

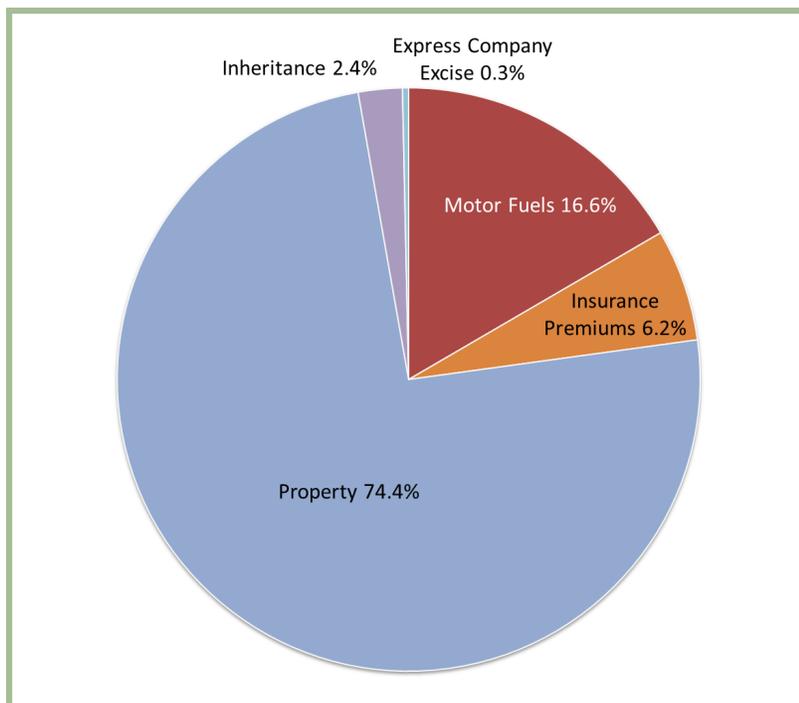
THE WAY WE'RE TAXED: A BRIEF HISTORY

BRIEFLY

The basic contours of the Washington tax structure have been relatively fixed for more than seventy years.

Most often, people express concerns about two features of our tax structure: The presence of a gross receipts tax on business and the absence of a personal income tax. Both characteristics have been around a long time, tracing back to the Great Depression. And the history behind them is instructive. In this report, the Washington Research Council looks back on the evolution of a remarkably durable state tax structure.

Chart 1: State Taxes in 1925,
\$18.2 Million



From Statehood to Great Depression

In the forty years from statehood to the Great Depression, Washington's principal state tax was the property tax, which the original state constitution called simply the "Annual State Tax." During that forty-year

period, the state added four other taxes: the insurance premium tax, in 1891; the inheritance tax, in 1901; the express (shipping) company excise tax, in 1907; and the gasoline tax, in 1921. As Chart 1 shows, in fiscal year (FY) 1925, these four taxes provided 26 percent of the state's \$18.2 million in tax revenue, while the property tax provided 74 percent.

The 1929 legislature passed and the governor signed a bill (HB 217) to establish a sixth state tax: a franchise tax on the income of financial institutions. In June 1930, however, the state supreme court threw out this tax, declaring that it violated the equal protection provisions of the federal and state constitutions.

The 1929 legislature also sent to the voters a constitutional amendment regarding the property tax. The constitution's original language required the legislature to "provide by law a uniform and equal rate of assessment and taxation on all property in the state." The amendment slightly weakened this uniformity requirement to read: "all taxes shall be uniform upon the same class of property . . . all real estate shall constitute one class." The amendment also added to the constitution this broad definition of property: "the word 'property' as used herein shall mean and include everything, whether tangible or intangible, subject to ownership." Voters approved the proposal as the 14th amendment to the Washington state constitution in November 1930.

When the national economy failed after 1929, state personal income collapsed, falling more than 45 percent from \$1.15 billion in 1929 to \$632 million in 1932. Over that same period, property tax levies came down

only slightly, from \$78 million to \$73 million. As a result, property taxes rose as a share of personal income from 6.8 percent in 1929 to 11.6 percent in 1932. Property tax delinquencies soared, reaching 30 percent of the tax roll in 1932 and 1933.

Facing unprecedented budget conditions, citizens and legislators scrambled to relieve the property tax burden and to find new sources of tax revenue. In the next several years their efforts to institute personal and corporate income taxes were stymied by the 14th amendment's broad definition of property.

Initiatives 64 and 69

In November 1932, Washington voters approved two initiatives. The first initiative (I-64) limited regular property taxes to 40 mills (four cents for each dollar of assessed value). I-64 also specified that property be assessed at 50 percent of market value.

The second initiative (I-69) established personal and corporate graduated income taxes. The constitutionality of the income taxes was immediately challenged, however, and the superior court ordered the state tax commission not to collect the taxes. As a result, the 1933 legislature sought an alternate tax to replace the lost property tax revenue; it passed a temporary tax on business gross receipts that was to expire July 31, 1935. While the legislation (SHB 92) named this tax the occupation tax, today it is commonly called the business activities tax, to avoid confusion with the current business and occupation tax. The 1933 legislature also voted to send a constitutional amendment allowing a graduated income tax to the November 1934 statewide ballot.

As passed by the legislature, the business activities tax featured 11 different rates, ranging from 0.1 percent (agricultural production) to 5.0 percent (license fees paid to societies of authors, composers and publishers). Governor Clarence Martin vetoed a paragraph imposing the 0.1 percent tax on agricultural production and a paragraph imposing a 0.6 percent tax on services and any type of business not explicitly covered by the act. (Without the second veto, the first veto would have increased the tax on agricultural production to 0.6 percent.) In 1934 the legislature passed and Governor Martin approved HB 196, extending the business activities tax at a 0.5 percent rate to services and businesses not explicitly covered. This bill also explicitly exempted agricultural products and insurance premiums (which were already subject to the

insurance premiums tax) from the business activities tax.

In September 1933, the state supreme court struck down the (I-69) income taxes. Citing the "peculiarly forceful constitutional definition" of property introduced by the 14th amendment, the court ruled income to be property and all income to fall into a single class of property that must therefore be taxed uniformly. The business activities tax, in contrast, survived legal challenge, with the court ruling that it was a tax on the privilege of doing business rather than a tax on property.

In November 1934, voters rejected the constitutional amendment to allow a graduated income tax.

Revenue Act of 1935

The 1935 legislature passed the most sweeping tax measure in the state's history, the Revenue Act of 1935. The business gross receipts tax was made permanent and renamed the business and occupation (B&O) tax. The tax rate for extractors, manufacturers, retailers and wholesalers was set at 0.25 percent, while that for services and other businesses was set at 0.5 percent. Public service companies, which had been subject to the business activities tax, were exempted from the B&O tax and made subject to a new public utility tax at rates varying from 0.5 percent to 3.0 percent, depending on the type of service. The Revenue Act also initiated taxes on retail sales and use (2 percent), liquor sales (10 percent), cigarettes (1 cent per 20 cigarettes), admissions (5 percent), the conveyance of real estate (0.1 percent), radio broadcasting (0.5 percent), fuel oil (1/4 cent per gallon) and a flat-rate tax on corporate income (4 percent).

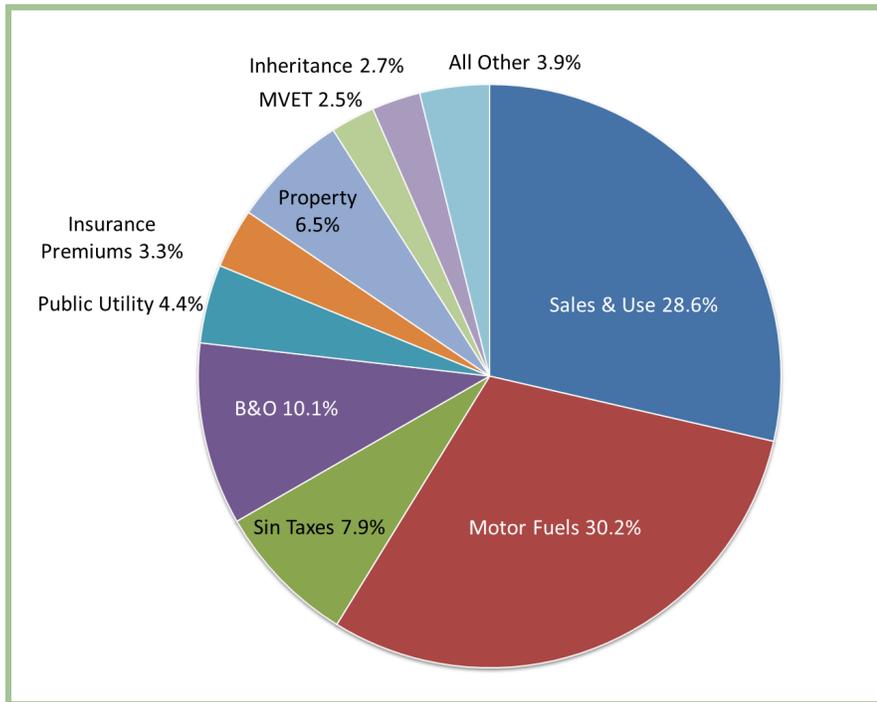
The 1935 legislature also enacted a statute (HB 513) establishing a personal income tax with two rates (3 percent and 7 percent) and sent to the voters for a second time a constitutional amendment to remove the "peculiarly forceful" definition of property and allow graduated personal and corporate income taxes. The voters rejected this constitutional amendment in November 1936, and the state supreme court overturned the personal and corporate income taxes, as well as the tax on radio broadcasting.

Voters again defeated amendments to allow graduated personal and corporate income taxes in 1938 and 1942.

Motor vehicles were exempted from state and local property taxes in 1937 and were made subject to the Motor Vehicle Excise Tax (MVET) instead.

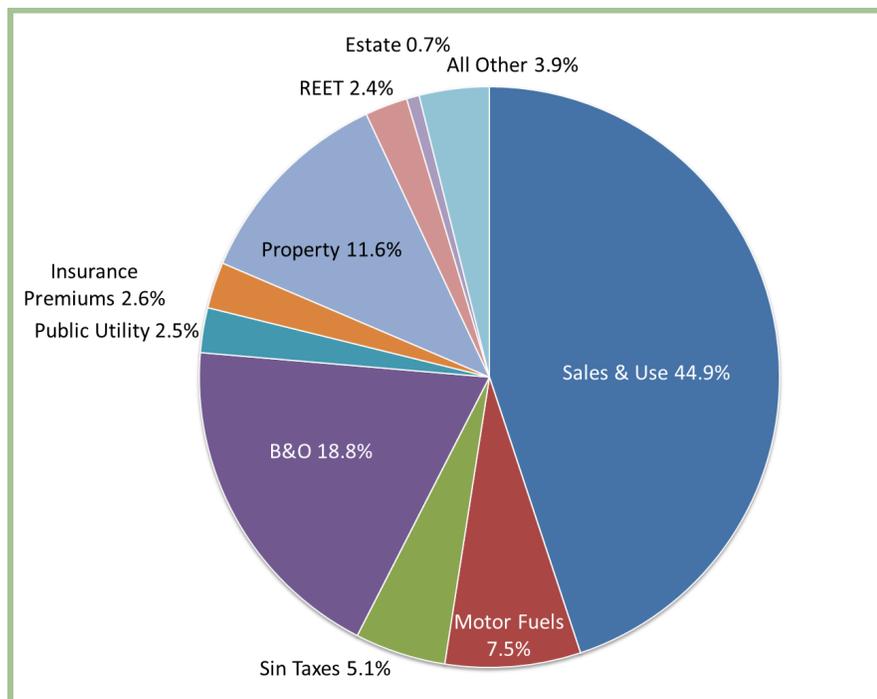
As a result of the property tax restrictions imposed by I-64 and the new taxes created in response, the share of state tax revenue coming from the property tax fell dramatically.

Chart 2: State Taxes in 1940, \$53.5 Million



By 1940, the property tax provided only 6.5 percent of state tax revenue. The motor fuels tax was the largest single source of state revenue in that year (30.2 percent). It was followed in importance by the sales and use taxes, and the B&O tax. Sin taxes (on ciga-

Chart 3: State Taxes in 2011, \$16.0 Billion



rettes, liquor, beer and wine) together provided more revenue to the state than did the property tax.

Since that time, the set of major state taxes is little changed; although, with rate changes and additions to and subtractions from tax bases, the relative contributions of various sources have changed.

Compare Chart 3, which shows state tax revenue in 2011, to Chart 2. The largest change is in revenue from taxes on motor fuels, which are now just 7.5 percent of state revenue. In 1944 voters approved the 18th amendment to the state constitution, dedicating motor fuel taxes to highway purposes. Sales and use tax revenue grew from 28.6 percent of the total in 1940 to 44.9 percent in 2011; B&O tax revenue, from 10.1 percent to 18.8 percent; and property tax revenue, from 6.5 percent to 11.6 percent.

The real estate excise tax (REET), which is paid by the seller of real estate, was introduced as a county tax in 1951 and became a state tax (at a 1 percent rate) in 1981. The conveyance tax was folded into the REET in 1987. In 1940, the conveyance tax provided 0.2 percent of state revenue, while in 2011, the REET provided 2.4 percent.

In 1981, voters approved Initiative 402, which replaced the inheritance tax with an estate tax equal to the maximum amount of state tax creditable against the federal estate tax. In 2001, the federal credit for state estate taxes was eliminated, which had the effect of eliminating the state estate tax. In 2005, the legislature enacted a stand-alone state estate tax. In 1940, the inheritance tax provided 2.7 percent of state revenue, while, in 2011, the estate tax provided 0.7 percent.

In November 1999, voters approved Initiative 695, which repealed the MVET and capped vehicle license fees at \$30. The state supreme court ruled I-695 unconstitutional, but the legislature, bowing to the will of the people, repealed the tax in March 2000.

Limits on Property Taxes

The statutory 40 mill limit on regular property tax rates and the requirement that property be assessed at 50 percent of true value, initially imposed by I-64 in 1932, were reaffirmed by voters in 1934 (Initiative 94), 1936 (Initiative 114), 1938 (Initiative 129), 1940 (Referendum Bill 5) and 1942 (Referendum Bill 6). These provisions were then placed in the state constitution by the 17th amendment in 1944.

In 1972, the state constitution was amended to limit regular property taxes to one-percent of true value.

In 1971, the legislature capped the annual increase in local governments' revenues from regular property taxes at 6 percent plus an increment for new construction (known as the 106 percent limit). The 1979 legislature extended the 106 percent limit to the state levy. Referendum Bill 47, which voters approved in 1997, tightened the 106 percent limit for the state to the lesser of inflation or 6 percent of revenues, plus an increment for new construction. (This limit, with a few exceptions, also applied to local governments.)

In 2000, voters passed Initiative 722, which replaced the 106 percent limit with the 102 percent limit. This limited revenue growth to the lesser of 2 percent or inflation with the same exceptions. In November 2000, the constitutionality of I-722 was challenged in court. In response, I-722's supporters filed Initiative 747, presumably as a safety net should I-722 be invalidated. I-747 further reduced the growth limit factor to the lesser of inflation or 101 percent of the previous year's collections.

In September 2001, the state supreme court ruled I-722 unconstitutional. In No-

vember 2001, voters passed I-747. On November 8, 2007, the state supreme court found that I-747 violated the constitutional provision requiring an initiative to clearly set forth the statute(s) it would amend. The governor then called a special session of the legislature, during which it passed HB 2416, which limits the levy for a taxing district to the lesser of inflation or 101 percent of the previous year's revenues plus an increment for new construction.

Discussion

Somewhat surprisingly, the basic contours of the Washington tax structure have been relatively fixed for more than seventy years. Roughly once every decade, high-profile efforts are undertaken to "reform" the system, typically by adding a business or individual income tax. Such efforts, however, have generally met with significant public resistance at the polls. Clearly, these efforts will continue. As they do, it is useful to reflect on the history behind the way we tax.