Washington Research Council

Policy Brief

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Toward a Thoughtful Review Of Tax Policies

Briefly

The Citizen's Commission on the Performance Measurement of Tax Preferences, which was established in 2006, is the most recent of a series of legislative attempts to craft a mechanism to weed "tax preferences" from the state tax code.

Every four years the Research Division of the state Department of Revenue (DOR) publishes a comprehensive report (the Tax Exemptions Study) on various *tax preferences* (statutorily defined as exemptions, exclusions, deductions, preferential tax rates, deferrals and credits) that are part of Washington state's tax system. The term, "preferences," is pejorative, suggesting the referenced tax policies represent favors done by the Legislature for select taxpayers. Yet, as it has been enshrined in statute, we will occasionally use the term here as unfortunate shorthand for the various tax policies captured in the statutory definition.

The 2012 edition of the study examined 452 tax preferences and estimated that they would save taxpayers $24.1 billion in state taxes during the 2011–13 biennium. Numbers this large attract a lot of attention. Over the years, some have argued that the state could painlessly raise a great deal of money by ending policies referenced in the study.

It is not that simple. The tax policies that generate the majority of taxpayer savings apply broadly, represent mainstream tax policy nationally, define the intended tax base, have been adopted by state voters, or avoid double taxation of a transaction or good. Take for example the sales tax exemption for personal and professional services ($3.2 billion state, $1.5 billion local), the business and occupation (B&O) tax exemption for employee wages ($2.9 billion state), the sales tax exemption for food ($2.0 billion state,$741 million local), and the sales tax exemption for gasoline and diesel fuel ($1.7 billion state, $614 million local).

Those who are seeking extra state revenues generally target narrower preferences that benefit businesses. Washington businesses, however, already bear among the nation's highest tax burdens. Ernst and Young calculates that in fiscal year 2012 businesses paid Washington state and local governments $16.4 billion dollars in taxes. This represented 53.9 percent of all taxes these governments received. The effective tax rate on business in the state (calculated as the ratio of taxes to private sector gross state product was 5.3 percent, tied with Kansas for 14th highest among the 50 states and five-tenths of a percentage point higher than the 4.8 percent national average effective state and local tax rate (Ernst & Young 2013).

The business tax burden would be considerably higher were it not for so-called tax preferences. In addition to lowering the overall business tax burden, these policies play a special role in normalizing the tax structure. Although they are sometimes described as incentives, more often than not preferences serve to offset disincentives that our tax system would otherwise create against economic development.

To assure that these policies work as intended, lawmakers have tried to sub-

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ject them to systematic review. We'll briefly review four such efforts undertaken since the early 1970s.The most recent of these of these is the Citizen Commission for the Performance Measurement of Tax Preferences, established in 2006.

Citizen Commission

In 2006 the Legislature enacted EHB 1069 creating the Citizen Commission to perform periodic "performance audits" of tax preferences. The term performance audit was lifted from Initiative 900 (approved by voters in November 2005), which gave the state auditor independent authority to conduct performance audits of agencies and programs.

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 serve as nonvoting members. The Joint Legislative Audit and Review Committee (JLARC) provides staff to the Commission, with support from the Department of Revenue.

The Commission was instructed to develop a 10-year schedule to review all preferences. Preferences were generally to be reviewed in the order enacted. Preferences with a statutory expiration date could be scheduled for review before that date. Explicitly excluded from review were "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."

JLARC is to review preferences according to the schedule developed by the Commission and develop recommendations whether each preference should be continued, modified or repealed. Specific factors to be included in JLARC's review include the taxpayers affected by the policy, public policy objectives, evidence of the policy's effect, the fiscal impact of the policy, and the existence of similar policies in other states.

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.

2011 Change in Review Process

A proviso in the 2010 supplemental operating budget (SB 6444) established a task force for reform of procedures dealing with tax preferences. Responding to recommendations of this taskforce, the 2011 legislature (SB 5044) provided the Commission flexibility to consider factors other than order of enactment when scheduling tax preference reviews for review and specifically allowed "grouping preferences for review by type of industry, economic sector or policy sector." The same bill added to the list of factors that must be included in JLARC's review a comparison of the economic impact of the tax preference to the economic impact of the governmental activities foregone because of the preference. While the statute provides that the impact comparison be made using the state's input-output economic model, this requirement is necessarily a difficult, hypothetical and subjective undertaking.

- Between 2007 and 2012, JLARC made recommendations to the legislative fiscal committees on 158 tax policies. The results are summarized in Table 1.
- In 87 cases, JLARC recommended that a tax policy without an expiration date be continued. In each of these cases the preference does continue.
- In seven cases, JLARC recommended that a preference without an expiration

JLARC Recommendation:	Implemented	Bill Introduced But Not Enacted	Made Different Policy Choice	Allowed to Expire	No Action Required	No Action Taken	*Total*
Allow to Expire			5	7			12
Continue					87		87
Continue and Modify Expiration Date	9			3			12
Review and Clarify	3	31		1		5	40
Terminate		5				2	7
Total	12	36	5	11	87	7	158

Table 1: Implementation of JLARC Recommendations

date be terminated. In none of these cases did that happen.

- In 12 cases, JLARC recommended that tax preferences be allowed to expire on the scheduled date. In seven of these cases, the Legislature did allow the preferences to expire; in the other five, the preferences were continued.
- In 12 cases, JLARC recommended that tax preferences' expiration dates be extended. In nine of these cases, the Legislature did so; in the other three, the preferences were allowed to expire.
- In 40 cases, JLARC requested that the Legislature review the preference and clarify its intended purpose. In only three of these cases did the Legislature do so; in one case, the exemption expired.

For 20 of the 158 tax preferences reviewed, the Commission's recommendation to the Legislature differed from JLARC's. The results for these cases are summarized in Table 2. In none of the five cases where the Commission recommended that a preference be terminated did the Legislature do so. In one of the four cases where the Commission recommended that a preference be allowed to expire, the Legislature chose to extend it; in the other three cases the preferences have not yet reached their expiration dates.

2013 Change in Review Process

A tax bill enacted in 2013 (ESSB 5882) contained a number of provisions intended to improve tax preference transparency and accountability:

- 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.
- If the legislative purpose is to improve industry competitiveness, or to create or retain jobs, the taxpayer must file an annual survey with DOR.
- Taxpayers claiming a new preference must report the amount claimed as part of their regular tax returns filed with DOR. (This requirement does not apply to property tax exemptions, constitutionally required tax preferences, cases where the annual tax savings are less $1,000, and cases where the tax payer is allowed to file returns annually as opposed to monthly or quarterly.)
- The amount claimed under a new preference is subject to public disclosure, unless either DOR

Table 2: Implementation of Commission Recommendations in Cases Where Different from JLARC

Commission Recommendation:	Implemented	Bill Introduced But Not Enacted	Made Different Policy Choice	Allowed to Expire	No Action Required	No Action Taken	*Total*
Allow to Expire			1		3		4
Review and Clarify	1	4		2		4	11
Terminate		5					5
Total	1	9	1	2	3	4	20

determines that disclosure would economically harm the taxpayer or the amount is less than $10,000.

The bill instructed DOR, in consultation with the legislative auditor, to make recommendations by December 1, 2013 to the House and Senate fiscal committees on ways to update and improve the annual reports and annual surveys that beneficiaries of various tax preferences are required to file with DOR, with the goal of both making the data more relevant and reducing the administrative burden on taxpayers. The bill also instructed the legislative auditor to convene a task force to study the appropriate data and metrics to be included in tax preference performance statements, with findings and recommendations to be reported to the House and Senate fiscal committees by January 1, 2014.

Before the Citizen Commission

Between 1970 and 2006, there were three notable attempts by legislators to establish mechanisms for reviewing tax preferences. Echoes of these earlier approaches continue to reverberate in legislative chambers.

Constitutional sunset and review. In 1972, a constitutional amendment to automatically sunset most tax preferences appeared for voter approval on the November ballot as House Joint Resolution 1 (HJR 1).

Under HJR 1 every constitutional or statutory tax exemption, deduction, exclusion and credit (other than property tax exemptions for religious organizations) would expire on March 1, 1977 unless it had been re-enacted by statute or constitutional amendment. On March 1 of every tenth year thereafter (i.e. 1987, 1997, 2007 …) all preferences that had been enacted or reenacted within the preceding ten years would expire.

Proponents of the amendment argued that many existing tax preferences were no longer necessary or pertinent, that eliminating tax preferences would lower tax rates for other taxpayers, and that those who enjoy tax preferences should have the responsibility for defending the need for them at least once every ten years. Opponents of the amendment argued that the amendment could raise taxes by $800 million annually; that the Legislature could not be trusted with such an important responsibility; and that many companies would be unwilling to locate or remain in a state which might revise all of its tax preferences at once.

On Election Day voters decisively rejected the amendment by a 44.9 percent/55.1 percent margin.

Statutory sunset and review. In 1981, as the state suffered the effects of recession, the Legislature instructed DOR to "conduct a new study of the financial impact of tax exemptions." In 1982, while this study was underway, the Legislature passed a bill (ESB 4250) that introduced the term tax preference and established "a mechanism for scheduling periodic evaluations of tax preferences together with a system for their termination, continuation, or modification." The Legislature's Select Joint Committee on Sunset Review was instructed to "identify tax preferences which might appropriately be scheduled for termination" and develop legislation to automatically sunset these preferences over a four-year period, beginning June 30, 1984. Each of the preferences so scheduled to sunset would be reviewed by the Legislative Budget Committee a year before its sunset date. Based on the Legislative Budget Committee's report, fiscal committees of the House and Senate would consider legislation to reestablish or modify the preference.

DOR delivered its report on existing tax preferences in November 1982. This report included detailed analyses of 94 tax preferences. The Select Joint Committee included 93 of the 94 preferences in the sunset bill it sent to the 1983 legislature (WSRC 1983). The House Ways and Means Committee scheduled two lengthy hearings on the bill (HB 119). Don Burrows, who was DOR director at the time, describes what happened next:

> At this point things started to turn sour…. [The two hearings] attracted the largest gathering of opponents to

Tax Preference Defined

As used in this chapter, "tax preference" means an exemption, exclusion, or deduction from the base of a state tax; credit against a state tax; a deferral of a state tax; or a preferential state tax rate.

1982, ESB 4250

be seen in a legislative hearing in recent memory….The legislature got the message. Neither the house nor the senate took any further action on the bill drafted by the sunset committee. (Burrows 1983)

The Legislature took no further actions under the 1982 sunset law, although it remained on the books until 2006.

Regular Tax Exemption Study. In place of the sunset process, the Legislature in 1983 instituted a requirement that DOR submit to the Legislature every other year beginning in January 1984 "a listing of the amount of reduction for the current and next biennium in the revenues of the state or the revenues of local government collected by the state as a result of tax exemptions." The definition provided for the term *tax exemption* was identical to that previously provided for the term tax preference.

The bill made the governor responsible for recommending which exemptions should be repealed.

> Beginning in January, 1984, and every four years thereafter the governor is requested to review the report from the department of revenue and may submit recommendations to the legislature with respect to the repeal or modification of any tax exemption. The ways and means committees of each house and the appropriate standing committee of each house shall hold public hearings and take appropriate action on the recommendations submitted by the governor (2ESB 3090).

In 1999 the tax exemption study became a quadrennial publication (SB 5915).

The gubernatorial reviews resulted in few recommendations to repeal tax preferences.

Discussion

Periodically over the years, particularly during times of economic hardship, lawmakers and interest groups have attempted to mine the Tax Exemptions Study for gold. They've routinely found there's not much there. The vast majority of the state's tax exemptions, credits and deferrals have withstood scrutiny. The policy justifications have been clear and warranted. Lawmakers have a responsibility to review tax policy. While we have concerns over some criteria written into law (e.g., comparing the "costs" of a tax exemption to the "benefits" of foregone government spending), thoughtful and systematic review can help assure that the state's approach to taxation produces desired policy consequences.

Previous Washington Research Council reports (see, for example, *Leveling the Field with Tax Preferences*) have examined interstate tax competitiveness, the role of incentives in tax policy, and the characteristics of the Washington state tax structure that require the use of exemptions to avoid instances of multiple taxation. In later briefs this session, we will continue that examination.

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