TAX FOUNDATION Since 1937

SPECIAL REPORT

October 2010
No. 186

Washington Voters to Consider High-Earner Income Tax

Initiative 1098 Would Significantly Worsen State's Competitive Tax Climate and Raise Constitutional Questions

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Introduction

Washington State is currently one of seven states with no state income tax, but that may change on November 2 when voters decide Initiative 1098. That measure would introduce an income tax on high-earners at a rate of 5% on income over $200,000 ($400,000 for couples) and 9% on income over $500,000 ($1 million for couples).

Officials estimate that the new tax would raise approximately $2.2 billion per year. Of that amount, $600 million would be used to reduce property taxes by about 4% and provide additional credits against the state gross receipts

Key Findings

- *If Initiative 1098 passes, a constitutional challenge to the law is likely and would have strong arguments and precedents.*
- *Since the income tax was ruled unconstitutional in Washington, Evergreen State voters have rejected constitutional amendments to adopt an income tax in 1934, 1936, 1938, 1942, 1970 and 1973. The vote in 1973 was 77% against the tax despite approval by the legislature and the governor.*
- *Washington would be the first state since Connecticut in 1991 to enact a personal income tax.*
- *Comparative rankings of state tax climate by the Tax Foundation and other research groups uniformly praise Washington's current system of forgoing a tax on wages and other income, and those rankings would plummet if a personal income tax is enacted.*
- *Washington's new income tax would be out of the norm in two respects: it will apply to all adjusted gross income with no exemptions or deductions, and it will apply only to high-income earners.*
- *Just as several other states are overturning so-called millionaires' taxes or allowing them to expire, Washington would be adopting one.*

tax. New spending commitments on health care and education would claim the remaining $1.6 billion.[1]

The Constitutionality of an Income Tax in Washington

If Initiative 1098 passes, it is likely to face serious constitutional challenge. First, Washington's constitution contains a uniformity clause, the purpose of which has been described as "strict constitutional provisions requiring equal and uniform taxation."[2] Initiative 1098's extremely narrow base (exempting over 98% of taxpayers) would probably violate that provision, which was adopted in 1930. Similar constitutional provisions in Illinois, Massachusetts, and Pennsylvania have prevented those states from adopting multiple-bracket income taxes as proposed in Washington.[3]

Second, Washington's constitution limits annual property taxes to 1% of value.[4] This provision becomes a constitutional prohibition on income taxes because the uniformity clause defines property very broadly:

> 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.[5]

Washington's definition of property as "everything" resembles the federal Internal Revenue Code's definition of "gross income" as "all income from whatever source derived."[6] Indeed, the Washington Supreme Court has stated that "[i]t would certainly defy the ingenuity of the most profound lexicographer to formulate a more comprehensive definition of 'property.'"[7] Consequently, the state courts have consistently ruled that because property is everything, income is property, and income taxes must be uniform and cannot (with property taxes) exceed 1% of value.[8]

Similar constitutional provisions in Illinois, Massachusetts, and Pennsylvania have prevented those states from adopting multiple-bracket income taxes as proposed in Washington.

For example, in 1933 the Washington Supreme Court ruled that a recently enacted graduated income tax was unconstitutional.[9] Distressed by the fact that they were invalidating a popularly enacted measure at a time of plummeting property tax revenues, the Court nevertheless held that income is property under the uniformity clause enacted three years earlier. Because it was imposed in a non-uniform manner, it was unconstitutional. Contrary to claims by Initiative 1098 proponents today that

1 Washington State Office of Financial Management, "Fiscal Impact for Initiative 1098," http://www.ofm.wa.gov/initiatives/2010/1098.pdf.

2 Morton Horowitz, *The Transformation of American Law: The Crisis in Legal Orthodoxy,* 20-24 (1992).

3 See, e.g., Arangold Corp. v. Zehnder, 787 N.E. 2d 786, 793 (Ill. 2003) ("To survive scrutiny under the uniformity clause, a nonproperty tax classification must (1) be based on a real and substantial difference between the people taxed and those not taxed, and (2) bear some reasonable relationship to the object of the legislation or to public policy."); Kelley v. Kalodner, 181 A. 598, 602 (Pa. 1935) ("[A] tax which is imposed at different rates upon the same kind of property, solely on the basis of the quantity involved, offends the uniformity clause."); In re Opinion of the Justices, 165 N.E. 900, 901-03 (Mass. 1929) (concluding that a graduated income tax explicitly violates the state constitution). See also Mich. Const. art. 9, § 7 (No income tax graduated as to rate or base shall be imposed by the state or any of its subdivisions.").

4 Wash. Const. art. 7, § 2.

5 Wash. Const. art. 7, § 1.

6 26 U.S.C. §61.

7 Culliton v. Chase, 25 P.2d 81, 82 (Wash. 1933).

8 See, e.g.,

9 Culliton, 25 P.2d at 84.

the 1933 Court relied on since-overturned U.S. Supreme Court cases, members of the majority explicitly avoided that reliance.[10] Proponents also argue that the income tax could survive constitutional challenge if it is framed as an "excise tax," although courts generally look at how a tax operates rather than what it is called by its sponsors.

In essence, a majority of voters will be deciding whether to impose a tax on 1.2% of the population plus nonresidents.

The Proposed Tax Has a Narrow Base and High Rate

Since the income tax was ruled unconstitutional in 1933, Evergreen State voters have rejected constitutional amendments to adopt an income tax multiple times, in 1934, 1936, 1938, 1942, 1970, and 1973. That last attempt failed by 23% to 77%, despite the endorsement of the legislature and governor.[11] Initiative 1098, which is not a constitutional amendment, hopes to overcome this opposition by greatly limiting the application of the tax to a small share of the population. In essence, a majority of voters will be deciding whether to impose a tax on 1.2% of the population plus nonresidents.

Even a broad-based individual income tax would probably amplify the volatility of Washington's tax system, not reduce it.

Economists generally agree that good state tax systems levy low rates on a broad base, and treat all taxpayers the same while minimizing economic distortions. The more riddled a tax system is with special preferences, the more likely it is that decisions will be made based on tax reasons rather than market forces. High-earner income taxes also tend to be very volatile, generating large amounts of revenue in good economic times but plummeting sharply in recessions.[12] Even a broad-based individual income tax would probably amplify the volatil-

Table 1

Year-to-Year Changes in State Tax Revenue in the U.S., as a Percentage of Previous Year, Fiscal Years 2000-09 (in real terms)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total Taxes	+ 4.3%	+ 0.9%	– 6.0%	+ 0.3%	+ 4.9%	+ 6.1%	+ 6.4%	+ 2.8%	– 0.7%	– 8.5%
Property Taxes	– 9.1%	– 8.1%	– 8.8%	+ 5.4%	+ 6.1%	– 4.1%	+ 4.8%	– 0.1%	– 3.3%	+ 4.1%
General Sales Taxes	+ 2.6%	+ 0.0%	– 1.4%	+ 0.5%	+ 4.3%	+ 4.0%	+ 4.4%	+ 0.9%	– 2.7%	– 5.0%
Excise Taxes	+ 0.2%	– 1.5%	+ 3.4%	+ 5.3%	+ 4.0%	+ 1.1%	+ 5.1%	+ 2.7%	– 1.2%	– 2.3%
Individual Income Taxes	+ 8.6%	+ 3.9%	– 13.0%	– 4.3%	+ 5.3%	+ 8.5%	+ 7.1%	+ 5.1%	+ 0.9%	– 12.1%
Corporate Income Taxes	+ 2.2%	– 5.4%	– 24.7%	+ 9.9%	+ 3.7%	+ 21.3%	+ 17.2%	+ 8.0%	– 8.0%	– 22.6%

Source: Data from U.S. Census Bureau and Bureau of Labor Statistics.

10 See id. at 82 (Holcomb, J., for the majority) ("None of the decisions from other states have any bearing upon the law before us, because of our peculiarly forceful constitutional definition and the difference in their constitutional authorization or restriction."); id. at 84 (Steinert, J., concurring) ("Much argument of counsel has been devoted to an analysis of various decisions arising under the Constitutions of other states and of the United States. Those decisions are of little aid to us here, because they rest upon peculiar constitutional provisions obtaining in those jurisdictions."). The confusion may occur because the court discusses both the Fourteenth Amendment to the Washington Constitution (the Uniformity Clause) and the Fourteenth Amendment to the U.S. Constitution (the basis for the U.S. Supreme Court's rulings).

11 Jason Smith, "An Income Tax for Washington State?" *Economic Opportunity Institute Discussion Brief* (Sept. 2002), http://www.eoionline.org/tax_reform/reports/IncomeTaxWashingtonState-Sep02.pdf.

12 See, e.g., Joseph Henchman, "State Budget Shortfalls Present A Tax Reform Opportunity," *Tax Foundation Special Report,* No. 164 (Feb. 2009), at http://www.taxfoundation.org/research/show/24321.html.

ity of Washington's tax system, not reduce it. (See Table 1).

Some have cited research showing that Washington is among the most distributionally regressive state tax systems.[13] It is important to remember, however, that state tax systems generally are regressive, particularly when compared to the overwhelmingly progressive federal income tax. Also, recent research on property taxes finds them to be progressive, but some current comparisons of state tax progressivity continue to cite studies from the 1970s that considered property taxes to be regressive.[14]

State Income Taxes for Late-Adopting States Generally Expand Over Time

Eleven states have adopted a state income tax since World War II (see Table 2). Their history with these taxes generally shows a pattern: introduction at a certain level, rate increases across-the-board to a peak, and a slight reduction in at least the highest rate in the last twenty years. (No state has repealed a major tax in that time, except Alaska after the discovery of oil.)

Of the eleven "late-adopting" states, most have raise their rates on both low- and high-income people. Nine have higher rates on the lowest bracket now than when the tax was first introduced (New Jersey and Connecticut are the exceptions). Nine also have a higher rate on the top bracket now than when first introduced (West Virginia and New Jersey are the exceptions).

Of the eleven states that most recently adopted an income tax, nine have higher rates on the lowest bracket and nine have higher rates on the top bracket.

This trend is also seen in the federal income tax. Introduced in 1913 at rates ranging from 1% on income over $2,500 to 7% on income over $500,000, the lowest rate today is 10% and the top rate at one point reached 94%. Compared to where they are upon introduction, income tax rates tend to go up over time, and this could be true for Washington State as well, given that Initiative 1098 does

Table 2

States Adopting Income Taxes Since World War II
Rate on Lowest Non-Zero Bracket and Rate on Highest Bracket

State	1970	1980	1990	2000	2010
Connecticut (1991)				3.0% – 4.5%	3.0% – 6.5%
New Jersey (1976)		2.0% – 14.0%	2.0% – 3.5%	1.4% – 6.37%	1.4% – 8.97%
Ohio (1971)		0.5% – 3.5%	0.743% – 6.9%	0.716% – 7.228%	0.587% – 5.925%
Rhode Island (1971)		19% of federal tax	22.96% of federal tax	26.5% of federal tax	3.75% – 9.9%/6.0% flat
Pennsylvania (1971)		2.2%	2.1%	2.8%	3.07%
Maine (1969)	1.0% – 6.0%	1.0% – 10.0%	2.0% – 8.5%	2.0% – 8.5%	2.0% – 8.5%
Illinois (1969)	2.5%	2.5%	2.5%	3.0%	3.0%
Nebraska (1967)	13.0% of federal tax	15% of federal tax	2.0% – 5.9%	2.51% – 6.68%	2.56% – 6.84%
Michigan (1967)	2.6%	4.6%	4.6%	4.4%	4.35%
Indiana (1963)	2.0%	1.9%	3.4%	3.4%	3.4%
West Virginia (1961)	1.65% – 7.6%	2.1% – 9.6%	3.0% – 6.5%	3.0% – 6.5%	3.0% – 6.5%

Source: Tax Foundation.

not restrict the Legislature from changing the tax rates and breadth over time.

The New Income Tax's Top Rate Would be the Fourth Highest in The United States

If adopted, Washington's top income tax rate of 9% would be the fourth highest top state rate in the country in 2011, behind Hawaii (11%), Oregon (11%), and California (10.3%). (Rhode Island has approved a tax reform to take effect in 2011, reducing its top income tax rate from 9.9% to 5.99%. New Jersey's top rates have expired and its new top rate is 8.97%.)

Table 3

Top State Income Tax Rates for Individual Tax Returns in 2011

State	Individual Income Tax Rates
Hawaii	11.0% (on income over $200,000)
Oregon	11.0% (on income over $250,000)
California	10.3% (on income over $1 million)
Hawaii (2nd bracket)	10% (on income over $175,000)
Oregon (2nd bracket)	9.9% (on income over $125,000)
California (2nd bracket)	9.3% (on income over $47,055)
Washington*	**9.0% (on income over $500,000)**
Oregon (3rd bracket)	9.0% (on income over $7,650)
Hawaii (3rd bracket)	9.0% (on income over $150,000)
Iowa	8.98% (on income over $63,315)
New York	8.97% (on income over $500,000)
New Jersey	8.97% (on income over $500,000)
Vermont	8.95% (on income at the federal top rate)
Vermont (2nd bracket)	8.9% (on income at the second highest federal rate)
Maine	8.5% (on income over $19,450)
Hawaii (4th bracket)	8.25% (on income over $48,000)
Vermont (3rd bracket)	8.25% (on income at the third highest federal rate)
California (3rd bracket)	8.0% (on income over $37,233)

* If Initiative 1098 passes.

Source: Tax Foundation.

Washington would jump from having no income tax to being among the top state income tax rates overall (See Table 3).

Before 2004, double-digit state income tax rates had effectively disappeared in the United States. States had come to recognize that their tax systems must be competitive in attracting capital investment, job creation, and entrepreneurial activity in an increasingly globalized economy. Even in times of fiscal distress, the income tax was considered the last thing states raised, for fear of damaging economic growth when the economy recovers.

Washington's lack of an income tax is a major selling point for the state.

Some states have bucked this trend in recent years, turning to income taxes on high-earners. Beginning in 2003, New York adopted two new top brackets (the top rate of 7.7% applied to income over $500,000) as a three-year temporary measure, which expired in the midst of the property tax boom at the end of 2005. In 2009, New York attempted to address its budget shortfall in part by adding back the top brackets as a three-year measure, with a top state rate of 8.97% on incomes over $500,000.

New Jersey followed its neighbor in June 2004 when then-Governor James McGreevey signed into law an 8.97% tax rate on income over $1 million, retroactive to January 1, 2004, raising the top rate from 6.37%. While this makes it the first true "millionaires' tax," it was still a lower rate than California's then-top rate of 9.3%, which applied to income over about $41,000. In November 2004, California voters narrowly approved Proposition 63 (53.8% to 46.2%), creating a 10.3% top rate on income over $1 million to fund mental

13 See, e.g., "Piecemeal tax approach doesn't go far enough to fix system," *The Olympian* (Oct. 8, 2010), at http://www.theolympian.com/2010/10/08/1396669/piecemeal-tax-approach-doesnt.html.

14 See, e.g., Michael Lorelli, "State and Local Property Taxes," *Tax Foundation Special Report,* No. 106 at 9-11 (Aug. 1, 2001), http://www.taxfoundation.org/research/show/136.html.

services programs. In 2008, Maryland added four brackets, including a top rate of 6.25% on income over $1 million that will expire at the end of 2010.

During 2009, more states joined the trend and several states expanded theirs with higher rates and lower thresholds. As part of its 2009 budget agreement, California raised its top rate from 10.3% to 10.55% for two years. New Jersey raised its top rate to 10.75% on income over $1 million, an increase that expired at the end of 2009. Hawaii added three brackets through 2015, including a top rate of 11% on income over $200,000. Oregon voters approved an 11% top rate on income over $250,000 for 2009-2011, with a permanent 9.9% top rate on income over $125,000 after that date. Wisconsin added a top rate of 7.75% on income over $225,000; Delaware added a top rate of 6.95% on income over $60,000; and Connecticut added a top rate of 6.5% on income over $500,000. The Maine legislature tried to cut its top rate from 8.5% to 6.5% but at the last hour joined the millionaires' tax trend by adding a 6.85% rate on income over $250,000, but this was repealed at the ballot box.

The trend may be new, but the policy has been tried before. Before the 1990s, several states maintained double-digit income tax rates, including California (11% until 1996) and Hawaii (10% until 1998).[15] These rates came down due to a combination of booming tax revenues from all sources, and growing expert understanding that location decisions of highly mobile entrepreneurs are sensitive to state income tax rates, particularly in the interstate context. To attract and keep good talent, create jobs and drive economic growth, legislators knew that state tax systems had to be competitive with their neighbors. We all recognize that taxes matter.

We still see elements of that today. Even in adopting its millionaires' tax, New York did not let its rate go above neighboring New Jersey, and other states are wary of crossing the 10% psychological barrier. The California Franchise Tax Board has taken pains to deny that their 10.3% top tax rate is in the double digits, referring on their website and on tax forms to a 9.3% top rate and elsewhere noting that there is a 1% surcharge.[16] This would especially be important for Washington, given that its lack of an income tax is a major selling point for the state.

Paying for broadly available public services through disproportionate taxes on high-income earners raises serious equity questions.

Initiative 1098, as a high-earner income tax, mimics an income tax increase earlier this year in neighboring Oregon, which itself followed an income tax increase in California. Another pocket of such taxes occurred in the Northeast, starting with New Jersey and spreading to New York, Maryland, and Connecticut. New Jersey is now leading the other way in letting those taxes expire, with Maryland to follow next year. Washington should consider the dangers of following Oregon, particularly because Oregon has no sales tax and California's income tax is scheduled to drop in 2011.

The Impact of the Income Tax on Washington's Business Climate Ranking

Each year, the Tax Foundation produces its *State Business Tax Climate Index*, which is designed to measure the relative competitiveness of state tax structures. Tax systems that are

15 Some states had double-digit income tax rates since the 1990s, but also permit deduction of federal taxes from the state income tax. In these states (such as Montana in the 1990s and Iowa today), the high marginal tax rate on personal income is not immediately comparable to other states because of deductibility.

16 See William Ahern, "California Legislators Push for More Double-Digit Income Tax Rates," *Tax Foundation Fiscal Fact,* No. 134 (Jul. 14, 2008), at http://www.taxfoundation.org/research/show/23370.html.

simple, neutral, transparent, stable, and pro-growth score highly; tax systems that fall short relative to their neighbors score low.

If the provisions of Initiative 1098 had been in effect on July 1, 2010, Washington's tax system would have ranked as the 48th best for economic activity on the Tax Foundation's State Business Tax Climate Index, instead of ranking 11th best, as it did with no income tax.

Washington State scores well in the *Index*, routinely in the top 15 of states. Key to this high ranking has been the absence of a major tax, which also means the absence of the associated compliance burden, administrative cost, and deadweight loss to the economy. The economic benefit of being one of the seven states that do not tax income tax in many ways counters Washington's continued use of an economically destructive gross receipts tax (the B&O tax).

In the *2011 State Business Tax Climate Index*, Washington scores as the 11th best business tax climate, as of the snapshot date of July 1, 2010. If the provisions of Initiative 1098 had been in effect on that date, the added costs associated with an entirely new tax, and the way it is structured, Washington would have scored 48th. This is a serious sign that the tax change would negatively affect Washington's state business tax climate.

Conclusion

If states are still concerned about interstate tax competition, what has really changed? The short answer is priorities. States that adopt new taxes on high-income earners are ones where policymakers are persuaded to ignore concerns about long-term economic growth in favor of a short-term budget fix that simultaneously avoids deep spending cuts and tax increases on the majority of voters. In New Jersey, while the new millionaires' tax raised revenue for the state and helped reduce a budget shortfall, it reduced the state's overall economic output and harmed its ability to grow during and after the recession.[17]

Millionaires' taxes will generally raise revenue in the short term without a sudden exodus of wealthy people fleeing to the state next door. But over the medium term, as business make planned location decisions, the taxes will hurt the state's economy.

This is the tradeoff that proponents of taxes on high-income earners usually fail to acknowledge. Yes, such taxes will generally raise revenue in the short term without a sudden exodus of wealthy people fleeing to the state next door, especially in Hawaii. But over the medium term, the taxes will negatively impact location decisions. People expanding old businesses or creating new ones will incorporate the higher cost of doing business into their decision-making, and steer clear of the state.

New taxes on high-income earners have the best chance of implementation where policymakers are persuaded to focus just on short-term problems and minimize concerns about long-term economic growth. It is true that paying for unemployment benefits and state services is a bigger challenge in a time of

17 See Gerald Prante, "Did People Flee New Jersey After 2004 Income Tax Hike?," *Tax Foundation Tax Policy Blog* (Apr. 14, 2009), at http://www.taxfoundation.org/blog/show/24618.html

recession. State budget shortfalls are a result of trying to keep spending commitments based on naïve assumptions about tax revenue growth from the boom; ultimately states will need to reprioritize those promises.

Washington State has an economically destructive B&O tax, and valid criticisms are raised about the structure of some of the other taxes. The solution is not to enact another flawed tax.

Additionally, paying for broadly available public services through disproportionate taxes on high-income earners raises serious equity questions. Such taxes are also highly volatile and contribute to the boom-and-bust cycle of state budgets because the incomes of such individuals vary more than with other types of tax revenue. Finally, such taxes can undermine long-term economic growth.

Washington State has an economically destructive B&O tax, and valid criticisms are raised about the structure of some of the other taxes. The solution to this is not to enact another flawed tax. Washington residents should raise these concerns and resist efforts to substitute damaging short-term fixes for real long-term pro-growth tax reform.

TAX FOUNDATION
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SPECIAL REPORT (ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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