



Using Tax Policy to Promote Economic Vitality

Briefly

- The state and local tax burden, and the types of taxes paid, are key factors of business success
- In Washington, businesses pay 58 percent of state and local taxes, the national average is 44 percent
- The state ranks sixth highest in business taxes per-employee
- The B&O tax raises more per employee than most other states raise through income taxes on business profits
- Washington business taxes rank high, but adjustments to the tax code mitigate their impact
- Business tax adjustments are called “preferences” but often exist to create fairness, not favors, and to protect existing Washington jobs or to attract new ones
- Applying the B&O tax or the sales to business to business transactions results in a haphazard distribution of tax burden across businesses and competitive unfairness
- Many tax preferences target businesses that primarily sell to out-of-state customers in order to stimulate economic activity
- Many competitor states reduce corporate income taxes on out-of-state sales
- A “clawback” of tax preferences should not occur when a firm has fulfilled its obligations
- Washington has a state commission that reviews most tax preferences on a 10-year schedule
- The commission is instructed to evaluate whether preferences achieve their public policy objectives, but objectives are not always specified in the law
- 15,000 businesses are eligible for the manufacturing and R&D equipment sales tax exemption
- Research and Development tax incentives can have spillover effects benefitting the general public
- Sales tax exemptions for new data centers have boosted overall tax collections in rural communities
- Tax preferences have secured our region’s commercial aerospace leadership for decades
- The many national firms that started in Washington state attest to a success formula which includes a tax code that, while imperfect, nonetheless fosters business and job creation

Introduction

The amount of the state and local tax burden overall, percentage of taxes paid by business, and the types of taxes paid are key factors in business success and job creation. In national comparisons, Washington ranks as a high business-tax state, when measured either by taxes paid by businesses per employee or by the proportion of revenue generated by taxes on business. That burden, however, has periodically been mitigated by adjustments made to the tax code: Some of these adjustments ensure fair tax treatment and make Washington competitive with other states: others create incentives to bring new jobs to the state; still others protect existing jobs coveted by other states.

According to the Council on State Taxation (COST), businesses paid about \$7,600 per employee in state and local taxes in Washington in fiscal year (FY) 2015. This was the sixth highest per-employee tax burden in the country; the average across all states was about \$5,800 per employee. Combining state and local taxes, businesses bear 57.8 percent of the entire tax burden in Washington, versus 44.1 percent nationally. From FY 2014 to FY 2015, business taxes paid to the state and its local governments rose 4.5 percent, the eighth highest increase among the states.

While state business taxes are relatively high, the overall tax burden in Washington is middling. The most recent data from the Census Bureau’s annual surveys of state and local government finances show that tax collections by Washington’s state and local governments totaled \$4,557 on a per capita basis in FY 2014. Washington’s taxes ranked 19th highest across the 50 states by this measure. FY 2014 state and local tax collections were equal to 9.7 percent of state residents’ personal income. Washington’s taxes ranked 33rd highest by this measure (FTA 2016).

Washington’s tax structure

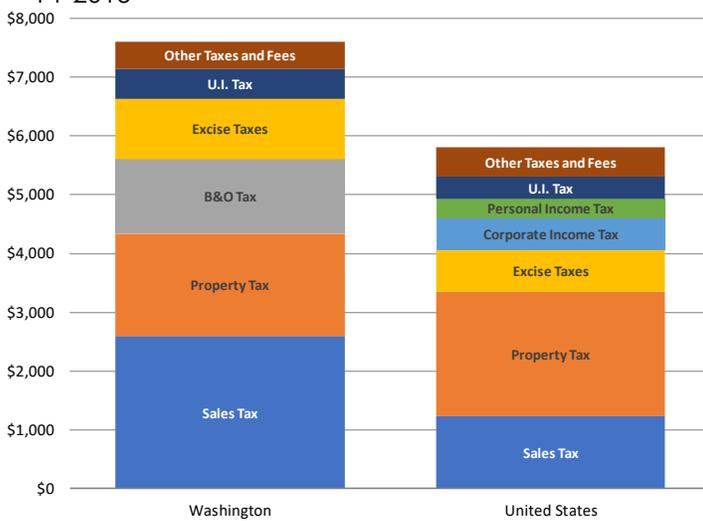
Chart 1 shows the breakout of per-employee state and local taxes imposed on business by tax type comparing Washington to the combined total of all 50 states.

Here is a closer look at the key components of Washington’s tax structure as they affect businesses operating in the state:

SALES TAXES. Retail sales taxes paid by businesses on their purchases from other businesses account for the largest share of state and local taxes paid by Washington businesses, at 34 percent of the total. Washington ranks third highest in sales taxes paid by business per employee.

According to the Tax Foundation, Washington’s state sales tax rate of 6.5 percent ranked ninth highest in the country as of July 1, 2016. The Tax Foundation estimates the average local rate across the state to be 2.4 percent, giving a combined state and average local rate of 8.9 percent, which ranks fifth highest in the country. But with the sales tax, rates are only the first part of the equation, the second part being the definition of the tax base: what gets taxed. Like most states, Washington does not charge tax on groceries, drugs and many professional services. It does not tax items that will be resold, or raw materials used in manufacturing, but it does tax most general business purchases like office supplies,

Chart 1: State and Local Business Taxes Per Employee, FY 2015



cleaning services and, very importantly, construction and maintenance of facilities.

When the sales tax is applied to business purchases, such as equipment, facilities and other business inputs, decision-making by firms is distorted, and this leads to inefficiencies. For example, forcing manufacturers to pay sales tax on parts and labor when they maintain or upgrade machinery and equipment discourages them from doing so. This reduces labor productivity; lower labor productivity, in turn, reduces the bargaining power of labor. And in the long run, the older, less modern factories are the first to be shuttered when the economy hits a downturn.

PROPERTY TAXES. Property taxes account for the second largest share of state and local taxes paid by Washington businesses, at 22.9 percent. Washington ranks 30th in property tax per employee.

Two factors contribute to the relatively low property tax burden. First are constitutional and statutory limits on property tax rates: Without special votes, the constitution provides that no taxpayer's tax bill can exceed 1 percent of the property value. Further, collections by all taxing jurisdictions have been statutorily capped at a 1-percent annual increase. Second is the constitutional uniformity provision, which requires that household and business property be taxed at the same rate.

BUSINESS AND OCCUPATION TAX. The business and occupation (B&O) tax accounts for the third largest share of taxes paid by Washington businesses, at 16.7 percent. The B&O tax is the primary business entity tax in Washington state. In most other states, the primary business entity taxes are corporate income taxes and personal income taxes applied to business income that is "passed-through" to the owners' personal income tax returns. As seen in Chart 1, the B&O tax generates more revenue per employee than the national average of state corporate income taxes and personal income taxes imposed on owners' profits. Combining gross receipts taxes with corporate in-

come taxes and personal income taxes on business profits, Washington ranks third in this aggregate tax per employee.

Because the B&O tax is imposed on each business transaction, a single good can be taxed multiple times as it moves through a supply chain, a situation called "pyramiding." Because of pyramiding, the effective tax rate on final production is higher than the statutory rates charged at any one stage.

We discuss pyramiding in more detail below.

Adjustments: The tax exemption list

The tax burden on Washington businesses would be even higher were it not for various adjustments (exemptions, exclusions, deductions, reduced tax rates, deferrals and credits) that are part of the Washington state tax system. Collectively, these adjustments are often called "tax preferences." This term is unduly tendentious, suggesting the adjustments represent favors done by the Legislature for select taxpayers. In general, these provisions serve to distribute the tax burden in ways that are more fair to individuals and less damaging to the state's economy.

Every four years the Research Division of the state Department of Revenue (DOR) publishes a comprehensive report (the *Tax Exemption Study*) cataloguing various tax preferences. Over the years, some have argued that the state could painlessly raise a great deal of money by "closing the loopholes" catalogued in the study. The 2016 edition of the study identifies 694 tax preferences and estimates that they will save taxpayers \$54.1 billion in state taxes during the 2017–19 biennium. However, the DOR study notes that eliminating the provisions—many of which are voter-approved, popular, and consistent with good tax policy (the sales tax exemption on food for example)—would only yield the state \$30.1 billion in additional revenue. It cites four reasons for this discrepancy: (1) elimination of property tax exemptions would

result in lower tax bills for other property owners rather than higher revenues to the state; (2) constitutional prohibitions would prevent taxing certain activities; (3) taxpayer behavior would change; and (4) compliance factors would reduce actual tax receipts.

Five preferences account for one-half of the \$30.1 billion: Extending the sales tax to personal and professional services is projected to yield \$4.7 billion; extending the B&O tax to employee incomes, \$3.8 billion; extending the estate tax to the full value of all estates, \$2.6 billion; extending the sales tax to food and food ingredients, \$2.8 billion; extending the sales tax to public utilities, \$1.4 billion.

The tax expenditure concept—which is attributed to the late Stanley Surrey, a Harvard law school professor who served as Assistant Secretary of the Treasury for Tax Policy in the Johnson Administration—arguably could provide a useful framework for analyzing tax adjustments. Yet, the theoretical construct has faltered in practical application.

Indiana University professor John Mikesell explains Surrey's concept:

Stanley Surrey ... observed that any tax structure in practice includes two elements. The first element is the [normal or benchmark] tax policy structure that has been developed to raise revenue. This defines the standard according to which the cost of government will be divided. The second element is the structure that has been enacted to provide relief and subsidization for certain taxpayers. (Mikesell 2012)

Surrey dubbed the adjustments intended to deliver relief and subsidization *tax expenditures*. He believed that tax expenditures should be regularly reviewed as part of the budget process and that regular reports cataloguing and valuing tax expenditures would facilitate this. The U.S. Department of the Treasury's Office of Tax Analysis and the U.S. Congress's Joint Committee on Taxation both pre-

pare annual reports on federal tax expenditures. The Institute on Taxation and Economic Policy finds that 46 states and the District of Columbia produce tax expenditure budgets of some sort and counts Washington's Tax Exemption Study as one (ITEP).

The tax expenditure budget, however, rests on a fragile foundation. For policy-making purposes, a tax expenditure report is only as good as its benchmark tax structure. As Mikesell observes,

if the benchmark structure is inadequately defined, the tax expenditure budget becomes a "hit list" for extra revenue, without much attention to which tax provisions are sensible elements of distribution of the cost of government and which represent the use of the tax structure for [other purposes]. (Mikesell 2002)

And, while some Washington policymakers would wish otherwise, the state's exemption report falls short as an expenditure budget. Mikesell categorizes DOR's Tax Exemption Study as a "revenue reducer list," which makes "no attempt to distinguish provisions that define the basic tax structure from provisions that deliver a preference to certain elements of the private economy" (Mikesell 2012). In other words, the report provides "little guidance" to legislators seeking to use it to shape policy (Mikesell 2002).

Many of the exemptions listed in Washington state's report are part of the state's basic tax structure. Take for example the "cash discount" exemption (RCW 82.08.010(1, b)): When a retailer provides a customer a discount from the list price of a good (e.g. through a store coupon or a loyalty card), sales tax on the transaction is calculated based on the discounted price rather than the list price. This is not a "loophole." Rather, collecting sales tax on the value of the discount would be gouging.

Another example of a tax exemption that is part of basic tax structure is the exemption of insurance premiums from the

B&O tax (RCW 82.04.320). These premiums are subject to the insurance tax, which is explicitly levied in lieu of other state taxes (RCW 48.14.080). Similarly, the public utility tax is imposed in lieu of the B&O tax, and utility charges that are subject to the public utility tax are exempt from the B&O tax (RCW 82.04.310(1)).

Pyramiding

Pyramiding is a major problem with both the B&O tax and the sales tax.

As noted above, a single good can be subject to B&O tax multiple times as it moves along a supply chain. For example, B&O tax might be paid on the sale of a log by a logging company to a mill, then on the sale by the mill of lumber made from the log to a distributor, then on the sale of the lumber by the distributor to a lumber yard, and finally on the sale of the lumber by the lumber yard to a builder. Thus, the wood in the log is taxed four times under the B&O tax. (No B&O tax is collected on the sale of the home by the builder; that transaction is instead subject to the real estate excise tax.)

The pyramiding with the sales tax is a bit different. In the example above, the wood would only be subject to sales tax once, at the "final sale" from the lumber yard to the builder. The earlier transactions are not taxed because they are deemed to be purchases for resale. But other inputs used along the path of the wood from the forest to the house are subject to sales tax. The logger pays sales tax on the chain saw used to cut the tree down and on oil used to lubricate the chain. The mill owner pays sales tax when purchasing a forklift used to move the lumber around the mill. The distributor pays sales tax when purchasing the truck used to move lumber from the mill and when the truck returns to the dealer for servicing. The lumber yard pays sales tax when purchasing cash registers and the rolls of paper on which receipts are printed. All pay sales tax on telephone services.

Pyramiding results in a haphazard distribution of tax burden across businesses as

well as competitive unfairness. Industries that are vertically integrated pay no B&O tax as they transfer materials from one process to another within the company, while businesses that are disaggregated pay the tax as materials move through a supply chain consisting of different businesses.

Taxes as a share of the final product price will vary between firms producing the same product depending on the degree to which production is vertically integrated. And taxes will vary across industries depending on the complexity of production processes. This distorts business decision making, and reduces the efficiency of the economy.

Many tax preferences lessen the amount of pyramiding in the retail sales tax and the B&O tax. Although DOR's Tax Exemption Study does not recognize it, these preferences move the taxes towards rather than away from the appropriate benchmark taxes.

From his review of state tax expenditure budgets, Mikesell concludes that,

regardless of whether the structure is explicit almost all states operate with the understanding, at least in the background, that their retail sales tax is intended as a general tax on consumption. (Mikesell 2012)

If the sales tax is intended to be a general tax on consumption, it is appropriate to exclude business-to-business transactions from the tax. Exemptions of such transactions from the tax move the system towards the benchmark tax on consumption.

The 2002 report of the Washington State Tax Structure Study Committee (which was chaired by William H. Gates, Sr.) identified pyramiding as one of the significant structural problems with Washington's tax system. With regard to the B&O tax the Committee noted:

Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax

on goods as they move through the production chain is a fundamental problem that requires correction.
(WSTSSC 2002)

Although fewer business-to-business transactions are hit by the sales tax than by the B&O tax, pyramiding is a greater concern for the former because of the sales tax's much higher rate.

Pyramiding of sales and use taxes is potentially an even greater problem, as the amount of these taxes businesses pay on inputs exceeds the amount of B&O tax they pay by as much as 40 percent. (WSTSSC 2002)

Reducing taxes on businesses that sell out of state

Many tax preferences are intended to reduce the tax burden of businesses that sell goods or services to customers located outside of the state. "Exporting" businesses play a critical role in the economic base model of regional development. Arguably, preferences for exporting businesses should be seen as part of the normal tax structure.

In recent years, many states have restructured their corporate income taxes to reduce or eliminate taxes on sales to out-of-state customers by changing the "apportionment" rules that determine the share of a multistate business's income

that is subject to the state's corporate tax. Often the tax expenditure reports of these states do not treat the revenues lost due to these restructurings as tax expenditures.

Because of these changes, state reliance on the corporate income tax has fallen. This is reflected in Chart 2, which shows the amount of revenue received by states from their corporate income taxes as a percentage of their total tax revenue. In 1980 state and local governments received 6.4 percent of their revenue from corporate income taxes; in 2015, 3.9 percent. This decline is not simply a reflection of a decline in the corporate income available to tax: State and local corporate income tax revenues have fallen relative to federal corporate income tax revenues, even as the top federal tax rate has fallen from 46 percent in 1986 to 35 percent today.

In 1980 state governments received 21 cents in corporate income tax for each dollar that federal government received. In 2015 states receive only 13 cents. (See Chart 3.)

For many years, standard practice was to apply the "three-factor" apportionment rule put forward in 1957 by the National Conference of Commissioners on Uniform State Laws. Under this rule, the share of a business's income taxable by a state was a simple average of three factors: (1) the share of the business's property located in the state, (2) the share of the business's employment (measured by compensation) located in the state, and (3) the share of the business's sales located in the state. In the case of tangible property, the location of the sale was deemed to be the state in which the buyer took physical delivery. For services, the location of the sale was deemed to be the state in which the greatest proportion of the income-producing activity was performed.

Over time state policymakers have recognized that they could lessen the tax burden on firms that export from the state by jiggering the apportionment

Chart 2: Share of Total State and Local Taxes from Taxes on Corporate Profits

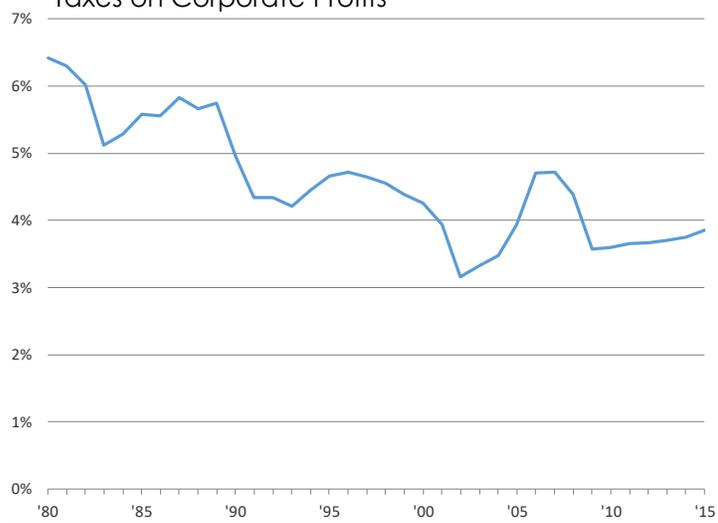


Chart 3: Ratio of State and Local Corporate Profits Taxes to Federal Corporate Profits Taxes



rule to reduce the weights given to property and employment (which necessarily involves increasing the weight given to sales). In 1986 80 percent of states with a corporate income tax used the traditional three-factor formula. By January 2016 only nine states used the traditional equally weighted three-factor formula. In 20 states the apportionment rule depends only on sales (this is commonly termed the single sales factor rule). The remaining states are somewhere in between.

Oregon and California are two of the states that have shifted to the single sales factor rule. Neither of these states considers the loss of revenue from the shift to be a tax expenditure. The state of California's most recent tax expenditure report says:

... now that mandatory single-sales factor apportionment is required for most multi-state businesses and is used by almost one-half of the states in the nation, it should be treated as part of California's basic tax structure. As such, this report does not treat mandatory single-sales factor as a tax expenditure. (page 2)

Similarly, Oregon's most recent report says;

The single sales apportionment formula defines the structure of an established

tax, so the single sales factor formula does not meet the statutory definition of tax expenditure. (page 399)

In Washington, the B&O taxes under the wholesaling or retailing classifications have long been destination based: Wholesaling or retailing B&O is not collected on goods sold and delivered to out-of-state customers. DOR's Tax Exemption Study does not consider these tax savings to be a tax preference.

State legislation enacted in 2010 (Second Engrossed Substitute Senate Bill 6143) changed the apportionment rules under the B&O tax for services and for royalties for the use of intangible property. Prior to 2ESSB 6143, services were apportioned based on where the services were produced, and royalties were allocated to the legal domicile of the licensor. With 2ESSB 6143 revenue for both services and royalties is apportioned based on location where the customer receives the benefit of the services or intangible property. The bill included this finding:

The legislature further finds that there is a trend among states to adopt a single factor apportionment formula based on sales. The legislature recognizes that adoption of a sales factor only apportionment method has the advantages of simplifying apportionment and making Washington a more attractive place for businesses to expand their property and payroll. (2ESSB 6143)

The most recent edition of DOR's Tax Exemption Study does not consider the tax savings conferred by 2ESSB 6143 to be a tax preference.

Nevada and Ohio recently adopted gross receipts taxes similar to Washington's B&O. In both cases the states apportion gross receipts according to a single sales factor rule, relieving exported sales from the tax. Similarly, the state of Texas's margins tax (which is midway between a gross receipts tax and an income tax) apportions according to a single sales factor rule.

Clawbacks

Tax preference programs that provide benefits to a firm in exchange for long-term benefits for the community sometimes include “clawback” provisions that allow governments to recover money or end a tax adjustment if the firm does not fulfill specific obligations. The conditions that would trigger a clawback should be clearly stated in the legislation creating the tax policy and be solely based on a lack of performance of the terms of the agreement.

Political pressures can lead to attempts by legislators to repeal tax preferences as clawbacks in cases where the firms have clearly met their agreed to obligations. Such repeals are not true clawbacks. Attempts to rewrite tax policy in terms that violate the contractual understanding reduce the credibility of the state in negotiating future tax adjustments and incentives, to the great detriment of the economic climate and competitiveness of that state.

Washington’s tax policy review program

In 2006 the Legislature created the Citizen Commission for the Performance Measurement of Tax Preferences to oversee periodic reviews of tax preferences (EHB 1069). The Commission has seven members: The chairs of the two largest caucuses in the House, the chairs of the two largest caucuses in the Senate, and the governor each individually appoint one voting member. The state auditor and the chair of the Joint Legislative Audit and Review Committee (JLARC) serve as nonvoting members. JLARC provides staff to the Commission, with support from the Department of Revenue and the Employment Security Department.

The Commission is instructed to develop a 10-year schedule to review all preferences. Under the 2006 legislation, preferences were generally to be reviewed in the order enacted, although preferences with a statutory expiration date could be scheduled for review before that date.

Subsequent legislation (SB 5044, in 2011) provided the Commission flexibility to consider factors other than order of enactment when scheduling tax preference reviews and specifically allowed “grouping preferences for review by type of industry, economic sector or policy sector.”

Explicitly excluded from review are “tax preferences that are required by constitutional law, sales and use tax exemptions for machinery and equipment for manufacturing, research and development, or testing, the small business credit for the business and occupation tax, sales and use tax exemptions for food and prescription drugs, property tax relief for retired persons, and property tax valuations based on current use.” In addition, the commission is allowed to omit “any tax preference that the commission determines is a critical part of the structure of the tax system.”

JLARC staff is to review preferences according to the schedule developed by the Commission and recommend whether each preference should be continued, modified or repealed. JLARC reports its preliminary findings and recommendations to the Commission for review and comment. JLARC then prepares a final report of findings and recommendations, which includes the Commission’s comments and separate recommendations, for the House Finance and Senate Ways and Means committees.

In the first nine years, only 14 preferences were recommended for termination by either JLARC or the Commission. Not one of the 14 has been ended. In 12 cases either JLARC or the Commission has recommended that a preference with a sunset date be allowed to expire on schedule. In three of these cases the preference has been extended.

Among the factors to be considered in JLARC’s review of a preference are its public policy objectives and evidence that it has advanced those the objectives. JLARC has frequently found it difficult to identify policy objectives in the

legislative record. In 98 cases either JLARC or the Commission has declared itself unable to recommend whether a preference should be terminated because its public policy objective is not clear, and therefore has requested that the legislature clarify the intended objective. In only nine of these cases has the legislature done so.

A tax bill enacted in 2013 (ESSB 5882) mandates that new tax preferences automatically sunset after ten years unless the legislation establishing the preference explicitly states otherwise. Legislation establishing a new tax preference must contain a tax preference performance statement identifying the legislative purpose of the tax preference and specific metrics by which the effectiveness of the tax preference in meeting this purpose should be measured

The bill also instructed the legislative auditor to prepare a report for the House and Senate fiscal committees on the appropriate data and metrics to be included in tax preference performance statements. This report was delivered in January 2014. In it, the legislative auditor described the profound difficulties faced in evaluating the effectiveness most tax preferences.

Determining whether the behavior of private individuals and organizations was caused by a tax preference is an extremely complicated exercise. ... A myriad of factors can play into why decisions are made by individuals and organizations. Isolating whether or how much a tax preference influenced these decisions, in an objective and evidence-based manner, is rarely possible. ... [I]f JLARC staff are asked whether any given tax preference had a causal relationship on behavior under our audit standards, more often than not our answer will be inconclusive. ... Inconclusive evaluations will tend to be accompanied by an audit recommendation to ... "allow to expire" [if there is an expiration date in law], or to "review and clarify" future

expectations if there is no expiration date in law.

Instead, the auditor recommended that tax preferences be judged according to the achievement of prespecified target outcomes (e.g. the number of jobs added at firms benefiting from the preference) without regard to cause and effect:

It is much more likely that an evaluation will have a conclusive answer to whether a target was achieved than an answer to whether there was a causal relationship between a tax preference and a target. ... the Legislature can ask whether a certain outcome met a target level. Then the Legislature could explicitly instruct the JLARC staff to find that the tax preference was effective if that target level was achieved.

While evaluation of preferences against 10-year-old targets will simplify the immediate task for JLARC staff, it is not clear that such analyses will provide much use to legislators trying to decide whether to renew or repeal a tax preference. The legislative auditor's admission that JLARC staff can rarely determine causality calls into question the value of the current preference review process.

Four prominent tax policy adjustments in Washington

The following descriptions of four tax preferences granted to industry in Washington illustrate that tax preferences strengthen Washington's economy by reducing inequities in the tax system and creating incentives to site important activities in the state:

MANUFACTURING AND R&D MACHINERY AND EQUIPMENT. Businesses that manufacture goods, either for sale directly to customers or as inputs to other manufacturers, can receive an exemption from sales tax on the purchase of machinery and equipment used in production, in research and development and for product testing. They can also receive exemptions on the cost of installation as well as the maintenance and upgrading of that equipment.

The definition of “manufacturing” includes creation of software, but Microsoft is implicitly excluded from the preference, and therefore does not benefit. The exemption does not apply to small tools and consumables.

DOR estimates that manufacturers received exemptions totaling about \$378 million in 2016, with about 80 percent of the savings coming from state sales tax reductions and 20 percent from local sales tax reductions. DOR estimates that about 15,000 firms in the state would be eligible for this tax preference.

The importance of manufacturing to Washington state’s economy can’t be overstated. On average, two additional jobs are created for every job in this sector. Average job quality is high, despite the fact that a college education is not required for most of these positions. And competition with other states for keeping or attracting companies that create these kinds of jobs is fierce.

As noted above, a basic principal of good tax policy is that activities be taxed only once, preferably at the end of the chain of transactions. The cost of machinery is an input to the manufacturing process. Firms buy equipment and depreciate it over some period of time, taking a charge for that machinery each year. That charge shows up as an expense on their income statement just like raw materials and labor. All of those costs will be taxed when the product itself is sold to a consumer.

Thirty-five states have general exemptions for manufacturing equipment and machinery. Seven states have limited exemptions or credits, or tax machinery and equipment at a lower rate. Five states have no sales tax at all. (CCH 2016)

The decision by the Legislature to omit the exemption from review by the Citizen Commission suggests that it is now part of the normal tax structure.

RESEARCH AND DEVELOPMENT. In 1995, just as the state was waking up to the potential for technology-based economic de-

velopment, the legislature enacted two tax preferences designed to encourage research and development (R&D) activity that would, in time, promote the growth of these industries. Although the software industry clearly benefited, a large aim of the program was to foster growth in biotechnology industries that have very high up-front research costs and long lead times.

Under the program, businesses engaging in high-tech R&D could receive a deferral and ultimate waiver of sales and use taxes on facilities and equipment, and receive a B&O credit for their R&D activities. The program became effective in 1995, with an original sunset of July, 2004 that was extended to the end of 2014.

The Citizen Commission, with the staff support of JLARC, reviewed these preferences during its 2012 cycle and recommended that they be allowed to expire. The Legislature failed to take any action to renew them, and the program ended January 1, 2015. Software firms (other than Microsoft) were added to the manufacturing exemption program, as noted above, and biotech and medical device manufacturers have a separate sales tax exemption program that sunsets in 2017.

Governor Inslee has proposed a new R&D credit that would apply to advanced aerospace manufacturing, life sciences and environmental technology.

The fate of the R&D tax preferences is a good illustration of the challenges of agreeing on objectives within an evaluation program. Economists argue that corporate R&D has large spillover effects, such that the business undertaking the R&D work reaps only part of the benefit, with benefits also accruing to other firms in the industry. To compensate firms for providing industry-wide benefits through their R&D program, and to keep those R&D activities robust, tax incentives are appropriate. According to this view, which prevails in 43 other states, the evaluation should be based on growth of R&D activity and its public

benefit. And, in fact, the JLARC report identifies a public policy objective to “encourage expenditures in research and development.”

Thirty-seven states provide some sort of R&D credit (Walczak et al. 2016).

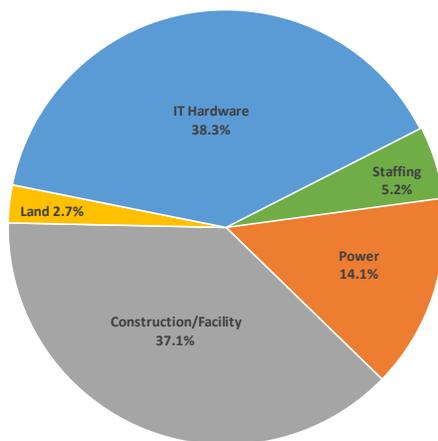
DATA CENTER EQUIPMENT. Developers of data centers—large facilities that house hundreds or thousands of computer servers—can receive an exemption from sales tax for the purchase of servers and backup power equipment. They can also receive exemptions on the cost of installation as well as the maintenance and upgrading of that equipment. Data centers must have at least 100,000 square feet of space to qualify for the exemption.

DOR estimates that data center builders and operators will be exempt from about \$57 million in sales taxes in 2016, with nearly 80 percent of that savings coming from state sales tax and 20 percent from local sales taxes. DOR has identified 27

years of a typical five-megawatt enterprise data center, as estimated by CBRE Research (CBRE Research 2015). Over this 10-year horizon, the amounts spent on constructing and equipping a data center are more than 14 times the amount spent staffing the facility. Absent the data center tax preference, the full value of construction/facilities and IT equipment would be subject to the sales tax and the amount of sale tax paid would be greater than the amount paid to staff the center.

Greatly increased sales and property tax revenues in Grant County and the city of Quincy show the positive impact the presence of data centers can have on local economies and tax revenues. Between 2006 and 2015 property tax revenues grew by 76 percent for Grant County and 331 percent for Quincy compared to 45 percent for the state. Over the same period, sales tax revenue grew by 124 percent for the county and 248 percent for the city versus 21 percent for the state.

Chart 4: Ten-Year Cost Breakdown for New Enterprise Data Center



existing and new data center that will be eligible for tax exemptions. Most of the data centers built and equipped under this program are in Grant and Douglas counties.

Data centers are extremely capital intensive operations. Chart 4 shows the distribution of costs (taxes excluded) over ten

AEROSPACE. The process for siting the assembly facility for the Boeing 787 Dreamliner highlighted the vigorous competition between states to land industries that produce quality jobs. The prospect of an open competition for a new commercial airplane assembly plant took the economic development world by storm, touching off what Site Selection magazine called “one of recent memory’s most widespread recruiting wars.”

In other states, economic development agencies can assemble aggressive attraction packages, including cash assistance. Washington is constitutionally prohibited from offering direct assistance. Coupled with a high tax burden on aerospace manufacturing, the state needed to remove tax disincentives to stay competitive.

The state developed what became known as the aerospace tax incentive package, enacted in June 2003, which ultimately led to Boeing building the 787

in Everett. In subsequent sessions, the Legislature extended these tax policies to other employers, including non-manufacturers such as engineering companies working on components and systems, in the adjusted B&O rate. The entire package, except the sales tax exemption for facilities, was extended to suppliers of tooling to Boeing and to certain repair stations.

The next test of the state's commitment to aerospace came in 2013 with the question of where the updated version of the 777 would be assembled and where the wings would be built. The Legislature responded by extending the expiration date of the entire package from the original sunset of 2024 to a new sunset of 2040.

JLARC and the Commission reviewed the package of aerospace tax preferences in 2014. The Commission report states that the public policy objectives of the tax package are:

- *To encourage the continued presence of the aerospace industry in Washington;*
- *To reduce the cost of doing business in Washington for the aerospace industry compared to locations in other states;*
- *To provide jobs with good wages and benefits.*

The 2014 report states that these objectives are being met (JLARC 2014).

Governor Inslee, in promoting the most recent aerospace package, explicitly stated:

The attraction of the 787 and retention of the 737 and 777 programs in Renton and Everett secures the region's commercial aerospace leadership for decades.

According to the state Department of Commerce, the industry had a total economic impact to the Washington state economy of 252,800 jobs, \$21.3 billion in wages and \$94.7 billion in sales in 2015.

Studies had shown that the tax burden imposed on aerospace in Washington

prior to the 2003 package was extremely high (WSTSSC 2002). These tax reductions simply bring this state's tax treatment of the industry more into line with competitor states. The governor stated that the aerospace tax policy continued in 2014 will bring \$20 billion in new tax revenue to Washington state by 2042, according to projections from the state Office of Fiscal Management (OFM) at the time. Meanwhile opponents have cited huge "costs" to the state—\$8.7 billion—for these tax preferences. This projection is based upon a questionable assumption: that the future level of business activity in Washington state for the recipients is independent of the preferences.

Government policies in Washington or other states, the future macro economy, potential competitors, and a number of other factors could affect business activity here. Projections about tax revenues—gains or losses—as far away as 2042 should be taken with more than a single grain of salt. What is clear, however, is that the adopted policy had the desired effect of securing the aerospace cluster in Washington for the foreseeable future.

The results of Washington's tax policy

Remaining prosperous requires constant vigilance and attention to the cost of doing business. A large percentage of Washington's tax revenues comes from businesses, which makes it especially important that we adjust the code so that it treats businesses in a fair and productive way. The vast majority of these tax preferences simply serve to level the playing field for the state's businesses and to improve tax policy.

As illustrated by the success the state has had securing production of the next generation of Boeing planes and in recruiting data centers, the tax policies in place have resulted in economic activity, job creation, and increased state revenues.

Tax adjustments are a valuable policy tool that allows state government to re-

duce inequities in the tax system and create incentives, both of which make Washington more competitive in the world and among the fifty states. These policies maintain and attract new high-quality jobs, which in turn multiply into more jobs in the economy, while drawing tax revenues to the state which might otherwise go elsewhere.

The large number of national firms that have originated and first thrived here attests to a success formula that includes entrepreneurial vision, a productive workforce, and a tax code which, while not perfect, fosters business and job formation leading to substantial economic growth.

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