



Economic Opportunity Institute

POLICY BRIEF

An Incremental Approach to Improve Washington State's Tax System

A proposal for a tax on high-income households

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Executive Summary

Washington state's tax system is antiquated and unsuited for the 21st century economy. The state's heavy reliance on sales taxes gives Washington the most regressive tax system in the nation. The current array of taxes also does not produce revenues that grow along with the economy. As one result, Washington is slipping behind many other states in providing services that are essential for a vibrant economy and high quality of life. According to the Census Bureau, Washington ranked 30th in per pupil spending on elementary and secondary education in 2002. Washington is near the bottom among all states in providing upper division college slots for young adults and in funding transportation and parks.

Washington is one of only seven states with no personal income tax. A new tax on high-income households would more fairly distribute taxes and produce revenues that would grow with the state's economy and need for services, particularly if linked to a reserve account and reductions in other taxes.

Estimated Annual Revenue in 2001

Tax rates	Annual revenue in 2001	% of Washington households taxed
1% on \$200,000-\$500,000 (\$400,000 couples) 3% on \$500,000-\$1 million 5% on \$1 million+	\$548,317,950	2%
3% on \$200,000-\$500,000 (single and married) 5% on \$500,000-\$1 million 7% on \$1 million+	\$944,425,130	2%
1% on \$250,000-\$500,000 (\$500,000 couples) 3% on \$500,000-\$1 million 5% on \$1 million+	\$519,264,646	less than 2%
3% on \$250,000-\$500,000 (single and married) 5% on \$500,000-\$1 million 7% on \$1 million+	\$857,284,836	less than 2%
1% on \$1 million + (single and married)	\$80,778,270	0.2%
5% on \$1 million + (single and married)	\$403,891,350	0.2%

Source: Estimated by author from Internal Revenue Service data.

See the full brief for discussion of:

- changes in the distribution of household income over the past quarter century
- lessons from other states
- constitutional and political questions
- volatility and a rainy day fund
- administrative costs
- linking the new tax to reductions in existing taxes.

I. Introduction

Washington state's tax system is antiquated and unsuited for a 21st century economy and democracy. The state's heavy reliance on sales taxes gives Washington the most regressive tax system in the nation. Low-income households pay five times as much of their income in state and local taxes as the highest-income households. The middle class is taxed at twice the rate of the most affluent fifth.¹ The current array of taxes also does not produce revenues that grow along with the economy. Because of this structural deficit and because over time people are spending less of their income on goods that are taxed, the state has had to repeatedly raise tax rates to avoid cuts in services. This situation helps fuel tax-cutting initiatives that reduce revenues while only marginally reducing the taxes paid by the average Washingtonian.

As one result, Washington is slipping behind many other states in providing services that are essential for current and future quality of life. According to the U.S. Census Bureau, Washington ranked 30th in per pupil spending on elementary and secondary education in 2002 and 45th in education spending relative to personal income.² Washington is close to the bottom among all states in providing upper division college slots for young adults.³ Despite having the 4th most heavily used state park system in the country, the state is 47th in funding for parks and has recently begun to close down parks in various parts of the state.⁴ Washington is also near the bottom among all states in transportation spending.⁵ The state's health care safety net is quickly losing its ability to sustain access to health care and shore up local health care systems, and 45,000 children were recently cut off from the state's public health insurance programs.⁶

This brief examines the pros and cons of a tax on high-income households that would more fairly distribute taxes and produce revenues that, on average, would grow at least as fast as the state's economy. Such an income tax would apply to only 2% or fewer of the state's households but would help stabilize state revenues and could raise as much as a billion dollars a year (see revenue estimates below) to more adequately fund important public services. The new tax could also be coupled with a reduction in sales or property taxes, lowering the average family's tax bill.

Key Features of A High-Income Tax

- Focuses on high-income individuals and households (top 2 percent of tax filers).
- Raises \$240 million to \$1 billion a year on a sustainable basis.
- Includes a reserve account to ensure stable revenues.
- Caps the size of the reserve account.
- Allows a portion of new revenues or surpluses in the reserve account to be used to lower other taxes (e.g. sales or property).

This brief presents a rationale for a high-income tax in the context of changes in society and the state's economy. It compares the proposed income tax to other states' tax systems and examines the interaction between federal and state taxation. The brief also reviews design principles that will lead to a fairer tax system with stable revenues. The paper proposes scenarios for program design, estimates revenues available from the options, and outlines reductions in other taxes that would be possible if a tax on high incomes were adopted.

While improving the state's tax system makes sense on fairness and efficiency grounds, any such change must pass both political and legal hurdles. Some interpretations of constitutional jurisprudence hold that most forms of income tax would be unconstitutional in Washington. Because any income tax proposal in Washington is likely to face a constitutional challenge, we discuss this issue in a separate section below.

II. Washington's Tax System and Its Growing Problems

Washington's current tax system was set in place in the 1930s. Its features include one of the nation's highest sales tax rates and a Business and Occupation (B&O) tax that, alone among the 50 states, taxes total business revenues instead of profits. Unlike 43 other states, Washington does not have any personal income tax.⁷

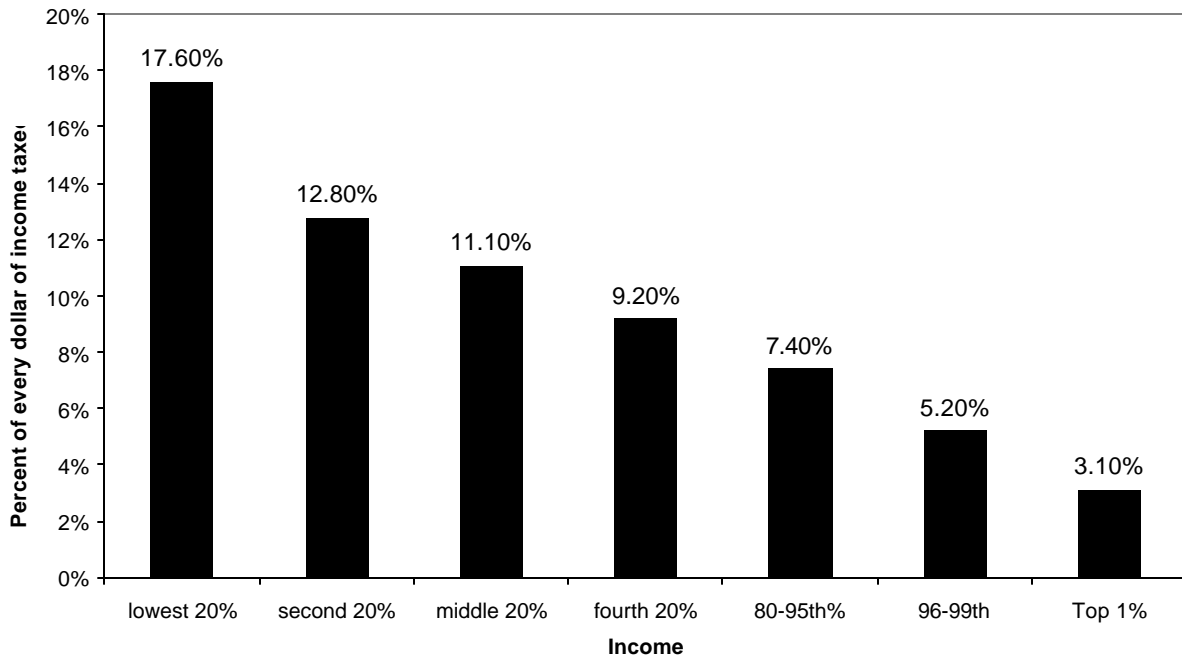
These elements of the tax system together produce a number of negative consequences for families, businesses, and the state's economy. The absence of an income tax requires a continued heavy reliance on sales and business taxes. (Property taxes in Washington are very close to the national average.) The B&O tax that taxes total revenues instead of profits is especially hard on small and start-up businesses. Because retail purchases do not increase at the same rate as household income and more and more consumption is shifting to untaxed services and Internet sales, sales tax revenues are continually shrinking as a proportion of the state's economy.⁸ According to the state Department of Revenue, sales taxes have been growing at about 85% of the rate of total personal income. At the same time, demand for public services tends to increase at the same pace as personal income. For example, as family incomes rise, people drive more, they expect higher quality public schools, and a higher proportion of young adults apply to state colleges.⁹

Washington's tax system falls short of producing sufficient revenues compared to other states. Washington was 32nd in the nation in state and local taxes per \$1,000 of personal income in 2000, the latest year for which comprehensive Census Bureau data are available. Washington's relative position has dropped steadily since 1997 when it ranked 11th, which has led to a growing state crisis in funding for basic needs including education, transportation, social services, and health care.¹⁰ Recovery from the recession will help but not solve the underlying problem of insufficient public revenues.

Washington's tax structure results in middle- and lower-income households paying much more of their earnings in state and local taxes than higher-income families. The fifth of families with the lowest incomes pay 18 cents of every dollar to state and local taxes; the middle fifth pays 10

cents of every dollar, while the richest 1% pay about three cents.¹¹ This fundamentally imbalanced system has resulted in the state being named one of three top “tax havens for the very wealthy” by Bloomberg Finance Magazine.¹²

Figure 1: Percent of every dollar of income taxed, by income group, Washington, 2002



Source: Institute for Taxation and Economic Policy, *Who Pays? A Distributional Analysis of Taxes in All 50 States*, January 2003.

III. Advantages to a State Income Tax

This paper examines a tax on high-income households as a targeted approach to raising additional revenues. An income tax would be the best way to make the overall tax system more fair. In addition, over time income taxes grow, on average, at the same rate as the economy and therefore can help keep revenues aligned with the need for services.¹³

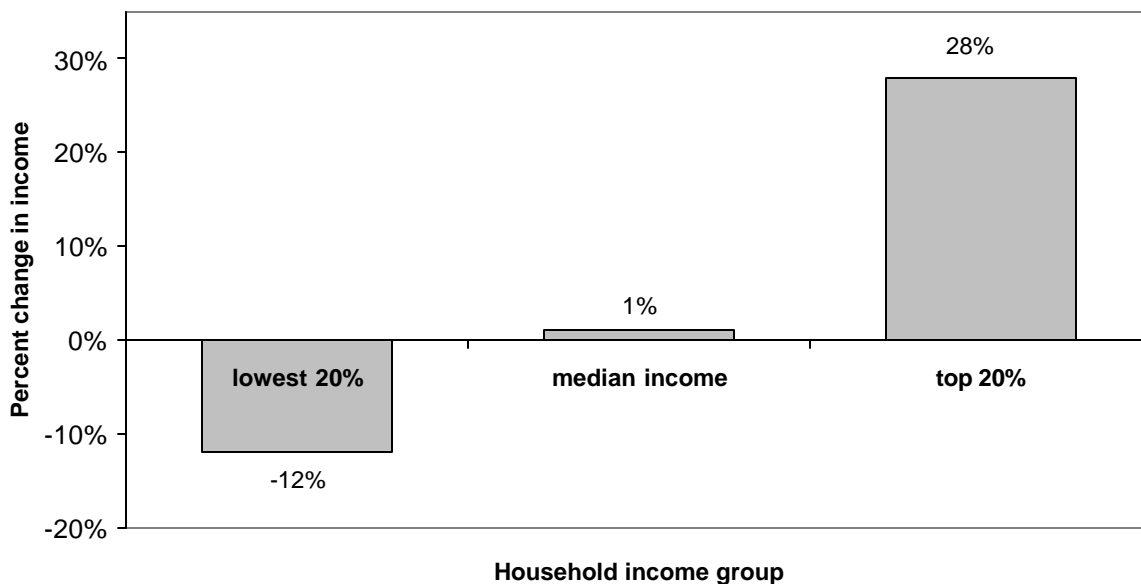
An income tax that targets the state’s highest-income households will most quickly get at the core of Washington’s tax problems by producing more revenue to upgrade services while simultaneously allowing some reductions in the tax rates of middle- and lower-income households. The continued good fortunes of very high-income households strengthen the rationale for shifting taxes upwards. High-income families and individuals have done extraordinarily well over the past quarter-century in comparison to the majority of families. The bottom 90% of families have lost shares of national income. In contrast, the top 10% have seen

their share of income increase from 33% in 1980 to 44% in 2000. Even this understates the actual gains of the highest-income households. Much of the increase in income has accrued to the top 1% of households who saw their share almost double from 8% to 17% during this time period.¹⁴

This pattern of income inequality--where the more you have, the faster your income grows--is mirrored by similar trends in the concentration of wealth (net worth) in the hands of the highest-income fractions of the population.¹⁵ The United States stands alone in the rapid shift of income and wealth toward the top fractions despite efforts to blame inequality on uncontrollable forces of globalization. These trends also depart from the experience of much of the past century, when inequality actually lessened and gains at the top were proportionate.¹⁶

Trends in Washington mirror national patterns. A national study using data through 1998 found that in Washington the lowest-income fifth of families actually lost almost 10% of their real income over the decade of the 1990s, whereas the top fifth gained almost 20%.¹⁷ A more recent Northwest Environment Watch analysis of Census Bureau Current Population Survey data comparing household income from the 1988-1990 period to the 1999-2001 period showed even more substantial declines for the bottom fifth of households, a 28% gain for those in the top fifth, and income stagnation for those in the middle (Figure 2).¹⁸

Figure 2. Percent change in average inflation-adjusted income for Washington households at select points in the income distribution, from 1988-90 to 1999-2001



Source: Northwest Environment Watch, *Falling Behind: Economic Security State by State*, June 25, 2003

Those segments of the population that have done best in the current economy have also benefited most from recent federal tax changes. For example, federal tax cuts during the 2001-2003 period resulted in an average savings in 2003 of \$93,500 for those with incomes over \$1 million,

compared to an average of \$217 for the middle fifth of households. Fifty-three percent of U.S. households received \$100 or less in federal income tax reduction during 2003 as a result of the 2001-2003 tax cuts.¹⁹ In the longer term, the top 1% is slated to get a federal tax cut of 17% over the 2003-2010 period, compared to a cut of 5% for the remaining 99% of taxpayers.²⁰

Instituting a new tax on high-income households at the state level has the advantage of having minimal negative effect on overall consumer demand in the state's economy. Since more of the income of very high-income households, on the margin, goes to investment and to consumption outside the state, tax cuts concentrated at the top do the least to stimulate the economy, whereas tax *increases* on this group minimize any short-term reductions in local consumer demand. Also, if tax increases on high-income households were coupled with tax reductions on middle- and lower-income households, these changes could actually help stimulate consumer demand in Washington's economy.²¹

Because state income taxes can be deducted from federal taxes, a portion of a new Washington income tax would be "exported" to the federal government, reducing the net new tax on high-income households. On average, up to one-third of the state income tax as proposed below would be offset by lower federal taxes on the highest-income households.²²

IV. Lessons from Tax Systems of Other States

Currently, Washington is one of only nine states that do not have a broad-based income tax. Two of the nine, New Hampshire and Tennessee, tax some of the non-wage income of the highest-income households via a tax on dividends and interest income. Given this, only six states other than Washington do not have any direct tax on the incomes of the most affluent households.²³ Adopting a moderate tax on the highest-income households in Washington would therefore help place the state solidly among the mainstream of states and counteract some of the current system's negative features while still imposing a relatively light level of taxation on the state's high-income households.

Comparative income taxes. A review of the tax systems of other states identifies design features that may be appropriate for a new tax for Washington. This examination reveals tremendous variations in tax rates, the number of income brackets taxed at different rates, the break points for the various brackets, the allowance of personal or itemized deductions, and the tax reference base (e.g. federal adjusted gross income, federal taxable income, or some other standard).

Most states use federal tax returns as a starting point for calculating state income tax. As summarized in Table 1, calculating taxes as a percent of federal adjusted gross income (AGI) is the most popular method, adopted by 27 states (See Appendix Table 1 for additional details). This line of the federal tax form incorporates most sources of income but represents income before most exemptions and all itemizations. Many of these states allow a deduction for each member of a household. Ten states reference federal taxable income after exemptions and

itemized deductions have been taken. Finally, five states have their own idiosyncratic reference point and do not explicitly reference federal tax return calculations at all.

Table 1. Summary of state tax features

No income tax of any kind	7 states
Tax on dividend and interest income only	2 states
Income tax	42 states*
Income tax states using AGI	27 states
Income tax states using federal taxable income	10 states
Income tax states using some other formula	5 states
Number of flat tax states	6 states
Range of number of tax brackets	1 to 10
Range of low rates (includes flat tax states)	.36% to 6%
Range of high rates (includes flat tax states)	3.07% to 11%
*Includes the District of Columbia	
Source: Federation of Tax Administrators, "State Individual Income Taxes," http://www.taxadmin.org/fta/rate/ind_inc.html .	

Six states have a flat tax, levying the same percentage on millionaires and minimum-wage earners. Colorado and Pennsylvania tax all income levels and do not allow any personal exemptions, whereas the other four flat tax states allow some exemptions, ranging from a \$1,000 exemption per person in Indiana to \$3,300 in Massachusetts.²⁴ Most states have at least two tax brackets, and Missouri and Montana have the largest number at 10. For states with a graduated tax, the starting point for taxation ranges from \$500 in Alabama to \$29,050 in Vermont.²⁵ The income level at which the highest-income bracket begins also varies substantially, ranging from a low of \$3,000 in Alabama and Maryland for single filers to \$500,000 in New York. Rates on the highest incomes also vary substantially, from a low of 3% in Illinois to 11% in Montana. Table 2 lists the top tax rates for all states with an income tax.²⁶

Table 2. Top income tax rates by state

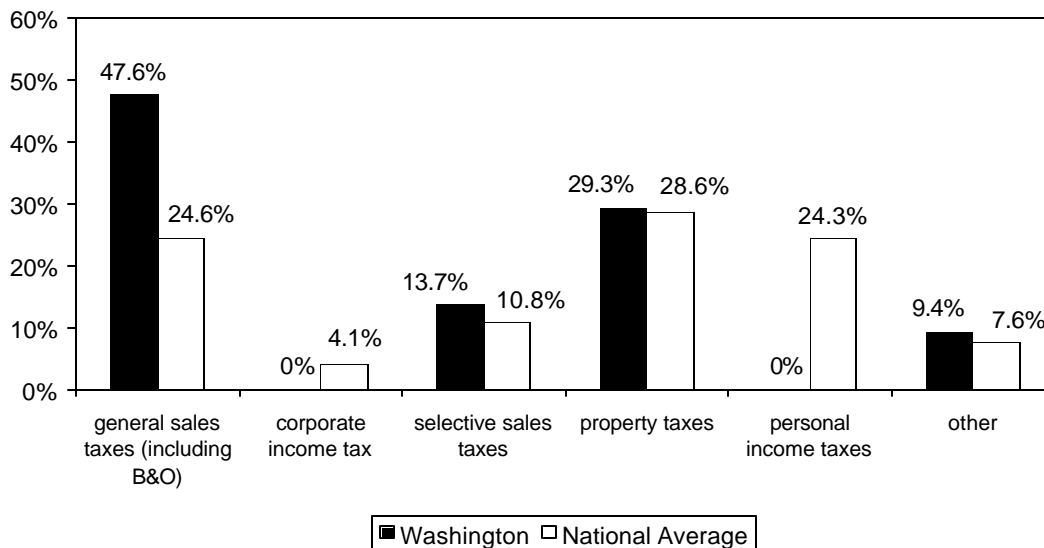
Alabama	5.0	Missouri	6.0
Arizona	5.04	Mississippi	5.0
Arkansas	7.0	Montana	11.0
California	9.3	Nebraska	6.84
Colorado	4.63	New Jersey	6.37
Connecticut	5.0	New Mexico	6.8
Delaware	5.95	New York	7.70
Georgia	6.0	North Carolina	8.25
Hawaii	8.25	North Dakota	5.54
Idaho	7.8	Ohio	7.5
Illinois	3.0	Oklahoma	6.75
Indiana	3.4	Oregon	9.0
Iowa	8.98	Pennsylvania	3.07
Kansas	6.45	Rhode Island	25% of federal tax liability
Kentucky	6.0	South Carolina	7.0
Louisiana	6.0	Utah	7.0
Maine	8.5	Vermont	9.5
Maryland	4.75	Virginia	5.75
Massachusetts	5.3	West Virginia	6.5
Michigan	4.0	Wisconsin	6.75
Minnesota	7.85	Dist. Of Columbia	9.0
Source: Federation of Tax Administrators			

Stabilizing revenues. Over time, an income tax tends to produce revenues that grow at or slightly above the rate of growth in the economy, whereas other taxes, such as sales taxes, grow more slowly, creating a gap between needs and revenues.²⁷ Taxes on high-income households are likely to produce substantial revenues given recent trends in income inequality. However, such taxes are also more volatile than taxes levied on a broader range of income levels. Therefore, it is important to include features that smooth out sharp rises and falls in revenue.

To counteract volatility, most states rely on a balance of sales, property, business, and income taxes. As a result, any unusual contractions in revenues in one tax may be balanced out by steady revenues, or at least lower rates of revenue contraction, in others. Figure 3 displays the proportion of various state and local taxes across all states compared to Washington. While Washington's reliance on property and selective sales taxes (such as alcohol and tobacco) is fairly typical, it differs dramatically on other taxes. On average, states receive about one-quarter of revenue from personal income taxes and less than 30% from general sales taxes and corporate business taxes combined. In contrast, nearly half of state and local revenue in Washington

comes from general sales taxes and the B&O tax (which the Census Bureau and most economists classify as a sales tax, paid indirectly by consumers).²⁸

Figure 3. Revenue sources for state and local taxes, Washington and national average, fiscal year 2000



Source: U.S. Census Bureau, "State and Local Government Finances."

During the 2001 recession and era of slow growth that followed, sales taxes fell less than income taxes because of unusual factors that buoyed consumption. Steady expansion of home values and exceptionally low interest rates helped stimulate consumption, especially of durable goods such as furniture or appliances. In contrast, rapid run-ups in stock option income during the 1990s temporarily inflated income tax revenues in some states, which then fell sharply when the stock market crashed.²⁹

In order to counteract revenue fluctuations, many states employ a reserve fund that holds any surplus generated during high revenue growth periods and releases these funds when an economic or revenue downturn occurs. In 2002, 47 states, including Washington, had some sort of reserve account. Reserve funds are usually filled by the transfer of year-end revenue surpluses to the account according to state law. Most states either earmark the funds for use in emergencies and/or require a supermajority vote (often two-thirds) for the funds to be spent.³⁰

Oregon, often identified as having unstable revenues because of its income tax, is one of only three states that have no sales taxes at the state or local level. Oregon relies on income tax for 47.9% of state and local revenues. In addition, the state is only one of three without any budget reserve fund.³¹ These factors, rather than the presence of an income tax, are the main sources of its revenue instability.

V. Constitutional and Political Questions

Some observers believe that instituting a graduated income tax or one targeting high-income households in Washington would require a constitutional amendment. In 1933 the State Supreme Court invalidated a graduated income tax passed by initiative one year earlier. The court ruled that income is property and therefore subject to the constitutional restrictions placed on taxing personal property. Under this interpretation, any income tax adopted without a constitutional amendment must be a flat tax, at a rate no higher than 1%, and with no more than \$3,000 in income exempted.

Whether or not the 1933 ruling currently prohibits the adoption of a graduated or high-income household tax without a constitutional amendment is open to question, however. Tax uniformity provisions were adopted by many states during the 19th century in response to political pressures by various industrial interests for preferential property tax rates. While conservative courts of the early part of the last century interpreted property tax uniformity provisions as applying to income, many of those rulings have since been overturned. The U.S. Supreme Court rulings upon which such interpretations were originally based have also been overturned. At present, only Pennsylvania operates under a similar state constitutional interpretation, and the language in its constitution requiring flat taxation is more sweeping than comparative language in Washington.³²

Because of the possibly tenuous legal status of the current State Supreme Court rulings, one pathway for adopting a tax as outlined in the paper would be for the Legislature to pass such a law outright, with the understanding that it would be challenged in the courts. While the current court might well choose to overturn earlier rulings and allow the new tax to stand without a constitutional amendment, there is no doubt that this approach would delay the implementation of such a law. Therefore, making such a change will require a long-term perspective.

The other barrier to a tax on high-income households is political. Washington voters have decisively defeated personal income tax proposals numerous times since 1932, most recently in 1973. Conventional wisdom continues to maintain that supporting an income tax is political suicide in this state. However, evidence from other states shows that voters can support new or higher income taxes, particularly if they are coupled with reductions in other taxes or devoted to popular services such as education. Connecticut adopted an income tax for the first time in 1991, and it has retained popular support.³³ In Tennessee, a state without a general income tax, a 2002 poll showed that a majority had shifted to support an income tax as long as it was coupled with sales tax reductions.³⁴ Recently, even some conservative states have either adopted broad tax reforms with popular support or have seen voter sentiment become more favorable to income tax increases as the problems of unbalanced tax systems became apparent. For example, voters in Louisiana passed a measure sponsored by Republican State Representative Vic Stelly that resulted in reductions in sales and utility taxes along with an increase in income tax rates. The measure passed after a low-key campaign emphasizing that the measure would reduce taxes for the majority of the state's taxpayers.³⁵ In Illinois, voters polled recently supported income tax increases to fund education, as long as any measure was coupled with property tax reductions,³⁶ and in June 2004, the New Jersey Legislature accepted the governor's proposal to increase income taxes on households making over \$500,000.³⁷

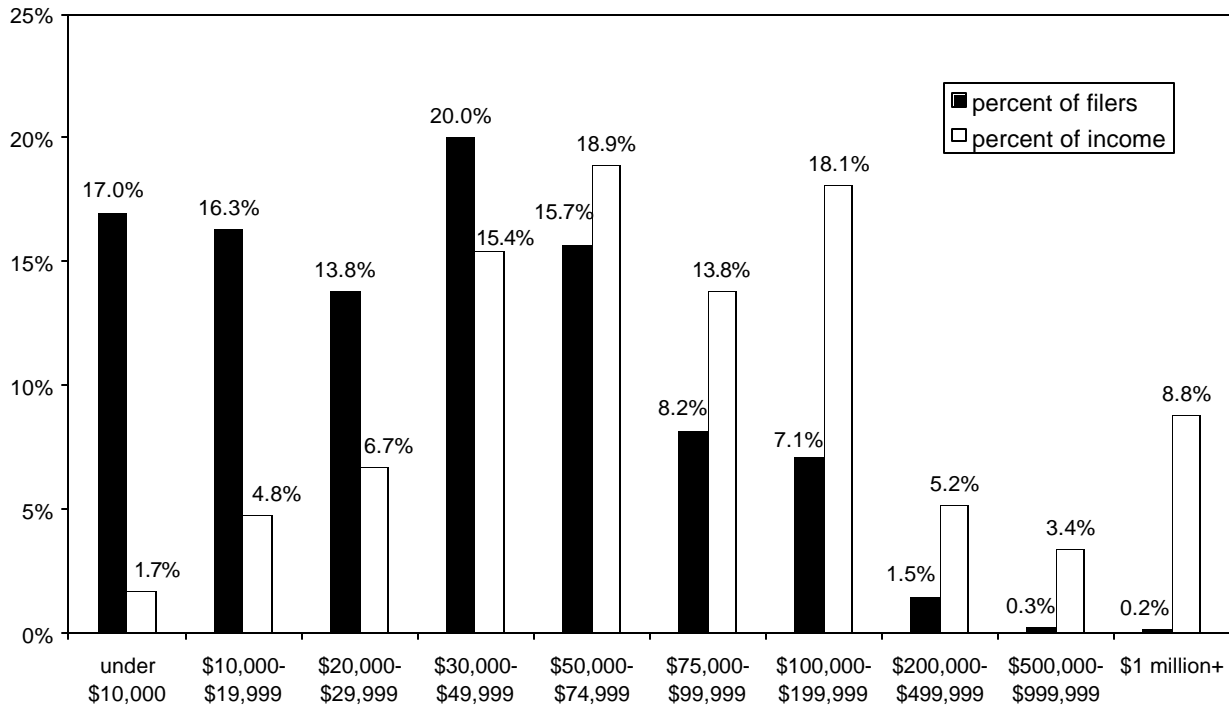
VI. Tax Scenarios for Washington

An income tax targeted at high-income households might be an option for Washington. The scenarios outlined here would raise new revenue for high-priority public services, while reducing the regressivity and structural deficit that plague the current tax structure. They are designed to be simple and easy to explain, comply with, and administer. Given that any system will be subject to economic cycles, coupled with the proposed tax is a reserve account to stabilize available revenues. Once a reserve account is fully established, additional dollars may be dedicated to reducing other, regressive taxes. A prime candidate for linked tax reduction is the sales tax. Such a change would further reduce regressivity of the system and allow the state to discard its role as the state with the nation's highest sales tax rate. Another possibility would be to reduce the property tax, either generally or through an expansion of the tax exemption for lower-income senior and disabled homeowners.³⁸

The high-income household tax proposal calculates tax liabilities based on Adjusted Gross Income (AGI) as reported on federal tax returns. Such a feature would put the tax in the mainstream of states and minimize the number of calculations necessary to calculate payments. Tying the tax to adjusted gross income also avoids duplicating the distortions of the federal tax code and de-links the state from changes in federal tax law that would otherwise increase complexity and potentially add to instability of revenue. Since the tax would be calculated from information from an existing document, monitoring of compliance would be relatively simple.

Real tax return data for 1997 through 2001 from the Internal Revenue Service (IRS) have been used in estimating revenues from the new system. Figure 4 shows the proportion of total adjusted gross income as reported to the IRS by Washington tax filers in various income groups, along with the proportion of total filers represented by each income group. In 2001, households making \$200,000 and above accounted for 2% of all tax filers but over 20% of income in the state for that year.³⁹ Because the income groups at the very top account for such a high proportion of total state gross income, this group is the focus for the new tax. Such a targeted tax will maximize revenue while minimizing the number of households paying the new tax.

Figure 4. Distribution of Washington tax filers and share of total state gross income by income band, 2001



Source: Calculations from Internal Revenue Service Data

This paper presents several options for rates and exemption levels. One group of options proposes three marginal rates, with each income group taxed at 2% higher than the prior group. Starting rates begin at 1%, 2%, or 3%. With these starting points, the top rates on households with over \$1 million in income vary from 5% to 7%. All taxpayers receive a standard, very generous deduction, beginning at \$200,000 or \$250,000, assuring that the average rates increase gradually as income increases. In some scenarios, the very generous deduction for couples filing jointly is doubled. Higher rates apply only to income over the set thresholds. For example, in the 1%, 3%, and 5% scenario with a \$200,000 deduction, high-income taxpayers are not taxed on their first \$200,000 of income. For the \$200,000 to \$500,000 group, income over \$200,000 is taxed at 1%. For the next group, \$500,000 to \$1 million, income between \$200,000 and \$500,000 is taxed at 1%, and income between \$500,000 and \$1 million is taxed at 3%. The 5% rate applies only to income over \$1 million.

The table also includes scenarios where only households with incomes over \$1 million are taxed, with taxes applying at a flat rate on all income exceeding \$1 million. As Table 3 shows, revenues raised in a single illustrative year (2001) range from a low of \$81 million to a high of \$944 million, depending on the array of rates and income groups taxed.⁴⁰

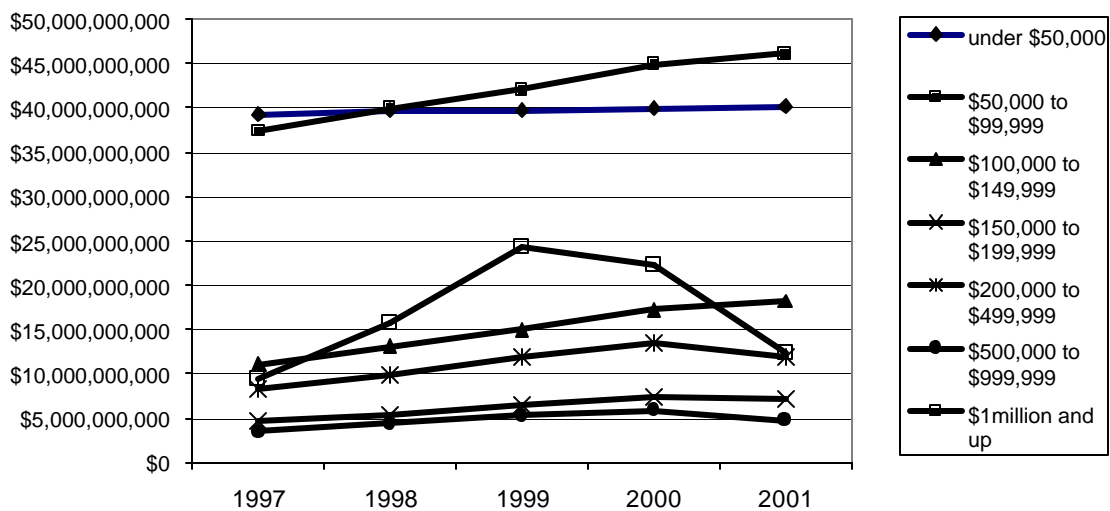
Table 3: High-income tax options and estimated annual revenues in 2001

Starting at \$200,000 or \$250,000, variable marginal tax rates			
A. Exemption set at \$200,000, no additional exemptions for joint filers			
<i>Marginal tax rate for:</i>	<i>1% to 5% rates</i>	<i>2% to 6% rates</i>	<i>3% to 7% rates</i>
0-\$200,000	0.0%	0.0%	0.0%
\$200,000-\$500,000	1.0%	2.0%	3.0%
\$500,000-\$1,000,000	3.0%	4.0%	5.0%
\$1,000,000 and above	5.0%	6.0%	7.0%
TOTAL REVENUE	\$575,425,150	\$759,925,140	\$944,425,130
B. Exemption set at \$200,000, double exemption for joint filers:			
<i>Marginal tax rate for:</i>	<i>1% to 5% rates</i>	<i>2% to 6% rates</i>	<i>3% to 7% rates</i>
0-\$200,000	0.0%	0.0%	0.0%
\$200,000-\$500,000	1.0%	2.0%	3.0%
\$500,000-\$1,000,000	3.0%	4.0%	5.0%
\$1,000,000 and above	5.0%	6.0%	7.0%
TOTAL REVENUE	\$548,317,950	\$705,710,740	\$863,103,530
C. Exemption set at \$250,000, no additional exemptions for joint filers			
<i>Marginal tax rate for:</i>	<i>1% to 5% rates</i>	<i>2% to 6% rates</i>	<i>3% to 7% rates</i>
0-\$250,000	0.0%	0.0%	0.0%
\$250,000-\$500,000	1.0%	2.0%	3.0%
\$500,000-\$1,000,000	3.0%	4.0%	5.0%
\$1,000,000 and above	5.0%	6.0%	7.0%
TOTAL REVENUE	\$546,378,385	\$701,831,611	\$857,284,836
D. Exemption set at \$250,000, double exemption for joint filers			
<i>Marginal tax rate for:</i>	<i>1% to 5% rates</i>	<i>2% to 6% rates</i>	<i>3% to 7% rates</i>
0-\$250,000	0.0%	0.0%	0.0%
\$250,000-\$500,000	1.0%	2.0%	3.0%
\$500,000-\$1,000,000	3.0%	4.0%	5.0%
\$1,000,000 and above	5.0%	6.0%	7.0%
TOTAL REVENUE	\$519,264,646	\$647,604,132	\$775,943,618
Flat tax on income over \$1 million only (no additional exemptions)			
<i>Tax rate:</i>	<i>TOTAL REVENUE</i>		
1%	\$80,778,270		
3%	\$242,334,810		
5%	\$403,891,350		
7%	\$565,447,890		

Source: Author's calculations from Internal Revenue Service, income tax returns from Washington state for 2001.

Volatility. Because some forms of income, such as stock options and dividends, that tend to be concentrated at the top of the income spectrum are volatile, revenues from taxes on the highest income groups will tend to vary more than those from the middle and lower income groups. As Figure 4 shows, total gross income by income group over time fluctuates more as income increases. The total income for households under \$50,000 was relatively flat between 1997 and 2001, while the combined incomes of middle class households, defined here as having \$50,000 to \$100,000 in income, steadily increased over this period.⁴¹ In contrast, the total gross incomes of groups over \$200,000 actually declined in 2000 or 2001. Volatility is most marked in those receiving \$1 million or more in a year. For this group, a sharp decline followed an equally dramatic rise in the total income received.

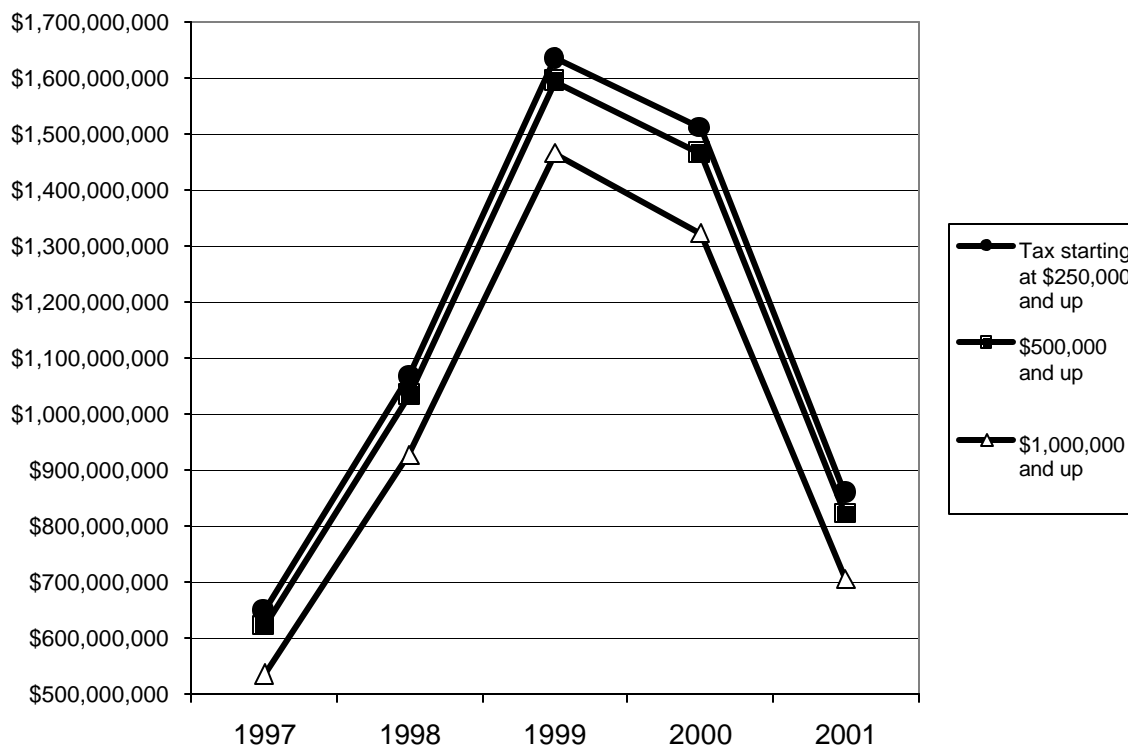
Figure 5. Total adjusted gross income by income group, Washington, 1997-2001



Source: Calculations from Internal Revenue Service Data

Not only are incomes above \$1 million most volatile, they also produce the bulk of the revenues from a new income tax as proposed here. Including a broader spectrum of high-income households produces more revenue for state services but does not dramatically lessen volatility. Figure 5 illustrates how volatility would have affected tax revenues had a high-income tax been in place in Washington over the 1997-2001 period. The revenues shown estimate applying a 3% rate to incomes between \$250,000 and \$499,999, a 5% rate to incomes between \$500,000 and \$999,999, and a 7% rate to incomes above \$1 million.

Figure 6. Total estimated Washington income tax revenue, as affected by range of income taxed, 1997-2001



Source: Author's calculations from IRS tax data for Washington state. Figure shows estimated revenues from a 3% rate on incomes between \$250,000 and \$499,999, a 5% rate on incomes between \$500,000 and \$999,999, and a 7% rate on incomes above \$1 million (with no double deduction for joint filers).

Reserve account. A tax on high-income households would help reduce the regressivity of Washington's tax system. This income tax would also improve the "elasticity" of state revenues—their ability to keep up with growth in the state economy. However, the resulting revenue volatility would have to be offset by coupling the new tax with a reserve account.

While income taxes on average keep pace with or exceed the growth rates of the economy, at any one time such taxes may exceed or lag the rate of total economic growth. The best way to stabilize revenues would be to link such an income tax with a mandatory reserve requirement. Once the reserve account was filled according to specifications, additional revenues could be earmarked to reduce other state taxes or expand services.

In Washington, a budget stabilization account was set up in 1981. This original account was replaced in 1993 by an "emergency reserve fund" to hold funds in excess of the spending growth allowed by the passage of statewide Initiative 601, which was implemented in that year. Originally, spending funds from this account required a two-thirds vote, but this supermajority requirement was repealed in 2001.⁴²

A reserve account to smooth out the fluctuations in a new tax on high-income households could have the following features. For example, if tax rates of 3%, 5%, and 7% were chosen, with a deduction of \$250,000 for all taxpayers, the tax would have raised, on average, \$1.14 billion dollars per year over the 1997-2001 period. Table 4 shows a simulation of how this account would have worked had it been initiated in 1997. In this example, the reserve is set up so that any revenues in a particular year in excess of \$1 billion would go into the reserve account, with reserve dollars immediately released in any year when revenues fall below \$1 billion. Over the late 1990's economic expansion, the reserve account would have grown quickly, exceeding \$1.2 billion by 2000. In 2001, when revenues dropped below \$1 billion, \$143 million would have been shifted back to revenues to assure \$1 billion of available revenue. The total reserve could be capped at, say, \$2 billion, with any dollars over that amount devoted to tax reductions elsewhere in the state's tax system.

Table 4: Estimated revenues and reserves with household exemption at \$250,000 and tax rates of 3%, 5%, and 7%

	1997	1998	1999	2000	2001
Annual Revenue	\$647,153,890	\$1,065,058,205	\$1,633,188,279	\$1,509,784,946	\$857,284,836
Available Revenue	\$647,153,890	\$1,000,000,000	\$1,000,000,000	\$1,000,000,000	\$1,000,000,000
Reserve	0	\$65,058,205	\$698,246,484	\$1,208,031,430	\$1,065,316,266

Note: Revenues in any one year over \$1 billion are placed in the reserve account. When revenues are below \$1 billion, dollars are automatically shifted from the reserve account to ensure \$1 billion of available revenues. Any possible investment gains in a reserve account are not reflected here. Figure shows revenues after accounting for one \$250,000 deduction per household (no double deduction for joint filers).

For the sake of simplicity, this example is shown with a flat revenue goal of \$1 billion. However, to ensure that revenues from the income tax kept pace with economic growth and the demand for state services, the reserve system should be established with an automatic inflator, for example linked to average economic growth over the previous three years.

Linked tax reductions. Over time, this proposed tax may result in a substantial buildup of revenues in the reserve account. Excess revenues over those needed to provide for a suitable reserve could be dedicated to reduction in those taxes that most unfairly fall upon the average Washingtonian. Some obvious candidates are reductions in sales or property taxes. As reserves exceed a maximum of \$2 billion, reduction in the sales tax could occur simultaneously. Alternately, some proportion of the steady \$1 billion in revenue likely to result from the tax could be dedicated from the outset to reduce the sales tax, with any excess reserves funding additional reductions. For each 0.5% reduction in sales tax, the state would lose about \$500 million in annual revenues. Therefore, if the state gained \$1 billion in annual revenues from an income tax but also reduced the state sales tax rate from 6.5% to 6%, the net increase in annual state revenues would be \$500 million.

Another possibility would be to link revenues received in excess of a specific limit to a reduction in the state portion of the property tax. Possible designs include a reduction for all property owners in the state levy, which currently accounts for about one-fourth of property taxes (local governments and districts receive the bulk of property taxes). The reduction could also take the form of a "homestead" credit, currently adopted in a number of states, which exempts a specified

percent of home value from taxation. This approach was incorporated into House Bill 3076, introduced into the Washington Legislature in 2004. While available to all homeowners, this proposal would provide proportionately most relief to the lowest-income homeowners who are likely to have homes of relatively modest values. Without special provisions, however, the homestead exemption approach could shift additional property taxes to renters, including some of the state's lowest-income residents, if landlords passed higher taxes along. Alternately, the state's current exemption for low-income elderly and disabled homeowners, currently available only to a few, could be substantially expanded.

Administrative costs: While a tax as described in this paper would bring in substantial revenues, it would also require the creation of a new set of tax collection procedures and the hiring of staff in the Washington State Department of Revenue (DOR) to administer and enforce the tax. In Table 5 the net impacts of administrative costs on revenues is calculated using two scenarios. The first assumes administration would cost 1% of revenues—approximately the administrative cost of the state's current business and occupation tax. As the table shows, this estimate has relatively small revenue implications.

For a more conservative (high-cost) estimate of collecting the new tax, DOR estimated that for a proposed broad-based income tax (Senate Bill 6228), possible ongoing costs would be \$126 million per biennium, or \$63 million per year on an ongoing basis to collect the tax. While the tax analyzed by the DOR would affect larger numbers of people—over two million—it is possible that costs for the tax as proposed here would be similar. Not as many taxpayers would be subject to withholding, although enforcement costs would likely be of similar magnitude, and many of the functions would have a similar cost regardless of the scale of the collections. As such, the information in the following table represents the likely range for the ongoing cost of administering the tax.

Table 5: Net revenues under two administrative cost scenarios, with \$250,000 household exemption and tax rates of 3%, 5%, and 7%

	1997	1998	1999	2000	2001
Annual Revenue Before Admin Costs	\$647,153,890	\$1,065,058,205	\$1,633,188,279	\$1,509,784,946	\$857,284,836
Revenues if Admin Costs At 1% of Average Revenues	\$635,728,950	\$1,053,633,265	\$1,621,763,339	\$1,498,360,006	\$845,859,896
Revenues if Admin Costs of \$63 million/year*	\$584,153,890	\$1,002,058,205	\$1,570,188,279	\$1,446,784,946	\$794,284,836
*Costs not adjusted for inflation. Revenues estimated from 1997-2001 data from IRS (with no double deduction for joint filers).					

A new income tax could also have substantial start-up costs. The Department of Revenue estimate for SB 6228 (2004) pegged those at about \$23 million for each of the first two years.

These costs are not included in the analysis of possible revenues because this paper is not a fiscal note and is designed to show the likely ongoing net gains from such a tax. However, it is important to note that the net revenues in the table would not be reached during the first few years of the new tax.⁴³

VII. Conclusion

Washington's tax system is broken and needs to be repaired. Two features of the system—an extremely unfair distribution of taxes and the failure of revenues to keep up with public needs as the state's economy grows and changes—call for specific remedies. A tax targeting high-income households would begin to address these problems. Such a tax would improve the state's long-term revenue outlook while simultaneously making the system more equitable. It would definitely allow for a reduction in the draconian tax rates currently imposed on the lowest-income families.

While this system would allow reductions in other taxes, it is still designed to lead to a net increase in state revenues. Without such a change, Washington's public services will see continued funding reductions, with consequent deterioration in access and quality of public services. The state is beginning to experience severe reductions in its quality of life as its education, parks, and health care systems experience both relative and absolute decline. And, adequate revenues for essential investments in services that aid the economy—such as transportation and education—are essential if we are to maintain a vibrant economy. A tax on a small portion of the state's highest-income households would improve the stability and adequacy of revenues needed to support a high quality of life for all.

This proposed tax is not a substitute for broader measures to reform the state's tax structure. The state's B&O tax is widely regarded as unfair to certain types of businesses, particularly small and start-up businesses. Each year the state loses billions of dollars to tax exemptions, most of which continue indefinitely and have never been evaluated to determine if they achieve a net public benefit. Because consumption will continue to shift to services, measures to extend sales taxes to currently untaxed services would also provide more revenue stability and allow additional reductions in overall sales tax rates. While not fixing all the problems of the state's tax system, a tax on high-income earners would represent a substantial start in the process of modernizing the tax system and making it more responsive to the needs of all Washington residents.

APPENDIX

State Individual Income Taxes (Tax rates for tax year 2004 -- as of January 1, 2004)									
STATE	Fed. Tax Base	Tax Rates		Number of Brackets	Low- and High-Income Thresholds		Personal Exemptions		
		Low	High		Low	High	Single	Married	Child
Alabama	n/a	2.0	5.0	3	\$500	\$3000	\$1,500	\$3,000	\$300
Alaska	No income tax								
Arizona	Fed. AGI	2.87	5.04	5	\$10,000	\$150,000	\$2,100	\$4,200	\$2,300
Arkansas	n/a	1.0	7.0	6	\$3,999	\$27,500	\$20	\$40	\$20
California	Fed. AGI	1.0	9.3	6	\$5,962	\$39,133	\$80	\$160	\$251
Colorado	Fed. taxable income	4.63	4.63	1	Flat rate	Flat rate	none	none	none
Connecticut	Fed. AGI	3.0	5.0	2	\$10,000	\$10,000	\$12,500	\$24,000	\$0
Delaware	Fed. AGI	2.2	5.95	6	\$5,000	\$60,000	\$110	\$220	\$110
Florida	No income tax								
Georgia	Fed. AGI	1.0	6.0	6	\$750	\$7,000	\$2,700	\$5,400	\$2,700
Hawaii	Fed. taxable income	1.4	8.25	9	\$2,000	\$40,000	\$1,040	\$2,080	\$1,040
Idaho	Fed. taxable income	1.6	7.8	8	\$1,104	\$22,074	\$3,100	\$6,200	\$6,200
Illinois	Fed. AGI	3.0	3.0	1	Flat rate	Flat rate	\$2,000	\$4,000	\$2,000
Indiana	Fed. AGI	3.4	3.4	1	Flat rate	Flat rate	\$1,000	\$2,000	\$1,000
Iowa	Fed. AGI	0.36	8.98	9	\$1,211	\$54,495	\$40	\$80	\$40
Kansas	Fed. AGI	3.5	6.45	3	\$15,000	30,000	\$2,250	\$4,500	\$2,250
Kentucky	Fed. AGI	2.0	6.0	5	\$3,000	8,000	\$20	\$40	\$20
Louisiana	Fed. AGI	2.0	6.0	3	\$12,500	25,000	\$4,500	\$9,000	\$1,000
Maine	Fed. AGI	2.0	8.5	4	\$4,250	16,950	\$4,700	\$7,850	\$1,000
Maryland	Fed. AGI	2.0	4.75	4	\$1,000	3,000	\$2,400	\$4,800	\$2,400
Massachusetts	Fed. AGI	5.3	5.3	1	Flat rate	Flat rate	\$3,300	\$6,600	\$1,000
Michigan	Fed. AGI	4.0	4.0	1	Flat rate	Flat rate	\$3,100	\$6,200	\$3,100
Minnesota	Federal taxable income	5.35	7.85	3	\$9,010	\$62,440	\$3,100	\$6,200	\$3,100
Mississippi	Other	3.0	5.0	3	\$5,000	\$10,000	\$6,000	\$12,000	\$1,500
Missouri	Federal AGI	1.5	6.0	10	\$1,000	\$9,000	\$2,100	\$4,200	\$2,100
Montana	Federal AGI	2.0	11.0	10	\$2,199	\$76,199	\$1,740	\$3,480	\$1,740
Nebraska	Federal AGI	2.56	6.84	4	\$2,400	\$26,500	\$94	\$188	\$94
Nevada	No income tax								
New Hampshire	<i>Dividends and interest only</i>								
New Jersey	n/a	1.4	6.37	6	\$20,000	\$75,000	\$1,000	\$2,000	\$1,500
New Mexico	Federal AGI	1.7	6.8	5	\$5,500	\$26,000	\$3,100	\$6,200	\$3,100
New York	Federal AGI	4.0	7.70	7	\$8,000	\$500,000	\$0	\$0	\$1,000
North Carolina	Federal taxable income	6.0	8.25	4	\$12,750	\$120,000	\$3,100	\$6,200	\$3,100
North Dakota	Federal taxable income	2.1	5.54	5	\$28,400	\$311,950	\$3,100	\$6,200	\$3,100

State Individual Income Taxes (Tax rates for tax year 2004 -- as of January 1, 2004)									
Ohio	Fed.AGI	0.743	7.5	9	\$5,000	\$200,000	\$1,200	\$2,400	\$1,200
Oklahoma	Fed.AGI	0.5	6.75	8	\$1,000	\$10,000	\$1,000	\$2,000	\$1,000
Oregon	Fed. taxable income	5.0	9.0	3	\$2,600	\$6,500	\$151	\$302	\$151
Pennsylvania	n/a	3.07	3.07	1	Flat rate	Flat rate	\$0	\$0	\$0
Rhode Island	Fed.AGI	25% Fed. tax liability	n/a	n/a	n/a	n/a	n/a	n/a	n/a
South Carolina	Fed. taxable income	2.5	7.0	6	\$2,400	\$12,300	\$3,100	\$6,200	\$3,100
South Dakota	No income tax								
Tennessee	<i>Dividends and interest only</i>								
Texas	No income tax								
Utah	Fed. taxable income	2.30	7.0	6	\$863	\$4,313	\$2,325	\$4,650	\$2,325
Vermont	Fed. taxable income	3.6	9.5	5	\$29,050	\$319,100	\$3,100	\$6,200	\$3,100
Virginia	Fed.AGI	2.0	5.75	4	\$3,000	\$17,000	\$800	\$1,600	\$800
Washington	No income tax								
West Virginia	Fed. AGI	3.0	6.5	5	\$10,000	\$60,000	\$2,000	\$4,000	\$2,000
Wisconsin	Fed. AGI	4.6	6.75	4	\$8,430	\$126,420	\$700	\$1,400	\$400
Wyoming	No income tax								
Dist. Of Columbia	Fed.AGI	5.0	9.0	3	\$10,000	\$30,000	\$1,370	\$2,740	\$1,370

For simplicity, income thresholds presented here are for single filers. Rates may be applied differently for married couples in various states. For additional details, see Federation of Tax Administrators, "State Individual Income Taxes," http://www.taxadmin.org/fta/rate/ind_inc.html.

Endnotes

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²²McNichol, *Using Income Taxes to Address State Budget Shortfalls*, Center on Budget and Policy Priorities, June 13, 2003.

²³One of the six, Florida taxes intangible wealth (such as stocks and bonds) as property. The other states without an income tax are Alaska, Nevada, South Dakota, Texas, and Wyoming.

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²⁶For additional details, see Federation of Tax Administrators, “State Individual Income Taxes,”

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⁴⁰Under the assumption that the new tax was put in place without concurrent reform of the state’s B&O tax, it may be advisable to allow an additional credit against the state income tax for B&O tax paid by sole proprietors, who would otherwise be taxed twice on the same income. Over the 2001-03 sole proprietors accounted for about 4.6% of the B&O tax. If an offsetting credit were allowed, the net revenues shown here would be reduced by about \$95 million per year.

⁴¹Since these revenues are not inflation-adjusted, some of this “flatness” may be a result of some households “inflating” into a higher income group.

⁴²Washington State Tax Study Commission, “Appendix D: Rainy Day Fund,” 2002.

⁴³Under the assumption that the new tax was put in place without concurrent reform of the state’s B&O tax, it may be advisable to allow an additional credit against the state income tax for B&O tax paid by sole proprietors, who would otherwise be taxed twice on the same income. Over the 2001-03 sole proprietors accounted for about 4.6% of the B&O tax. If an offsetting credit were allowed, the net revenues shown here would be reduced by about \$95 million per year.