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I-1098 Income Tax Proposal: Wrong Diagnosis, Wrong Prescription

Briefly

Even for those who favor an income tax, the peculiar, punitive and volatile tax imposed by I-1098 can not be considered acceptable. It jeopardizes the recovery, destabilizes revenues, and chases away jobs and investment.

For the first time since 1973, Washington voters may be asked to approve an income tax initiative on the November ballot. Initiative 1098, with the high-profile backing of Bill Gates, Sr., the chair of the 2002 Tax Structure Study Committee, and the Service Employees International Union, would impose a steeply progressive graduated tax targeted at high earners to raise $1.7 billion in new revenues annually. After modest reductions in business and property taxes, supporters of the initiative project it would provide a bit more than $1 billion in dedicated funding for health and education programs.

In a significant departure from previous efforts, I-1098 proposes to impose an income tax by initiative, not constitutional amendment. This means, in the event the initiative passes constitutional muster (opinions differ), the tax rates, thresholds, etc., established in I-1098 can be modified at will by a simple majority of the legislature after two years. The measure provides no constitutional protections for taxpayers.

Signatures are currently being gathered. Supporters need to present 241,153 valid signatures to the Secretary of State by July 2 to qualify for the November ballot.

As this Policy Brief details, the proposed income tax would penalize small business owners and entrepreneurs, destabilize the tax system by introducing a highly-volatile revenue stream, and damage our state's national and global competitiveness for new investment and job creation. The I-1098 income tax scheme departs from fundamental policy principles and demonstrates a faulty understanding of the Washington tax structure.

Because the new income tax targets only the very top of the income distribution, its revenue stream will be very volatile. This will increase the likelihood of serious fiscal crisis the next time that the economy turns down.

Marginal tax rates will be among the nation's highest for high-income individuals. Because S corporations, LLCs and partnerships are "pass-through entities" that are not taxed at the corporate level but instead have their income passed through to owners' (shareholders') individual tax returns, I-1098 imposes a substantial new business tax on many of this state's small, emerging, and dynamic enterprises. This is certain to discourage entrepreneurial activity in the state.

The initiative does nothing to reduce the taxes paid by those at the bottom of the income distribution.

Initiative Details

Income subject to the tax. For Washington residents, I-1098 defines taxable income to be adjusted gross income (AGI) as calculated at the bottom of the first page of the federal 1040 income tax form less interest received on federal obligations (which the state is prohibited from taxing). This covers all income. For a taxpayer who invests in S corporations, LLCs, or partnerships, all income derived from those entities is taxable even if it is not distributed to the taxpayer.

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For nonresidents, taxable income equals the net income in AGI that is "derived from or connected with sources in this state."

Other than interest received on federal obligations, the only deductions allowed in calculating taxable income are those that are taken on the first page of the federal 1040 form, i.e. the adjustments that convert total income into adjusted gross income. The deductions that are itemized on Schedule A and entered on the second page of federal form 1040 are not allowed. Thus, taxpayers will not be able to deduct medical and dental expenses, home mortgage or investment interest payments, charitable gifts, unreimbursed employee expenses or investment management fees.

Calculation of the tax. The initiative specifies separate tax formulas for married couples who file joint federal returns and for individual filers. The joint filer formula also applies to state registered domestic partners who choose to file a joint state return and to surviving spouses (taxpayers whose spouses died during either of the two tax years preceding the current tax year).

> *For a married couple filing jointly:* If taxable income is less than or equal to $400,000, no tax is due; If taxable income is greater than $400,000 but less than or equal to $1,000,000, the tax equals 5 percent of the amount by which income exceeds $400,000; If taxable income is greater than $1,000,000, the tax equals $30,000 (the tax for a couple with exactly $1,000,000 of taxable income) plus 9 percent of the amount by which income exceeds $1,000,000.
>
> *For an individual filer:* If taxable income is less than or equal to $200,000, no tax is due; If taxable income is greater than $200,000 but less than or equal to $500,000, the tax equals 5 percent of the amount by which income exceeds $200,000; If taxable income is greater than $500,000, the tax equals $15,000 plus 9 percent of the amount by which taxable income exceeds $500,000.

Vote of the people required to raise rates. The initiative specifies that income tax rates "may not be increased for any income level without a [simple] majority vote of the legislature and submission of the changes to the people for approval." After two years, however, it will take only simple-majority votes in the two houses to suspend or repeal the voter-approval requirement.

Recent legislative activity makes such assurances far from convincing. In the last decade, earmarks, fund dedications and tax limitations have been routinely "suspended" as the state has struggled with budget shortfalls. A similar provision placed into state law by Initiative 601 (1993) requiring that tax increases receive either two-thirds majority approval of each house of the legislature or simple majority approval in each house and voter approval to raise taxes has been suspended twice by simple majority votes in the legislature, most recently in February of this year (Engrossed Substitute Senate Bill 6130).

Tax relief. The initiative modestly reduces the state property tax rate and increases the business and occupation tax credit for small businesses.

Section 301 of the initiative specifies that, "beginning in 2012, the state property tax levy is reduced by twenty percent of the levy amount that would otherwise be allowed under this chapter without regard to this section." The 2012 state property tax levy will be collected in 2013, so it would be in 2013 that state property tax payers would first see the benefit of the state property tax reduction.

The $1.8 billion 2009 state property tax levy was 21 percent of the $8.6 billion total of property tax levies in the state. As the state tax is little more than 20 percent of total property taxes, I-1098 will reduce the typical property tax bill by about 4 percent.

Currently small businesses are relieved of obligation to pay business and occupation tax via a small business tax credit of $70 per month ($840 per year) for businesses in the services category and $35 per month ($420 per year) for businesses in all other categories. Beginning in 2012, I-1098 increases the credit to $4,800 per year for small businesses in all categories. At the 0.471 percent rate that applies to retailing, this credit would eliminate B&O liability for a business with $1,019,000 in revenue. At the 1.8 percent rate that applies to services through June 30, 2013, the credit would eliminate liability for a business with $266,667 in revenue; while at the 1.5 percent rate that will apply thereafter (assuming the legislature allows the rates to return to pre-2010 levels), liability will be eliminated for a business with $320,000.

Although initiative backers boast that the credit will relieve 80 percent of small businesses of a B&O tax liability, the estimated value of the expanded credit amounts to less than 10 percent of annual B&O collections. Further, because many of these businesses are organized as “pass through” entities, business income will flow through to owners’ AGI and be subject to the income tax.

Table 1: The Economic Opportunity Institute's estimates of the annual revenue change from Initiative 1098

	Annual Revenue Change
Income tax	$1,700 million
Property tax	($357 million)
B&O tax	($249 million)
Net New Revenue	$1,094 million

Sources: Income tax—Institute for Taxation and Economic Policy estimates for 2009; Property tax—20% of state receipts for 2009; B&O tax—Department of Revenue estimate for 2012.

Dedication of revenues. The initiative creates a new state account called the Education, Health Services, and Middle Class Tax Relief Trust into which the income tax revenues are to be deposited. Again, this provision may be overturned by a simple majority vote of the legislature after two years.

Each year, the state treasurer is to transfer from this account to the general fund a sum of money sufficient to offset the loss in general fund revenue due to the reduction in the state property tax rate and the expansion in the small business B&O credit.

Of the remaining income tax revenue (which the initiative terms the net revenue from the tax), 70 percent is to be transferred to the education legacy trust account. The other 30 percent of net revenue is to be used to fund the basic health plan, state and local public health services, and long-term care and other health services for seniors and people with disabilities.

Revenue estimates. Supporters cite estimates that the proposed income tax would have yielded $1.7 billion in revenue to the state in 2009, while the property tax reduction would have cost the state $357 million in that year. The small business B&O credit would reduce state revenues by $249 million in 2012.

Volatility of the Income Tax

The I-1098 income tax will be extremely volatile. A variant of the so-called “millionaire’s tax,” the graduated tax imposed by I-1098 violates established tax policy principles and would seriously destabilize our revenue system, threatening state services and assuring future fiscal crises. Put another way,

Chart 1: Year-over-year percentage changes in total state income tax and sales tax revenues, by quarter

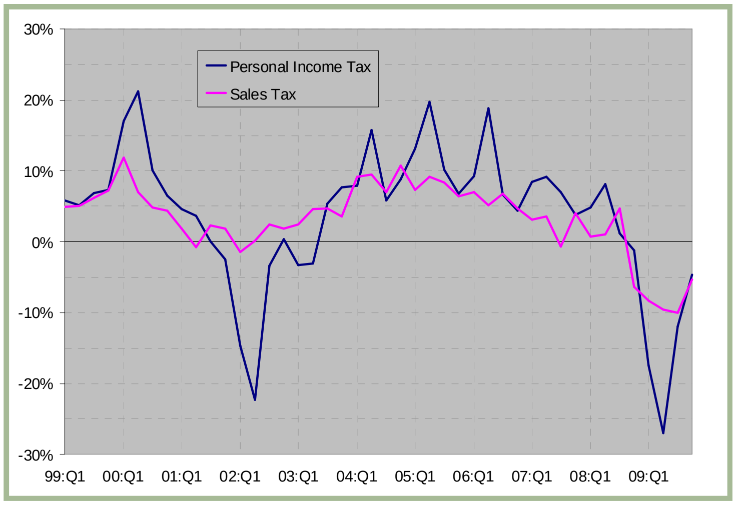


Chart 2: Year-over-year percentage changes in Washington AGI, by year

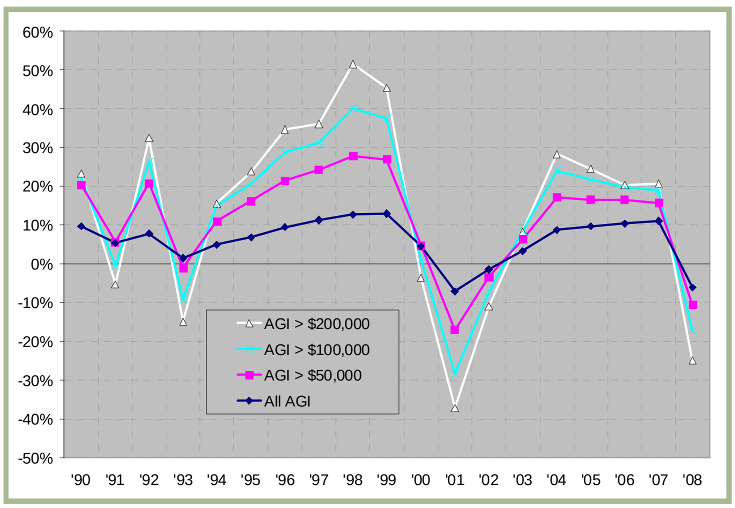
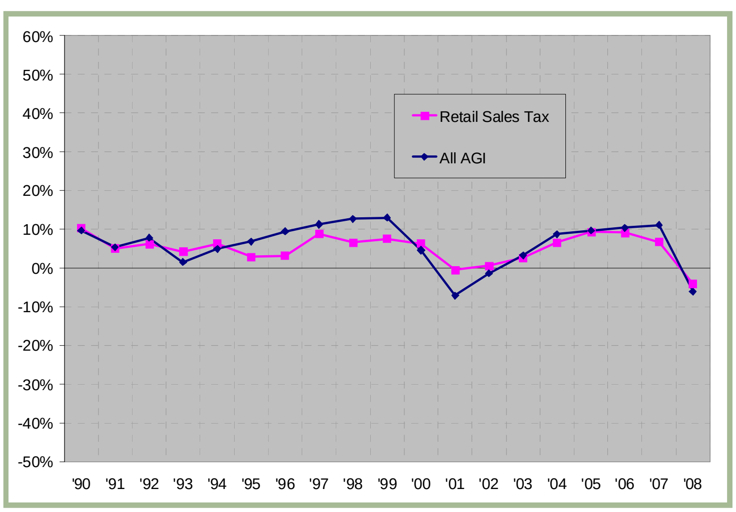


Chart 3: Year-over-year percentage changes in Washington retail sales tax and AGI, by year



I-1098 puts the state budget on a wild roller coaster and increases the velocity.

For the 50 states as a whole, revenue from the personal income tax has been significantly more volatile than revenue from the sales tax. On Chart 1 we have graphed, by quarter, year-over-year percentage changes in aggregate state income and sales tax revenues (Boyd and Dadayan 2020). During both the recent Great Recession and the earlier Dot-Com Recession state income tax revenue fell by a greater percentage than sales tax revenue. During the intervening economic expansion, income tax revenue grew more than sales tax revenue.

When it comes to the volatility of a tax, it is truly the case that the devil is in the details. For example, a sales tax that exempts food will be more volatile than one that taxes food. Similarly a sales tax that taxes construction labor will be more volatile than one that exempts construction labor.

In the case of the income tax, the degree of progressivity is a key determinant of volatility. On Chart 2 we have graphed percentage changes for Washington State in: (1) total adjusted gross income of state residents as reported to the Internal Revenue Service for the various years, (2) total AGI in excess of $50,000 per return, (3) total AGI in excess of $100,000 per return, and (4) total AGI in excess of $200,000 per return. These curves show the annual growth rates in revenue to the state from hypothetical flat rate taxes on AGI where (1) all AGI is taxed, (2) the first $50,000 is exempt, (2) the first $100,000 is exempt, and (4) the first $200,000 is exempt. With no exemption, year-over-year revenue growth would have been positive in 16 of the 19 years. Tax year 1990 shows the largest growth, 13.0 percent, while 2001 shows the largest decline, 7.2 percent. For 2008, revenue would have been down 6.1 percent.

In 2002, the Washington State Tax Structure Study Committee (commonly known as the Gates Committee) concluded that a flat rate income tax without an exemption would be a bit more volatile than the state's current sales tax (WSTSSC 2002, Appendix C-16). Chart 3 confirms that the flat rate tax on AGI would have been more volatile than the sales tax over the 1989–2008 period. In 2001, when the tax on all AGI would have been down 7.2 percent, the sales tax was down only 0.5 percent, while in 2008 where the flat tax on AGI would have been down by 6.2 percent, the sales tax was down by 4.2 percent.

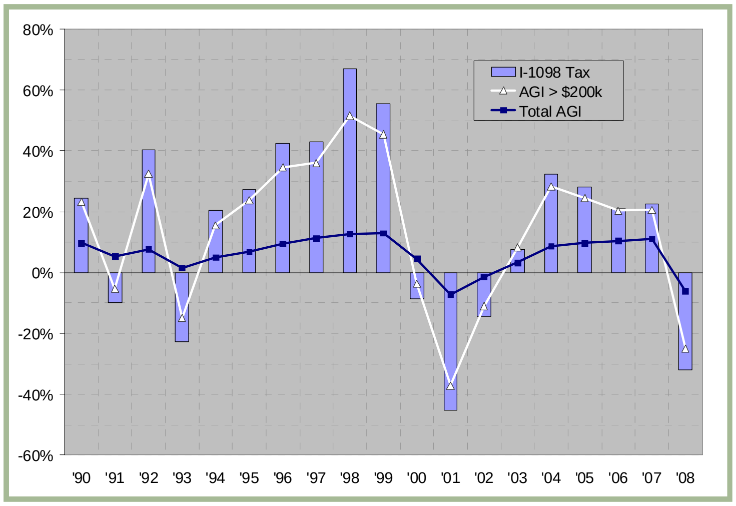
Returning to Chart 2, adding an exemption for the first $50,000 of income makes the income tax more volatile. With the $50,000 exemption there are four years in which income tax revenue declines. The peak increase, 27.7 percent, would have occurred in 1998; the peak decrease, 17.1 percent, would have occurred in 2001. The 2008 decrease would have been 10.6 percent.

Exemption amounts of $100,000 and $200,000 bring even higher volatility. With the $200,000 exemption, there would have been tax revenue decreases in 6 of the 19 years. The peak increase would have been 51.5 percent in 1998. The peak decrease would have been 37.1 percent in 2001. The decrease in 2008 would have been 25.0 percent. The cumulative decline from 1999 to 2002 would have been 46.0 percent.

The clear lesson is that as the exemption level moves up, revenue from the income tax becomes more volatile.

The I-1098 income tax can be thought of as the sum of four income taxes: a 5 percent basic tax with a $200,000 exemption for individual filers; a 5 percent basic tax with a $400,000 exemption for joint filers; a 4 percent surtax with a $500,000 exemption for individual filers; and a 4 percent surtax with a $1,000,000 exemption for joint filers. (For the 2008 tax years, joint filers accounted for 86.7 percent of Washington returns with $200,000 or greater AGI.) This sum will be more volatile than the tax where the exemption is uniformly $200,000.

Chart 4: Year-over-year percentage changes in revenue from the I-1098 income tax, by year



The columns on Chart 4 show our estimate of what the annual changes in revenue from the I-1098 income tax would have been over the 1990–2008 period. For reference the chart also shows the annual change in AGI and the annual change in AGI in excess of $200,000 per return.

By our estimate, revenue from the I-1098 tax would have fallen in 6 of the 19 years. The biggest increase would have been in 1998 (67 percent), the biggest decrease would have been in 2001, 45 percent. The cumulative decrease from 1999 to 2002 would have been 57 percent. The decrease in 2008 would have been 32 percent. (We estimate 2008 revenue would have been about $1.6 billion.)

These substantial swings in revenue, a result of introducing a highly volatile tax to a relatively stable revenue stream, compound the risks to state services and taxpayers during uncertain economic times.

Fairness

Supporters of I-1098 argue that the initiative will improve the fairness of Washington's tax system by transferring a greater share of it onto the wealthy, citing Institute on Taxation and Economic Policy (ITEP) calculations that the burden of Washington's tax structure falls disproportionately on the lower income groups. I-1098 backers and ITEP fundamentally misread the distribution of the state tax burden.

ITEP—the research arm of Citizens for Tax Justice, a labor-backed advocacy group—fails to accurately measure the tax burden. The organization's treatment of Washington's major business tax, the B&O, is different from its treatment of the major business taxes of most other states, the personal and corporate income taxes. The comparison is also biased by the fact that ITEP examines tax burdens at a single point in time rather than over the full lifecycle of the taxpayer.

The data on AGI for Washington taxpayers come from summaries of Washington income tax returns in the IRS publication *Sources of Income*, which is available at the tax statistics section of the IRS web site.

For details on how we estimate the growth in I-1098 tax revenues, see our research note, "Estimating I-1098 Tax Revenues," forthcoming.

Measuring Tax Burden

Economists distinguish between two notions of who pays the burden of a tax. Statutory incidence shows from whom the government directly collects the money. Economic incidence shows who ultimately pays after accounting for all of the changes in market prices that the tax induces. The basic lesson of the theory of tax incidence is that statutory and economic tax burdens are

The Shifting Burden of a Tax on Income

The fact that taxes are borne by immobile factors means that the extent of redistribution that is feasible at the local level is very limited. Assume, for instance, that some community decides that doctors are too wealthy. The local government, accordingly, imposes a licensing tax on doctors in an attempt to redistribute income from this wealthy class of individuals to others. Doctors, in making their decisions about where to set up practice, will look at their prospects in different communities. When they discover that after-tax income is lower in this community than elsewhere, they will be discouraged from setting up practice in this community. If the tax is not too high, doctors who are already established will not leave; the costs of moving exceed the losses from the tax. The fact that its doctors do not leave may fool the community into thinking that it has been successful in extracting some additional tax out of doctors; in the short run they may be right. But gradually, as fewer doctors move into the community, the scarcity of doctors will become felt, and their wages will be bid up. Wages will continue to be bid up until the after tax wage of the doctor will equal what could be earned elsewhere. In the long run doctors do not bear the burden of the tax (although they do in the short-run). In the long run, the community bears the burden of the tax, in the form of less medical services and higher prices for doctors.

Joseph Stiglitz
Economics of the Public Sector, 2nd Edition

not necessarily related, and this “means that taxes on capital may be borne by workers, that investment incentives may be injurious to capitalists, that taxation of foreigners may simply represent indirect domestic taxation, and that generations alive many decades in the future may be supporting those currently alive.” (Kotlikoff and Summers) ITEP notes that “assumptions about state and local tax incidence can often be quite different from, say, the incidence of a national tax due to the mobility of factors of production (capital and labor) . . . ” (ITEP 1998). The quote from Nobel Laureate Joseph Stiglitz, chairman of the Council of Economic Advisers for President Clinton, in the sidebar to the left illustrates how mobility might shift an income tax on doctors onto their patients.

Because people and businesses are mobile, state and local governments have only limited ability to redistribute income. Public finance experts who study the appropriate allocation of functions within the federal-state-local hierarchy of government conclude therefore that redistribution—to the extent it is a policy objective—is primarily a federal responsibility.

The federal tax system – and therefore, the federal-state-local tax system - is progressive. To quote the Gates Committee: “Analysis by the Committee confirmed that when evaluating the total tax system—local, state and federal—all states have progressive taxes and the differences among states are not as great” (WSTSSC 2002, page 53;). Table 2 shows the distribution of the federal tax burden across income classes in 2007 as calculated by analysts at the Urban Institute/Brookings Institution Tax Policy Center. This table shows the share of income paid to the federal government as taxes rises with income. For the lowest income quintile, the federal tax burden averaged 4.7 percent of income. For the top 1 percent, federal taxes averaged 29.4 percent of income.

Table 3 shows ITEP’s estimates of the distribution of state and local tax burdens in 2007 for all states combined and for Washington State.

Table 2: Tax Policy Center estimates of the distribution of the federal tax burden in 2007

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$10,966	$26,830	$49,154	$83,924	$147,688	$329,011	$1,860,547
Taxes as Percent of Income	4.7%	10.4%	16.3%	19.1%	22.1%	25.4%	29.4%

The Tax Policy Center’s model assumes that the individual income tax is borne directly by individual income taxpayers; both the employee and employer share of payroll taxes are borne by the employee; the corporate income tax is borne by recipients of capital income (interest, dividends, capital gains, and rents); and the estate tax is borne by decedents.

For the nation as a whole, ITEP’s analysis indicates that the share of income taken by state and local taxes falls as income rises, from 10.9 percent of income for the bottom quintile to 6.4 percent of income for the top 1 percent. The ITEP analysis only measures the taxes paid by a resident to his or her own state. A recent study by the Tax Foundation, estimates that nonresidents pay 31 percent of state and local taxes. Accounting for these uncaptured taxes, which include corporate income and business property taxes that are allocated to out-of-state owners, state and local taxes are actually less regressive than the table indicates.

Comparing the Total Tax row for Washington to the corresponding All State row shows taxes as a share of income higher than the national average in the first four quintiles and lower than the national average in the fifth.

Table 3: ITEP estimates of the distribution of the state and local tax burden in 2007

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: Top 1%
U.S. Average							
Average Income in Group	$10,700	$25,500	$42,900	$69,900	$122,400	$277,900	$1,768,000
Sales & Excise Taxes	7.1%	5.9%	4.7%	3.7%	2.8%	1.7%	0.9%
General Sales—Individuals	3.3%	3.0%	2.5%	2.1%	1.6%	1.0%	0.5%
Other Sales & Excise—Ind.	1.6%	1.1%	0.8%	0.6%	0.4%	0.2%	0.1%
Sales & Excise on Business	2.1%	1.8%	1.4%	1.1%	0.8%	0.5%	0.3%
Property Taxes	3.7%	2.8%	2.9%	2.9%	2.9%	2.4%	1.4%
Property Taxes on Families	3.6%	2.7%	2.7%	2.8%	2.7%	2.1%	0.7%
Other Property Taxes	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%	0.7%
Income Taxes	0.2%	1.4%	2.2%	2.6%	3.1%	3.6%	4.2%
Personal Income Tax	0.2%	1.4%	2.2%	2.6%	3.1%	3.5%	3.9%
Corporate Income Tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%
Total Taxes	10.9%	10.0%	9.7%	9.3%	8.8%	7.8%	6.4%
Washington							
Average Income in Group	$11,000	$28,200	$49,900	$78,900	$132,100	$294,600	$1,795,000
Sales & Excise Taxes	13.1%	10.0%	8.3%	6.7%	5.1%	3.3%	1.8%
General Sales—Individuals	4.4%	3.6%	3.2%	2.6%	2.0%	1.3%	0.7%
Other Sales & Excise—Ind.	3.9%	2.7%	2.2%	1.8%	1.3%	0.8%	0.3%
Sales & Excise on Business	4.8%	3.7%	3.0%	2.4%	1.8%	1.2%	0.8%
Property Taxes	4.2%	2.7%	2.9%	2.8%	2.5%	2.3%	1.1%
Property Taxes on Families	4.2%	2.7%	2.8%	2.8%	2.4%	2.0%	0.5%
Other Property Taxes	0.1%	0.0%	0.0%	0.1%	0.1%	0.2%	0.6%
Income Taxes	—	—	—	—	—	—	—
Personal Income Tax	—	—	—	—	—	—	—
Corporate Income Tax	—	—	—	—	—	—	—
Total Taxes	17.3%	12.7%	11.2%	9.5%	7.6%	5.5%	2.9%

The difference is most dramatic in the lowest quintile, which ITEP calculates to pay 17.3 percent of income in state and local taxes, versus 10.9 percent for the all state average. Surprisingly, the general sales tax (the state's most productive revenue source) accounts for only 1.1 of the 6.4 point gap. Other sales and excise taxes on individuals account for 2.3 points of the gap, while sales and excise taxes on business account for 2.7 points of the gap.

Included in the other-sales-and-excise-taxes category are taxes such as the gasoline tax, the public utility tax, and sin taxes such as the beer tax and the cigarette tax. The Washington Legislature recently raised the latter two taxes to help close the state budget gap, arguing in part that these are voluntary taxes, i.e., consumers can choose not to purchase things like beer and cigarettes.

The sales-and-excise-taxes-on-business category includes the general sales tax businesses pay on goods they purchase that are not ingredients incorporated in the goods they sell, public utility taxes and the B&O tax. Washington's unique B&O tax explains the large gap between Washington and the all state average in the sales-and-excise-taxes-on-business category.

Flawed Allocation of B&O Tax in ITEP Model

ITEP allocates the B&O tax in this way: For industries whose output is sold primarily in-state, the B&O tax is borne by state residents according to their share of total consumption. For industries whose products are primarily exported from the state, 50 percent of the B&O tax is assigned to wages and 50 percent to capital. The share assigned to capital is allocated to individuals—both residents and out-of-state owners of capital—proportional to the income they received from capital. A large share of B&O taxes were thus shifted onto consumers and workers.

We don't believe that this is appropriate. The B&O is a tax on business income and the assignment of its burden should parallel the assignment of the corporate income tax and the personal income tax as it applies to business income. (We should note in passing that the supporters of I-1098 believe that the burden of the B&O falls on business owners. This is why they classify expanding the B&O exemption as middle class tax relief.)

For non-corporate businesses, whose income is taxed on the owner's personal income tax return, the tax is allocated to the owner. B&O taxes paid by non-corporate businesses should likewise be allocated to the owner. For businesses that fall under the corporate income tax, tax payments were treated as taxes on capital and allocated to individuals--both residents and out-of-state owners of capital—proportional to the income they received from capital. In states where corporate tax revenue was above average, the excess was assigned to either in-state wages or out-of-state consumption depending on the type of activity. Corporate B&O should be treated the same way.

The sales-and-excise-taxes-on-business category accounts for two-thirds of the tax gap between Washington and the all-states average for the second income quintile, virtually all of the gap for the third quintile, and more than the whole gap for the fourth quintile.

Lifecycle Analysis of Tax Burden

A key reason that the tax burden on the members of the first quintile appears to be so high is that their expenditures considerably exceed their incomes. ITEP uses the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey (CES) to determine how family expenditures vary with income. This survey finds that on average low income households spend more than they take in income. Table 4 shows average annual expenditures by income class for 2008 from the households reporting incomes less than $5,000 had, on average, negative incomes. Nevertheless this group of households earning less than $5,000 annually had average consumption of $23,036. Those households with income between $5,000 and $9,999 had average income after taxes of $8,214 (income tax refunds and refundable credits explain why after-tax income is greater than before-tax income) and average expenditures of $19,125. For households with incomes between $20,000 and $29,999 the average after tax income is $25,355 and average expenditures are $30,367. The data strongly support the contention that the tax burden analysis for the lower income categories is seriously flawed and of little value.

The first category for which average income exceeds expenditures is $40,000 to $49,999. This is also the first category for which after tax income is less than before tax income.

Since in the long run it is not possible for families to spend more than they make, the reported incomes clearly understate the economic well-being of these families and overstate their relative tax burdens.

Focusing the distribution of tax burden among taxpayers at a single point in time is misleading. The proper measure of tax burden relates taxes and income over the lifecycle. Incomes move up and down from year to year, and people save and borrow to smooth out consumption. A tax on income con-

Table 3: 2008 Consumer Expenditure Survey, Average Annual Expenditures by Income Class

Income class	Less than $5,000	$5,000 to $9,999	$10,000 to $14,999	$15,000 to $19,999	$20,000 to $29,999	$30,000 to $39,999	$40,000 to $49,999	$50,000 to $69,999	$70,000 and more
Income before taxes	($1,092)	$8,003	$12,662	$17,461	$24,896	$34,708	$44,733	$59,319	$128,930
Income after taxes	($814)	$8,214	$13,119	$17,840	$25,355	$35,027	$44,621	$58,610	$123,254
Average annual expenditures	$23,036	$19,125	$21,120	$25,536	$30,367	$35,778	$40,527	$50,465	$83,700

centrates individuals' tax payments in the higher earning years while a tax on consumption spreads the payments out more evenly. Consider flat consumption and income taxes that impose the same lifetime burden: At any single point in time the consumption tax will appear to be regressive compared to income tax. For this reason the ITEP analysis, which measures burdens at a single point in time, is biased against states that, like Washington, rely heavily on consumption taxes.

State and federal fiscal systems comprise both tax policy and public expenditures, and to focus exclusively on taxation is to miss the big story on redistribution. In a classic 1986 study, Joseph Pechman of the Brookings Institution concluded that "the tax system has very little effect on the distribution of income." In contrast to the tax system, Pechman found the system of transfer payments to be highly progressive. And when taxes and transfers were combined, the system appeared quite progressive (Pechman 1985).

The popular conception that Washington's tax system is the most regressive in the nation is based on a study with serious flaws that bias the comparison to other states. The system is certainly less regressive than the study makes it appear. When federal taxes are considered—as they should be—the tax system is progressive and when expenditures are considered the overall system is even more progressive.

Business Climate

The mobility of people and businesses that limits the ability of state governments to redistribute income also accentuates the damage that bad tax policies can do to a state economy.

If I-1098 is enacted Washington would be one of only nine states with an 8.5 percent or greater top marginal income tax rate. Table 4 shows the top rate in each of the eight other states. Hawaii and Oregon have the highest rates, 11 percent. The Oregon rate will drop to 9.9 percent after 2012.

All states except for New Jersey allow itemized deductions to be subtracted from AGI in the calculation of taxable income, although New York phases-out the deductions at higher income levels. Four of the eight states—Hawaii, Iowa, Maine and Vermont—provide preferential treatment for capital gains.

Table 4: The eight states with the top marginal income tax rates in 2010

	Top Rate	On Income Greater Than: Individual Return	On Income Greater Than: Joint Return	Deductions Allowed	Preferential Capital Gain Treatment
Hawaii	11.00%	$200,000	$400,000	Yes	Yes
Oregon	11.00%	$250,000	$500,000	Yes	No
California	10.55%	$1,000,000	$1,000,000	Yes	No
Vermont	9.40%	$372,951	$372,951	Yes	Yes
Iowa	8.98%	$63,316	$63,316	Yes	Yes
New Jersey	8.97%	$500,000	$500,000	No	No
New York	8.97%	$500,000	$500,000	Phase-Out	No
Maine	8.50%	$19,750	$39,500	Yes	Yes
Washington with I-1098	**9.00%**	**$500,000**	**$1,000,000**	**No**	**No**

On May 20, Gov. Chris Christie vetoed legislation to raise New Jersey's top marginal rate to 10.75 percent. On June 8, Maine voters rejected a tax reform proposal dropping the top marginal rate to 6.85 percent, while limiting deductions. On June 9, Gov. Don Carcieri signed legislation dropping Rhode Island's top marginal rate from 9.90 to 5.99 percent.

In California a separate Mental Health Services Tax at the rate of 1 percent applies to taxable income over $1,000,000. Excluding this "millionaire's tax," California's top marginal rate, 9.55 percent, kicks in at $46,349 for single filers and $92,698 for joint filers.

At first glance, I-1098's 9 percent top rate would rank Washington 6th highest on the list. All five of the states ahead of Washington allow deductions, however. Two of the five have preferential treatment for capital gains, while a third, Rhode Island, gives taxpayers the option to pay a flat 6.75 percent tax on AGI. On the other hand, the income thresholds at which the 9 percent rate kicks in are relatively high, however, and the increment of income below $200,000 for individuals and $400,000 for joint filers is not taxed, which will make for more favorable comparisons of average tax rates. There is, of course, no constitutional guarantee of these rates and brackets.

National Rankings Affected

No matter what the average rates are, the high marginal rates will effect the state's position in several prominent national business climate rankings. Washington ranks 9th best in the Tax Foundation's 2010 State Business Tax Climate Index. The overall index bends five major components indexes: corporate tax, individual income tax, sales tax, unemployment insurance tax and property tax. Washington ranked 33rd, 1st, 50th, 26th, and 21st respectively in these components. The state's high overall ranking was largely due to the lack of an income tax, which resulted in the "number one" ranking in that component. One of the key criteria that the Tax Foundation uses in evaluating a state's income tax is the top marginal tax rate. Curtis Dubay, who for several years was responsible for the Tax Foundation index, says that "with a 9 percent rate [Washington] would plummet" in the ranking.

Washington ranks 5th highest in the Small Business and Entrepreneurship Council's Business Tax Index for 2010. Two of the inputs into this ranking model are a state's top tax rates on marginal tax rates on personal income and personal capital gains. With the I-1098 income tax, Washington's ranking would fall from 5th to 21st.

The higher state and local taxes discourage economic development, especially when the funds are not spent on goods and services that benefit the economy (Bartik 1991 and Wasylenko 1997). Much of the empirical work on taxes and economic growth focuses on the overall level of taxation or on business taxes specifically, although studies also find that the level of personal taxes influence economic growth (Wasylenko and McGuire 1985; Goss and Phillips 1994).

A recent econometric study by Poulson and Kaplan (2008) found a statistically significant negative effect of personal income taxes on state GDP growth over the 40-year period from 1964 to 2004. Similarly, Laffer, Moore, and Williams (2010) calculate that from 1998 to 2008 the average GDP growth in the nine states without an income tax was 86.3 percent, while the average growth in the nine states with the highest top personal income tax rate was just 59.8 percent.

The I-1098 tax would be unique among state taxes in the way it exclusively targets people with high incomes. John Havens of the Boston College Center for Wealth and Philanthropy studied migration to and from the state of New Jersey, with a special emphasis on the wealth of migrants, over the ten-year period from 1999 to 2008 [Havens 2010]. He found that from 1999 to 2003 the average net worth of households moving into New Jersey was $675,984 while the average net worth of households moving out was $482,554. The overall impact of migration was to increase wealth in the state by $98.3 billion. From 2004 to 2008 the average wealth of in-migrating households was $363,126, and the average wealth of out-migrants was $618,328. Over this five-year period migration decreased New Jersey wealth by $69.8 billion.

Havens then compared the New Jersey migration experience to those of nearby New York and Connecticut. He found:

> 1) New Jersey experienced a proportionately larger decline in the average wealth of in-migrating households (46 percent) than either New York (31 percent) or Connecticut (32 percent).
>
> 2) In the last five years, the average wealth of out-migrating households as a proportion of the average wealth of in-migrating households is much larger for New Jersey (1.70) than for either New York (1.37) or Connecticut (1.25).

These dissimilarities "suggest a factor or factors idiosyncratic to New Jersey ... accelerated the net outflow of wealth from New Jersey in comparison to New York and Connecticut, … [affecting] high wealth households more than households of lesser wealth."

An obvious candidate for the factor accelerating the net outflow of wealth is New Jersey's personal income tax. In 2004 the state raised the rate on income in excess of $500,000 from 6.37 percent to 9.87 percent.

Flight of Wealth

The comparisons with New York and Connecticut, while telling, seriously understate the negative impact of the New Jersey millionaire's tax. Havens is comparing three states at the bottom of the rankings. New York and Connecticut may look good relative to New Jersey, but both have also experienced a flight of wealth as a result of punitive taxation of high earners. Connecticut ranks 36th in gross state product growth 1998-2008; New Jersey, 48th; and, New York, 50th.

A look at the two West Coast states with highly progressive tax structures confirms the tale. California ranked 46th in GSP growth. And Oregon, which in January boosted its already high top tax rates on high earners, ranked 41st (Laffer, Moore and Williams 2010).

California, New York, New Jersey and Connecticut also rank in the bottom ten in net domestic migration (people leaving one state to move to another) in the last decade, according to Census data.

The Oregon experience clearly suggests the problems Washington budget writers and taxpayers will have with I-1098. Despite proponents' claims of revenue growth from the passage of Measure 66 and 67, boosting taxes on high earners and unprofitable businesses, the state forecasters say this in their most recent risk assessment:

> Another uncertainty facing the Oregon economy is the impacts from the two tax measures which were passed on January 26. Studies on both sides of the issue from respectable sources derived very different conclusions. Given the uncertain nature of the impact of these two tax measures, we will not incorporate possible impacts into the Oregon economic forecast." (Oregon Office of Economic Analysis 2010)

One reason the promises of new revenue may not pan out can be found in the Rich States, Poor States analysis, shedding further light on the New Jersey, Connecticut and New York comparisons:

> Examining IRS tax return data by state, E.J. McMahon measured the impact of large income tax rate increases on the rich in Connecticut, which raised its tax rate in 2003 to 5 percent from 4.5 percent, New Jersey, which raised its rate to 8.97 percent from 6.35 percent in 2004, and New

York, which raised its tax rate to 7.7 percent from 6.85 percent in 2003. Over the period from 2002 to 2005, the "soak the rich" tax hikes were followed by a significant reduction in the number of rich people paying taxes in each of these states relative to the national average.

Constitutional Issues

In 1933, in the case Culliton v. Chase, the Washington Supreme Court overturned a graduated income tax that had been enacted by the voters through Initiative 69. The court ruled that the graduated tax was unconstitutional because income is property and the Washington State Constitution stipulates that "all taxes shall be uniform upon the same class of property."

Attorney Hugh Spitzer, who was vice chair of the 2002 Washington State Tax Structure Study Committee, has argued that the Culliton case was wrongly decided and that the present state Supreme Court would overturn the 1933 decision if given the opportunity (WSTSSC 2002, Appendix B). Of course, for now, the Court's decision stands.

I-1098 supporters acknowledge that the initiative is intended to be a vehicle to take the constitutional issue back to the court and believe that the court is more likely to overturn the earlier ruling if the tax in question has been blessed by a majority of state voters rather than just a majority of state legislators. If that should happen, the result will be a statutory imposition of a state income tax, with no barriers to the legislature's ability to determine tax rates, bases, and brackets by a simple majority vote.

Observations

There is a lot not to like about I-1098 even if one thinks that the state's tax stool needs a third, income tax, leg.

Revenue from the tax will be hard to forecast and extremely volatile. The initiative virtually assures that the next mild downturn in the economy will be a severe fiscal crisis for the state.

Although I-1098 supporters have claimed their measure is necessary to "balance" the distribution of the burden, the initiative does nothing to accomplish that purported objective.

The property and business tax relief claimed by the initiative is trivial when compared to the heavy new burden placed on entrepreneurs, investors, and business owners. By taxing S corporation, LLC, and partner income as it does, I-1098 imposes stiff new business taxes. The high tax rate established for those at the top of the income distribution will discourage entrepreneurs who chase long odds in the hopes of a big payday from rolling the dice here and deprive Washington employers of a powerful recruiting tool. That will reduce the prosperity of us all. The experience in other states confirms the negative consequences for economic vitality and job creation when government imposes punitive tax burdens on high earners.

Even for those who favor an income tax, the peculiar, punitive and volatile tax imposed by I-1098 cannot be considered acceptable. It jeopardizes the economic recovery, destabilizes the state revenue system, and chases jobs and investment from Washington.

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