
CHAPTER TWO

REFORMING TAXATION

1. Policy Recommendation: Support Washington families by enacting tax relief

The proper purpose of taxation is to raise money to fund the core functions of government in a neutral way. A “fair field and no favors” is a good motto for a strong tax system, one without political favors or carve-outs for privileged interest groups. A principled tax system promotes social justice because it treats all citizens equally, regardless of social standing, insider dealing or political influence.

The following tax principles provide guidance for a fair and effective tax system; one that raises needed revenue for basic government services, while minimizing the financial burden lawmakers impose on their fellow citizens:

- Simplicity
- Accountability
- Neutrality
- Equity
- Complementary
- Competitiveness
- Reliability
- Transparency

Washington current tax structure provides reliable revenue growth. Though there is no recession-proof tax structure, Washington consistently ranks as having relatively stable tax collections compared to other states. The reason is that Washington’s three major tax sources (sales, gross receipts, and

property) are among the least volatile elements of the economy. Data shows, however, that a graduated income tax is among the most volatile of revenue sources.

The relative stability of Washington's tax collections has also been noted by Standard & Poor's. From the rating firm's August 2019 bond rating for the state:

- “Good recent economic growth relative to that of the nation and a sales tax-based revenue structure that has demonstrated less sensitivity to economic cycles than income tax-reliant states;”
- “Washington's revenues have historically exhibited less cyclicity than others (due in part to lack of personal income tax);”
- “The state's reliance on retail sales, and business and occupation taxes typically affords Washington more revenue stability than other states that rely on personal income tax revenues;”
- “In addition, we have observed that capital gains-related tax revenues are among the most cyclical and difficult to forecast revenues in numerous other states.”¹

Though fairly reliable, Washington tax structure is often criticized for having an undue effect on families, compared to businesses. This concern is the result of how lawmakers have layered on new taxation over the year, while providing little tax relief. The people of Washington now pay over 50 different kinds

1 “State of Washington, Appropriations, General Obligation,” Standard & Poor's Global Ratings, by analysts Jillian Legnos and Oscar Padilla, August 28, 2019, at <https://www.tre.wa.gov/wp-content/uploads/2020ABT-R-2020AB-SP-2019.08.28-Report.pdf>.

of taxes at the state and local level.²

Further, Washington has some of the highest excise taxes in the nation. The state's sales tax rate has not been reduced since 1982. One tax in particular, the Motor Vehicle Excise Tax (MVET) is in need of reform because officials do not tax the true value of cars and trucks, instead using inflated values that result in a higher tax.

MVET viewed as unfair

The Motor Vehicle Excise Tax (MVET) is imposed by the Sound Transit agency in King, Pierce and Snohomish counties, where the majority of Washington residents live. Many families pay the MVET many times in one year, because officials apply it to a wide range of vehicles, including cars, trucks, motorcycles, motor homes and trailers. Some families pay the tax on as many as five or six different vehicles and trailers every year, resulting in hundreds of dollars in cost per family.

In addition to the high tax burden imposed on families, the MVET is considered unfair because of the artificial method officials use to set a vehicle's value. Officials use an inflated value schedule, instead of true market value, to decide the tax burden they impose on vehicle owners. This results in the overvaluing of most vehicles, which enables Sound Transit officials to unfairly take more tax revenue from the public.

Further, some cities impose a car tab tax through a local Transportation Benefit Districts (TBDs), but these are flat fees that everyone pays equally regardless of the type of vehicle. Legitimate car tab taxes, whether an MVET or through a TBD, should only

2 "The Tax Reference Manual, Information on State and Local Taxes in Washington State," by Kathy Oline, Assistant Director, compiled by Don Taylor, Research Division, Washington State Department of Revenue, January 2010, at http://dor.wa.gov/docs/reports/2010/Tax_Reference_2010/TRM%202010%20-%20Entire%20Document.pdf.

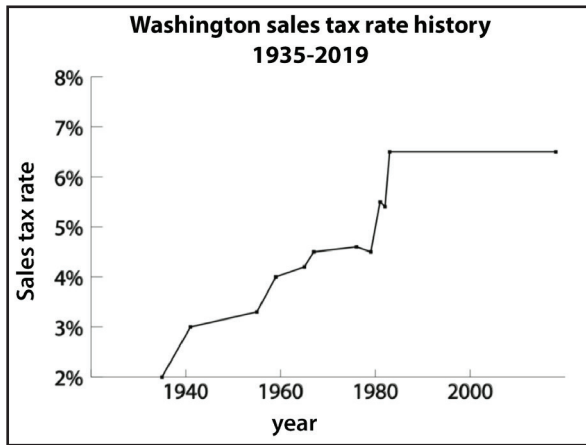
fund roads used by the general public. Taxes for transit, which is already richly funded, should be broad-based and approved separately by voters.

State sales tax rate has not been reduced since 1982

In addition to heavy vehicle taxes, state and local officials impose a high sales tax on Washington residents. The total state and local rate on consumer purchases, except food and medicine, often exceeds ten percent, one of the highest rates in the country.

In King County, officials impose the highest sales tax rate in the state, making it harder to find work and earn a living in otherwise prosperous urban communities. By imposing a high sales tax rate, public officials force Washingtonians to devote an ever-larger share of household income to funding government agencies and subsidizing public programs.

When it was first imposed in 1935, the state sales tax rate was just two percent, a modest rate that most families could afford. The state tax is currently 6.5%, with local sales taxes added on top, and citizens have not seen a rate reduction since 1982, as illustrated below.



Washington state sales tax rate started at just 2%. Since then lawmakers have more than tripled the tax burden to 6.5%.

Recently the federal courts have expanded the sales tax based by ruling, in the *Wayfair* case, that state lawmakers can tax out-of-state businesses³ The larger tax base, the growing state economy and continued large increases in state revenue growth mean that lawmakers are in a good position to provide sales tax relief for Washington families.

Providing property tax relief

As lawmakers and local officials increase total property collections, they increase the amount each property owner must pay. In addition, local officials often ask voters for special levies, saying tax increases are needed to pay for essential public services, even when regular property tax revenue is already increasing. When levies are framed as preventing cuts in schools, parks and medical services people feel pressured to vote “yes,” despite the higher cost.

The result is a rising financial burden that falls hardest on people living on fixed incomes, the elderly, the disabled and the unemployed. Public officials should manage the normal increases in regular tax collections responsibly, or use it to provide tax relief, rather than seeking more money by increasing the financial burden they place on the most vulnerable people in the community.

2. Policy Recommendation: Adopt a constitutional amendment requiring a supermajority vote to raise taxes

In February 2013, the state supreme court overturned the voter-approved requirement that proposed tax increases must receive a supermajority vote of the legislature, or voter approval, to be enacted. When the supreme court strikes down a law passed by the people, the legislature often seeks to implement what the people

³ *South Dakota v. Wayfair, Inc.*, United States Supreme Court, decided June 21, 2018, at https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf.

want. Recent examples include Initiative 695, to reduce car tab costs, and Initiative 747, to limit yearly property tax increases. In both cases, after the courts ruled against popular ballot initiatives, lawmakers of both parties joined together to pass bills that carried out the will of the voters.

Ballot measures to limit tax increases consistently receive strong voter support. Approval of Initiative 1366 in 2015 represented the sixth time in 26 years that voters have approved the policy of requiring a supermajority vote in the legislature to pass tax increases. Voters passed similar measures in 1993, 1998, 2007, 2010 and 2012. In addition, in 1979 voters approved a revenue limit based on the growth in state personal income (Initiative 62), which required a supermajority vote of lawmakers to exceed the limit.⁴

Supermajority vote requirements are common

Requiring a supermajority vote in the legislature to increase taxes is not unique to Washington. Seventeen states have some form of supermajority vote requirement for tax increases. Supermajority requirements are common in provisions of Washington's own constitution.

There are currently more than 20 supermajority vote requirements in the state's constitution. Several of these provisions have been part of the Washington constitution since statehood. The most recent one was added by lawmakers, and confirmed by voters, in 2007.

4 Initiative 62, "Limitation on State Tax Revenues," "List of All Initiatives to the People" and "List of All Referendum Measures" at "Initiative and Referendum History and Statistics," Washington Secretary of State, at <https://www.sos.wa.gov/elections/initiatives/statistics.aspx>, accessed September 4, 2019.

A supermajority vote requirement is not undemocratic

Since supermajority vote restrictions are a common way for the people to place limits on government power, lawmakers should send voters a proposed constitutional amendment to require a supermajority vote in the legislature to raise taxes. Such a proposal would not be undemocratic. Instead, it would be consistent with existing constitutional precedents for requiring higher vote thresholds for certain government actions.

A statewide poll in 2016 found that 65% of voters want lawmakers to send them a constitutional amendment requiring a supermajority vote to raise taxes.⁵ Voters and lawmakers clearly want reasonable limits on raising taxes. Passage of a constitutional amendment would set this popular commonsense policy in place and decide the matter once and for all, without further interference by the courts.

3. Policy Recommendation: Do not impose a state income tax, including an income tax on capital gains

Washington is one of only seven states that do not tax personal incomes (two other states do not tax general income but have narrow taxes on interest). Doing so would fundamentally alter Washington state's tax structure, changing it from one that mainly taxes consumption to one that also taxes people's work and productivity.

Each of the 50 states levies a different combination of taxes on the people who live, work or travel within its borders. These different types and levels of taxation have a profound effect on the actions of residents and business owners, and taxation can

⁵ "New Poll: Lawmakers should act on supermajority for taxes amendment," by Lisa Shin, press release, Washington Policy Center, January 5, 2016, at <http://www.washingtonpolicy.org/publications/detail/new-poll-lawmakers-should-act-on-supermajority-for-taxes-amendment>.

significantly impede personally opportunities and economic growth. More than any other type of tax, an income tax can stifle a state's economic growth, de-stabilize public finances and limit people's take-home pay.

A graduated income tax is unconstitutional in Washington

Since 1933, the Washington state supreme court has issued several opinions on Article 7, Sections 1 and 2 of the state constitution to require taxation of property, which includes income, to be uniform and limited to a rate of one percent. For example, the state supreme court ruled in 1951, "It is no longer subject to question in this court that income is property."

While there is no ban on a flat income tax of one percent, nearly 90 years of legal precedents show that a graduated or targeted income tax that treats people with different income levels differently is considered unfair and unconstitutional in Washington.

Despite these repeated rulings from the state supreme court, income tax proponents say these rulings are "antiquated." Faced with this argument in 1960, the state supreme court ruled:

"The argument is again pressed upon us that these cases were wrongly decided. The court is unwilling, however, to recede from the position announced in its repeated decisions. Among other things, the attorney general urges that the result should now be different because the state is confronted with a financial crisis. If so, the constitution may be amended by vote of the people."⁶

With the voters unwilling to amend the constitution to allow an

6 "Timeless advice from WA Supreme Court on income taxes," by Jason Mercier, Washington Policy Center, September 6, 2017, at <https://www.washingtonpolicy.org/publications/detail/timeless-advice-from-wa-supreme-court-on-income-taxes>.

income tax, income tax tax-increase advocates are again trying to get the judges to reverse their past rulings.

A state income tax is unpopular

Lawmakers should send voters a crystal clear state constitutional amendment banning income taxes in Washington. Based on past elections, the people clearly oppose a state income tax in Washington and a proposed ban would probably pass. Washington voters have overwhelmingly rejected income tax proposals ten times, including six proposed constitutional amendments.

Here is the record of popular opposition to measures proposing a state income tax:

- 1934 – House Joint Resolution 11..... defeated 43% to 57%
- 1936 – Senate Joint Resolution 7 defeated 22% to 78%
- 1938 – Senate Joint Resolution 5 defeated 33% to 67%
- 1942 – Constitutional Amendment defeated 34% to 66%
- 1944 – Initiative 158 defeated 30% to 70%
- 1970 – House Joint Resolution 42 defeated 32% to 68%
- 1973 – House Joint Resolution 37 defeated 23% to 77%
- 1975 – Initiative 314 defeated 33% to 67%
- 1982 – Initiative 435 defeated 34% to 66%
- 2010 – Initiative 1098 defeated 36% to 64%

In Tennessee, lawmakers wanted to assure citizens that imposing a state income tax was not just one legislative session away. They asked voters to approve a constitutional amendment banning income taxes. As the sponsor of the Tennessee income tax ban explained:

“This is going to help us bring in jobs to Tennessee. We can say not only do we not have an income tax, but we’ll never

have an income tax.”⁷

In 2014, Tennessee voters passed the proposal with 66% of the vote and the state’s constitutional ban on a state income tax went into effect.

As in Tennessee, lawmakers in Washington should let the people vote on a constitutional amendment that makes our state’s ban on an income tax clear, while protecting the ban from being overturned by a surprise court ruling in which judges ignore past legal precedents.

Capital gains taxes are income taxes

Some politicians have called for imposing a state capital gains income tax on the people of Washington state. They claim, however, this type of tax is an “excise tax” and not an income tax, in hopes of getting around the state constitution’s prohibition on graduated income taxes.

Every state revenue department in the country, however, classifies a capital gains tax as an income tax. Those that tax capital gains do so through their income tax codes. No state taxes capital gains as an “excise tax.” All states without a capital gains tax have one factor in common – no personal income tax.

In response to a congressional inquiry, here is the Internal Revenue Service (IRS) description of a capital gains tax:

“You ask whether tax on capital gains is considered an excise tax or an income tax? It is an income tax. More specifically, capital gains are treated as income under the tax code and

⁷ “Senate OKs measure to ban Tenn. income tax,” by Lucas Johnson II, *Business Week*, March 9, 2011.

taxed as such.”⁸

Washington’s nonpartisan legislative staff agrees, stating in a bill report for one capital gains tax proposal:

“In addition to the federal tax, capital gains are often subject to state income taxes. Most states do not have separate capital gains tax rates. Instead, most states tax capital gains as ordinary income subject to the state’s income tax rates.”⁹

Capital gains income taxes are unstable

Besides being unconstitutional, a capital gains income tax is bad budget policy. The volatile history of capital gains income taxes in other states shows this form of taxation does not provide fiscally sound revenue for government services.

As warned by former California Governor Jerry Brown, income taxes on capital gains are extremely volatile. Heeding Governor Brown’s recommendation, California voters in 2014 approved a constitutional amendment to restrict the use of capital gains for state spending.

Explaining the impact of the constitutional amendment, the California Legislative Analyst’s Office (LAO) said: “This constitutional amendment separates state spending from the rollercoaster of revenue volatility.”

⁸ Letter from U.S. Department of the Treasury, Internal Revenue Service to U.S. Representative Dan Newhouse, September 25, 2018, quoted in “IRS: Capital gains tax ‘is an income tax’,” by Jason Mercier, Washington Policy Center, September 25, 2018.

⁹ “SB 5129, increasing revenues for the support of state government,” Senate bill Report, Washington State Legislature, January 14, 2019, at <http://lawfilesexternal.wa.gov/biennium/2019-20/Pdf/Bill%20Reports/Senate/5129%20SBA%20WM%2019.pdf>.

In addition, the California's LAO report states:

“Probably the single most direct way to limit the state's exposure to the kind of extreme revenue volatility experienced in the past decade would be to reduce its dependence on the source of income that produced the greatest portion of this revenue volatility – namely, capital gains and perhaps stock options.”¹⁰

Researchers at Standard and Poor's found that, “State tax revenue trends have also become more volatile as progressive tax states have come to rely more heavily on capital gains from top earners.”¹¹

Similarly, analysts at the Washington state Department of Revenue found that:

“Capital gains are extremely volatile from year to year. Revenue from this proposal will depend entirely on fluctuations in the financial markets and can be expected to vary greatly from the amounts presented here.”¹²

Officials point to the benefit of no state capital gains income tax

Government officials in Washington state recognize the public benefit of not taxing capital gains. The state Department of Commerce noted that in Washington:

10 “Revenue Volatility in California,” by Elizabeth G. Hill, Legislative Analyst, California Legislative Analyst's Office, January 2005, at http://www.lao.ca.gov/2005/rev_vol/rev_volatility_012005.pdf.

11 “Income Inequality Weighs On State Tax Revenues,” S&P Capital IQ, Global Credit Portal, Standard and Poor's, September 15, 2014.

12 “Fiscal Note for HB 2563: Establishing a state tax on capital gains,” Washington State Legislature, February 2, 2012.

“We offer businesses some competitive advantages found in few other states. These include no taxes on capital gains or personal or corporate income. We also offer industry-specific tax breaks to spur innovation and growth whenever possible.”¹³

Department of Commerce officials warned that if an income tax is imposed it would mean “one less tool that we have in our economic development toolbox.”

For these reasons lawmakers should maintain Washington’s competitive advantage and not adopt a highly volatile, and likely unconstitutional, capital gains income tax.

4. Policy Recommendation: Affirm the state ban on local income taxes

In 1984 the state legislature adopted RCW 36.65.030, “Tax on net income prohibited.” Acknowledging this clear restriction on a local income tax, the City Attorney of Seattle reported in a 2014 legal analysis that cities do not have the authority to impose a local income tax.¹⁴

Despite this clear prohibition, in 2017 the Seattle City Council enacted one anyway, in hopes of persuading the courts

13 “Choose Washington – Pro-Business,” Washington State Department of Commerce, February 8, 2015 at <https://web.archive.org/web/20121213195601/http://choosewashingtonstate.com/why-washington/our-strengths/pro-business/>.

14 “City of Seattle Attorney in 2014: ‘The legislature has not granted cities the authority to impose an income tax,’” by Jason Mercier, Washington Policy Center, April 18, 2019, at <https://www.washingtonpolicy.org/publications/detail/city-of-seattle-attorney-in-2014-the-legislature-has-not-granted-cities-the-authority-to-impose-an-income-tax>.

to ignore their prior rulings and allow a local income tax.¹⁵ As expected, a King County Superior Court judge immediately invalidated Seattle's income tax saying it was clearly illegal under state law.¹⁶ The Court of Appeals, however, issued a surprising decision on July 15, 2019 in this case.

The Court of Appeals did rule unanimously that Seattle's graduated income tax was unconstitutional, based on the numerous state supreme court decisions. Surprisingly, however, the Court also invalidated the prohibition on local governments imposing a flat income tax. This ruling means officials in cities may be able to impose a flat local income tax pending review by the state Supreme Court.

Many lawmakers say they oppose an income tax, but they took no action on HB 1588 during the 2019 Legislative session. HB 1588 provides:

“The Legislature restates its refusal to delegate to a city, county, or city-county, as a whole or as a governing body, the power to impose a tax on the personal income of individuals or households . . . This prohibition, and the definition of income specifically, are to be construed broadly by any reviewing court to affect the policy of this state that there exist absolute clarity and certainty in state law that there is no local government authority to levy any form of income tax on individuals or households.”¹⁷

15 “Timeless advice from WA Supreme Court on income taxes,” by Jason Mercier, blogpost, Washington Policy Center, September 6, 2017, at <https://www.washingtonpolicy.org/publications/detail/timeless-advice-from-wa-supreme-court-on-income-taxes>.

16 “Judge rules Seattle income tax illegal,” by Jason Mercier, blogpost, Washington Policy Center, November 22, 2017, at <https://www.washingtonpolicy.org/publications/detail/judge-rules-seattle-income-tax-illegal>.

17 “HB 1588: Clarifying the prohibition of the imposition of a local income tax,” Washington State Legislature, January 24, 2019, at <https://app.leg.wa.gov/billsummary?BillNumber=1588&Initiative=false&Year=2019>.

Banning local income taxes would serve the public interest by helping to maintain the state's competitive advantage of having no income taxes. Lawmakers should re-affirm the state ban on local income taxes to discourage local officials from trying to imitate Seattle's legal games.

5. Policy Recommendation: Replace Business and Occupation tax with Single Business Tax

Washington's Department of Revenue defines the Business and Occupation (B&O) tax as a tax on "gross receipts of all business operating in Washington, for the privilege of engaging in business." Gross receipts refers to total yearly business income, the total value of sales, or the total value of products, whichever is applicable. The B&O tax is the second-largest source of revenue for the state, after the sales tax.

As a levy on gross receipts, the B&O tax does not allow business owners to deduct the cost of doing business, such as the payments they make for materials, rent, equipment or wages, when they calculate how much they must pay.

It is important to remember the B&O tax was originally adopted as a "temporary" emergency tax in response to the Great Depression. In 1933 the state Supreme Court upheld the tax, saying:

"This law is, perhaps, not perfect. No tax law yet devised has been entirely fair and just to all in its practical workings. This is an emergency measure, limited by its terms to a two-year period. If it works injustice to some, it will be but temporary, and such temporary injustice, if any, must be borne for the common good."¹⁸

18 *State ex rel. Stiner v. Yelle*, Washington State Supreme Court, September 8, 1933, at <http://courts.mrsc.org/washreports/174WashReport/174WashRepo rt0402.htm>.

A system riddled with preferences

The B&O tax creates severe distortions and puts Washington employers, especially small and start-up businesses, at a competitive disadvantage. To try to mitigate this unfairness, the legislature has passed numerous special deductions, credits and exemptions as a benefit to some industries. At the same time, lawmakers have raised B&O tax rates, in order to increase revenue while giving some industries favored treatment. The result is a complex system of high tax rates riddled with hundreds of preferences and special exemptions.

There is a better way - a simple, fair Single Business Tax. While based on total receipts like the B&O tax, a Single Business Tax would eliminate the current system's unfair and confusing tangle of tax rates and preferences and replace it with a simplified system that treats all business owners equally and uses one fair, flat rate.

How it would work

Each year business owners would choose one of three ways to calculate how much tax they owe, and they would be allowed to use the method that results in the lowest tax burden. Business owners would calculate their tax based on:

1. Total gross receipts minus labor costs, or;
2. Total gross receipts minus all production costs except labor, or;
3. 60% of total gross receipts.

To find the dollar amount of tax owed the business owner would then multiply the taxable receipts by the Single Business Tax rate. Cities could levy their own business taxes, but the same uniformity standard would apply – any local business tax would have to be based on a single rate applied equally to all business owners, with

no loopholes, special exemptions or political favoritism.

The business owner would send the final amount owed for each taxing jurisdiction to the state in one payment. State officials would then place the revenue from the state business tax in the treasury, and distribute the local business tax revenue to different local governments.

A simpler, fairer tax

This proposal would eliminate today's confusing list of over 40 tax rates that state officials now impose on business activities every year. It would repeal the layers of special-interest tax credits and exemptions that have built up over the decades, and would provide relief to small businesses with low profitability. The Single Business Tax could be phased in over several years to allow time for citizens and policymakers to adjust to the new system.

Enacting a Single Business Tax would bring simplicity, equity and fairness to Washington's tax code. It would end thousands of hours of compliance time for business owners and ordinary citizens, and encourage job creation and economic growth, while providing the Governor and lawmakers with reliable revenue to fund the core services of government.

6. Policy Recommendation: Create a tax transparency website like the [fiscal.wa.gov](https://www.fiscal.wa.gov) site

There are approximately 1,800 taxing districts in the state whose officials impose various taxes on Washingtonians.¹⁹ There is no single resource, however, to help individuals and businesses learn which taxing districts and rates they are subject to, and how much officials in each taxing district add to their total tax burden.

¹⁹ "Bipartisan state tax transparency website bill proposed," by Jason Mercier, Washington Policy Center, January 28, 2019, at <https://www.washingtonpolicy.org/publications/detail/bipartisan-state-tax-transparency-website-bill-proposed>.

Chapter 2: Taxation Policy

A typical home, for example, can be located in as many as ten different taxing districts.

To help improve the transparency of state and local taxation, state leaders should create an online searchable database of all tax districts and tax rates in the state. The database could be modeled after the state's high-quality budget transparency website: fiscal.wa.gov.

If enacted by state officials, this recommendation would set up an online database where citizens could find their state and local tax rates (such as property and sales taxes) by entering a zip code, street address, or by clicking on a map showing individual taxing district boundaries.

Enhancing trust in government

A non-binding online calculator would allow individuals and business owners to estimate their total tax burden and know which officials are responsible for imposing each tax. To facilitate a searchable database, taxing districts would report their tax rates to the state annually and report any changes in their tax rates within 30 days of imposing rate changes.

SB 6032 Sec 135 (4) of the 2018 Supplemental Budget would have created a tax transparency website (SB 6590). Within days of the bill's passage, however, the tax transparency section was vetoed by Governor Inslee.

Increasing the ease of public access to state and local tax rates would enhance trust in government and increase the public's understanding of the cost of government services. Improved transparency would also promote healthy tax competition among geographic areas. Citizens could compare different tax burdens imposed by local officials, based on where they decide to live or locate their businesses.

Lawmakers should again pass this bipartisan proposal to create an online searchable website of all tax districts and tax rates in the state, and urge the Governor to sign this popular commonsense measure.

Additional Resources

“How to reform Washington’s tax structure,” by Jason Mercier, Policy Brief, Washington Policy Center, March 2019

“Call capital-gains tax for what it really is – an income tax,” by Jason Mercier, *The Seattle Times*, March 29, 2019

“Bipartisan state tax transparency website bill proposed,” by Jason Mercier, Washington Policy Center, January 28, 2019

“SJR 8208 and SJR 8209, to amend the state constitution to require a two-thirds vote in the legislature to raise taxes,” by Jason Mercier, Legislative Memo, Washington Policy Center, January 2016

“Proposed capital gains tax is likely an unconstitutional income tax and would be an unreliable revenue source,” by Jason Mercier, Legislative Memo, Washington Policy Center, March 2015

“History of Washington state tax ballot measures since 1932,” by Jason Mercier, Legislative Memo, Washington Policy Center, January 2012