Washington Law Review

Volume 39
Number 5 *Symposium: The Washington State Tax Structure*

1-1-1965

State and Local Tax Problems from the Labor Point of View

Joe Davis

STATE AND LOCAL TAX PROBLEMS FROM THE LABOR POINT OF VIEW

JOE DAVIS*

This is a short presentation of what is believed to be the representative viewpoint of labor with respect to the inequities and inadequacies of the system as we now understand it. It is not intended to be an exhaustive examination of the taxing system now in use in the State of Washington.

First it should be pointed out that no one person can presume to speak for or present all of labor's viewpoint. Within labor are many diverse viewpoints, but all are in general agreement as to the following inadequacies of the tax system now employed.

1. By placing too much reliance upon the sales tax, the system;
   A. is regressive and inequitable,
   B. is fast reaching the point of diminishing returns;
2. The present tax structure fails to provide adequate revenues;
   A. by severely limiting local district revenue sources,
   B. by allowing wide variations in assessment levels of the property tax,
   C. by creating a deterrent to business in the business and occupation tax application.
3. The system subsidizes business at the expense of the consumer and home owner;
   A. by heavy reliance on the sales tax rather than a heavier property tax, particularly on income producing properties,
   B. by shifting costs which should be more adequately assessed by specific programs such as unemployment insurance and industrial (accident and medical aid) insurance to the general fund for sales tax support.
4. By failing to tax intangibles or income from intangible property, the tax structure;
   A. places major reliance upon sales and property taxes, which inevitably tend to be inequitable and regressive,
   B. exempts from tax substantial amounts of wealth possessed by

* President, Washington State Labor Council, AFL-CIO.

some individuals and taxes equal amounts of wealth if held in the form of real estate, or taxed personal property.

5. The system permits substantial avoidance of citizens' financial responsibility to their government;
   A. by grossly inequitable assessment ratios on property both within and between counties,
   B. by deliberate concentration of personal holdings in non-taxed intangibles, with relatively low ratio of income being spent on taxable items,
   C. which appears to be incorrectable without the addition of a graduated net income tax as part of the overall tax plan.

Virtually every form of tax creates, to a degree, some inequities. Sales taxes hit the low income groups hardest. Property taxes, without centralized assessment control, are frequently inequitable between counties, and even more within counties. For example, within the past two years the writer has found residential properties which sold in the same price class being taxed with as much as a one-hundred per cent variation, with frequently the lower priced house being taxed double that of houses costing more.

The business and occupation tax, applying as it does to gross rather than net income, falls heavily on the marginal producer, and is a particular deterrent to those industries having a high volume turnover with a low mark-up. Such a tax tends to discourage industry more than any other single aspect of our tax system. The reliance on a sales tax, with a low property tax, does to a great extent compensate for this adverse impact, but its negative aspects are readily apparent.

Sales Tax. Labor is particularly concerned with the adverse impact of the sales tax upon the low income, aged, and retired groups. The obvious disparity of the proportion that a 2,500 dollar income is taxed, as compared to the proportion that a 50,000 dollar income is subject to tax, needs no further examination, except to say that a five per cent sales tax is not the answer.

The Property Tax. Washington, with a relatively low per capita property tax, as compared to the other western states, or the U.S. average, automatically forces reliance upon other types of taxes. Without the ability to resort (absent a constitutional amendment) to an income tax, the only other answer has been a continually increasing sales tax or the enactment of a host of nuisance excise taxes.

The limitations of the property tax with a forty mill limit, as a revenue producer are not in and of themselves undesirable, if there were equity in the application. The forty mill limit inevitably creates differences in levels of educational opportunities between school districts, since some can and do pass special levies and others cannot or will not. An analysis of the effect of the school equalization formula used for apportionment of school funds reveals a further disparity between counties with high and low assessment ratios. Lack of centralized control over assessments has made the elected county assessor into a budget officer whether or not he likes the role.

The forty mill limit and unequal assessments result in disproportionate local debt loads, in the form of special levies and bonds for school construction. This forces a shift in school financing from a normal pay-as-you-go tax plan, to abnormal reliance upon special levies and longer term debt in the form of general bond issues. The Legislature could cure this by changing the school apportionment law to provide that state school monies be apportioned in the same ratio as assessed valuations in each county are to the state tax valuations, for that same county.

A more realistic approach to assessments might make it possible to preserve the forty mill limit and still meet the demands of an expanding educational system. Without such a realignment further increases in the sales tax appear inevitable unless serious consideration be given to an income tax on a graduated or progressive basis.

A Graduated Net Income Tax

Labor in the State of Washington has long advocated enactment of a graduated net income tax. The arguments in support have been most ably presented in *State and Local Taxes* a 1958 publication of the AFL-CIO.[1]

> Income is the best measure we have of ability to pay taxes. If we truly believe that a citizen's contribution to his government's expenditures should depend on his relative economic position, then we must favor a tax which is related as closely as possible to income and family status.
>
> Furthermore a tax levied on income, particularly on personal income, is likely to stay there. All taxes, whether derived from property, sales, gross receipts or on some other base, must ultimately be paid from someone's income. Unfortunately, most of the impact of these taxes can be passed forward and added to the price people ultimately pay for goods and services. *Why shouldn't the tax be levied on income right away and on a basis related to a family's ability to pay?*

[1] AFL-CIO, State and Local Taxes (1958).

In addition, the income tax is a "cycle-sensitive" tax; that is, if the rates remain unchanged, it will automatically take more from individuals and corporations when they are best off and less when their income falls. This is good for the economy because, as mentioned before, in bad times a lower tax payment encourages individual and business expenditure while in good times the higher tax yield lessens inflationary pressures and also makes possible the accumulation of government reserves.

Opponents of the income tax make much of its fluctuating yield. The answer, of course, is not to reject it because revenues fall off in bad times; most tax yields tend to decline during depressions. It is more fruitful to counteract the instability of income taxes—and thereby withstand the imposition of regressive sales and similar taxes—by encouraging state and local governments to set aside reserves during good times and also by increasing their legal power to borrow during bad times. . . .

Finally, a progressive state income tax does *not* extract an unreasonable levy against wealthier families and corporations. While income is also taxed by the federal government it is important to remember that the amount paid as a tax to the state can be deducted from income before computing the federal tax. As a consequence, the payment of the state tax substantially reduces the size of the federal tax.[2]

A discussion of deductibility quickly sets aside the erroneous argument against "confiscatory" or double taxation. Again quoting from the same AFL-CIO publication:

[I]t is necessary to unmask the propaganda leveled against all state income taxes both individual and corporate. It runs like this:

"Federal income tax rates are already so high, the states must stay away from this form of taxation and certainly not increase state income taxes where they already exist. If because of state action, individual or corporate income tax rates go any higher, the effect would practically result in the confiscation of all income in the higher brackets."

This propaganda often includes an example that is calculated to clinch the argument. It might run like this: "In 1957 Uncle Sam already took 90 percent of any income over $100,000 of a single taxpayer. Therefore, the further imposition of a 15 percent state tax on the same income means that the taxpayer not only is subjected to 100 percent confiscation of his income over $100,000; he actually would have to pay out 5 percent more than his income above that level to meet his combined federal and state income taxes."

Actually, this just can't happen! All of the states can raise their top individual income tax rates to 15 percent and higher, and substantially increase their rates on corporate incomes, without any confiscatory results. It is surely worth a careful look at this argument so that it can be successfully exposed wherever it is used.

---

[2] *Id.* at 32-33.

These spokesmen for special privilege carefully refrain from pointing out that:

1. Under federal law, most state and local taxes are deductible expenses before calculating federal income taxes. That is, in computing net income subject to the federal income tax, an individual or a corporation may deduct as expenses their state and local tax payments, including state individual and corporate income taxes. *Result: Because of this allowable deduction, federal income taxes go down as state taxes go up.*

2. Furthermore, two-thirds of the states that now levy income taxes also allow the taxpayer to deduct his *federal income tax payments* before computing net individual or corporate income subject to the state tax. *Under this system of "double" deductibility, both the federal tax and the state tax are reduced to a degree that almost cancels out the entire impact of the state tax.* Under both single and double deductibility, the tax saving which results increases as incomes rise. For lower and middle income families and corporations with small profits, the saving from deductibility is insignificant or nil. . . .[3]

The AFL-CIO doesn't oppose the provision of the federal tax laws which allows deduction of local and state taxes before computing federal taxes. This allowance, although it principally benefits high income individuals and corporations, permits the states to increase their revenue from income taxes at far less than a dollar-for-dollar cost to the taxpayer. Much of the cost of high income taxes in the states is actually borne by the federal government and this subsidy is equally granted to all of the 48 states, if they have income tax laws on their books.

In addition, this allowance has the effect of minimizing interstate tax differentials; it protects higher income tax states against the competition of states whose rates are low and those who do not have income taxes at all. . . .

The AFL-CIO strongly opposes, on the other hand, the provision in two-thirds of the states that allows double deductibility—the additional privilege of deducting federal taxes before computing state income taxes. Under double deductibility, the revenue loss to the state is considerable and the reduced yield to the state accrues almost exclusively to the benefit of high income individuals and corporations. While *single* deductibility reduces the progressivity of an effective state tax rate structure, it involves no revenue loss to the state. Double deductibility, however, not only converts the state income tax into a regressive tax—all of the added gain for the wealthiest becomes a revenue loss for the state.[4]

With this background, it would appear that the State of Washington is ignoring an opportunity to shift some of its tax burden to the federal government. (Which might be a better approach than trying to get the federal government to "earmark" part of the federal income tax for the

[3] See *Id.* at 44-45 for an example of how the deductibility systems actually work out.
[4] *Id.* at 42, 44-48.

states). Apparently other states have done this, thereby avoiding heavy reliance upon the regressive sales tax, and without any real detriment to attraction of industry—or growth of per capita income.

Without a graduated net income tax, we will continue to subsidize the federal government as compared to those states which have an income tax. Without a start now in that direction, we appear to be headed inevitably in the other direction of an increasing general sales tax.

A realistic proposal for the legislature to consider might include the necessary inducement or assurance to the voter-taxpayer that a reduction of the sales tax would accompany the enactment of a graduated net income tax. Some assurance of equalization of property assessment ratios to insure equitable distribution of property taxes between counties, within counties, and between residential and business properties would add to the attractiveness of the proposal.

The Washington voter-taxpayer has time and again proved his discernment between good and poor proposals, between waste and frugality, between meritorious issues, and those with less merit. He has also demonstrated his willingness to vote for taxes, for expenditure of public monies, and for necessary or even just desirable projects and programs, when the facts are properly and ably presented.

PAYROLL TAXES

An integral part of state government, "business climate" and tax discussions, is that part of the system known as payroll taxes. At the state level the unemployment insurance tax (actually a 90% offset or credit against the basic 3% Federal P/R Tax) and the industrial insurance taxes (consisting of an accident insurance tax paid completely by the employer—and the consumer—and a medical aid tax paid equally by the employer and the workman) are regularly a source of differences of opinion between labor and management. Management tends to consider the taxes too high and wants to curtail the programs, whereas labor believes the taxes are a constantly reducing portion of the total payroll costs and thereby not adequate to support programs which both labor and management agree are worthwhile in principle. This steady erosion of the adequacy of the income to these funds has not only made it very difficult to keep the programs current, much less add to their adequacy, but it has also been a multi-million dollar hidden dividend to industry.

Unemployment Insurance. For example, the unemployment compensation tax (at 2.7 per cent) originally applied to all covered earnings. After two years, a limit of the first $3,000 of covered wage per employee was placed in the law, and under this provision the tax actually applied and was collected on over ninety-five per cent of all covered wages. Inflation and wage rate increases occur, and the same limit of a tax base (the first $3,000) now limits the tax applying to less than fifty per cent of covered wages.

Consequently the income to the fund is only half as adequate as the original tax level, and the tax not now collected amounts to a hidden dividend or tax rebate of 35-45 million dollars a year, to industry as a whole. True, some industries paid tax on 100 per cent of the yearly earnings of $1,500 for a part-time employee, and now pay 100 per cent on the $2,500-$3,000 yearly earnings for the same employee. But the real comparison is the state tax of $81 (2.7 per cent of $3,000) which was collected on the man who in 1939 made just $3,000. Now, the same job, by the same man with the same employer, is still taxed $81 (2.7 per cent of *first* $3,000) on a yearly total pay of possibly $6,000. So we find the fund tied to an archaic income structure, which simply cannot support reasonable increases in benefit amounts without raising questions of insolvency or undesirable reduction of a fine reserve fund. Actually the 1939 level permitted dividends in good years. Now none are possible, and benefits in Washington State lag behind comparable states.

The adequacy of the reserve creates a financing problem. Labor has never advocated to the legislature, any actuarially unsound proposals in the unemployment compensation field. Since Washington's reserve fund is slowly drifting down from the "adequacy" point, any proposed increase in benefit amounts, *i.e.* higher amounts for those claimants held to the present $42.00 maximum, inevitably demands an accompanying increase in the income to the fund. The only alternative is a substantial curtailment of benefits, which is industry's method of financing higher benefit limits.

This is, in effect, saying "take the present income to the fund and divide it up any way you want. Cut the number of claimants and pay the rest more, or spread it out thinner to more people, but don't take away our hidden dividend. We don't want to pay as much as we used to." It is understandable that labor gets a little annoyed with industry's continual pointing to the "horrible example" and thereby condemning the entire unemployment insurance program, in an attempt to create a misleading smoke screen to hide the real fact—which is that industry is paying less and less payroll tax for unemployment insurance in proportion to total payroll costs.

Congress has recognized this problem and increased the taxable wage base for social security purposes from the original $3,000 to the present figure of $4,800. The State of Washington, if it expects to have a realistic unemployment insurance program, should have the program do the job originally contemplated. Namely, providing maintenance income to the claimant—out of work through no fault of his own, who is ready, willing, and able to work—and also providing an economic bulwark against the adverse impact upon the community of mass unemployment. There can be no choice then, but to make substantial changes, essentially as follows:

1. Restore the tax base to its original adequacy.
2. Increase the maximum weekly benefit to an amount equal to fifty per cent of the state's average weekly wage. Actually the *average* weekly benefit amount should approximate fifty per cent of the state's average weekly wage.
3. Extend coverage to several major groups not now covered *e.g.*:
   A. Agricultural, except those employees earning less than fifty dollars in any one quarter.
   B. Employees of both non-profit organizations and government.

If these things are done, labor will meet, discuss and evaluate any proposals which are realistically made to tighten eligibility requirements to disqualify those who do not need the coverage, and to realign the reserve ratio as an expression of total wages rather than covered wages.

Labor is not, however, interested in futile discussions in changing the excellent experience rating plan, which provides incentives to those employers who provide stable or expanding gross amounts of employment from year to year. Industry's ubiquitous proposal to shift the experience rating plan to one which provides incentive to each employer—not to provide employment, but to fight claims, irrespective of merit, has little charm for labor.

Industrial Insurance. The same comments with respect to erosion of the adequacy of the benefits as were made above about unemployment insurance, can also be made about this program, with some modification. Since the rating system here employed permits the "State Fund"

(Department of Labor and Industry) to adjust premium rates yearly (or more often in emergencies) the variables of frequency, severity and benefit levels tend to merge and lose identity within classes. As a result, rates for a given class may actually be reduced during or right after the major impact of a benefit increase (as authorized by the legislature) has taken place, due to lessened frequency of accidents within the class. In contrast, rates may go up without benefit increase. Unfortunately, some industry would rather "control costs" in this field by opposing nominal benefit increases, than by reducing frequency and severity of accidents by good management of safety programs. Thus legislative lobby pressure against benefit change develop to a degree completely out of proportion with realism. Further, most industries fail to concern themselves with the adequacy of appropriations to the department for sound management and good safety field inspection and supervision. The inevitable result is to have the same award levels paid to more people, rather than to have—as labor would like to see—higher award levels paid to fewer (injured) people.

Without taking cognizance of contemporary fringe benefits which do not appear in total wage figures, the industrial insurance premium total of today is a smaller percentage of total wages than it used to be, thus in effect providing for a hidden dividend or rebate to industry. Obviously, the consumer is the one who pays, nominally, for all costs of production, except those losses absorbed temporarily by the marginal producer. However, lessened payroll taxes (like unemployment insurance dividends) have little or no tendency to be noticeably reflected in the "reduced" cost of an article to the consumer.

Labor does not quarrel with lower payroll taxes, if the lessened tax results from less unemployment, or less accidents. But labor does question the advisability, or desirability to our economic society, if the lessened payroll tax results from inadequate benefit levels or curtailed coverage. The expectable result of inadequate coverage by payroll taxes is to throw a portion of the burden over onto the General Tax Fund in the form of supplemental payments through public assistance. Payroll tax problems in the industrial insurance field, which is one of the most complex areas of state government, could be improved in the following ways:

1. Converting our present benefit schedule from one based on marital and dependent status, to one based on percentage of wages—or geared to an individual's prior wage level.

2. Converting our present method of compensating permanent partial disability by a lump sum or time payment, to a permanent partial pension plan.
3. Converting our present experience rating system, and risk classification plan, from one of many classes, and deviated rates for good experience and adverse rates for bad experience, to one of merged classes with a basic minimum rate for all industry,[5] and additional adverse rate loadings for those individual employers whose experience (accident cost-wise) is in excess of the average for their industry.

The third suggestion is posed not as a concrete proposal of "labor" but as an "idea" worth examining. It would appear, except for those few industries with an exceptional safety record, that the present rating plan for industrial insurance fails in the following ways:

1. It does not accomplish its primary purpose or justification, which is to encourage safety practices by industry. This is because of the mechanics of the base, minimum and maximum rate relationships. The good operator's rate is not low enough if he is classified in a high rate industry, and the poor operator—accident-wise—doesn't get a high enough rate—in a low rate industry.
2. The present plan also severely penalizes the "new operator" by making him pay a basic rate for too long a beginning period without any possibility of a "retrospective" rating for good experience. This, more than any other tax, curtails or adversely affects the establishment of a new business (particularly in a high rate class).

The function of the department with respect to rating systems should be freed of its legislative chains and encouraged to parallel the practices of private insurance casualty companies with respect to flexibility of classification plans, retrospective rating plans, and adverse ratings. Further, there should be a recognition by all industry, and particularly the service industries, that it has a minimum obligation to carry a share —possibly even a disproportionate share—of the cost of providing an effective safety program and an adequate compensation plan for those who are injured despite the safety plan. These two improvements would go a long way toward curing some of the ever-present problems of Industrial Insurance payroll taxes.

[5] This is used in the unemployment compensation program but there it is expressed as a maximum with some deviation for good experience (measured by a formula), if reserve fund excesses permit dividends.