

# Economic Opportunity Institute Blueprint

## A Concise History of Washington's Tax Structure

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### Key Findings

Since 1935, the retail sales tax, business and occupation tax, and property tax have been the major sources of Washington state revenues.

- Since 1935, legislators have raised the retail sales tax rate eight times. Meanwhile, citizen initiatives have limited property and other taxes.
- Due to the absence of a graduated income tax and a heavy reliance on the sales tax, Washington state's tax system has evolved to the point of being rated the most regressive tax system in the country.
- Although voters defeated income tax measures 7 times between 1935 and 1982, today's climate may be right for major changes in Washington's tax structure.

### Introduction

Washington state's basic tax structure has remained for the most part unchanged since the passage of the Revenue Act of 1935. From the beginning of statehood in 1889 until the Revenue Act of 1935, Washington's tax structure was predominantly reliant upon property taxes. With the passage of the Revenue Act of 1935, state government in Washington began to focus more on a variety of excise<sup>1</sup> taxes for generating revenue. Most notably, the retail sales and use tax and the business and occupation (B&O) tax were

permanently implemented, and to this day continue to be the major sources of state government revenue. Lawmakers have consistently struggled to find new sources of tax revenue as voters increasingly choose to limit property taxes and selective excise taxes. Numerous attempts to implement a personal net income or corporate net income tax have been stymied by the state Supreme Court's narrow interpretation of the state constitution's tax uniformity clause. In fact, the Washington Supreme Court

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As a result of Washington's overwhelming reliance on the retail sales tax, the state is ranked as having the most regressive tax system in the country.

ruled a 1932 income tax initiative approved by voters as unconstitutional. Consequently, any attempt to implement a net income tax in Washington has been assumed to require a constitutional amendment. Since 1935 voters have rejected various ballot initiatives and constitutional amendments aimed at implementing a personal or corporate income tax in Washington.

Washington state's current public finance structure relies more heavily than that of other states on the retail sales and use tax as a source of public revenue. Washington is one of seven states that does not levy a state income tax.<sup>2</sup> It is anticipated that in the current 2001-03 biennium, retail sales and use taxes will account for 56% of total state general fund tax revenues.<sup>3</sup> Business and occupation taxes (B&O) and property taxes will account for 18% and 11% of the total respectively. The remaining 15% of total general fund revenues will originate from real estate excise taxes and other miscellaneous tax, license and fee revenues.<sup>4</sup>

Sales taxes are regressive taxes.<sup>5</sup> As a result of Washington's overwhelming reliance on the retail sales tax, it is ranked as having the most regressive tax system in the country.<sup>6</sup> According to a 1996 study by the Institute on Taxation and Economic Policy and Citizens for Tax Justice, Washington families in the lowest 20% income bracket pay 17% of their income in taxes while Washington families in the top 1% income bracket pay only 3.6% of their income in taxes.<sup>7</sup> For comparison purposes, in California, a state that has property taxes, sales taxes, and graduated income taxes, families in the lowest 20% income bracket pay 12% of their income in taxes while families in the top 1%

income bracket pay 11.6% of their income in taxes.

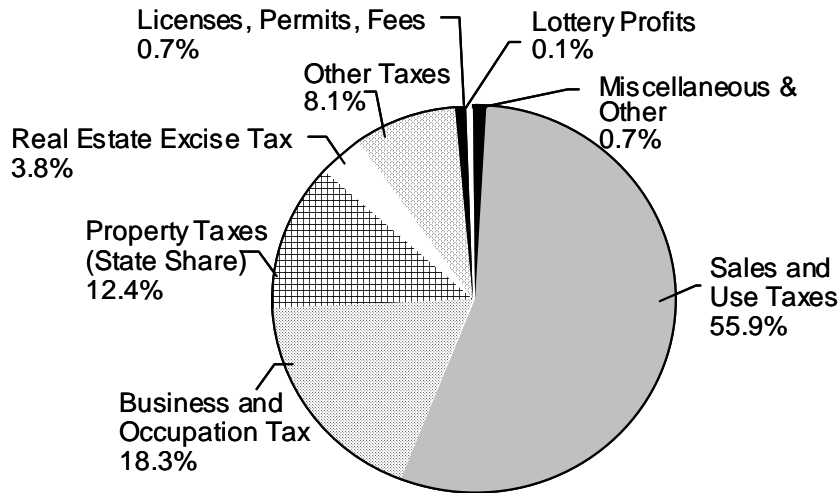
Washington is the only state in the nation that levies business taxes upon gross revenues.<sup>8</sup> Most other states levy taxes upon a business's net income. Tax rates in Washington vary depending on the classification of business activity. The B&O tax "pyramids" tax liability because the tax on gross revenue taxes firms on income generated at different levels of production. As a result, vertically integrated firms in Washington may have a competitive advantage over non-vertically integrated firms. In addition, the tax imposes a heavier burden on new and small businesses that may not be as profitable as larger well established firms.

Property taxes in Washington are a very important aspect of local government funding. Property taxes have been subject to numerous changes in Washington state, particularly in recent years. Many voters have become frustrated by what they perceive to be a complex and unfair appraisal process. In addition, many are caught unprepared for large increases in tax liability resulting from increases in property values, particularly those on fixed incomes. While property taxes are considered regressive in Washington state,<sup>9</sup> they do offer a relatively predictable and stable source of government revenue.

This report provides a brief overview of the evolution of Washington state's tax structure, including major legal decisions, legislative developments, and citizen initiatives that have shaped the current tax system. This will provide a background and context that will be useful for discussion on reforming the current system. ❖

## Washington State Revenues

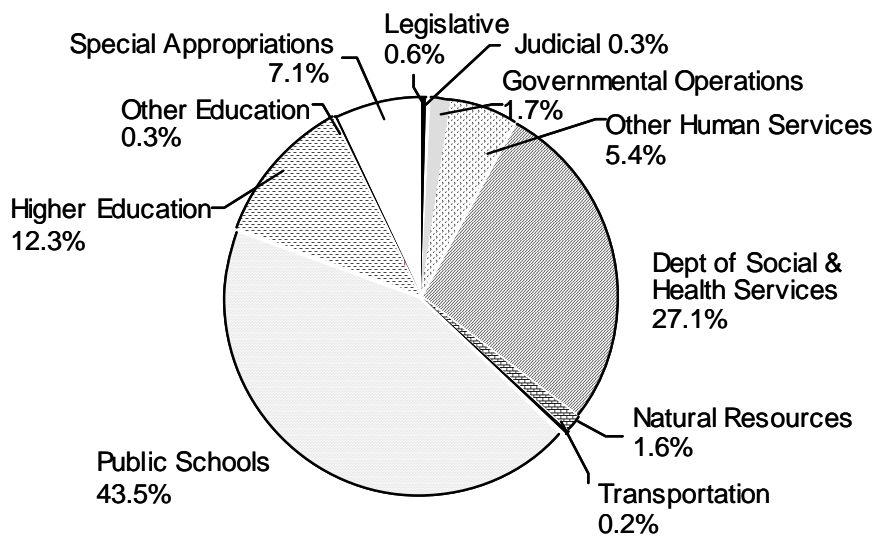
### Estimated General Fund Revenues for the 2001-03 Biennium



Source: State of Washington Office of Financial Management

## Washington State Expenditures

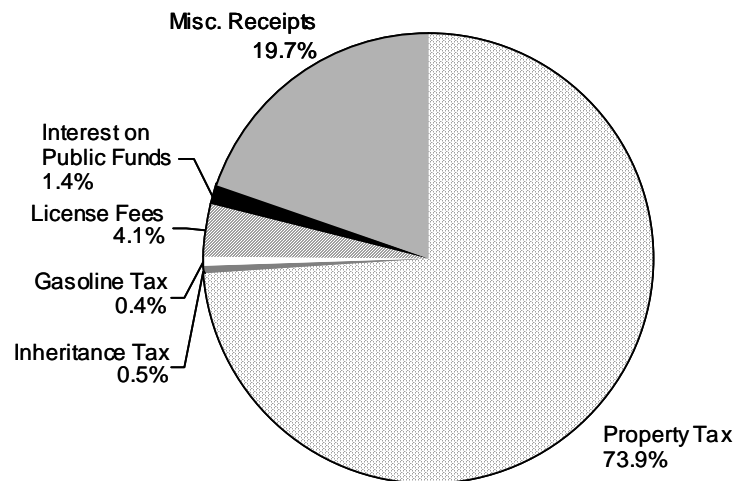
### General Fund Expenditures 2001-03 Biennium



Source: Legislative and Accountability Program Committee (LEAP)

## Period 1: 1889 – 1935

### Washington State Revenues from All Sources In 1921



Source: Report of the State of Washington Tax Investigation Committee (1921)

During the early years of statehood Washington relied predominantly on property taxes as a source of public revenue. When adopted upon statehood in 1889, the Washington State Constitution created the framework for a public finance system. Article VII of the Washington Constitution stated that *all property* was to be taxed in proportion to its value. Furthermore, Article VII established that all property in the state be assessed and taxed at a uniform and equal rate. Tax uniformity clauses were prevalent among states towards the end of the nineteenth century. As Washington established statehood in 1889, 41 of the 45 states had some form of tax uniformity clause in their constitutions.<sup>10</sup>

#### Inheritance Tax

One of the first forms of taxation to be implemented in Washington other than the property tax was the state inheritance tax. Adopted by the state legislature in 1901, the policy included different rates of taxation depending on the amount of property transferred and the relationship of the heir. In 1902,

the inheritance tax was challenged in court as being in violation of the constitution's uniformity clause. In its ruling the Washington Supreme Court interpreted the inheritance tax not as a tax on property, but as an excise or impost (i.e. tax) on the privilege of inheriting property.<sup>11</sup> The court held that equality and uniformity applied only to a tax on property; therefore the Legislature was ruled to have much greater latitude in selecting the objects upon which it may impose a tax when the tax is denominated as an excise or impost tax.<sup>12</sup> This opened the door to new types of excise taxes, such as the motor vehicle license tax in 1905 and the fuel tax in 1921.

#### Intangibles

By 1907 taxing authorities were finding it virtually impossible to enforce the taxation of intangible personal property. In response, the Legislature amended the tax law to provide that money plus a number of specified types of intangible personal property should no longer be subject to the property tax. These exempt intangibles included mortgages,

notes, accounts, moneys, certificates of deposits, tax certificates, judgments, state, county, municipal and school district bonds and warrants. The state Supreme Court later ruled money to be a tangible property and thus the exemption of money to be unconstitutional. Stocks, bonds and money market accounts are an increasingly important source of wealth in today's economy, but they still remain exempt under Washington's tax system.<sup>13</sup>

### Fourteenth Amendment

Fundamental change was made to the tax system in 1930 with the passage of the fourteenth amendment to the state constitution. Previously, *all* property was to be taxed at a uniform and equal rate. This amendment allowed for the classification of personal property for purposes of taxation. In other words, this allowed the Legislature to use its discretion in exempting or implementing different tax rates upon different classes of property. An important qualification was that all real estate was to remain one class of property, except in the case of mining and reforestation land.

### 1930 - 35: A Time of Change

The early 1930s produced major legal and policy developments in Washington's tax system, which are largely responsible for the composition of today's tax system. As the scope of government programs grew in the 1920s, the state's significant reliance on the property tax was not a sustainable source of revenue. With the onset of the depression in the 1930s, many landowners came upon hard times and could not pay their annual property tax obligations. This problem was not unique to Washington, but mirrored a larger national trend. Consequently, property taxes became lightning rods for protest during depressions, partly because their heaviest burden fell on farmers and urban-suburban

homeowners.<sup>14</sup> Voters in Washington responded to this crisis by filing numerous ballot initiatives related to taxation. Initiative 64, filed in 1932, called for limiting state and local property tax collection to 40 mills (1 mill = .001) based upon an assessed value of 50% of the true and fair market value of such property. As a complement to this, Initiative 69 called for implementing a graduated personal net income tax and a graduated corporate income tax. A coalition of agriculture, labor and education interests joined with disgruntled urban property owners to overwhelmingly pass the income tax measure with a 70% majority.<sup>15</sup> The companion property tax limitation measure was also passed.

Two groups of Seattle businessmen immediately challenged the income tax measure in court, claiming that it was unconstitutional under Washington's uniformity clause. The Washington Supreme Court agreed with this contention by holding that income is property and that a tax upon income is a tax upon property.<sup>16</sup> Thus, an income tax with a graduated rate would be a violation under Washington's strict requirement that taxes be levied in an equal and uniform manner upon identical classes of property. The significance of this decision was that subsequent attempts to implement a graduated income tax in Washington were assumed to require a constitutional amendment.

In 1933, as a response to the property tax limitation measure and in anticipation of the Supreme Court's income tax ruling, the Legislature passed a temporary B&O tax. The B&O tax of 1933 established varying rates to the gross receipts of businesses. This tax was also promptly challenged in court.<sup>17</sup> In a closely divided 5-4 decision the court declared the B&O tax to be an excise tax and not subject to the strict uniformity and equality provisions of the

Period 1  
1889 – 1935

In 1932, voters overwhelmingly passed an income tax measure, but the state supreme court ruled it as unconstitutional.

Period 1  
1889 – 1935

In 1934, voters rejected the first of 7 attempts to amend the constitution in order to allow a state income tax.

constitution. Thus, the Legislature was held to have the power of creating classes of taxpayers upon the basis of business activities performed, and as to the classes created, could impose a tax at different rates upon differing types of gross receipts.<sup>18</sup>

In 1934, the Legislature made its first attempt to amend the state constitution in order to allow a graduated income tax. The voters rejected this proposal by a 43% yes to 57% no margin. Why was there a sudden change from the overwhelming support for income taxes in 1932? The passage of the earlier property tax limitation initiative was largely responsible for the changing attitudes towards an income tax. With a threat of higher property taxes, such taxpayers might have looked at other revenue sources as a means of limiting pressures on real property. For them, the issue was made irrelevant once an upper limit had been placed on real property assessments.<sup>19</sup> Furthermore, the Legislature had just recently implemented a temporary version of the state B&O tax, which provided additional state revenue. This would be the first of seven subsequent proposals put to the people for a personal or corporate income tax — all of which would go down to defeat.

### **The Revenue Act of 1935**

By 1935, a poor economy in combination with the 1932 voter-approved reduction in property taxes had led to a severe revenue shortfall. With the defeat of the 1934 income tax initiative,

legislators felt they had few alternatives and passed a bill implementing a major overhaul to the tax system. This overhaul came to be known as the Revenue Act of 1935.

The composition of Washington's current tax system is the result of major changes made by the Revenue Act of 1935. The two major changes originating from the Revenue Act were the implementation of the retail sales and use tax and the permanent adoption of the state business and occupation tax. The Revenue Act of 1935 also implemented a host of excise taxes including cigarette taxes, liquor taxes, and public utility taxes.

Within the Revenue Act the Legislature once again attempted to implement a net personal and corporate income tax. In an attempt to comply with the Supreme Court's previous ruling, the tax would be levied on corporations for "the privilege of exercising their corporate franchises." In regards to the personal income tax, the Legislature attempted to levy the tax "for the privilege of receiving income therein while enjoying the protection of its laws."<sup>20</sup> The Supreme Court ruled both the personal and corporate income tax laws unconstitutional.<sup>21</sup> In another income tax attempt, the 1935 Legislature put forth a proposal to voters for a comprehensive revision of the state constitution relating to taxation that would allow for a state income tax and major changes to property taxes. The proposal was defeated by a 22% yes to 78% no margin.❖

## Post-1935

The Revenue Act of 1935 created the foundation for Washington's current tax system. Since that time, lawmakers have struggled to find new sources of tax revenue in order to widen Washington's tax base and respond to citizens' demands for more government services.<sup>22</sup>

Voters have consistently defeated proposals for adopting a personal or corporate income tax. At the same time, voters have repeatedly chosen to cap growth in property taxes. As a result, the state has come to rely more heavily on the retail sales and use tax, along with other miscellaneous excise taxes. In addition, the state Legislature has given local governments more authority to levy local taxes, many of which have been in the form of increased local option sales taxes.

Since 1935, the state sales tax rate has been raised eight times and now stands at 6.5%. Coupled with local option sales taxes, some counties currently have combined sales tax rates of 8.9%. Except for the addition of various credits, exemptions and rate changes, the state B&O tax is fundamentally the same as it was when permanently enacted in 1935.

## Property Tax Developments

Property taxes have always been a major source of revenue for Washington's state and local governments. For taxation purposes, property in Washington is classified into two broad categories: real property and personal property. Since the 1930s various forms of tax exemptions have been implemented relevant to both personal and real property. As Washington's overall tax base has broadened to reflect an increasingly complex economy, property taxes have continued to diminish in importance.

The first major post-1935 development in property tax law occurred with the 1944 constitutional amendment that

made permanent the 1932 property tax limit of 40 mills on 50% of the fair market value. This permanent limitation ensured that state and local governments would have to rely on sources other than property taxes for the growing demand for government services. No other significant changes were made to Washington's property tax system until the 1960s. In order to get around the constitution's strict tax uniformity requirements, two constitutional amendments related to property taxes were passed. The 47th amendment, passed in 1966, allowed property tax exemptions for senior citizens. The 53rd amendment, passed in 1968, allowed for current use property tax assessments for open space and farmlands.

In the 1970s major changes started to take place in regards to property tax law in Washington. The focus of these changes was towards reining in growth in property tax collections. A 106% limit law (that is, 6% limit on annual growth within a taxing district) applying to local regular levies was passed in 1971. This was later extended to the state portion of the levy in 1979. In 1972, voters passed the 55th constitutional amendment, which limited regular levies to 1% of the true and fair market value. In combination with this change, the Legislature increased the assessment standard to 100% of market value, as opposed to the previously set 50% standard. This in effect capped the regular property tax levy at \$10 per \$1,000 assessed value. It should be noted that this \$10 per \$1,000 limit applied only to regular levies, which still allowed for special district levies such as port districts, utility districts and other voter-approved levies to operate for a combined total often much higher than the \$10 regular limit.

Since 1997, voters have voiced their discontent with property taxes by approving several initiatives aimed at

## Period 2: 1936 – 2002

Period 2  
1936-2002

Since its original implementation in 1935, Washington's sales and use tax has evolved to be the largest source of revenue for state government.

reducing property taxes within Washington. The first law to be approved by voters was Referendum 47, which was passed in 1997 by a 64% yes to 36% no majority. This referendum possessed three major components: 1) it made permanent a 4.7% reduction in the state levy that was instituted in 1996; 2) it reduced the 6% limit on annual growth within a taxing district to a growth factor no greater than the annual inflation rate, and 3) it instituted a value-averaging scheme for individual taxpayers to limit large value increases. The third provision was found unconstitutional by the state Supreme Court in 1998.

Another property tax limitation measure, Initiative 722, was passed by voters in 2000, but was ruled unconstitutional by the state Supreme Court for violating the constitutional requirement that laws deal with a single subject. In 2001, Initiative 747 was passed by voters with a 58% yes to 42% no margin. This measure requires state and local governments to limit the aggregate growth in annual property tax collections within each taxing district to 1% per year, unless the voters approve an increase greater than this limit.<sup>23</sup>

### **Sales and Use Tax Developments**

Since its original implementation in 1935, Washington's sales and use tax has evolved to be the largest source of revenue for state government. The sales and use tax has been increased eight times from its original 2% implementation rate and now stands at 6.5%. In 1970 the Washington Legislature authorized a local option sales tax of 0.5% to cities and counties. In 1982, this was supplemented by the authorization of another local option tax of up to 0.5% for cities and counties. Various other local sales and use tax options have been authorized for special local government purposes such as public transit, criminal justice, public facilities

and correctional facilities. These various local option taxes combined with the state levy of 6.5% have led to sales tax rates of 8.8% in parts of King County and 8.9% in parts of Snohomish County.

Since first implemented in 1935, there have been numerous laws passed allowing credits, deferrals and exemptions for certain items from the state sales and use tax. Exemptions range from various farm-related products and producer goods, to labor and services (but not materials) performed on public roads and transportation facilities owned by the federal or local governments.<sup>24</sup> Motor vehicle fuel is another substantial commodity that is exempted from the sales and use tax.<sup>25</sup> Certain items that may violate the federal interstate commerce clause have also been exempted from the state sales tax. Since its passage in 1935, professional and personal services have been exempt from the state sales tax. The Washington Department of Revenue estimates that ending this exemption could generate approximately \$2 billion annually in state and local revenue.<sup>26</sup>

### **Business and Occupation Taxes**

The state B&O tax has remained unchanged in structure since its permanent adoption in 1935; however, numerous exemptions, credits, deductions and rate changes have been implemented over the last 65 years. In 1987, the U.S. Supreme Court ruled that the B&O tax was unconstitutional among certain interstate transactions. In response, the Washington Legislature implemented several specific credits to reduce the possibility of double taxation for manufacturing firms that do business in this and other states.<sup>27</sup>

In the year 2000, there were 98 various B&O tax exemptions, credits and deductions targeted towards numerous business activities within the Washing-

**Table 1. The Ten Largest B&O Exemptions and Credits Implemented Since 1990**

Period 2  
1936-2002

Description	Year Enacted	Annual Cost to State 1999-2001 Biennium, in thousands	Type
Health maintenance orgs.	1993	\$171,325	Exemption
Small business credit	1994	49,271	Credit
Research & development	1994	37,665	Credit
Wholesaling of grain	1998	15,301	Exemption
Church day care	1992	1,983	Exemption
Trust accounts	1997	1,669	Exemption
Property management	1998	1,411	Exemption
Software development	1999	1,349	Credit
Life insurance sellers	1991	1,062	Exemption
Conditioning of seed	1998	997	Exemption

Source: WA Department of Revenue

ton economy.<sup>28</sup> Thirty of these credits, exemptions and deductions have been implemented since 1990 (Table 1).<sup>29</sup> In its current form, six different B&O tax rates apply to various business activity classifications.<sup>30</sup>

**Inheritance Tax**

The inheritance tax was first adopted in Washington in 1901, making it one of the first taxes implemented in Washington other than the property tax. Since 1981, the inheritance tax has functioned as a “pick up” tax to the federal inheritance tax. Individuals subject to the federal inheritance tax are allowed a certain amount of credit on their federal liability for the amount they pay in state estate taxes. Many states, including Washington, have levied the maximum state credit allowed towards the federal liability. In practical terms this has meant that the taxpayer did not have to pay any additional tax above the federal liability; instead the federal government simply returned part of what it collected back to the state in the form of a credit.

New federal legislation passed in 2002 will gradually phase out the federal

inheritance tax by 2010,<sup>31</sup> and phase out state credits by 2005. Since the Washington Constitution does not allow entities other than the state of Washington to collect taxes on its behalf, the Washington Legislature has periodically adjusted its inheritance tax rates to be consistent with the federally allowed state credit. The current Washington state law reflects the federal Internal Revenue Code as of January 1, 2001. Thus, the new federal legislation will not affect Washington state estate tax revenues unless Washington amends its statutes to reflect the 2002 Internal Revenue Code.

**Miscellaneous Excise Taxes**

The motor vehicle fuel tax, implemented in 1921, is one of the oldest excise taxes in Washington. The eighteenth amendment to the Washington Constitution, adopted in 1944, earmarked all motor vehicle fuel taxes to be used exclusively for highways. The current motor vehicle fuel tax rate in Washington is at 23 cents per gallon. In November of 2002 voters will vote on a proposed 9 cent increase in the motor vehicle fuel tax. Taxes on

In 2000, there were 98 B&O tax exemptions, credits, and deductions.

1936 – 2002

alcohol, cigarettes and tobacco products have been in place since the Revenue Act of 1935 and are becoming an increasingly important source of dedicated funding for health and health care programs. The real estate excise tax was authorized as a county tax in 1951. The tax source was shifted to the state in 1981 and is almost entirely dedicated towards public education. Public utilities in Washington are exempt from the B&O tax; instead they are subject to the state public utility tax. Most public utilities are taxed at a rate of 3.8% on gross receipts.

The motor vehicle excise tax (MVET) was enacted in 1938 and grew to be an important source of revenue for state and local governments. By 1999, the state portion of the tax accounted for \$841 billion, or 7.3% of all state tax revenue.<sup>32</sup> In 1999 voters attempted to repeal the MVET by passing Initiative 695, which the Washington Supreme Court ultimately ruled to be unconstitutional. Acting upon what they perceived as the true intention of the voters, state lawmakers repealed this important funding source during the 2000 legislative session. ❖

## Income Tax Developments

Washington state voters have soundly defeated income tax proposals seven times since 1935. Beginning with a 1935 legislative proposal, Washington voters defeated three separate constitutional amendments to implement an income tax between 1935 and 1942.

In 1938 the Legislature put forth a proposal to voters that would have added a single sentence to the Constitution allowing a graduated income tax, but it was defeated by a 33% yes to 67% no margin. The 1942 Legislature tried once more to gain voter approval of a simple change to the Constitution that would have allowed a state income tax, but it again failed by a 31% yes to 69% no margin. In 1951 the Legislature attempted to implement a corporate income tax by utilizing the previously attempted strategy of placing an excise tax, measured by net income, on the privilege of exercising corporate franchises.<sup>33</sup> The Supreme Court struck down this law as a tax on property (in this case income being property) and therefore a violation of the Constitution's uniformity clause.

### 1970 - HJR 42

It took until the 1969 legislative session, 28 years after the last previous

attempt, for the Washington Legislature to put another proposal before voters to amend the state's Constitution in order to allow an income tax. The strong support of Governor Dan Evans was a major factor leading to the adoption of the proposal by the Legislature. Governor Evans was able to convince his Republican colleagues that the state needed an income tax as a major ingredient to the overall tax system. Passed with overwhelming support from the Republican-controlled House and Democrat-controlled Senate,<sup>34</sup> House Joint Resolution 42 was referred to the people in November 1970 as a proposed constitutional amendment for major tax reform. The proposed amendment would have capped property taxes at 1% of their true and fair market value while permitting the Legislature to tax income at a single rate, or at a graduated rate after 1975 with voter approval. The initial single rate to be imposed was 3.5% on both personal adjusted gross income and corporate taxable income. In addition, the state sales tax was to be decreased from 4.5% to 3.5% along with a 50% reduction in the state business and occupation tax.

Proponents of House Joint Resolution 42 argued that reform was important because Washington's tax system did not meet any of the essentials needed for a good tax structure.<sup>35</sup> They argued that the income tax was the fairest and most equitable means of obtaining revenue.<sup>36</sup> Moreover, they argued that the implementation of an income tax was the only realistic hope of relief from sales and property taxes.<sup>37</sup> Opponents feared that the tax reform measure would open up a new field of taxation with no limit. They pointed out the fact that efforts to place a ceiling on the proposed income tax were voted down in the Senate.<sup>38</sup> Despite strong support from the popular Governor Dan Evans in the months before the November vote,<sup>39</sup> the referendum was soundly defeated in every county of the state. The overall state total was 31.5% yes to 68.4% no.

It is likely that the infamous "Boeing Bust" played a substantial role in voters' reaction to the tax reform measure. In 1970, Washington state was in the midst of an economic recession resulting from massive layoffs in the aerospace industry. In 1971, employment in the aerospace industry had contracted to 40,500, down from 104,500 in 1968. In addition, statewide unemployment in Washington approached 10%.<sup>40</sup>

### 1973 - HJR 37

In 1973, the Legislature referred another constitutional amendment to the people for a graduated income tax. Similar to the 1969 referendum, this tax reform proposal passed out of a Republican controlled House and a Democrat-controlled Senate.<sup>41</sup> Republican Governor Dan Evans once again supported the measure. The proposal, known as House Joint Resolution 37, would have established graduated rates for individuals not to exceed 8% and an income tax rate on corporations not to exceed 12%. The proposal contained a host of other tax revisions including capping sales tax

rates and business and occupation tax rates, eliminating special school operations tax levies, and eliminating food and prescription drugs from the state sales tax.

Proponents of House Joint Resolution 37 emphasized how an income tax would help curb the escalation in property taxes resulting from special school levies. In addition, they cited how a graduated income tax could help to make Washington's tax system less regressive.<sup>42</sup> Opponents objected to the measure because it would result in a shift from funding schools with local levies to an increased emphasis of funding schools at the state level.<sup>43</sup> Similar to the 1970 attempt at tax reform, this referendum was soundly defeated in every county of the state. The overall margin of defeat was 22.9% yes and 77% no. It has been 28 years since this proposal was defeated and since then the Legislature has refrained from bringing a personal income tax proposal back to the voters of Washington.

### Corporate Income Tax Proposals

Within the past 27 years two ballot initiatives dealing with corporate income taxes have been put forth to the voters of Washington. In 1975, Initiative 314 proposed a 12% income tax on corporations. Revenues from this proposal were to be dedicated specifically for school support. The measure was defeated by a 33% yes to 66% no margin. This initiative was not in the form of a constitutional amendment; therefore it is questionable, even if it had passed, whether the courts would have allowed it to be implemented. In the midst of Washington's deepest economic recession since the Great Depression, Initiative 435 went to the ballot in 1982 as a proposal for a 10% corporate income tax. Along with the new corporate income tax, this proposal would have repealed the state sales tax

1936 – 2002

Voters overwhelmingly defeated income tax proposals in the early 70's.

1936 – 2002

Some challenge the notion that a graduated income tax would require a constitutional amendment today.

on food<sup>44</sup> and exempted corporations from the state business and occupation tax. This initiative was defeated by a 33% yes to 66% no margin — identical to the margin of the previous corporate income tax proposal. Because this income tax proposal was not in the form of a constitutional amendment, it is likely that it would have also faced legal obstacles if passed.

Various studies in the past have acknowledged the need for an income tax in Washington state. A 1989 special committee report commissioned by Governor Booth Gardner recommended reducing the state sales tax to 3.75% in combination with the implementation of a 3.75% flat personal income tax; the income tax proposal would also include a personal exemption level of \$2,000 and a standard deduction of \$10,000. Although the tax-reform plan received some editorial support, it went nowhere with the legislature.<sup>45</sup> The 2001 Legislature has put together a Washington State Tax Structure Committee that is again studying Washington's tax system. The committee is expected to release its findings along with potential tax alternatives by November of 2002.

#### **An Income Tax for the Future?**

It has been 28 years since the people of Washington have had a chance to vote on a state personal income tax proposal. Due to past Washington Supreme Court rulings, the conventional wisdom holds that any graduated income tax proposal in Washington state would require a constitutional amendment. A constitutional amendment in Washington requires a two-thirds majority vote in the Legislature and a majority vote of the people.

There are some that challenge the notion that a graduated income tax would require a constitutional amendment. University of Washington

Professor Hugh Spitzer has criticized the Washington Supreme Court's previous characterization in *Culliton v. Chase* of income as a class of property as an outdated interpretation.<sup>46</sup>

Instead of reciting the "income equals property" argument, Spitzer suggests that the Court should revisit the net income tax with a reasoned argument that takes into account contemporary legal developments. He points out that the U.S. Supreme Court has reversed or altered previous decisions that the Washington Supreme Court relied on in *Culliton v. Chase*.

In addition, he notes how other state courts have since revised their income-as-property interpretations to be more compatible with a graduated income tax policy. The viewpoint advocated by Spitzer recognizes income as something in motion, something that can either cease moving and itself become an income-producing asset (i.e. property) or that can be alternatively consumed and disappear. Only when income is converted into an asset is it then appropriately treated and taxed as property.

Other legal scholars contend that the Washington Supreme Court should reexamine its property versus excise dichotomy in analyzing state tax measures and should instead apply a consistent set of classification principles in analyzing all taxes.<sup>47</sup>

A flat income tax levied on gross income could be enacted in Washington state without a constitutional amendment. However, to be consistent with prior Supreme Court rulings income would be classified as personal property and thus be subject to the 1% levy limit of the 55<sup>th</sup> Amendment, with an allowable exemption of no more than \$3,000.<sup>48</sup> ❖

Washington's tax system has been without major change since 1935. The 1935 Revenue Act permanently put into place the sales and use tax, the B&O tax, and various excise taxes. Once a mainstay of government funding, the property tax has been subject to various ballot initiatives aimed at reducing its importance as a major government revenue source. As of today, Washington's tax system has evolved to be an unbalanced system that disproportionately relies on the regressive sales tax as a source of revenue.

Seventy years ago the Washington Supreme Court ruled a proposed graduated income tax passed by voters to be a violation of the Constitution's tax uniformity clause. As a result of the court ruling, the Legislature has referred constitutional amendments to the people for a graduated income tax seven times. The proposed amendments have

overwhelmingly failed all seven times. It has been 28 years since the last constitutional amendment for an income tax went before voters. Some contend that the legal environment has evolved such that the Legislature could implement a graduated income tax without a constitutional amendment. Recent polling suggests that Washington voters hold a general preference for raising taxes over cutting specific government programs.<sup>49</sup>

A looming state budget crisis, in combination with an unbalanced and unfair tax system, presents the people of Washington with an opportunity to move forward with substantial tax reform. In order to be a useful resource for those interested in tax reform, this report has identified the key legal and policy developments which are responsible for the current Washington tax structure.

## Conclusion

## APPENDIX

### Timeline of Major Tax Events in Washington

#### Period 1: 1889 – 1935

- 1889 The state constitution calls for uniform and equal rates to be assessed on all forms of taxable property. The Legislature may grant exemptions.
- 1901 Inheritance tax implemented
- 1930 14<sup>th</sup> amendment allows classification of personal property
- 1932 Voters approve a graduated personal net income tax and graduated corporate income tax by a 70% yes - 30% no margin. The Washington Supreme Court rules in a 5-4 decision the income tax to be a violation of the state's tax uniformity clause and therefore unconstitutional
- 1932 Voters also approve a limit on state and local property tax collections (40 mills total and 5 mills for state levy)
- 1933 Temporary business and occupation (B&O) tax on gross revenues implemented by the Legislature
- 1934 Voters defeat a graduated personal income tax (43.4% yes - 56.6% no)
- 1935 **Revenue Act of 1935 enacted:** Major components are retail sales and use taxes of 2% and permanent adoption of a B&O tax (0.25% basic rate and 0.50% for services).  
Also included are cigarette taxes, liquor taxes, public utility taxes, admissions taxes and conveyance taxes.

#### Period 2: 1936 – 2002

- 1936 Voters defeat graduated personal income tax (22.2% yes - 77.8% no)
- 1937 Motor Vehicle Excise Tax enacted – 1.5% of value
- 1938 Voters defeat graduated personal income tax (33.1% yes - 66.9% no)
- 1941 Sales tax increased from 2% to 3%
- 1942 Voters defeat graduated personal income tax (31.3% yes - 68.7% no)
- 1944 17<sup>th</sup> amendment limits property tax levies to 40 mills on 50% assessment
- 1951 Corporate franchise tax based on gross income passed, but overturned on nonuniformity grounds
- 1951 B&O tax increased  
(new rates = 0.30% basic rate and 0.60 for services) + 20% surtax
- 1955 Sales tax increased from 3% to 3.33%, B&O tax increased (0.40% basic and 0.60 for services)
- 1959 Sales tax increased from 3.33% to 4%
- 1965 Sales tax increased from 4% to 4.2%
- 1967 Sales tax increased from 4.2% to 4.5%
- 1970 Voters defeat personal and corporate income tax proposal (31.5% yes - 8.4% no)
- 1973 Voters defeat graduated personal and corporate income tax (22.1% yes - 7.1% no)
- 1975 Voters defeat corporate income tax initiative
- 1977 Off-premise consumption of food exempted from sales tax via initiative process

- 1981 Initiative 402 repeals the state inheritance and gift tax, but still allows Washington to collect the state credit portion of the federal estate tax
- 1981 Sales tax increased to 5.5%
- 1982 Voters defeat initiative for corporate income tax
- 1982 Budget crisis forces legislators to temporarily re-impose sales tax on food (1 year)
- 1983 Sales tax increased to 6.5%
- 1987 U.S. Supreme Court rules that certain parts of Washington's B&O tax violate the U.S. Constitution's interstate commerce clause (credit fix enacted by Legislature)
- 1993 Voters approve state expenditure limit (I-601)
- 1993 Retail sales and use tax expanded to cover certain personal services
- 1997 Voters pass referendum 47 restructuring property tax
- 1999 Initiative 695 passes repealing Motor Vehicle Excise Tax
- 2001 Initiative 747 passes requiring state and local governments to limit property tax levy increases to 1% per year

## Endnotes

- <sup>1</sup> An excise tax is broadly defined as a tax levied on the purchase or sale of a particular good or service.
- <sup>2</sup> <http://dor.wa.gov/content/WAtaxstudy/Washington%20State%20Tax%20Structure%20Overview/sld007.htm>
- <sup>3</sup> Washington State Office of Financial Management.
- <sup>4</sup> The state general fund is the predominate source of state discretionary spending and is where all major state tax revenues are deposited. The state general fund amounts to just over half of the total biennial \$43.07 billion operating budget. The balance of the total operating budget is funded through federal grants and various licenses, permits and charges for services. It should also be noted that when local government taxes are factored in, property taxes make up a larger proportion at 32% of the total while retail sales and use and B&O taxes combined account for 47% of total state and local tax revenues.
- <sup>5</sup> Bruce, Neil. *Public Finance and the American Economy*, Addison-Wesley 1998.
- <sup>6</sup> Citizens for Tax Justice, *Who Pays? A Distributional Analysis of Tax Systems in all 50 States*. 1996 <http://www.ctj.org/html/whopay.htm>
- <sup>7</sup> Citizens for Tax Justice, *Who Pays? A Distributional Analysis of Tax Systems in all 50 States*. 1996
- <sup>8</sup> <http://dor.wa.gov/content/WAtaxstudy/Washington%20State%20Tax%20Structure%20Overview/sld006.htm>
- <sup>9</sup> Washington State Tax Structure Study (May, 2002) <http://dor.wa.gov/content/WAtaxstudy/Equity%20paper%205-10-02.pdf>
- <sup>10</sup> Spitzer, Hugh D. *A Washington State Income Tax - Again?* University of Puget Sound Law Review, Vol.16 No. 2 1993.
- <sup>11</sup> *State v. Clark*, 30 Wash. 439, 71 Pac.20 (1902).
- <sup>12</sup> Harsch, Alfred. *The Washington Tax system: How it Grew*, 39 Wash. Law Review, 944 (1965)<http://dor.wa.gov/content/WAtaxstudy/symposium/Page1.htm>
- <sup>13</sup> The state of Florida currently levies a tax on intangible property such as stocks and bonds. The rate levied in Florida is 0.15% (exempting the first \$80,000 in assets). This tax raised approximately \$600 million in revenue in 2000.
- <sup>14</sup> Campbell, Ballard C. *Tax Revolts and Political Change* Journal of Political History, Vol. 10 No. 1, 1998.
- <sup>15</sup> Spitzer, Hugh D. *A Washington State Income Tax - Again?*
- <sup>16</sup> *Culliton v. Chase*, 174 Wash.363 25 P.2d 81 (1933).
- <sup>17</sup> *State v. Yelle*, 174 Wash. 402, 25 P.2D 91 (1933).
- <sup>18</sup> Harsch, Alfred. *The Washington Tax System – How It Grew*.
- <sup>19</sup> Roberts, Philip J. *Of Rain and Revenue: The Politics of Income Taxation in the State of Washington, 1862-1940* U. Washington Ph.D. Thesis 1990.
- <sup>20</sup> Harsch, Alfred. *The Washington Tax System – How It Grew*.
- <sup>21</sup> *Jensen v Henneford* 53 P.2d (1936) and *Petroleum v Henneford* 55 P.2d (1936).
- <sup>22</sup> In regard to concerns related to the widening of Washington's tax base, it should be noted that for the purpose of collecting revenue, high tax rates, particularly on a narrow category of goods, should be avoided. This is a normative conclusion that is fundamental to the theory of tax policy. In other words, the broader the tax base, the lower the excess burden to the economy. This is directly relevant to Washington's heavy reliance on the retail sales tax. It should be noted that this is from an overall economic efficiency standpoint, however, there are also severe equity issues with Washington's reliance on the retail sales tax. For more on these issues see: Bruce, Neil. *Public Finance and the American Economy*.
- <sup>23</sup> [http://www.vote.wa.gov/2001/guide/measures\\_index.tpl](http://www.vote.wa.gov/2001/guide/measures_index.tpl)

- <sup>24</sup> *Washington Department of Revenue, Tax exemptions 2000: A Study of Tax Exemptions, Exclusions, Deductions, Deferrals, Differential Rates and Credits for Major State and Local Taxes in Washington* [http://dor.wa.gov/docs/reports/2000/Tax\\_Exemptions\\_2000/contents.htm](http://dor.wa.gov/docs/reports/2000/Tax_Exemptions_2000/contents.htm)
- <sup>25</sup> It should be noted that Motor Vehicle Fuel is subject to a separate tax .23/gallon tax. Under the state Constitution, revenues from this tax are to be used only for highways.
- <sup>26</sup> Washington Department of Revenue *Tax exemptions 2000*.
- <sup>27</sup> Washington Department of Revenue, *Tax Reference Manual (1999)*.
- <sup>28</sup> Based on calculations from the Washington Department of Revenue's *Tax exemptions 2000* Report.
- <sup>29</sup> Based on calculations from the Washington Department of Revenue's Tax exemptions 2000 Report, 2002 Tax Reference Manual, WA Department of Revenue.
- <sup>30</sup> Six different tax rates apply to various classifications of business activities. The current B&O tax rates are: 0.484% for manufacturing, wholesaling, and other activities; 0.471% for retailing, environmental cleanup, and radioactive waste cleanup for the U.S.; 0.275% for travel agents, stevedoring and freight brokers, and international investment management services; 0.138% for processing meat (at wholesale), processing soybeans, canola, and dry peas; manufacturing wheat into flour; manufacturing raw seafood; warehousing/reselling of prescription drugs, and manufacturing fresh fruit, vegetables and dairy products; 3.3% for disposal of low-level radioactive waste; and 1.5% for all services, public/nonprofit hospitals, and all other activities.
- <sup>31</sup> In its current form the legislation only temporarily phases out the estate tax. If no further action is taken the federal estate tax will resume again in 2011.
- <sup>32</sup> Washington Department of Revenue, *Tax Reference Manual (1999)*.
- <sup>33</sup> J. Thomas Carrato and Richard W. Hemstad. *Income Taxation in Washington: In a Class By Itself* U. Puget Sound L. Rev. 255 (1978).
- <sup>34</sup> In 1969 the Democrats held a 27-22 majority in the Senate and Republicans held a 56-43 majority in the House.
- <sup>35</sup> 1970 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>36</sup> 1970 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>37</sup> 1970 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>38</sup> 1970 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>39</sup> The Seattle Times October 9, 1970 *Evans puts hopes for tax reform on uncommitted*.
- <sup>40</sup> *A 50 year Perspective of Employment Trends in Washington State, 1947-1997* Washington State Employment Security Department, May 1998.
- <sup>41</sup> In 1973 the Democrats held a 30-19 majority in the Senate and the Republicans held a 51-48 majority in the House.
- <sup>42</sup> 1973 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>43</sup> 1973 Washington State Voter's Pamphlet, Office of the Secretary of State.
- <sup>44</sup> The state sales tax on food was temporarily implemented to mitigate the state budget crisis brought about as a result of a major national economic recession.
- <sup>45</sup> Roberts, Philips. *Of Rain and Revenue The Politics of Income Taxation in the State of Washington*.
- <sup>46</sup> Spitzer, Hugh D. *A Washington State Income Tax - Again?*
- <sup>47</sup> J Thomas Carrato and Richard Hemsted, *Income Taxation in Washington: In a Class by Itself*.
- <sup>48</sup> A 1% flat tax with federal personal exemptions and standard/itemized deductions would raise 1.1 billion per year. This is approximately 1/5 of the amount currently raised by the state sales tax.
- <sup>49</sup> Evans McDonough fiscal issues poll, conducted March 6 to 7, 2002.