. Revenue from the income tax would be placed in the state treasury and, like all public money, would become subject to allocation among the many competing priorities within the budget.

4. More Money will Not Help Public Schools

Even if 70 percent of net new revenues from Initiative 1098 were devoted to education spending as promised, Washington's public education experience and long-term research show that simply increasing spending does not improve learning outcomes for children.

Taxpayers contribute over \$10 billion per year toward the education of slightly less than one million public school students in Washington. Public school districts currently spend an average of \$10,100 per student per year, the highest level in state history. The largest budget item, comprising 83 percent of spending, is devoted to salaries and benefits. The statewide average for teacher pay with benefits is \$79,200. Average pay with benefits for school administrators is \$117,000.¹⁵

The level of spending in major school districts is even more striking. Seattle spends \$12,746 per student per year, a 36 percent increase in five years. In Seattle average teacher pay with benefits is \$92,100. Average administrator pay with benefits is \$106,900. In Spokane average teacher pay with benefits is \$81,300. Average administrator pay with benefits is \$107,700.¹⁶

State education spending has increased sharply in recent years, rising by more than 60 percent since 1999.¹⁷ The chart below shows the rising trend in education spending since 1982.

¹³ "2009-2011 Washington State Omnibus Operating Budget Cash Transfers to/from General fund-State," 2009-2011 Omnibus Budget Overview, Operating Only, Legislative Evaluation and Accountability Program Committee (LEAP), page 18, at www.leap.leg.wa.gov/leap/budget/lbns/2009partii.pdf.

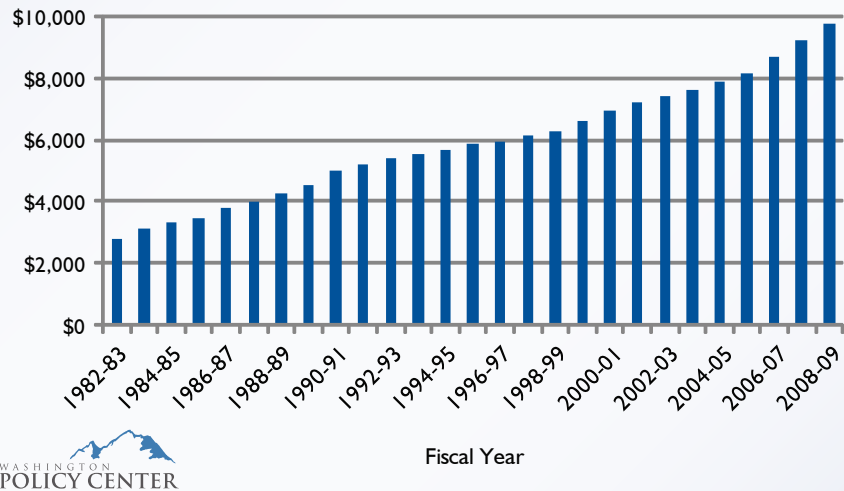
¹⁴ Ibid.

¹⁵ "Key Facts About Washington Public Schools: 2009 – 2010," by Liv Finne, Washington Policy Center, July 2010, at www.washingtonpolicy.org/publications/facts/key-facts-about-washington-public-schools-2009-2010.

¹⁶ "Key Facts About Seattle Schools," and "Key Facts About Spokane Schools," by Liv Finne, Washington Policy Center, September 2010.

¹⁷ "Key Facts About Washington Public Schools: 2009-2010," by Liv Finne, Washington Policy Center, July 2010, www.washingtonpolicy.org/publications/facts/key-facts-about-washington-public-schools-2009-2010.

Total General Fund Expenditure Per Student, 1982 - 2009



While spending on education has been steadily rising, academic achievement by Washington’s public school students has remained flat or declined. Only about two-thirds of public school students graduate. For minority students the graduation rate is even lower, just 50 percent. More than half (52 percent) of public school students who enter college are unprepared in math, English and reading.¹⁸

National research shows that placing an effective teacher in the classroom, not increased spending, is the most important factor in raising student achievement. Students taught by a high-quality teacher three years in a row score 50 percentile points higher on standardized tests than students of ineffective teachers. Students taught by a weak teacher two years in a row may never catch up.¹⁹

These findings indicate that better management of current funding and changes in teacher hiring, retention and training, not adding more money to the current system, would improve academic outcomes for public school children.

5. Initiative 1098 and the State Economy

Passage of Initiative 1098 would have a significant negative effect on the state economy. To the extent high-income earners devote their income to expanding existing businesses and creating new ones, Initiative 1098 would function as a tax on investment and job growth. Following is a summary of the wide-ranging impacts an income tax would have on Washington’s economy.

An Income Tax would Inhibit Job Creation

Imposition of a high-earners tax would come at a particularly bad time for the state economy. Washington is experiencing the worst recession in decades. More than 106,200 jobs, or 3.6 percent of payroll employment, were eliminated

¹⁸ Ibid.

¹⁹ “Cumulative and Residual Effects of Teachers on Future Student Academic Achievement,” by William L. Sanders and June C. Rivers, Value-Added Research and Assessment Center, University of Tennessee, November 1996, and “Teacher Quality and Student Achievement Research Review,” by Policy Studies Associates for the Center for Public Education, November 2005.

in 2009.²⁰ Most of the job losses have occurred in the private sector; job losses in government have been much lower. In many cases public-sector employees have received pay raises, while many of their private-sector counterparts have been laid off.

Initiative 1098 would target businesses and public institutions in the most productive, job-creating sectors. Computer technology, aerospace, medical research and telecommunications are major areas of investment and growth in Washington's economy. In these areas, the experience and intellectual ability of employees, not machinery, land or inventory, are a company's most valuable assets.

The same is true in higher education, where researchers seek the next breakthrough in medicine and basic science. These companies and institutions compete for top talent in a global marketplace. A special tax on high-earners would make it harder for innovative companies and university research programs to bring the best minds to Washington.

Research by the American Legislative Exchange Council shows that the nine states without an income tax, including Washington, had an average 18.2 percent increase in jobs over the last ten years, compared with an average jobs growth rate of only 8.4 percent for the nine states with the highest income tax rates.²¹ The states with no income tax not only outperformed states with the highest income tax rates, they achieved a higher level of economic growth than the average of all the states:

“For total GSP [Gross State Product] growth, the states with no personal income tax rate (PIT) have on average outperformed those states with the highest PIT rates by 26.5 percentage points over the past decade; they have outperformed the U.S. average by 20 percentage points.”²²

Initiative 1098's minimal reduction in state property and B&O taxes would not provide significant relief to major industries, and would do little to offset the increased difficulty a Washington-based company would have in recruiting new investors and highly-trained employees.

An Income Tax would Harm Small Businesses

Small businesses, those with 50 or fewer employees, make up 96 percent of all businesses in Washington and provide jobs for 41 percent of the state workforce. Many small business owners earn more than \$200,000 per year. While the exact number is unknown, Initiative 1098 opponents say that almost 70 percent of people earning over \$200,000 per year are small business owners.²³

Small business are frequently organized as “S” corporations. Owners of “S” corporations must report business income on their personal income tax forms, meaning the income tax created by Initiative 1098 would function as a direct tax on certain businesses.

Passage of Initiative 1098 means income earned through an “S” corporation would become subject to double taxation at the state level. First, the annual gross receipts of the business would be taxed through the state Business

²⁰ “State's job skid worst since ‘Boeing Bust,’” by Drew DeSilver, *The Seattle Times*, February 5, 2010.

²¹ “The Nine States with the Lowest and Highest Marginal Personal Income Tax (PIT) Rates, 1998 – 2008,” Rich States, Poor States, ALEC-Laffer State Economic Competitiveness Index, Arthur Laffer, et al., American Legislative Exchange Council, page 26, Table 8, 3rd edition, 2010, at www.alec.org/AM/PDF/tax/10RSPS/RSPS2010-Final.pdf.

²² *Ibid.*

²³ “I-1098's job-draining effects,” by Mike Sotelo and Craig Dawson, *The Seattle Times*, August 16, 2010.

and Occupation tax, which all businesses must pay. Second, these funds would be taxed again in part when the business owner reports business income on his personal federal IRS form. Initiative 1098 would require the business owner to then pay state income tax on any reported income over \$200,000, even though the business owner had already paid state B&O taxes on these earnings.

Impact on Family Businesses

In-state family-owned businesses would be penalized while their national and multi-national competitors would pay no state income tax. A family-owned “S” corporation would be required to pay up to 9 percent tax on earnings from the business before profit could be re-invested in growth and new hiring. Its corporate competitor, however, would pay no tax on profits retained by the company.

The owner of a prominent family-owned retailer who competes against national chains expressed concern about,

“...having the company earnings that are reinvested in our business taxed when those of my competitors are not.” He added that in his view Initiative 1098, “would devastate small and medium sized businesses in Washington.”²⁴

A similar concern was expressed by the owner of a traditional family-owned business in Seattle, who reports he is,

“...competing against huge chains that operate internationally. Their ability to flood the media and pressure suppliers makes them very tough competitors. It’s the growth of taxes and regulations that take a larger and larger bite out of our time, energy and capital to reinvest. I-1098 is bad news for local businesses!”²⁵

Initiative 1098 would Impede the Creation of New Businesses

Many start-ups are formed when high-paid executives of Washington-based corporations, like Microsoft or Amazon, leave their employer and start their own companies. Initiative 1098’s income tax would make it harder for these would-be entrepreneurs to save up the money needed to strike out on their own.

The same would be true of entrepreneurs who sell one successful start-up and use the proceeds to start another. This creative “churning” in a market economy is a major source of new ideas and new firms, and would be significantly hampered by Initiative 1098’s tax on high-earner incomes. Selling even a small company is often a multi-million dollar event. At these levels, Initiative 1098 would function as a 9 percent tax on capital formation.

An Income Tax would Impact Farm Income

The agriculture sector would also be affected by Initiative 1098. Many of Washington’s 39,000 farms are small businesses, and in a good year a farm family’s income can easily exceed \$200,000. This amount must support the family and pay for seed, fertilizer, equipment, wages for hired workers and other operating expenses.

In a bad year farm income can fall by more than half. Farmers rely on profits from years of high prices and good crop yields to balance out bad years. By

²⁴ “I-1098 threatens small, medium business,” by George Bartell, CEO of Bartell Drugs, *Puget Sound Business Journal*, Sept. 3, 2010.

²⁵ “I-1098 would add tax to local businesses,” by Michael Dunn, president, Dunn Lumber, *Puget Sound Business Journal*, September 10, 2010.

taxing away part of their income, Initiative 1098 would make it harder for farmers to be financially prepared to survive periods of low prices, natural disaster, crop failure, loss of overseas markets, or the dozens of other things that can go wrong for farmers.

No Income Tax is Official Economic Development Policy

Promoting Washington as one of only nine states without a general income tax is a key part of the state's economic development policy. State officials use the absence of an income tax as a major selling point in trying to attract new businesses to Washington. The state Department of Commerce lists "No income tax in Washington" as contributing to a favorable business environment. The Department's website says:

"Washington's lack of income tax helped earn the state the rank of 9th in the 2010 State Business Tax Climate Index by the Tax Foundation in Washington, D.C."²⁶

In a special advertising section recently published in a national business magazine, state officials highlight "0 income tax for individuals and business" as a leading business advantage for Washington.²⁷ They note that the number of registered businesses in the state has more than doubled in 15 years, adding:

"That's because of the favorable business climate. The state has no income tax and energy costs are below the national average."²⁸

This conclusion is supported by The Tax Foundation, which reports that the 10 states with the best business climate share one thing in common – they either have no sales tax or no income tax. The Foundation's Business Climate Index report finds:

"It is obvious that the absence of a major tax is a dominant factor in vaulting these ten states to the top of the rankings."²⁹

"Clearly a zero rate is the lowest possible rate and the most neutral base, since it creates the most favorable tax climate for economic growth. The states that have a zero rate on individual income, corporate income or sales gain an immense competitive advantage."³⁰

By enacting an income tax, Washington would be giving up a significant competitive advantage in relation to other states. Washington has a high sales tax. Adding an income tax means Washington would join the states that impose all the major forms of tax on their citizens. The Tax Foundation reports:

"The lesson is simple; a state that raises sufficient revenue without one of the major taxes will, all things being equal, out-compete those states that levy every tax in the state tax collector's arsenal."³¹

²⁶ "Favorable Business Environment, Tax Climate," Choose Washington, Washington state Department of Commerce, www.choosewashington.com/why/favorable/Pages/default.aspx, accessed August 26, 2010.

²⁷ "Best of the Northwest," Special Advertising Section, *Fortune Magazine*, September 6, 2010.

²⁸ Ibid.

²⁹ "2009 Business Climate Index," by Joshua Barro, Staff Economist, Background Paper Number 58, The Tax Foundation, October 2008, page 5, at www.taxfoundation.org/files/bp58.pdf.

³⁰ Ibid, page 10.

³¹ Ibid, page 5.

6. Some Residents would Leave Washington to Avoid the Income Tax

By definition wealthy people have more choices in life than middle- and low-income people. They also have access to legal and tax advice that other people do not need or cannot afford. Passage of Initiative 1098 would instantly raise Washington's income tax rate from zero to the fourth highest in the country.³² High-earners targeted by the tax would suddenly have a strong financial incentive to move out of state.

A change in residence would include pulling investments out of the state as well, since Initiative 1098 would tax non-residents who derive income from Washington businesses. In a survey of business owners and their views of Initiative 1098, 1.8 percent of respondents said they planned to leave Washington if the income tax measure passes, even though this was not one of the survey questions.³³

Income tax supporters say they are skeptical rich people and business owners would leave, but the experience of states indicates wealth is mobile and that high-earners will cross state lines to avoid higher taxes.

New Jersey increased its income tax in 2004 and found that over the next four years the household wealth of out-migrants exceeded that of new arrivals by \$70 billion, compared to a net inflow of \$98 billion in the previous five-year period.³⁴ "If you tax them they will leave," is how New Jersey's new governor put it.³⁵ *The Hill* newspaper reports, "...studies show top earners – the 1% of taxpayers paying 40% of income tax – are fleeing the Garden State."³⁶

Another income tax state, Minnesota, found that "...a significant long-term driver of lower individual income tax revenue is the out-migration of Minnesota residents to other states."³⁷ Among top states to which Minnesota residents moved were Florida and Texas, states with no income tax. Internal Revenue Service data show that between 1995 and 2007 more than \$3.6 billion in income left Minnesota. Those leaving tended to be people with higher-than-average income, who were hit hardest by Minnesota's income tax, which has a top rate of 7.85 percent.

Had this income remained in the state, Minnesota's state and local governments would have collected an estimated \$423 million in additional tax revenue.³⁸ In 2007, the latest year for which data is available, 4,428 taxpayers left Minnesota, reducing the state's tax base by over \$378 million in adjusted gross income.³⁹

The tax code influences economic behavior, as people respond to the financial inducements created by changes in public policy. This conclusion is

³² "State Individual Income Tax Rates as of February 1, 2010," Tax Data, The Tax Foundation, released March 25, 2010, at www.taxfoundation.org/files/state_individualincome_rates-20100325.pdf. The states with tax rates higher than 9% are Hawaii (11%), Oregon (11%) and California (10.55%).

³³ "Survey: Initiative 1098 would hurt small business, job growth," Association of Washington Business, August 25, 2010, at www.awb.org/articles/pressreleases2010/survey_initiative_1098_would_hurt_small_business_job_growth.htm.

³⁴ "Wealthy Avoid New Jersey," by Ashlea Ebeling, *Taxing the Rich*, Forbes.com, February 4, 2010, at www.forbes.com/2010/02/04/state-estate-income-tax-migration-personal-finance-rich-avoid-new-jersey.html.

³⁵ "The budget-slasher," *The Economist*, April 29, 2010, available at www.realclearpolitics.com/2010/04/30/budget-slasher_christie_thrills_the_right_scares_unions_233536.html.

³⁶ "N.J. gov. sets tone for US," by A.B. Stoddard, *The Hill*, May 5, 2010, at www.thehill.com/opinion/columnists/ab-stoddard/97603-nj-gov-sets-tone-for-us%3Fpage%3D2.

³⁷ "Minnesota's Out-Migration Compounds State Budget Woes," by J. Scott Moody and Dr. Wendy P. Warcholik, Freedom Foundation of Minnesota, February 2010, page 1, at www.freedomfoundationofminnesota.com/documents/TaxMigrationStudy.pdf.

³⁸ Ibid.

³⁹ Ibid.

supported by research showing that, "...the nine states without an income tax are growing far faster and attracting more people than are the nine states with the highest income tax rates. People and businesses change the location of income based on incentives."⁴⁰

7. Initiative 1098 would Reduce Charitable Giving

Initiative 1098's income tax rates would be applied to adjusted gross income for the year, so it would reduce the amount of money wealthy individuals and families have available for charitable giving. Adjusted gross income includes wages, salaries, tips, interest income, rental income, capital gains, income from pensions and retirement accounts, and alimony payments received by divorced spouses.⁴¹

Adjusted gross income is calculated *before* the taxpayer is allowed to lower his reported income by claiming deductions such as the federal standard deduction, the child tax credit, the dependent care credit, local property taxes, motor vehicle taxes, mortgage interest payments, contributions to retirement accounts and donations to charity.

Initiative 1098's 5 percent and 9 percent rates are much higher than similar federal effective tax rates applied to the same income, because the amount of taxable income can be substantially reduced before the federal rate is applied, while the state tax would be applied to the full amount. Under Initiative 1098, a person could donate 100 percent of his yearly income to charity, and still owe income tax to the state.

The estimated amounts that would be collected through the income tax – \$2.2 billion the first year and \$11.1 billion over the first five years – represent the amounts private individuals and families would not have available for voluntary purposes.

Not all of this money would otherwise go to nonprofits, but the imposition of a new tax on the adjusted gross income of wealthy individuals and families means some portion of it would be sent to the state treasury in Olympia, rather than given to the arts, poverty relief programs, local schools or other charitable causes.

8. Initiative 1098 and Tax Fairness

Income tax supporters say Initiative 1098 is "...a tax reform measure intended to make our tax code in Washington State more fair."⁴² The assessment of this claim depends on an understanding of the term "fair." Dictionary definitions describe "fair" as meaning impartial, equitable, free of favoritism or bias.

Initiative 1098 is not unbiased or impartial in its treatment of Washington citizens. It specifically targets a minority, as defined in economic terms, to shoulder the full cost of a new tax, while using state power to redistribute the benefits to others.

⁴⁰ "Tax Hikes and the 2011 Economic Collapse," by Arthur Laffer, *The Wall Street Journal*, June 7, 2010, at www.online.wsj.com/article/SB10001424052748704113504575264513748386610.html?mod=WSJ_latestheadlines.

⁴¹ U.S. Individual Income Tax Return, Form 1040, United States Internal Revenue Service, 2009.

⁴² "What is the purpose of I-1098?" Frequently Asked Questions, Yes on 1098, accessed August 27, 2010, at www.yeson1098.com/YesOn1098_FAQs_0826.pdf.

Initiative 1098 intentionally divides citizens along class lines, favoring some citizens while penalizing others. Income tax supporters say it includes, “tough provisions to ensure that middle-class families will pay less in taxes...” with, they say, “...very wealthy Washington State residents finally paying their fair share in taxes.”⁴³

Initiative supporters assert the proposed tax imposes “...a rate of taxation they [high-income earners] can easily afford,” without taking into account the financial sacrifices taxpayers would incur to meet their increased obligation to the state. For many small business owners, especially those filing as “S” corporations, the new tax may be more than they can afford, forcing them to sell assets or lay off workers to raise funds for the income tax.

Proposals to increase broad-based taxes, like local school levies, ask people to tax themselves to promote the common good. In contrast, the appeal made by income tax supporters is to ask the public to vote for a tax they say the vast majority of people will never have to pay.

Initiative 1098 proponents cite Washington’s high sales tax as the main example of how the tax code is unfair. Yet the initiative does nothing to change the sales tax. All of the tax relief benefit provided in Initiative 1098 goes to business owners and property owners. The initiative provides no direct relief to low-income residents who pay a higher proportion of their income in sales taxes.

Initiative 1098 clearly discriminates against one class of citizens. It divides communities along economic lines by imposing a significant new tax on a small minority, while exempting more than 98 percent of taxpayers.

9. State Income Taxes Do Not Lead to Fiscal Stability

Supporters of Initiative 1098 say the measure would “...provide stable revenue dedicated to protecting education and health care priorities...”⁴⁴ and would allow “...public revenue to better keep pace with economic growth and the need for services.”⁴⁵

The experience of other states shows an income tax does not contribute to increased stability in state finances. Oregon, New Jersey, and California all have income taxes and have suffered major budget shortfalls in recent years. Voters in Oregon recently raised the income tax rate in response to a budget crisis, showing that the previous income tax policy was inadequate to meet the state’s revenue needs.

With the recession all states are facing lower-than-expected tax revenues but, “...the ups and downs are greater in states such as Oregon, which rely on income taxes.”⁴⁶ This is true because “...states are not collecting as much from the high-end earners more likely to have capital gains and investment income.”⁴⁷ Oregon’s personal income taxes – based on 2009 returns due on April 15, 2010, were down by \$472.3 million, or 16.4 percent less than the previous year.⁴⁸

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ “Initiative 1098: The Right Fix for Washington’s Flawed Tax Structure,” by Marilyn Watkins, PhD, Blueprint, Economic Opportunity Institute, v1.3, April 2010, at www.eoionline.org/tax_reform/reports/I1098-brief-Aug2010update.pdf.

⁴⁶ “Income taxes linked to volatility, expert says Oregon is hit harder because it relies on earners’ money,” by Peter Wong, *Statesman Journal*, May 30, 2010.

⁴⁷ Ibid.

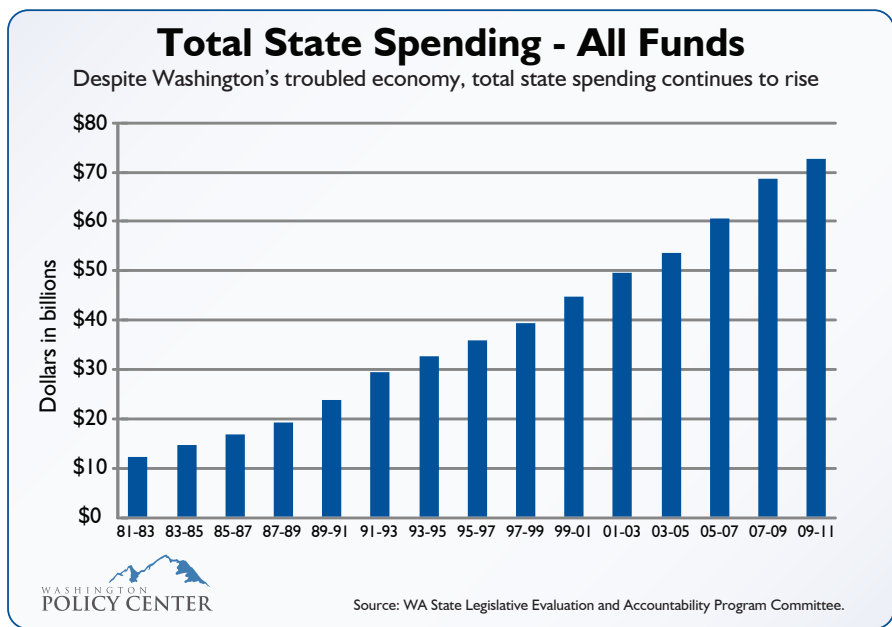
⁴⁸ Ibid.

Economists make similar predictions about the instability an income tax would bring to Washington state finances:

“The consensus [among national experts on taxation] is that the income tax – particularly the type of income tax proposed by I-1098 – might rake in more money, but it will also make state tax revenue more volatile than they are today.”⁴⁹

One researcher notes that, while people disagree about the merits of an income tax, “...on the factual question, volatility will be greater with an income tax.”⁵⁰

Over time, Washington’s current tax system has generated abundant revenues to fund state programs. During the strong economy lawmakers increased state spending by over 33 percent in a single four-year period. The chart below shows the consistent rise in the state’s all-funds budget over three decades, indicating a level of long-term financial stability that equals or exceeds that of income tax states over the same period.



Access to a new revenue stream would likely encourage Washington lawmakers to return to enacting large, permanent spending increases in each budget cycle. When economic activity slows or declines in recessionary years, personal incomes fall accordingly, and leave income tax states like Oregon and California with far less revenue than officials expected to receive.

10. Initiative 1098 is Unconstitutional under Current Case Law

Opponents of Initiative 1098 raise the serious objection that the measure is not constitutional, and that if passed it would swiftly be struck down by the state supreme court, as the court has done repeatedly with past income tax laws.

⁴⁹ “Income Tax Means Roller-Coaster Ride for Washington, Say Experts,” by Erik Smith, *Washington State Wire*, August 27, 2010, at www.washingtonstatewire.com/home/4854-income_tax_means_roller_coaster_ride_for_washington_say_experts.htm.

⁵⁰ Ibid, quoting Don Boyd of the Nelson A. Rockefeller Institute of Government at the State University of New York at Albany.

At issue is whether Initiative 1098, by imposing a tax on the income of 1.2 percent of residents and exempting everyone else, violates the state constitution's uniformity clause. The uniformity clause says:

“All taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only. The word ‘property’ as used herein shall mean and include everything, whether tangible or intangible, subject to ownership.”⁵¹

The historical purpose of this provision was to prevent powerful corporations, like railroads, from using their political influence to gain special treatment under the state's tax code. Today the uniformity clause is a fundamental principle of tax law. It continues to provide fair treatment among different types of property owners by ensuring the tax code is applied uniformly to all forms of property.

Sponsors of Initiative 1098 seek to avoid this constitutional obstacle by calling their proposal an “excise tax” that would be “...imposed on the receipt of all taxable income of resident individuals and on all individuals deriving income from sources with this state...”⁵²

Their view is the tax would apply to the act of receiving income, and would not be a tax on the income itself. This narrow distinction is meaningless, however, because the way Initiative 1098 is drafted the amount of tax a person owes would be based directly on the amount of income the person owns. The idea that Initiative 1098 would create a tax on an action (receiving income), and not on private property (money held as income) is artificial. In conception and in practice Initiative 1098 would function exactly like a tax on income held as property.

The supreme court ruling that invalidated the first state income tax made it clear that income is property under Washington's constitution. In describing how the word “property” is defined in the constitution, the court said:

“It would certainly defy the ingenuity of the most profound lexicographer to formulate a more comprehensive definition of ‘property.’”⁵³

Even so, labeling an income tax an excise tax has been tried before. In *Jensen v. Henneford* (1936), the state supreme court struck down an income tax law which the legislature had called an excise tax. In its ruling the court said that changing its name made no difference under the law because, “The character of a tax is determined by its incidents, not by its name.”⁵⁴

In *Power, Inc. V. Huntley* (1951), the court struck down a law creating a corporate income tax, again noting that changing the name of a tax, by labeling it “corporate,” does not change its nature.⁵⁵

Similarly, in *Apartment Operators Association of Seattle, Inc. v. Schumacher* (1960), the court struck down a law imposing a tax on rents, noting that for the building owner rent is income (property) and therefore subject to the uniformity clause of the state constitution.⁵⁶

Income tax proponents say that today's supreme court would rule differently, arguing that because of changes in U.S. Supreme Court precedents a

⁵¹ Washington State Constitution, Article 7, Section 1, “Taxation.”

⁵² Initiative 1098, Section 501, “Determination of Excise Tax.”

⁵³ *Culliton v. Chase*, 174, Wash. 363, 25 P.2d (1933).

⁵⁴ *Jensen v. Henneford*, 185 Wash. 209, 53 P.2d 607 (1936).

⁵⁵ *Power, Inc. V. Huntley*, 39 Wn.2d 191, 235 P.2d 173 (1951).

⁵⁶ *Apartment Operators Association of Seattle, Inc. v. Schumacher*, 56 Wn.2d 486, 351 P.2d 124 (1960).

tax on income no longer constitutes a tax on property, and therefore is not subject to Washington state's uniformity clause. Their primary citation for this view is a 1993 law review article by University of Washington professor Hugh Spitzer.⁵⁷

Since then, however, the state supreme court has affirmed its previous findings in *Harbour Village Apartments v. City of Mukilteo* (1999) and *Washington Public Ports Association v. Department of Revenue* (2003).⁵⁸

A legal analysis prepared by former State Supreme Court Judge Philip Talmadge at the request of Washington Policy Center provides more detail about the case law.⁵⁹ In his analysis Judge Talmadge points out that because Initiative 1098 includes a large exemption from tax (for 98.8 percent of income earners) it may violate the 14th Amendment of the U.S. Constitution, and Article 1, Section 12 of the state constitution, which prohibits special privileges or immunities being granted to any group.⁶⁰

“...the structure of Initiative 1098...coupled with the broad income exemption from the income tax suggests the sponsors are offering benefits to certain societal segments at the expense of another, something Article 1, Section 12 may forbid. This argument is enhanced because only businesses paying the B&O tax and property owners receive any benefit. Although almost everyone pays sales taxes, no beneficial relief is provided to that group.”⁶¹

These constitutional safeguards provide that Washington citizens are entitled to equal treatment under the law. This conclusion is consistent with the reasoning behind the uniformity clause; the tax code should treat citizens equally under the tax code by treating their property equally.

Contrary to what income tax supporters assert, supreme court rulings in recent years show the court has not changed its legal finding that income is property, and that a tax imposed on income is a property tax, not an excise tax. These rulings are current law in Washington, and they strongly indicate Initiative 1098 would be found unconstitutional if a fresh case on this issue were brought before the court. As Judge Talmadge concludes, “Initiative 1098 is clearly unconstitutional on the basis of existing case law.”⁶²

Conclusion

As public policy, Initiative 1098 represents a significant expansion of Washington's tax code. It would add a new way to tax without repealing or significantly altering any of the existing forms of taxation. Initiative 1098's reductions in two current taxes are modest, and could easily be reversed by the legislature.

⁵⁷ Washington State Income Tax – Again?” by Hugh Spitzer, 16 U. Puget Sound Law Review, 515, 1993.

⁵⁸ *Harbour Village Apartments v. City of Mukilteo*, 139 Wn2d 604, 989 P.2d 542 (1999), and *Washington Public Ports Association v. Department of Revenue*, 148 Wn2d 637, 62 P.3d 482 (2003).

⁵⁹ “Constitutionality of Initiative 1098,” by Philip A. Talmadge, Talmadge/Fitzpatrick, Tukwila, Washington, August 19, 2010, at www.washingtonpolicy.org/sites/default/files/Talmadge-Letter-Initiative-1098.pdf.

⁶⁰ Article 1, Section 12 of the Washington constitution reads, “Special privileges and immunities prohibited. No law shall be passed granting to any citizen, class of citizens, or corporation other than municipal, privileges or immunities which upon the same terms shall not equally belong to all citizens, or corporations.”

⁶¹ “Constitutionality of Initiative 1098,” by Philip A. Talmadge, Talmadge/Fitzpatrick, Tukwila, Washington, August 19, 2010, at www.washingtonpolicy.org/sites/default/files/Talmadge-Letter-Initiative-1098.pdf.

⁶² Ibid.

Far from reducing taxes significantly, Initiative 1098 would impose a major net tax increase. The new tax would target a select segment of citizens at first, but based on past actions, the legislature would likely apply the tax to more people by lowering the income thresholds in future years. Olympia lawmakers enacted major tax increases in 2005 and 2008, and they have shown that over time they tend to increase rates and broaden the application of a tax, rather than reduce the financial burden they place on citizens.

Initiative 1098 would add a new public burden on a severely weakened economy. Raising taxes on small employers, farmers and investors means they would have less money for hiring and investment, which in turn would slow business growth and reduce job opportunities. In addition, Initiative 1098 would negatively affect charitable giving, and the measure faces major constitutional obstacles if it is enacted.

Initiative 1098 is poor public policy introduced at a difficult time. By adding an income tax on top of the current tax structure, it would increase the state's tax burden and significantly slow Washington's economic recovery.

About the Author

Paul Guppy is Vice President for Research at Washington Policy Center. He came to WPC in 1998 after 12 years on the staff of the U.S. Congress, including service as Legislative Director, Chief of Staff and with the House Appropriations Committee, with a focus on budget policy and federal spending. He is the author of numerous published studies and articles, including the *Washington State Piglet Book*, and is editor of the *Policy Guide for Washington State*. He specializes in state and local tax systems, health care reform and free market economics. He is a member of the King County Citizens Election Oversight Committee, the State Commission on Tax Preferences, and the Attorney General's Eminent Domain Task Force. In addition, Paul writes WPC's monthly column in Spokane's *Spokesman Review* newspaper. Paul is a graduate of Seattle University and holds graduate degrees in political science from Claremont Graduate University and the London School of Economics.



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