

LEVELING THE PLAYING FIELD WITH TAX PREFERENCES

BRIEFLY

Removing tax preferences is not a budget panacea: Many so-called preferences actually work to normalize Washington's tax structure by reducing distortions, offsetting disincentives and avoiding pyramiding.

For several years, advocates of various spending programs have argued that rather than cut spending to address Washington's ongoing budget problems, the legislature should increase revenues by removing business tax preferences. A specific target last year was the business and occupation tax deduction for interest earned on first mortgage loans for residential property. The 2011 legislature enacted ESB 6635, under which financial businesses with locations in more than 10 states are no longer eligible for the deduction.

Tax preferences are in legislators' and advocacy groups' sights again this session. It is important to recognize that removing tax preferences is not a panacea: Many so-called preferences actually work to normalize Washington's tax structure.

With all the talk about business preferences, it may surprise many to learn that taxes paid by Washington businesses account for more than half of total state and local collections, and the tax burden on Washington businesses is one of the nation's heaviest. Ernst & Young calculates that state and local business taxes in Washington increased by 7.5 percent from 2010 to 2011 (the seventh highest increase among the 50 states). In fiscal year (FY) 2011, businesses paid Washington's state and local governments \$16.3 billion—56.8 percent of all taxes the governments received. The effective tax rate on business in the state (calculated as the ratio of taxes to private sector gross state product) was 5.5 percent, tied for 14th highest and five-tenths of a percentage point greater than the 5.0

percent national average. (Ernst & Young)

Still, as we wrote in "Clarifying the Role of Tax Preferences,"

The business tax burden would be considerably higher if it were not for a number of tax preferences: exemptions, deductions, deferrals, credits and special rates. In addition to lowering the overall tax burden of business, preferences play special roles in normalizing the tax structure. Although they are sometimes described as incentives, more often than not they serve to offset disincentives that our tax system would otherwise create against economic development. This is especially the case with respect to preferences related to sales taxes on business input purchases and the business and occupation (B&O) tax, which together account for nearly one-half of the business tax burden.

State tax systems ought to be judged according to five criteria of good taxation: economic neutrality, fairness, administrative simplicity, transparency and stability [WRC 2012]. Economic neutrality, the principle that tax systems should be designed to minimize distortions in economic decision making, is especially important for evaluating tax preferences: many preferences are intended to reduce distortions in the tax system and thereby level the playing field. (WRC 2011)

One Man's Tax Preference . . .

The state Department of Revenue (DOR)

publishes a tax exemption study every four years; it is an example of a “tax expenditure budget.” A 2011 report from the Center on Budget and Policy Priorities found that 44 states (including the District of Columbia) prepare some kind of tax expenditure report. (Leachman et al.) As the late Stanley Surrey, a Harvard law school professor who served as Assistant Secretary of the Treasury for Tax Policy in the Johnson Administration, explained,

Essentially, the tax expenditure concept, as applied to an income tax, regards such a tax as composed of two distinct elements. The first element contains the structural provisions necessary for implementation of a normal income tax . . . The second element consists of the special preferences . . . These departures from the “normative” income tax structure essentially represent government spending for the favored activities or groups through the tax system rather than through direct grants, loans, or other forms of government assistance. (Surrey and McDaniel 227-228)

The late economist David F. Bradford emphasized the importance of the choice of normative tax structure:

A tax expenditure list can be interpreted only in the light of the *basic* structure of taxation, to which specified provisions are regarded as exceptions. . . . Changes in the reference tax, including the applicable rate structure, change tax expenditures. (Bradford 242)

The appropriate normative system is not always obvious. According to Bradford,

What we call an income tax is a blend, or hybrid, of an accrual-income concept and a consumption concept. Under an accrual-income system all the accretions to wealth during a period . . . would be included in income subject to tax. In the actual system, some types of saving are actually deducted from current income, and both the saved amount and the return on it are subjected to tax only

after a period of years. Contributions to pension plans are a good example. (Bradford 7)

The deferral of taxes on contributions to pension plans is a tax expenditure if the reference is an accrual-income tax, but it is not a tax expenditure if the reference is a consumption tax.

Good tax policy should drive the selection of the reference tax (the benchmark normal tax base). A reference tax derived from principles of good tax policy is termed the *conceptual baseline* approach by Indiana University economist John Mikesell. According to Mikesell, specification of a conceptual baseline requires

a clear statement of what state tax policy actually is—not just an indication of how much money the state wishes to collect, but a conception of how the revenue raised should ideally be distributed across the private sector. It demands close attention to policy fundamentals. (Mikesell 46)

Instead of a conceptual baseline, the DOR tax exemption study uses what Mikesell calls a *reference law baseline*. As we explained in 2011, “This approach identifies tax expenditures according to statutorily specified exemptions and exclusions rather than deviations from accepted principles of good tax policy” (WRC 2011).

The Nature of Sales Taxes

The reference law baseline of DOR’s tax exemption study makes the evaluation of tax preferences under the sales, use and B&O taxes particularly problematic.

In Washington, general sales taxes (i.e. the retail sales and use taxes and the B&O tax) provided 65.5 percent of general fund-state revenue in 2011, while selective sales taxes (e.g. cigarette and liquor taxes) provided another 4.7 percent. (DOR 2012b) Public finance experts consider the B&O tax to be a sales tax, not an income tax (Musgrave and Musgrave 397; ITEP 14-15). Revenue from the B&O tax was \$3.1 billion in FY 2011 versus \$7.3 billion received

from the retail sales and use taxes. (DOR 2012b) The value of transactions subject to the B&O is much greater than the value subject to the retail sales tax (\$460.5 billion versus \$103.7 billion in calendar year 2011). (DOR 2012a)

A sales tax system like Washington's has a pyramiding problem, in which goods and services are taxed multiple times along the chain of production. This is troublesome from an economic efficiency standpoint, as we have described previously:

Applying the sales tax to business input purchases is bad because it creates non-uniformity in taxation. 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 it will vary across industries depending on the complexity of production processes.

Tax policy experts generally conceive the sales tax to be a tax on consumption and agree that businesses should not pay sales tax (retail sales or B&O) on input purchases. (WRC 2011)

A proper conceptual baseline for either the sales tax or the B&O tax would exclude business-to-business transactions.

The Washington State Tax Structure Study Committee said this about the B&O:

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 30)

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 105)

Many tax preferences "lessen the amount of pyramiding in the retail sales and use taxes and the B&O tax. They move the taxes towards rather than away

from the appropriate benchmark normal tax" (WRC 2011). These preferences help promote horizontal equity between firms, part of the neutrality principle of a good tax system. (WRC 2012)

Reviewing Tax Preferences

Even though many tax preferences represent good tax policy, regular scrutiny can help assure that the system remains good. Fortunately, the state has a process in place to review preferences. One of the recommendations of the Washington State Tax Structure Study Committee was that the legislature should "periodically review exemptions and incentives with the intent of removing those that do not yield the promised benefits or those that have outlived their useful life." And, in 2006, the legislature created the Citizen Commission for Performance Measurement of Tax Preferences, which must review all tax preferences at least once every ten years. A "tax preference" is defined as "an exemption, exclusion, or deduction from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate" (RCW 43.136.021).

The Joint Legislative Audit and Review Committee (JLARC) prepares an analysis of tax preferences for the Commission. Based on the 2012 report, the Commission recommended that eight preferences (of 23 reviewed) be terminated or allowed to expire. (JLARC)

High Tech Research and Development (R&D) Credits

Two of the preferences that the Commission recommended be allowed to expire were the high technology R&D deferral/waiver of sales and use tax and B&O tax credit. JLARC recommended the legislature review and clarify them "to determine if progress toward its high technology R&D objectives is sufficient and to consider identifying targets for investment and employment" (JLARC 12). The Commission rejected this recommendation, instead recommending that the legislature allow these credits to ex-

pire as scheduled in 2015. This recommendation is based on an analysis that “the cost of the preferences greatly exceeds the estimated benefits” (JLARC 13).

The estimated benefits cited by the Commission come from a study conducted by consultants from the Upjohn Institute (JLARC A4-1). The Upjohn analysis is flawed, however, because it fails to take into account knowledge spillovers, which are the primary justification for R&D credits. As economist Enrico Moretti explains:

The existence of significant knowledge spillovers means that the creators of new ideas are not always fully compensated for their efforts, as some of the benefit of their research inevitably accrues to others. . . .

The most important kind [of knowledge spillovers] flows between private companies. Innovative companies that invest in research appropriate just some of the benefits of their efforts. . . .

In one of the most rigorous studies to date, two economists—Nick Bloom of Stanford and John Van Reenen of the London School of Economics—followed thousands of firms between 1981 and 2001 and found that the spillovers were so large that R&D investment of one firm raised not only the stock price of that firm but also the stock price of other firms in the same industry. . . . A significant part of the spillover is local, because it occurs between firms that are geographically close. . . .

The problem is that the market provides less investment in innovation than is socially desirable, because the return on such investments cannot be fully captured by those who pay for it. The only way to correct for this market failure is for the government to step in and compensate those who invest in R&D for the external benefits that they generate. This is the main reason that the United States government, as well as governments in most

industrialized countries, subsidizes R&D through tax breaks. . . .

The problem is that the difference between private and social return on innovation is much larger than the current subsidies. . . . The lessons for economic policy are clear: the current U.S. tax credit for corporate spending on R&D is far smaller than it should be. . . . Because the benefit of spillovers is in part local—helping some communities but not others—the efficient distribution of cost is one in which state and local governments also contribute to the subsidy. (Moretti 217-220)

The Upjohn Institute study measures the benefits of the R&D credit in terms of gains in jobs and earnings at the firms receiving the credits. This is too narrow. The appropriate measure of the benefit of the R&D preferences is the value of additional knowledge spillovers enjoyed by local firms as a result of the R&D activities stimulated by the preferences.

But even if one chooses to focus on employment and earnings, the Upjohn Institute study underestimates the impact, as it does not include the R&D jobs that are indirectly generated in the state as a result of the knowledge spillovers from the R&D directly supported by the preferences. Knowledge spillovers are the reasons that we see R&D activities tightly clustered. An increase in R&D activity in the state makes the state a more productive place to do R&D. Through a virtuous circle, this in turn leads to a further increase in R&D in the state.

Further, according to JLARC, 44 states offer R&D tax credits for operating expenses—only Kentucky, Nevada, Oklahoma, South Dakota, Wyoming and Texas do not. Additionally, 32 states have sales and use tax exemptions for R&D machinery and equipment and six states have sales and use tax exemptions for R&D facilities. (JLARC 101-102) Clearly, if these credits are allowed to expire, Washington would be a less competitive location for business. HB 1303, introduced in the legislature this session, would extend the credit until

January 1, 2035.

Comment

Tax preferences, to use the state's terminology, are not unwarranted boons for business; rather, many serve to normalize Washington's tax structure or correct market failures. As we've written, "A careful analysis of business tax preferences makes clear that the vast majority of them have been adopted to offset disincentives, reduce distortions, avoid 'pyramiding,' and create a level playing field for in-state enterprises" (WRC 2011).

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