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THE WASHINGTON STATE TAX STRUCTURE AS VIEWED BY THE CONSUMER

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In evaluating the Washington tax structure from the view point of the consumer it is necessary to determine what is meant by "the consumer." For purposes of this discussion, the term consumer describes a member of the general public performing in his role as a householder rather than in his role as an employee, employer, or self-employed individual. In his role as a consumer, the individual has a certain set of criteria with which he can render a judgment in respect to his satisfaction with a tax structure. Cast in another role, this same individual may well have another set of criteria with which to judge a tax structure.

Our first problem, therefore, is to establish appropriate criteria to determine the efficacy of the system of state and local taxes as viewed by the consumer. In economic terms we would say that we wish to know what consumer welfare is with respect to the imposition of taxes. Once these criteria have been established, they will be used to evaluate the existing taxes in Washington.

The typical householder in all probability is neither well informed about the present tax structure nor its alternatives. However, for our discussion we shall assume a hypothetical consumer who: (1) is knowledgeable of the existing tax system and alternative systems, (2) has a welfare function typical of the majority of householders, (3) is rational in the sense that he wishes to maximize his consumer welfare, and (4) is capable of analyzing which tax or system of taxes most nearly maximizes his consumer welfare.

One might argue that the tax system preferred by our hypothetical consumer would be one of no taxes, and there may be such individuals, but they would not be typical. Virtually all householders, whatever their political label, desire that state and local governments provide certain services or affect certain kinds of income transfers. State and local governments do not have sufficient credit available to provide these services and transfers without the collection of tax revenues or related levies. The rational consumer who desires governmental serv-

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ices must regard his tax obligations as the means by which he pays for the services he seeks. The consumer's view of the tax system cannot be divorced from his demands for governmental services. One way of looking at our central problem, therefore, is to determine whether the consumer feels he is "getting his money's worth" for his tax dollar.

The Benefit and Ability to Pay Principles

The most important criterion of consumer welfare is probably that embodied in the *benefit principle* of taxation. This criterion dictates that taxes be imposed as nearly as possible in proportion to benefits received from the government. This criterion needs to be modified by the desire of consumers to redistribute income and it is in this connection that the *ability to pay principle* of taxation obtains.

In a general way most consumers probably regard their total tax obligations to state and local taxing jurisdictions as excessive relative to the services they feel they receive. There always appears to be a strong predilection on the part of all types of taxpayers, including consumers, to complain about the high cost of government as measured by tax obligations, much in the same way that consumers customarily complain about the "high cost of living."

Consumer Dissatisfaction. Complaints about the general level of of taxation may result from two factors. First, since the consumer does not contract for each of the governmental services he receives, as he does for an automobile, a medical examination, or a loaf of bread, he may not be aware of just what or how much he is purchasing with his taxes. Second, for most governmental services the consumer has no convenient yardstick by which he can measure value received. In the private market of our economy, the consumer generally has some alternative sources of supply from which to choose a commodity or service and he can compare the price charged by one supplier with that charged by another for the same or related commodity to determine whether he has "gotten his money's worth." In the area of governmentally produced commodities and services, such as police protection, fire protection, highways, municipal utilities, and a host of other areas of expenditure, the government is virtually the sole supplier and occupies a monopoly position. Irrespective of whether they are justified, consumers' suspicions of the prices charged by those with monopoly power are as prevelant today as they were in the time of Adam Smith.

Whatever system of taxes is used for the purposes of paying for governmental expenditures, consumers are always concerned over what might be called efficiency in government. As long as a consumer, through tax levies, is forced to give up his purchasing power or command over resources, he will demand that these resources be used by government in an efficient manner. In the absence of competition and a marketplace for the production and sale of governmental goods and services, it is incumbent upon any unit of government to use its tax revenues to produce goods and services desired by the majority of its taxpayers as efficiently as possible.

By the very nature of most governmental goods and services, some individual consumers will be dissatisfied because they are forced to pay for these goods and services whether they desire them or not. For example, suppose a dam is constructed to provide flood control for residents living downstream. All of these residents will receive the service of flood control. If all of the residents desire flood control and each is willing to pay his proportion of the necessary costs, there would be no reason why the service could and would not be provided by the private sector of the economy. However, if only a majority of the residents desire flood control and each is willing to pay this same proportional share of the cost, does it not seem reasonable that the service should be provided? The private sector will not provide the service because there is no way for a private firm to exact from the minority of residents, who do not desire the services, a price for the services they inevitably receive. A government, however, through its taxing power may exact from all of the residents who benefit, *i.e.* receive flood control, the necessary costs and, therefore, can and should provide the services desired by the majority. This is a commonly accepted principle of democracy. It is, of course, incumbent upon the government to determine that the total value of the benefits to society equals or exceeds the costs of the project, and to see that the costs of providing the service are minimized. It is not necessary that the sum of the benefits to the majority, those consumers who would vote in favor of government providing the service, exceed the costs since these costs will be shared by the minority as well as those who benefit, though unwillingly. This minority will always be dissatisfied with any tax which exacts revenue to pay for unwanted services. We wish to concern ourselves not with the views of consumers who would fall into such a minority but rather with those who by majority rule favor various types of government expenditures.

Not all government expenditures are of the flood control type, providing benefits to all members of a group or society indiscriminately. Many expenditures provide services or benefits primarily to the users of the service. For example, a bridge which reduces the travel time between two locations is primarily of benefit to those who potentially would travel between the locations, a recreation area is primarily of benefit to those who would use it, etc. The tax system which is appropriate for the funding of one kind of expenditure may be different from that appropriate to another. The criteria by which our hypothetical consumer must judge the tax system can be developed only in the context of the nature of governmental expenditures involved.

Types of Government Expenditures. Governmental expenditure programs may be divided into three categories. First, there are those whose benefits accrue to society generally although not necessarily equally to each consumer in society. Expenditures to maintain law and order, to protect property and civil rights, and to preserve and perpetuate democratic government itself are examples of this category. It is virtually impossible to determine the relative benefits to each individual of these services so that funding of this category of expenditures should come from a tax or system of taxes which is imposed upon all households if consumer equity is to be served.

Second, there are those expenditure programs whose benefits accrue primarily to those particular individuals who have sought these programs through the democratic process. Funding of these programs should be accomplished by taxes, licenses, fees, etc., which assign the costs to the beneficiaries. Only with such a tax system can we be consistent with the primary criterion of consumer welfare, the *benefit principle.*

The third category of expenditure programs are those designed to redistribute real income in society. Social welfare programs which provide income transfers to the aged, the blind, the indigent, the unemployed, etc. are obvious examples. However, many other programs are primarily of this character. The whole program of public institutions is designed to provide care of one sort or another for people who cannot afford care from the private market sector. Penal and correctional institutions as well as mental institutions provide benefits to society as well but they still involve income transfers. Funding of these expenditures should be accomplished by taxes which at least do not defeat the redistributional aims and which may further the aims.

Ability to Pay. The concept that taxes should be based upon ability to pay rather than simply benefits received is analogous to the belief on the part of the majority of consumers that the distribution of income among individuals in society resulting from private market forces is not one which a majority would accept as equitable. It is not simply a matter of the lower income groups using the taxing power of government through the democratic process to exact income from higher income groups, although occasionally one sees legislation of this type. Rather, it is suggested that the "Robin Hood" image is generally accepted in our society. We do not believe that the unemployed or the unemployable are themselves responsible for their income plight, nor do we believe that they should not share in the total real income of society. Most of us do not believe that the poor *deserve* to be poor, nor for that matter that the rich *deserve* to be rich. One's position on the income ladder is in part due to effort and perseverance but it is also greatly affected by the magnitude of one's inheritance of material wealth, innate capacities, education and training, and probably good fortune. Because of these beliefs most consumers willingly support programs which raise the level of income of the lower income classes. Such transfers are really negative income taxes. It must be recognized that these increases will come in part from transfers in the forms of positive income taxes levied upon higher income groups, whatever the particular kind of tax which is used to support these programs. If these consumers are rational and consistent in their views they should similarly support a tax structure which levies disproportionately larger obligations on higher income and/or wealthier taxpayers.

While it is possible abstractly to categorize governmental programs into the above threefold division, actual programs inevitably involve a mixture of the three categories. For example, expenditures for public education are one of the major and most costly of state and local government programs. Obviously the individuals (and their families) who receive publicly supported education receive substantial benefits. There is ample evidence to support the correlation between the amount of education an individual receives and his future income. The method of financing public education should perhaps reflect these benefits. However, lower income groups could not possibly afford the pro-rata cost of education even through secondary education, much less higher education, for their children. If these children are to receive the amount of education which most states now require by law, a transfer of income is necessary and such a transfer is effected by the subsidization of education from general tax funds. Finally, it is generally believed in our society that education of the youth provides benefits to all members of society. Not only is an educated population more productive, thus producing a larger total real income for society, but the preservation of a free democratic society surely depends upon a literate if not well educated population. For these reasons we feel justified in taxing those who have no children and those who choose to purchase private or parochial education for their children to pay for public education.

The distribution of the benefits of education between those receiving the education and the rest of society changes with the level of education. The higher the level of education, the greater will be the share of benefit to the recipient and the less to society generally. This is in part reflected by our methods of financing higher education as compared with common schools; but this alteration of method is probably inadequate to completely conform to the *benefit principle* of taxation. In our zeal for public education, our method of financing reflects our tendency to underestimate the benefits of the recipients and overestimate the societal benefits, particularly for higher education. Nor can these financing methods be justified on redistributional grounds. Our subsidization of higher education from general tax funds provides transfers of real income to the recipients and their families without respect to their level of income. This is not to argue against the amount of expenditure on education at any level, but rather upon the method of financing these expenditures.

Since most governmental programs, like public education, involve direct benefits to recipients, indirect benefits to society, and income transfers, methods of financing should reflect this. No single tax is likely to succeed in satisfying both the *benefit principle* and the *ability to pay principle.* A system of taxes levied to support any particular program should reflect the consumers' views of the relative importance of these factors.

Equity and Neutrality. Before examining Washington's tax system, two other criteria should be mentioned which are applicable to the consumers' judgment of a tax. The first is what we might refer to as equity among taxpayers in like circumstances. Once the tax base is determined, whether that base is income, expenditures, or some form of wealth, taxpayers with the same base should be required to pay the same amount of tax.

The other criterion is one of neutrality of a tax with respect to the allocation of resources among alternative productive uses, or the allocation of income among alternative expenditures. The former is a matter of economic efficiency in production, while the latter is concerned with consumer sovereignty both of which are important tenets of a free enterprise system. A particular tax may be used and its use might be justified as a penalty tax to discourage production or consumption of some good or service. A truly protective tariff or a prohibitive tax on narcotics would be an example of a penalty tax, and, of course, is not neutral but interferes with efficient production or consumer sovereignty. Justification requires that benefits to society resulting from the tax outweigh the benefits denied by the tax to particular individuals. Actually, most forms of taxation violate the neutrality criterion to some extent for it is in the nature of a forced levy that the discretion of the taxpayer is restricted in some manner. In judging a tax, one may hope simply to minimize the interference with economic efficiency and consumer sovereignty.

ANALYSIS OF WASHINGTON TAXES

The revenue system of the governmental units in the State of Washington consists of a large variety of different taxes, fees, and licenses. The most important of these are the property tax, the general retail sales tax, selective excise taxes, and the business and occupation tax. We shall discuss the merits of these taxes and the often proposed state income tax in terms of our criteria.

Property Tax. The property tax, used primarily for the financing of local government expenditures including common schools, is consonant to some degree with the *benefit principle*. To the extent that local government expenditures involve the maintenance of law and order and the protection of property rights, the benefits to property owners will vary with the amount of property, and the tax imposed against property as a base is therefore a reasonable one for these purposes. There are, however, certain shortcomings to this property tax. It is not a general property tax but a real property tax. Other forms of individual wealth or property typically are not subject to the tax with the minor exception of certain types of personal property. It has proved administratively infeasible to tax most personal property or intangible property. Thus, two individuals with the same total wealth and hence the same benefits from these governmental expenditures may have different proportions of real property in their portfolios, so that real property is a somewhat imperfect index of benefits. An individual may evade this tax obligation by changing the composition of his wealth.

The property tax is a major source of revenue for the financing of schools.[1] For these expenditures the property tax is a very imperfect index of benefits. There is little connection between a household's real property value and the number of children of school age. Even if one considers public education at this level to be of benefit to all members of society there is still little relation between the individual consumer's share of these benefits and his share of total taxable real property.

In terms of the *ability to pay* criterion, the property tax and the expenditures it finances produce some redistribution of real income. There is obviously some correlation between an individual's income and the taxable value of his real property so that a tax imposed on real property is similar to an income tax but again the relation between income and this particular form of wealth is far from perfect. Nevertheless, if consumers believe in the *ability to pay principle*, the property tax is a useful adjunct to other taxes (including an income tax) in achieving conformity with this principle. This tax imposes a levy against property which yields a real income to the owner-occupant while other taxes ignore this income.

The property tax has its greatest shortcomings with respect to the criterion of equity among taxpayers in equal circumstances. The rate of taxation varies from one tax jurisdiction to another and the assessed value of properties whose market value may be identical varies even more.[2] Even within a single tax jurisdiction the variation of assessed valuations of properties of the same market value is great. Assuming that the county assessors and their staffs are infallible in their appraisal judgments of the values of property, the relative market values of individual properties are continually changing and thus creating inequities. The assessor's office cannot administratively reappraise each property each year, so that even under ideal appraisal conditions equity among taxpayers is certain to be constantly violated.

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[1] WASH. CONST. art. 7, § 2, amend. 17(1944) limits school districts to a maximum levy of 10 mills unless an excess is approved by the voters.

[2] The variation in actual ratio of assessment for 1963 ranges from 14.6% in San Juan County to 25% in Grant County. WASHINGTON STATE RESEARCH COUNCIL, THE RESEARCH COUNCIL'S HANDBOOK 584-85 (1964-65 ed.).

Retail Sales Tax. The retail sales tax provides the largest amount of revenue of any tax in the State of Washington.[3] In terms of *the benefit principle* this tax bears little relationship to the distribution of benefits of the expenditure programs it finances.[4] However, it does provide for tax levies against tourists or other non-residents who receive the benefits of governmental expenditures and might not otherwise be subject to tax. On the other hand, alternative forms of revenue collections might be used to compensate for these benefits.

On the basis of the *ability to pay principle* the retail sales tax bears some relationship to individual income. In combination with the expenditure programs that it finances (education, welfare, public institutions, etc.), it does provide for a redistribution of real income. However, the tax liabilities resulting from this tax do not conform perfectly with the distribution of income. The proportion of an individual's income which is expended on those items which are subject to the retail sales tax diminishes with rising income, and probably increases with the size of the household unit.[5] This means that, even though the tax rate is four per cent on all taxable items, the tax obligation for a large, low-income family is greater in proportion to its income than the tax obligation for a smaller, high-income family is in proportion to its income. For consumers who feel strongly about redistribution of income and the *ability to pay* criterion, the retail sales tax does not meet this criterion as well as a tax levied on income or wealth which includes an increasing tax rate with the level of income or wealth.

It has often been suggested that the retail sales tax could be made to conform more closely to income if expenditures for certain classes of goods, for example food, were exempted. While the proportion of which expenditures other than food bear to income may be more nearly constant, the relationship is not clearly predictable. On the other hand, if the retail sales tax could be extended to cover the purchase of all goods and services and the purchase of assets as well, the tax could be made to resemble a flat rate income tax.[6]

With respect to equity among taxpayers the retail sales tax performs very well. It is relatively easy to enforce and evasion and avoidance are difficult.

[3] For figures on the Washington Retail Sales Tax, see *id.* and TAX FOUNDATION, INC., FACTS AND FIGURES ON GOVERNMENT FINANCE (12th ed. 1963).

[4] For a discussion of the programs financed by the retail sales tax, see Shipman, *Projected State Financial Needs,* 39 WASH. L. REV. 976 (1965).

[5] See RCW Ch. 82.08 for the application of the Washington Retail Sales Tax.

[6] *Ibid.*

With respect to the criterion of neutrality in affecting the allocation of resources or consumer expenditures the retail sales tax does little violence. The only problem arises in border areas adjoining states without such a tax. Here, the affect of the tax is to divert otherwise taxable expenditures to retail establishments across the border. The misallocation of resources in this connection is probably not significant.

Excise Taxes. Among the selective excise taxes, the taxes yielding the greatest amount of revenue are those levied upon gasoline, motor vehicles, liquor, cigarettes, and other tobacco products.[7] Most selective excise taxes violate the neutrality criterion with respect to consumer choice. The effect of the tax is to raise the price of the goods or services, and discourage its consumption relative to other goods. Unless it is the intention of the tax to penalize consumers who wish to consume the taxed article, such taxes cannot be justified on consumer welfare grounds. Two exceptions, however, should be noted. If it can be shown that the items taxed are purchased by consumers in amounts which increase with income, the taxes could be justified on the *ability to pay* principle. Such examples are thought of as luxury taxes. The difficulty with these taxes is in finding items which are a part of all consumers' expenditure patterns and in amounts which increase with income. The taxes on liquor and tobacco clearly do not meet this test.

The other important exception of selective excises which do not violate our criteria are those which are directly related to a program of benefits to particular individuals. Thus, taxes upon gasoline or motor vehicles are clearly justified on the *benefit principle.* The benefits to consumers of highways are obvious. The use of the highways is closely related to motor vehicles and the consumption of gasoline. The revenue from such special excises must, of course, be used for the program which provide the benefits to which they are related.[8] This same justification can be made for tolls or fees for the use of bridges or ferries, public recreation areas, licenses for hunting and fishing to support state game programs, payroll taxes to support unemployment or workmen's compensation benefits, or for tuition charges to institutions of higher education. From the standpoint of consumer welfare the tax system

[7] At the present time the excise taxes on the following items are: gasoline (7½ cents per gallon); cigarettes (7 cents per package; motor vehicles (2% of fair market value); house trailers (1% of fair market value); aircraft (1% of fair market value).

[8] Washington, by constitutional amendment, is required to pay revenue from motor vehicle license fees and excise taxes from motor vehicle fuel into the highway fund which is used exclusively for highway purposes. WASH. CONST. art. 2, § 40, amend. 18(1944).

makes too little use of the selective levy to support a selective benefit program.

Business and Occupation Tax. The business and occupation tax which collects a significant amount of revenue is perhaps the most maligned tax in the system, but the objections to it are largely from businesses rather than consumers. The small, self-employed businessman may confuse his interests as a business owner with his interests as a consumer since they are so closely interrelated but we are concerned here only with the consumer. This tax is essentially like a general sales tax levied at all levels of production instead of at retail only and the base of the tax is gross sales rather than net income. It is this feature which leads to complaints. Since the ratio of net income to gross sales is vastly different for different types of businesses, the tax cannot be said to conform to the *ability to pay* criterion. Apparently those businessmen who complain about the business and occupation tax are consciously or unconsciously strongly committed to the *ability to pay* criterion. Complaints typically arise in those industries which have a small net income relative to gross sales and thus must pay a larger tax in proportion to net income than others.

From the consumer's viewpoint, the business and occupation tax is no better or worse than a general sales tax except that the tax rates are not entirely uniform. Where the rate of tax varies for particular industries this tax takes on the undesirable characteristics of selective sales taxes. Such variation in rates might be justified on the basis of our criteria if the variation in rates caused the tax to conform more closely to net income and thus to the *ability to pay* principle.

Charges are frequently made that the business and occupation tax discourages the location of new industries or the expansion of existing industries. If this were true, it would be of some concern to consumer welfare. However, any level of taxation on a particular business which exceeds the level which would be imposed by the tax jurisdiction of some alternative site may discourage expansion or location. Taxes, however, are only one factor determining location or expansion and rarely are they the critical factor.[9] Moreover, while the business and occupation tax may discourage one type of business, any alternative tax on business which would collect the same amount of state revenue tax (including property or net income taxes) may discourage some

[9] See Strawn, *The Washington State Tax Structure as Viewed by Business*, 39 Wash. L. Rev. 1013 (1965).

other type of business. It is not at all clear, therefore, that the business and occupation tax is better or worse than alternative business taxes from the viewpoint of consumers.

Proposed Income Tax. As the costs of existing programs continue to rise faster than the tax revenues from the present system of taxes and as demands from the public for new programs continue, the state government will have to consider additional forms of taxation. Among those considered will be a personal income tax. Although this form of taxation has been proposed on several occasions by the legislature, judicial interpretation of the Washington Constitution has prevented the enactment of a net income tax without constitutional amendment.[10] We are not concerned here with estimating the public's willingness to vote for any new additional tax measure but rather whether such a tax as an alternative to the present taxes better satisfies the criteria of consumer welfare.

An income tax bears little or no relationship to the *benefit principle*. With respect to the *ability to pay* principle, a net income tax on persons conforms more closely than most other taxes and if the rate structure is progressive, *i.e.*, rises with income, this tax can redistribute income more effectively than almost any other tax.

With respect to the criterion of equity among taxpayers in equal circumstances, the net income tax has many shortcomings. The difficulty of defining net income, of preventing avoidance, especially at higher income levels through a host of loopholes, and the problems of enforcement are well known in connection with the federal income tax. The progressivity of the federal income tax is much less than might be supposed by the rate structure. More serious, however, is the fact that two individuals with the same real income may have quite different tax obligations.

CONCLUSION

In summary we have attempted to evaluate the most important forms of taxation in the State of Washington in terms of criteria which we believe relevant to the consumer's interests. No tax or system of taxes is likely to satisfy all of the criteria simultaneously since the criteria themselves are to some extent mutually conflicting in their objectives.

[10] See Culliton v. Chase, 174 Wash. 363, 25 P.2d 81 (1933) (holding that a net income tax is a tax on property and invalid under WASH. CONST., amend. 14) and Jensen v. Henneford, 185 Wash. 209, 53 P.2d 607(1936). See also Comment, *A Study of State Income Taxation in Washington*, 33 WASH. L. REV. 398 (1958).

Some consumers will value the *ability to pay* criterion more than the *benefit* criterion and thus find the system which is one kind of compromise lacking; while others believing more strongly in the *benefit principle* will also be dissatisfied. A more adequate system of taxes could be achieved in the view of our hypothetical consumer if: (1) more attention were given to levies upon specific beneficiaries where programs provide specific benefits; (2) more efforts were made to improve the operation of the property tax and perhaps other taxes to prevent inequity between taxpayers; (3) discriminatory excises unrelated to benefit programs were eliminated; (4) a net income tax were substituted in part for the general sales taxes in order to make the whole system conform more closely to the *ability to pay principle.*