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## I-1098 INCOME TAX PROPOSAL: WRONG DIAGNOSIS, WRONG PRESCRIPTION (SECOND EDITION)

### BRIEFLY

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

This is an update of a brief we initially published on June 8.

For the first time since 1973, Washington voters are being asked to approve an income tax proposal on the November ballot. Initiative 1098, with the high-profile backing of Bill Gates, Sr., (the chair of the 2002 Tax Structure Study Committee) and the Service Employees International Union, would impose a steeply progressive graduated tax targeted at high earners to raise \$2.9 billion in new revenues annually. After modest reductions in business and property taxes, the state Office of Financial Management projects the initiative would provide a bit less than \$2.3 billion in dedicated funding for health and education programs.

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

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

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

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

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

### INITIATIVE DETAILS

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

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

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

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

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

*For an individual filer:* If taxable income is less than or equal to \$200,000, no tax is due; If taxable income is greater than \$200,000 but less than or equal to \$500,000, the tax equals 5 percent of the amount by which income exceeds \$200,000; If taxable income is greater than \$500,000, the tax equals \$15,000 plus 9 percent of the amount by which taxable income exceeds \$500,000.

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

Supporters of the initiative say that legislators would never extend or increase the income tax without putting the issue to the voters. Recent legislative activity makes such assurances far from convincing. In the last decade, earmarks, fund dedications and tax limitations have been routinely “suspended” as the state has struggled with budget shortfalls. A similar provision placed into state law by Initiative 601 (1993) requiring that tax increases receive either two-thirds majority approval of each house of the legislature or simple majority approval in each house and voter approval to raise taxes has been suspended twice by simple majority votes in the legislature, most recently in February of this year (Engrossed Substitute Senate Bill 6130).

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

Section 301 of the initiative specifies that, “beginning in 2012, the state property tax levy is reduced by twenty percent of the levy amount that would otherwise be allowed under this chapter without regard to this section.” We interpret this to mean that property tax relief will begin with the

2012 property tax levy, which will actually be collected in 2013, so it would be in 2013 that state property tax payers would first see the benefit of the state property tax reduction.

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

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

The Office of Financial Management (OFM) projects that expansion of the credit would relieve 118,000 small businesses from B&O tax liability. This is 15 percent of the number of businesses with accounts classified “active” by the Department of Revenue and 35 percent of the number of businesses expected to file tax returns with DOR in 2012 if the initiative does not pass (see Appendix B). The estimated tax savings to businesses due to the expanded credit amounts to less than 7 percent of annual B&O collections.

Because many small businesses are organized as “pass through” entities, business income will flow through to owners’ AGI and be subject to the income tax.

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

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

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

Table 1: The OFM’s estimates of the annual revenue change from Initiative 1098 (Dollars in Millions)

	Calendar Year				
	2012	2013	2014	2015	2016
<b>Income Tax</b>	\$2,213	\$2,937	\$3,025	\$3,116	\$3,209
<b>B&amp;O Tax</b>	(\$250)	(\$259)	(\$261)	(\$271)	(\$281)
<b>Property Tax Relief</b>	(\$383)	(\$393)	(\$403)	(\$414)	(\$425)
<b>Net New Revenue</b>	<b>\$1,580</b>	<b>\$2,285</b>	<b>\$2,361</b>	<b>\$2,431</b>	<b>\$2,503</b>

**Revenue estimates.** The table to the right shows OFM’s estimates of the impact of I-1098 on state revenues by calendar year. OFM projects that the income tax would yield the state \$2.2 billion in 2012 and \$2.9 billion in 2013. Projected revenue then grows to \$3.2 billion in 2016. The large jump between 2012 and 2013 reflects the facts that a

significant part of the income tax revenue the state would receive in any calendar year would be payments on the prior year's income and that the state would receive no payments in 2012 on 2011 income.

OFM has based these revenue projections on federal tax data of Washington residents for the year 2006. Because of the staleness of this data and extreme volatility of the I-1098 (see below), the margin of error in these projections is quite large.

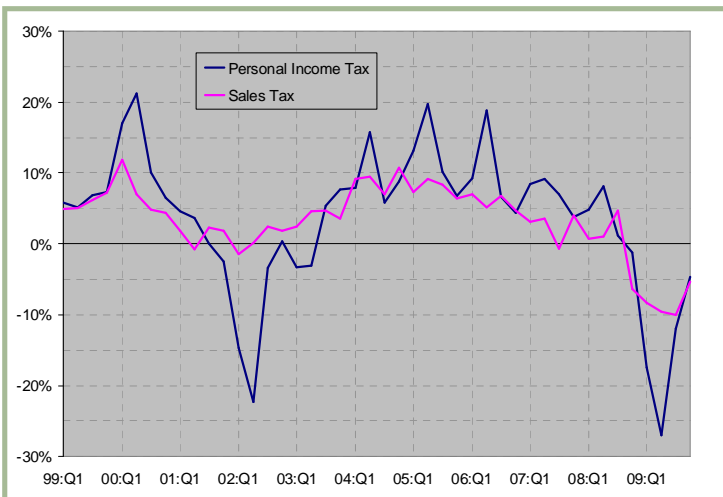
OFM projects that the expanded B&O credit would reduce 2012 state revenue by \$250 million in 2012, with the amount growing to \$281 million by 2016. We believe the 2012 number to be a bit high. OFM assumes that "the increase in the tax credit begins with tax returns filed after January 1, 2012. For annual taxpayers, this includes the 2011 tax return; for quarterly taxpayers, this includes the fourth quarter tax return; and for monthly taxpayers, this includes the December 2011 tax return." We disagree with OFM's interpretation that the expanded credit applies to 2011 activity. Section 302 of the initiative reads: "It is the intent of the voters that beginning in 2012, the [B&O tax] ... on small business must be eliminated by increasing the business and occupation tax credit to four thousand eight hundred dollars per year ..." To us, this means that the increased credit first applies to tax payments on 2012 activity. OFM's interpretation results in an obvious inequity with respect to the B&O tax on 2011 activity: The credit allowed to annual filers (\$4,800) would be greater than that allowed to quarterly filers (\$1,200), which in turn would be greater than the credit allowed to monthly filers (\$400).

OFM projects that the reduction in the state property tax rate would drop state revenue by \$383 million in 2012, with the revenue loss growing to \$425 million by 2016. As explained above, we believe that taxpayers will first see a property tax reduction in 2013 rather than 2012.

**VOLATILITY OF THE INCOME TAX**

The I-1098 income tax will be extremely volatile. A variant of the so-called "millionaire's tax," the graduated tax imposed by I-1098 violates established tax policy principles and would seriously destabilize our revenue system, threatening state services and assuring future fiscal crises. Put another way, I-1098 puts the state budget on a wild roller coaster and increases the velocity.

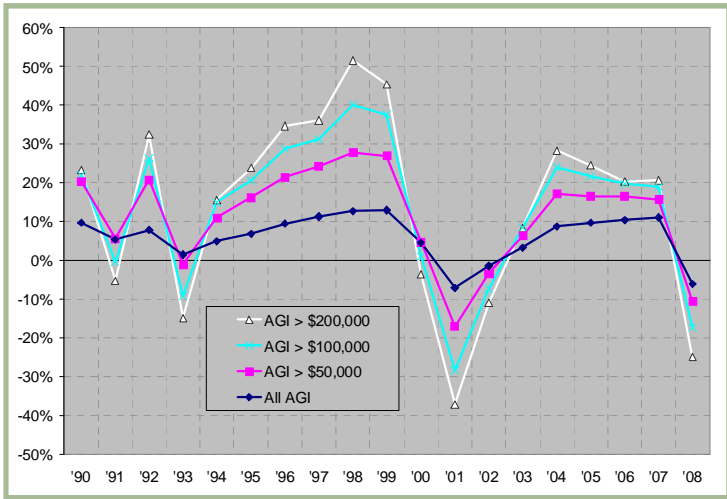
Chart 1: Year-over-year percentage changes in total state income tax and sales tax revenues, by quarter



For the 50 states as a whole, revenue from the personal income tax has been significantly more volatile than revenue from the sales tax. On Chart 1 we have graphed, by quarter, year-over-year percentage changes in aggregate state income and sales tax revenues (Boyd and Dadayan 2010). During both the recent Great Recession and the earlier Dot-Com Recession state income tax revenue fell by a greater percentage than sales tax revenue. During the intervening economic expansion, income tax revenue grew more than sales tax revenue.

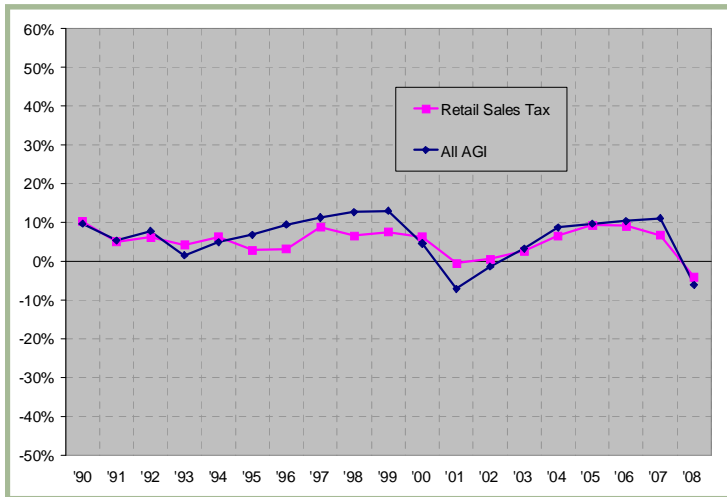
When it comes to the volatility of a tax, it is truly the case that the devil is in the details. For example, a sales tax that exempts food will be more volatile than one that taxes food. Similarly a sales tax that taxes construction labor will be more volatile than one that exempts construction labor.

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



In the case of the income tax, the degree of progressivity is a key determinant of volatility. On Chart 2 we have graphed percentage changes for Washington State in: (1) total adjusted gross income of state residents as reported to the Internal Revenue Service for the various years, (2) total AGI in excess of \$50,000 per return, (3) total AGI in excess of \$100,000 per return, and (4) total AGI in excess of \$200,000 per return. These curves show the annual growth rates in revenue to the state from hypothetical flat rate taxes on AGI where (1) all AGI is taxed, (2) the first \$50,000 is exempt, (2) the first \$100,000 is exempt, and (4) the first \$200,000 is exempt. With no exemption, year-over-year revenue growth would have been positive in 16 of the 19 years. Tax year 1999 shows the largest growth, 13.0 percent, while 2001 shows the largest decline, 7.2 percent. For 2008, revenue would have been down 6.1 percent.

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



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

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

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

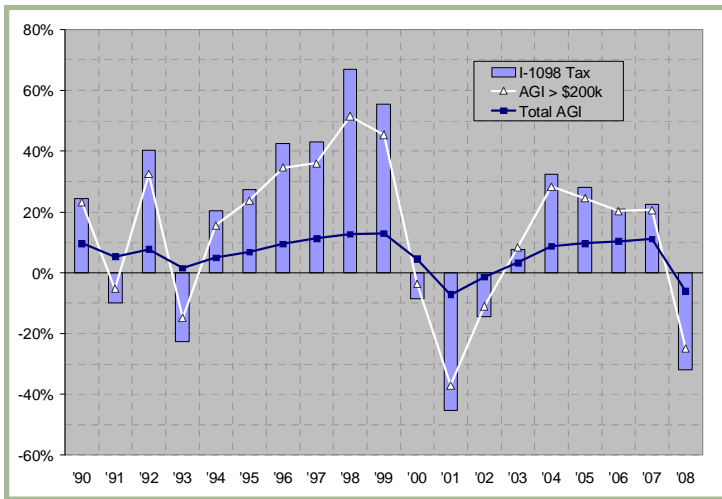
*The clear lesson is that as the exemption level moves up, revenue from the income tax becomes more volatile.*

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

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

The IRS summaries group returns in a limited number of categories by size of AGI. The top category is AGI exceeding \$200,000. To construct Chart 4, we assume that AGI follows the well-known Pareto distribution to extrapolate to higher AGI values.

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



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

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

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

**FAIRNESS**

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

THE SHIFTING BURDEN OF A TAX ON INCOME

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

Joseph Stiglitz  
*Economics of the Public Sector, 2nd Edition*

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

*Measuring Tax Burden*

Economists distinguish between two notions of who pays the burden of a tax. Statutory incidence shows from whom the government directly collects the money. Economic incidence shows who ultimately pays after accounting for all of the changes in market prices that the tax induces. The basic lesson of the theory of tax incidence is that statutory and economic tax burdens are not necessarily related, and this “means that taxes on capital may be borne by workers, that investment incentives may be injurious to capitalists, that taxation of foreigners may simply represent indirect domestic taxation, and that generations alive many decades in the future may be supporting those currently alive” (Kotlikoff and Summers 1987). ITEP notes that “assumptions about

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

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

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

state and local tax incidence can often be quite different from, say, the incidence of a national tax due to the mobility of factors of production (capital and labor) ..." (ITEP 1998). The quote from Nobel Laureate Joseph Stiglitz,

chairman of the Council of Economic Advisers for President Clinton, in the sidebar to the left illustrates how mobility might shift an income tax on doctors onto their patients.

Because people and businesses are mobile, state and local governments have only limited ability to redistribute income.

Public finance experts who study the appropriate allocation of functions within the federal-state-local hierarchy of government conclude therefore that redistribution—to the extent it is a policy objective—is primarily a federal responsibility.

The federal tax system—and therefore, the overall federal-state-local tax system—is progressive. To quote the Gates Committee: "Analysis by the Committee confirmed that when evaluating the total tax system—local, state and federal—all states have progressive taxes and the differences among

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

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

states are not as great" (WSTSSC 2002, page 53). Table 2 shows the distribution of the federal tax burden across income classes in 2007 as calculated by analysts at the Urban Institute/Brookings Institution Tax Policy Center. This table shows the share of income paid to the federal government as taxes rises with income. For the lowest income quintile, the federal tax burden averaged 4.7 percent of income. For the top 1 percent, federal taxes averaged 29.4 percent of income.

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

For the nation as a whole, ITEP's analysis indicates that the share of income taken by state and local taxes falls as income rises, from 10.9 percent of in-

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

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

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

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

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

#### *Flawed Allocation of B&O Tax in ITEP Model*

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

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

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

tions should be treated the same way.

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

*Lifecycle Analysis of Tax Burden*

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

Table 4: 2008 Consumer Expenditure Survey, Average Annual Expenditures by Income Class

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

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

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

Focusing the distribution of tax burden among taxpayers at a single point in time is misleading. The proper measure of tax burden relates taxes and income over the lifecycle. Incomes move up and down from year to year, and people save and borrow to smooth out consumption. A tax on income concentrates individuals' tax payments in the higher earning years while a tax on consumption spreads the payments out more evenly. Consider flat consumption and income taxes that impose the same lifetime burden: At any single point in time the consumption tax will appear to be regressive compared to income tax. For this reason the ITEP analysis, which measures burdens at a single point in time, is biased against states that, like Washington, rely heavily on consumption taxes.

State and federal fiscal systems comprise both tax policy and public expenditures, and to focus exclusively on taxation is to miss the big story on redistribution. In a classic 1986 study, Joseph Pechman of the Brookings Institution concluded that "the tax system has very little effect on the distribution

of income.” In contrast to the tax system, Pechman found the system of transfer payments to be highly progressive. And when taxes and transfers were combined, the system appeared quite progressive (Pechman 1985).

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

### **BUSINESS CLIMATE**

A number of academic studies have found that high marginal federal tax rates discourage entrepreneurship. Using data from the Panel Study on Income Dynamics, William Gentry and Glenn Hubbard find “a significant increase in entrepreneurial entry when tax rates are less progressive” (Gentry and Hubbard 2000, p. 283).

Using federal tax return data for the years 1985 and 1988 (before and after the Tax Reform Act of 1986), Robert Carroll, Douglass Holtz-Eakin, Mark Rider and Harvey Rosen look at the relationship between tax rates and investment and conclude “when a sole proprietor’s marginal tax rate goes up, the probability that he or she buys capital assets goes down, as does the expected amount of investment expenditures” (Carroll et al. 2000a, p. 442). A second paper by these authors finds a negative relationship between tax rates and revenue growth: “When a sole proprietor’s marginal tax rate goes up, the rate of growth of his enterprise goes down. ...A decrease in the marginal tax rate levied on a sole proprietor from 50 percent to 33 percent would lead to an increase in his receipts by about 28 percent” (Carroll et al. 2000b, p. 21).

These studies all focus on federal taxes. The mobility of people and businesses that limits the ability of state governments to redistribute income also accentuates the damage that high marginal tax rates can do to a state economy.

In a very interesting paper, Randall Holcombe and Donald Lacombe compare per capita income growth in counties on state borders with that in contiguous counties across the borders. This analysis uses two tax variables, the top marginal rate for the state’s income tax and the average tax rate calculated by dividing total state and local taxes by personal income. Holcombe and Lacombe find per capita income growth to be negatively related to both variables. “The more states raise their income tax rates compared to their neighbors, the slower will be their per capita income growth, and that the more average taxes rise in a state, the slower will be per capita income growth. Higher taxes mean slower income growth, and larger increases in marginal income tax rates have a negative impact on income growth, even holding constant the change in average taxes” (Holcomb and Lacombe 2004, p. 304).

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

If I-1098 is enacted Washington would have the fourth highest top marginal tax rate among U.S. states. For 2010, nine states have an 8.5 percent or greater top marginal income tax rate. Table 4 shows these states and rates. Hawaii and Oregon have the highest rates, 11 percent. The Oregon rate will drop to 9.9 percent after 2012.

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

California’s 10.55 percent top rate includes a separate Mental Health Services Tax at the rate of 1 percent, which applies to taxable income over

	2010 Top Rate	On Income Greater Than		Deductions Allowed	Preferential Capital Gain Treatment
		Individual Return	Joint Return		
Hawaii	11.00%	\$200,000	\$400,000	Yes	Yes
Oregon	11.00%	\$250,000	\$500,000	Yes	No
California	10.55%	\$1,000,000	\$1,000,000	Yes	No
Rhode Island	9.90%	\$372,950	\$372,950	Yes	No
Iowa	8.98%	\$63,316	\$63,316	Yes	Yes
New Jersey	8.97%	\$500,000	\$500,000	No	No
New York	8.97%	\$500,000	\$500,000	Phase-Out	No
Vermont	8.95%	\$372,951	\$372,951	Yes	Yes
Maine	8.50%	\$19,750	\$39,500	Yes	No
<b>Washington in 2012 with I-1098</b>	<b>9.00%</b>	<b>\$500,000</b>	<b>\$1,000,000</b>	<b>No</b>	<b>No</b>

\$1,000,000. California’s top rate is scheduled to drop to 10.3 percent in 2011.

For 2010, Rhode Island’s top marginal rate is 9.9 percent. That state’s top rate will drop to 5.99 percent in 2011.

On May 20, Gov. Chris Christie vetoed legislation to raise New Jersey’s top marginal rate to 10.75 percent. On June 8, Maine voters rejected a tax reform

proposal dropping the top marginal rate to 6.85 percent, while limiting deductions..

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

### National Rankings Affected

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

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

The I-1098 tax would be unique among state taxes in the way it exclusively targets people with high incomes. John Havens of the Boston College Center for Wealth and Philanthropy studied migration to and from the state of

New Jersey, with a special emphasis on the wealth of migrants, over the ten-year period from 1999 to 2008 [Havens 2010]. He found that from 1999 to 2003 the average net worth of households moving into New Jersey was \$675,984 while the average net worth of households moving out was \$482,554. The overall impact of migration was to increase wealth in the state by \$98.3 billion. From 2004 to 2008 the average wealth of in-migrating households was \$363,126, and the average wealth of out-migrants was \$618,328. Over this five-year period migration decreased New Jersey wealth by \$69.8 billion.

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

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

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

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

#### *Flight of Wealth*

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

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

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

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

Another uncertainty facing the Oregon economy is the impacts from the two tax measures which were passed on January 26. Studies on both sides of the issue from respectable sources derived very different conclusions. Given the uncertain nature of the impact of these two tax

measures, we will not incorporate possible impacts into the Oregon economic forecast.” (Oregon Office of Economic Analysis 2010)

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

Examining IRS tax return data by state, E.J. McMahon measured the impact of large income tax rate increases on the rich in Connecticut, which raised its tax rate in 2003 to 5 percent from 4.5 percent, New Jersey, which raised its rate to 8.97 percent from 6.35 percent in 2004, and New York, which raised its tax rate to 7.7 percent from 6.85 percent in 2003. Over the period from 2002 to 2005, the “soak the rich” tax hikes were followed by a significant reduction in the number of rich people paying taxes in each of these states relative to the national average.

### **CONSTITUTIONAL ISSUES**

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

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

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

### **OBSERVATIONS**

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

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

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

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

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

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**APPENDIX A: DEDUCTIONS AND I-1098**

For Washington residents, I-1098 defines taxable income to be adjusted gross income (AGI) as calculated at the bottom of the first page of the federal 1040 income tax form less interest received on federal obligations (which the state is prohibited from taxing). The deductions that are itemized on Schedule A and entered on the second page of federal form 1040 are not allowed. Thus, taxpayers will not be able to deduct a number of items, including home mortgage interest and charitable contributions, that are deductible for the federal income tax.

**DEDUCTIONS IN THE CALCULATION OF THE FEDERAL INCOME TAX**

Deductions enter into the calculation of a taxpayer’s federal income tax liability in two places on form 1040. Deductions for 13 specific items are taken on the first page. (Among these page 1 “adjustments” are educator expenses, health savings account deposits, moving expenses, self-employed pension and health insurance expenses, alimony paid, IRA deposits, student loan interest, and tuition.) The total of these deductions is subtracted from the taxpayers total income to get adjusted gross income.

Deductions for other items are itemized on Schedule A. Among the items deductible on Schedule A are medical and dental expenses, home mortgage and investment interest payments, charitable gifts, unreimbursed employee expenses and investment management fees. On page 2 of form 1040, the taxpayer subtracts from AGI exemptions and either itemized deductions or the standard deduction to calculate taxable income (TI).

The value of the itemized deductions that transform AGI into taxable income is much greater than the value of the statutory adjustments that transform total income into AGI. Here are numbers from the IRS’s summary of national returns for 2008: AGI, \$7.58 trillion; page 1 statutory adjustments, \$99.6 billion; standard deductions, \$376.3 billion; Schedule A itemized deductions, \$1.13 trillion. For 2008 federal taxpayers with AGI exceeding \$500,000, state and local taxes were 48 percent of itemized deductions; charitable contributions were 23 percent, mortgage interest was 9 percent; and investment interest was 8 percent. (<http://www.irs.gov/pub/irs-soi/08in14ar.xls>)

As the table below from the Center on Philanthropy at Indiana University shows, taxpayers with income above \$200,000 contribute disproportionately to health organizations, education institutions and the arts, while taxpayers with incomes below \$100,000 contribute disproportionately to religious causes (<http://www.philanthropy.iupui.edu/research/giving> focused on meeting needs of the poor July 2007.pdf ).

Table A1: Sum of Giving, by Subsector, by Income (\$ in billions)

	Religion	Combined	Basic Needs	Health	Education	Arts	Other	Total
< \$100,000	59.96	7.70	9.34	3.06	2.69	1.01	6.16	89.92
\$100,000 to \$200,000	11.39	2.16	2.46	1.12	1.14	0.44	1.17	19.88
\$200,000 to \$1 million	21.01	10.19	5.30	4.81	29.15	13.57	7.45	91.48
\$1 million or more	8.64	2.06	1.93	12.97	12.94	7.88	4.85	51.27
Total	101.00	22.11	19.03	21.96	45.92	22.90	19.63	252.55

## DEDUCTIONS IN THE CALCULATION OF STATE INCOME TAXES

Forty-three states impose income taxes. In two cases (New Hampshire and Tennessee) the tax is narrow, applying only to dividend and interest income. For most of the 41 states with broad income taxes, the calculation of state income tax liability closely parallels the calculation of federal liability. Thirty-two states start with AGI from the taxpayer's federal form. Three states start with taxable income from the federal form, while the remaining 6 states do not reference federal AGI or taxable income.

Those starting with federal AGI or taxable income make various additions or subtractions to the number taken from the federal return. The most common addition is interest on out-of-state state and municipal bonds. All state subtract from AGI or TI interest on federal bonds. Most subtract the portion of social security income that is subject to federal taxation. Many states subtract a portion of pension income. Some states subtract the portion of unemployment compensation that is included in AGI.

Thirty-two of the income tax states allow itemized deductions that largely mirror those on the federal Schedule A, including the deductibility of charitable contributions and home mortgage interest. This is summarized on the table on the following page, which is reproduced from a report by the Wisconsin Legislative Fiscal Bureau ([http://www.legis.state.wi.us/lfb/Informationalpapers/4\\_individual income tax provisions in the states.pdf](http://www.legis.state.wi.us/lfb/Informationalpapers/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf)). In the table, the entry "federal" indicates that deduction of the item follows the federal practice, "state" indicates that the deduction follows state-specific rules.

Nine of the income tax states do not provide itemized deductions for either interest expenses or charitable contributions, with these minor exceptions. These states are Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania and West Virginia. All but New Jersey and Pennsylvania provide the federal student loan interest deduction. Michigan provides a deduction for distributions from pension or retirement accounts that are contributed to a charity, so long as those distributions are included in AGI. New Jersey provides a deduction for Qualified Conservation Contributions. Indiana provides a tax credit of up to \$100 (\$200 for joint returns) for contributions to a college or university located in the state and a parallel credit for contributions to a state scholarship program (the Twenty-First Century Scholars Program).

Table A-2: Treatment of Itemized Deductions by Category by State, 2007

State	Itemized Deductions	State Income & Sales Taxes	Other Taxes	Interest Expenses	Medical Expenses	Charitable Contributions	Misc. & Other Deductions
Alabama	Yes	None	State	Federal	State	Federal	State
Arizona	Yes	Federal	State	Federal	State	State	State
Arkansas	Yes	None	Federal	Federal	Federal	State	Federal
California	Yes	None	State	Federal	Federal	State	State
Colorado	Yes	None	Federal	Federal	Federal	Federal	Federal
Connecticut	No	None	None	None	None	None	None
Delaware	Yes	State*	State	Federal	Federal	State	Federal
District of Columbia	Yes	None	Federal	Federal	Federal	Federal	Federal
Georgia	Yes	State	Federal	State	Federal	Federal	Federal
Hawaii	Yes	Federal	Federal	Federal	Federal	Federal	State
Idaho	Yes	None	Federal	Federal	Federal	Federal	Federal
Illinois	No	None	None	None	None	None	None
Indiana	No	None	None	None	None	None	None
Iowa	Yes	State*	Federal	Federal	Federal	State	State
Kansas	Yes	State*	Federal	Federal	Federal	Federal	Federal
Kentucky	Yes	None	Federal	Federal	State	Federal	Federal
Louisiana	Yes	State	State	State	State	State	State
Maine	Yes	None	Federal	Federal	Federal	Federal	State
Maryland	Yes	State*	Federal	Federal	Federal	Federal	Federal
Massachusetts	Yes	None	None	None	State	None	State
Michigan	No	None	None	None	None	None	None
Minnesota	Yes	None	Federal	Federal	Federal	Federal	Federal
Mississippi	Yes	None	Federal	Federal	Federal	Federal	State
Missouri	Yes	State*	State	Federal	Federal	State	Federal
Montana	Yes	State*	State	Federal	State	Federal	State
Nebraska	Yes	State*	Federal	Federal	Federal	Federal	Federal
New Hampshire	No	None	None	None	None	None	None
New Jersey	No	None	None	None	None	None	None
New Mexico	Yes	Federal	Federal	Federal	Federal	Federal	Federal
New York	Yes	State*	State	Federal	State	Federal	State
North Carolina	Yes	None	Federal	Federal	Federal	Federal	Federal
North Dakota	Yes	State*	Federal	Federal	State	Federal	Federal
Ohio	No	None	None	None	None	None	None
Oklahoma	Yes	Federal	Federal	Federal	Federal	Federal	Federal
Oregon	Yes	None	Federal	Federal	State	Federal	State
Pennsylvania	No	None	None	None	None	None	None
Rhode Island	Yes	Federal	Federal	Federal	Federal	Federal	Federal
South Carolina	Yes	None	Federal	Federal	Federal	Federal	State
Tennessee	No	None	None	None	None	None	None
Utah	Yes	State*	Federal	Federal	Federal	Federal	Federal
Vermont	Yes	Federal	Federal	Federal	Federal	Federal	Federal
Virginia	Yes	State*	Federal	Federal	Federal	Federal	Federal
West Virginia	No	None	None	None	None	None	None
Wisconsin	Yes	None	None	State	Federal	Federal	None

\*Does not allow itemized deductions for state income taxes but does permit itemized deductions for sales taxes deducted for federal income tax purposes.

## APPENDIX B: SMALL BUSINESS CREDIT

Currently small businesses are relieved of obligation to pay business and occupation tax via (nonrefundable) tax credits of up to \$70 per month (\$840 per year) for businesses in the services category and \$35 per month (\$420 per year) for businesses in all other categories. The credit phases out for a business whose B&O liability exceeds the maximum credit for its category. (“When the amount of [B&O] tax otherwise due ... exceeds the maximum credit, a reduced credit is allowed equal to twice the maximum credit, minus the [B&O] tax otherwise due ... . [RCW 82.04.4451]”)

Beginning in 2012, Initiative 1098 increases the credit to \$4,800 per year for small businesses in all categories. The phase-out provision would continue. At the 0.471 percent tax rate that applies to retailing, this expanded credit would eliminate B&O liability for a business with \$1,019,000 in revenue. At the 0.484 percent tax rate that applies to businesses in the manufacturing or wholesaling categories, the credit would eliminate liability for businesses with up to \$991,736 in revenue. At the 1.8 percent rate that applies to services through June 30, 2013, the credit would eliminate liability for a business with \$266,667 in revenue; while at the 1.5 percent rate that will apply thereafter (assuming the legislature allows the rates to return to pre-2010 levels), liability will be eliminated for a business with \$320,000. (Together, the retailing, wholesaling, manufacturing and services categories provide 93 percent of B&O tax revenue.)

The estimated cost to the state of the expanded credit is \$250 million in 2012, which would amount to less than 7 percent of B&O collections. Further, because many of the businesses that would benefit from the credit are organized as “pass through” entities, business income will flow through to owners’ personal income tax returns and be subject to the I-1098 income tax.

### WHAT SHARE OF BUSINESSES WOULD SEE B&O TAX ELIMINATED BY I-1098?

In its impact statement for Initiative 1098, the Office of Financial Management estimates that the initiative’s expansion of the small business credit would eliminate the business and occupation tax obligation for 118,000 Washington businesses. What fraction of Washington businesses would this represent?

There is a lot of confusion as to the answer to this question. Supporters of I-1098 originally claimed that the initiative would relieve more than 80 percent of businesses from the obligation to pay B&O taxes. We believe that the correct answer is somewhere between 15 percent and 35 percent.

The contentious issue is the number of businesses in the state—the denominator to the fraction. The logical starting point is number of “active” business tax accounts with the state’s Department of Revenue (DOR). At the beginning of September, DOR had 801,260 active accounts. Of these, 331,333 have been granted active non-reporting status by DOR, because their B&O obligations are fully offset by the existing small business B&O credit and their business activities do not require the collection of retail sales tax. The remaining 469,927 businesses are required to file tax returns with DOR.

### ESTIMATES FOR 2012

The OFM estimates that in 2012 there will be 478,000 businesses obliged to file tax returns with DOR, that 342,000 of these businesses will file returns, and that 317,000 of the filers will show positive B&O taxable income. The 25,000 businesses that file tax returns without positive B&O taxable income are exempt from the B&O for various reasons, but have other tax obligations to the state. OFM estimates 136,000 businesses will fail to file a required return. As OFM does not provide an estimate of the number of businesses with active non-filing status in 2012, we will assume that there are 331,000 of them, the current number.

Adding up the numbers gives an estimate of 809,000 businesses with active DOR accounts in 2012. Of these businesses, 342,000 (42percent) are expected to file tax returns. Some of the non-filers will be businesses that are not economically active, even though their accounts DOR accounts are administratively active. Others, however, do not file because they owe no B&O due to the existing small business credit.

OFM estimates that the existing small business B&O credit would fully offset the B&O 136,000 of the 317,000 businesses reporting positive B&O taxable income in 2012, so that under current law only 181,000 businesses would actually pay B&O to the state. This represents 22 percent DOR's active businesses.

I-1098's expanded credit would relieve another 118,000 businesses from the payment of B&O. This represents 15 percent of the 809,000 accounts classified as active by DOR, and 35percent of the 342,000 businesses expected to file returns in 2012.

Because DOR's list of active list includes some businesses that are not economically active, the 15percent figure understates the fraction of businesses that would be relieved of B&O obligation. Because a significant number of economically active state businesses are granted non-reporting status, the 35 percent figure overstates the fraction. The correct answer lies somewhere in between.

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