Washington Research Council

Policy Brief

March 7, 2019 PB 19-04

A Tax Expenditure Budget Wouldn't Improve State Tax Policy

Briefly

PSHB 1703 would expire tax preferences (the state's collective term for exemptions, exclusions, deductions, deferrals, credits, and preferential tax rates) unless they are readopted by the Legislature each biennium as part of a "tax expenditure budget."

Washington's current tax preference review process is already recognized as one of the nation's best, and no other state requires tax preferences to be readopted every two years. Requiring nearly all tax preferences to be readopted every two years would introduce considerable uncertainty for taxpayers, seriously weaken the four-year balanced budget requirement and not effectively improve tax policy in Washington.

Washington's tax system includes a number of "tax preferences." (This is the state's terminology; they are defined in statute as exemptions, exclusions, deductions, deferrals, credits, and preferential tax rates). Many of these serve to normalize our tax structure, as we discussed in "Leveling the Playing Field with Tax Preferences." For example, preferences are often used to "offset disincentives that our tax system would otherwise create against economic development" (WRC 2011).

Many economists and budget analysts believe it is important to regularly review tax preferences and ensure they are transparent to the public. Washington has a thorough and well-regarded process already in place (RCW 43.136).

Still, a bill (HB 1703) has been introduced in the Legislature this year that would require tax preferences to be included in the regular budget process and readopted every two years. (This brief describes the proposed substitute bill that was heard in the House Finance Committee on Feb. 26.)

The Current Review Process

The Department of Revenue (DOR) publishes a report every four years on Washington's tax preferences (the Tax Exemptions Study). The report details the purpose of each preference, taxpayer savings from the preference, and an estimate of the potential revenue gains to state and local governments if the preference were repealed. The most recent report was released in 2016.

The Citizen Commission for Performance Measurement of Tax Preferences develops a schedule by which tax preferences are reviewed at least once every 10 years. Some preferences are statutorily excluded from this review:

- Preferences required by constitutional law;
- Sales and use tax exemptions for machinery and equipment used in manufacturing, research and development, or testing;
- Business and occupation tax credit for small businesses;
- Sales and use tax exemption for food;
- Sales and use tax exemption for pre-

scription drugs;

- Property tax relief for retired persons; and
- Property tax valuations based on current use.

Additionally, the review may exclude a tax preference that the Citizen Commission determines is "a critical part of the structure of the tax system" (RCW 43.136.045).

The Joint Legislative Audit and Review Committee (JLARC) then reviews preferences according to the schedule. JLARC's review includes consideration of taxpayers affected by the policy, public policy objectives, evidence of the policy's effects, fiscal impacts of the policy, and whether other states have similar policies. JLARC then must recommend whether the preference should be continued, modified, or repealed. The recommendations are sent to the Citizen Commission for comment and then on to the Legislature for potential legislative action. (In most cases, the Legislature chooses not to act on the recommendations.)

Since 2013, state law requires that all new tax preferences expire after 10 years, unless the authorizing legislation states otherwise (RCW 82.32.805). Additionally, all new tax preferences must include a "tax preference performance statement" that identifies the public policy objective of the preference (e.g., to create or retain jobs). Taxpayers claiming new tax preferences must report the amount saved and file annual tax performance reports. (RCW 82.32.808)

(We discussed the process and its history in detail in a 2014 policy brief: "Toward a Thoughtful Review of Tax Policies.")

PSHB 1703

Proposed Substitute House Bill 1703 would require that operating budgets include a "discretionary tax expenditure budget." Tax expenditures are defined as exemptions, exclusions, deductions, credits, deferrals, or preferential rates (the same as the statutory definition of "tax preference" in RCW 43.136.021). The budget would not have to include tax expenditures required by the U.S. or state constitution or federal law. (The vast majority of Washington's tax preferences would be included in the tax expenditure budget, as we discuss below.)

The governor would be required to submit a discretionary tax expenditure budget to the Legislature along with his or her proposed operating budget. The governor would have to recommend ending or continuing tax expenditures that

- have no expiration date;
- have been recommended for legislative review and clarification by JLARC, "but for which the legislature has not clarified and adopted new performance measures and an expiration date;" or
- have state revenue reductions of more than $50,000 per year or $100,000 per biennium.

(The governor could also recommend repealing or modifying any other tax expenditure.)

The Legislature would have to adopt a discretionary tax expenditure budget as part of the operating budget bill each biennium. If tax expenditures that don't have an expiration date or have not been reviewed and clarified (as recommended by JLARC or the Citizen Commission) are not included in the budget, they would automatically expire at the end of the year.

If included in the budget, tax expenditures would have to be reauthorized each biennium until they would otherwise expire. Further, they would have to have statutory expiration dates no longer than 10 years or have been clarified pursuant to JLARC or Citizen Commission recommendations.

No new or existing tax expenditure would be allowed to be authorized for more than 10 years. The Legislature could expire any tax expenditure early with a simple majority vote, either within or without the budget process.

It is unclear why a 10-year maximum term would be required when the bill would effectively give every preference a two-year term. Further, heretofore we have ignored Section 2 of the bill, as it seems to be inconsistent with the rest of the bill. Section 2 would explicitly exclude from the tax expenditure budget tax preferences that have an expiration date or have been reviewed and clarified as recommended. But, as noted above, Section 4 would require every preference in the tax expenditure budget to have an expiration date or have been reviewed and clarified as recommended.

The bill would effectively gut the four-year balanced budget requirement.

Four-Year Balanced Budget Requirement. State law requires operating budgets to balance over four years. Section 2 of PSHB 1703 states that the four-year outlook

> *may utilize revenues from expenditures that will expire absent legislative readoption in the next biennial budget . . . and which are listed in the discretionary tax expenditure report prepared by the department of revenue . . . for the purposes of calculating available resources for the next ensuing fiscal biennium, provided that the omnibus operating appropriations act identifies the expiring tax expenditures*.

This suggests that the revenues associated with repealing all discretionary tax expenditures in the next biennium could be added to the available fiscal resources for that biennium (even if they were readopted for the current biennium), making it much easier to balance the current biennial budget over four years. It seems to mean that the Legislature could do so simply by listing (in the current budget) the tax expenditures it intends to expire in the next biennium. A legislature can't bind a future legislature, so this would effectively gut the four-year balanced budget requirement.

The bill also specifies that fiscal impacts of discretionary tax expenditures would have to be "included for informational purposes in the materials produced for the November state budget outlook." Further, an up-to-date list of discretionary tax expenditures (tax preferences that are not required by constitutional or federal law) would have to be maintained on the Economic and Revenue Forecast Council's website.

Changes to the Review Process. As noted above, several tax preferences are currently excluded from review by the Citizen Commission and JLARC (for example, the sales tax exemptions for food and prescription drugs). PSHB 1703 would exclude only preferences required by constitutional law.

Additionally, PSHB 1703 would require DOR's Tax Exemptions Study to be published every two years beginning in December 2020. (These changes would increase workloads for JLARC and DOR. The Legislature could also need to augment DOR's revenue estimating capacity. DOR's estimates in the Tax Exemptions Study are currently for information only; if tax expenditures are to be part of the budget, getting these numbers right would be much more important.)

What Tax Preferences Would be Affected?

The most recent Tax Exemptions Study identified 694 tax preferences in statute as of 2015. Altogether, DOR estimated that their value to state taxpayers would be $54.118 billion in 2017–19. However, if these preferences were repealed, state government would not gain that full amount in new revenues due to changes in taxpayer behavior, tax shifts, and the fact that some exemptions are constitutionally required. Thus, DOR estimated that the potential revenue gains to the state if the preferences were repealed would be $30.055 billion in 2017–19. This estimate is still too high; for example, it includes preferences that are highly unlikely to ever be repealed—like the B&O tax exemption for employee income and the sales tax exemption for food.

Of the 694 preferences in place in 2015, only 76 had expiration dates (and 19 of those have since expired). Nine of them have expiration dates that are more than 10 years away.

Based on the 2016 DOR study, 611 of the 694 preferences would have to be included in the discretionary tax expenditure budget under PSHB 1703. These preferences represent 99 percent of the 2017–19 potential state revenues from repealing all preferences. The top four preferences by value that would be included in the budget (representing 46 percent of the value affected) would be the exclusion of personal and professional services from retail sales and use taxes ($4.698 billion in 2017–19); the exemption of employee income from the business and occupation tax ($3.839 billion in 2017–19); the estate tax threshold ($2.571 billion in 2017–19); and the exemption of food and food ingredients from retail sales and use taxes ($2.581 billion in 2017–19).

Washington's current tax preference review process is recognized as one of the nation's best.

Best Practices

Washington's current tax preference review process is recognized as one of the nation's best. Pew names Washington as one of 14 leading states that "have well-designed plans for regular reviews, experience in producing quality evaluations, and a process for informing policy choices" (Pew 2017, 2019). Further, "Washington has one of the nation's longest-standing and most successful tax incentive evaluation processes. These evaluations have helped lawmakers improve incentive policy" (Pew 2017).

According to Pew, no states require tax preferences to be reauthorized every two years as PSHB 1703 would require.

Comment

PSHB 1703 states that its intention is "to improve transparency and accountability." Washington already has a nationally-recognized process for reviewing tax preferences. If the Legislature hasn't acted on a recommendation from JLARC and the Citizen Commission, it has made a policy choice.

The tax expenditure budget would include most tax preferences regardless of the reason for their existence. This does not reflect normal practice among tax policy experts. Moreover, the shift in terminology under PSHB 1703 from the already pejorative "tax preference" to "tax expenditure," which has a much narrower meaning in the literature, is objectionable.

Additionally, the bill would completely undermine the four-year balanced budget requirement. As we have written, the requirement is a valuable policy that promotes sustainable budgets (WRC 2019).

Ultimately, requiring nearly all tax preferences to be readopted every two years without regard to economic consequences would not be an effective way to improve tax policy in Washington. Instead, it would introduce considerable uncertainty for taxpayers and policymakers alike.

References

Department of Revenue (DOR). 2016. "2016 Tax Exemption Study." Jan. 21.

Pew Charitable Trusts (Pew). 2017. "How States Are Improving Tax Incentives for Jobs and Growth: A national assessment of evaluation practices." May.

——. 2019. "State Tax Incentive Evaluation Ratings." Jan. 24.

Washington Research Council (WRC). 2011. "Clarifying the Role of Tax Preferences." PB 11–05. April 5.

——. 2013. "Leveling the Playing Field with Tax Preferences." PB 13–02. Feb. 4.

——. 2014. "Toward a Thoughtful Review of Tax Policies." PB 14–03. Jan. 17.

——. 2019. "Washington's Budget Sustainability Requirements Work When Followed." PB 19–02. Jan. 4.

Washington Research Council
researchcouncil.org
206-467-7088