



Tax Incentives: Review or Remove

Summary

Washington state's tax code allows for over 430 tax preferences which provided \$46 billion dollars in savings for various taxpayers during the 1999-01 fiscal biennium. For the most part, tax preferences in Washington are not subject to a comprehensive review process that assesses their effectiveness.

Seven tax preference programs are scheduled to expire in the 2003-05 biennium (Table1). Many of these tax breaks were implemented with the goal of improving the local economy by creating jobs. However, there is little data available to assess whether or not they have achieved this objective.

Lawmakers have recently introduced several bills that would automatically extend all or some of these programs, despite a \$2.4 billion budget deficit. Extending these tax preferences will cost the state an estimated \$94.6 million and local governments \$23.8 million in lost tax revenue for the 2003-05 biennium. This amount would increase to \$317 million in the 2005-07 biennium.

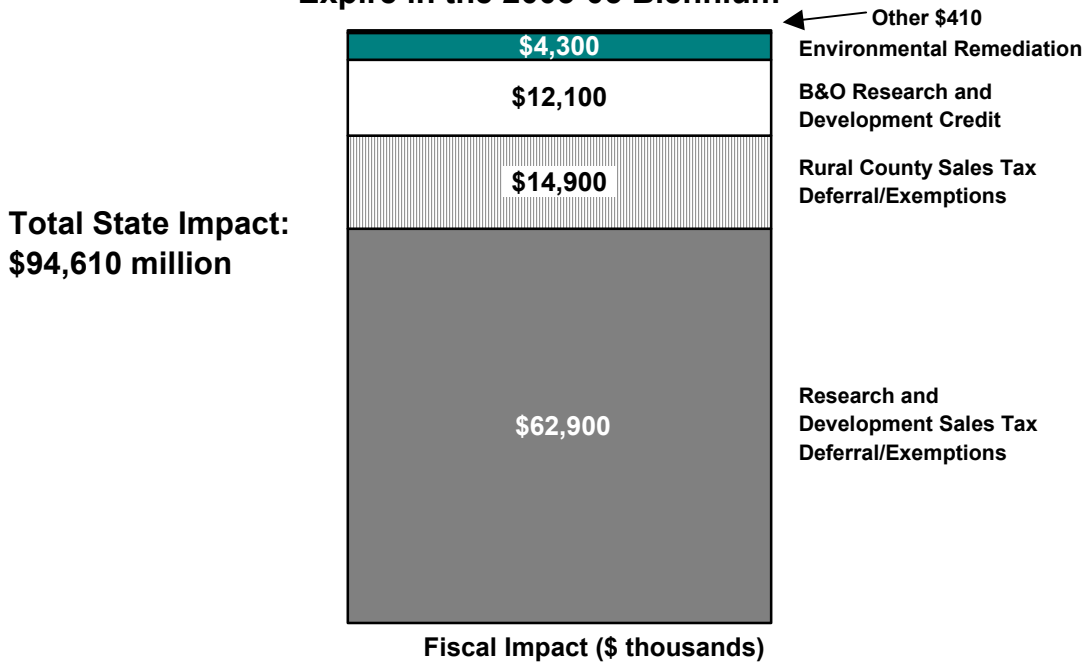
This loss in revenue needs to be evaluated alongside proposed cuts, including cuts to early education, K-12 and higher education, all of which are key components to a thriving regional economy. In addition, legislators should adopt a system for evaluating the effectiveness of the numerous tax preferences that currently exist.

Table 1. Tax Incentives Due to Expire in the 2003-05 Biennium

Program	Year of Enactment	Date of Expiration	Participating Businesses	Fiscal impact to the state if extended (2003-05 unless noted)
Sales Tax Deferral/Exemption for R&D	1994	7/1/04	60	(62,900,000)
B&O Tax Credit for R&D	1994	12/31/04	500	(12,100,000)
Rural County Sales Tax Exemption	1985	7/1/04	70	(14,900,000)
B&O Credit Help Desk	1999	12/31/03	30	(137,000) FY 2004
B&O Credit Rural Software	1999	12/31/03	25	(15,000)
B&O and Public Utility Tax Credit for Water Systems	1997	7/1/04	58	(230,000) per year
Environmental Remediation	1998	7/1/03	200	(4,300,000) FY 2004

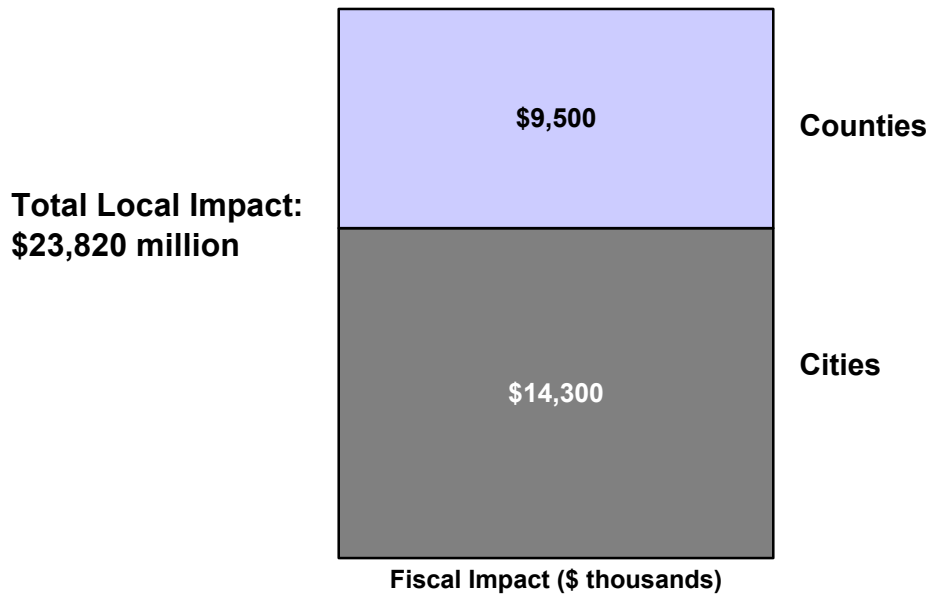
Source: Washington Department of Revenue and Fiscal Note for SB 5650

State Fiscal Impact of Extending Tax Incentives due to Expire in the 2003-05 Biennium



Source: Fiscal Note For SB 5650

Local Fiscal Impact of Extending Tax Incentives due to Expire in the 2003-05 Biennium



Source: Fiscal Note For SB 5650

Background

Tax preferences in Washington range in form and may include exemptions, credits, exclusions, deferrals and preferential rates. Many tax preferences are intended to comply with constitutional law or to benefit state agencies, charities and nonprofit organizations. Many others are intended to promote economic development, foster environmental stewardship, or directly benefit certain populations such as senior citizens.

Many of Washington's tax preference programs aim to catalyze economic development by granting tax incentives to businesses in the hope of creating jobs. Various programs target specific sectors of the economy (e.g. high tech) or specific regions of the state (e.g. rural and distressed counties). A salient question is ***whether these programs create economic activity that would not have been created in their absence.*** Academic research examining the relationship between tax incentives and economic development is inconclusive at best. Yet, throughout the 1990's the Washington legislature continued to enact business related tax incentive programs. Between 1994 and 1999 \$1.8 billion in various tax cuts and exemptions were implemented, many of which were in the form of tax incentives for business.¹ Between 1995 and 2000 high tech businesses alone received \$347.1 million dollars in tax credits and exemptions.²

An assessment of Washington's high tech research and development tax incentives completed by the Department of Revenue (DOR) in 2000 (the next assessment is due in 2003) resulted in less than convincing evidence that these programs are significantly influencing employers' business decisions. Between 1995 and 1999 the Department of Revenue "could not find a statistically significant and consistent employment impact for these programs as a whole."³ Using survey data provided by participating businesses the DOR estimates that in 1999 only 70 new jobs directly resulted from the research and development B&O tax credits, 41 of which were filled by Washington residents.

The Current Budget Context

In the midst of a \$2.4 billion deficit, Washington state is facing its worst fiscal crisis in recent memory. Seven Washington state tax incentive programs are due to expire in the 2003-05 biennium. Extending all seven of these programs will result in an additional \$94 million loss to the state general fund in the 2003-05 biennium. Local governments would realize an additional \$24 million loss, mostly in the form of deferred and exempted local option sales tax revenue. Meanwhile, education programs in Washington – the most critical component to succeeding in a knowledge-based high tech economy – are further squeezed by increasing enrollments and reduced funding.

Evaluating Tax Preferences

With substantial program cuts a near certainty, it is imperative that legislators closely scrutinize any policy that reduces the available tax base. However, it is impossible to gauge the efficacy of Washington's tax incentives programs because there is no

objective evaluation process in place. In its recently released report the legislatively appointed Washington State Tax Structure Committee recommended that, “the Legislature review exemptions and business incentives for economic or social goals every ten years”. A desirable evaluation process would establish clear policy objectives for each incentive and ensure that data be made available to thoroughly assess the effectiveness of each incentive in achieving its stated objectives.

A bill introduced in 2003 offers a step in this direction. House Bill 1869 would create a commission to schedule and oversee periodic audits of state tax preferences, particularly those established to affect the state’s business climate. Given the current fiscal climate and with no means of measuring the economic impact there is no justification for extending, or granting additional tax incentive programs.

Programs to Expire in the 2003-05 biennium

Sales Tax Deferral/Exemptions for High Tech Research and Development

The sales tax deferral program for research and development, enacted in 1994, is due to expire in July 2004. The deferral applies to taxes due on construction and purchases of equipment in specialized sectors of the economy. The eligible sectors include advanced materials, advanced computing, biotechnology, electronic device technology and environmental technology. The program currently has 60 participants. Repayment of deferred taxes is not required if the participating firm uses the qualified facility for an 8 year period. Continuing this program beyond its expected July 2004 expiration will cost the state General Fund an additional \$62.9 million for the 2003–05 biennium. Local governments will lose a combined total of \$20 million in the 2003–05 biennium.⁴

Business & Occupation Tax Credit for High Tech Research and Development

The B&O tax credit program, enacted in 1994, is identical to the sales tax deferral program in that it targets research and development activities for businesses operating in the advanced materials, advanced computing, biotechnology, electronic device technology and environmental technology sectors of the economy. Businesses are eligible for a maximum annual credit of \$2 million for qualifying research and development expenditures. Continuing this program beyond its expected December 2004 expiration will cost the state General Fund an additional \$12 million in the 2003-05 biennium and \$63 million during the 2005-07 biennium.

Rural County Sales Tax Deferral

The rural county sales tax deferral program, enacted in 1985, is intended to create and retain jobs in rural Washington. The deferral is available to businesses that invest in new construction or equipment and are engaged in manufacturing, research and development or computer services in 32 rural counties. If the qualified project remains in effect for eight years the deferred sales taxes do not have to be repaid. The program is scheduled to expire as of July 2004. If the program is extended it will cost the state General Fund \$15 million and local governments approximately \$4 million in the 2003–05 biennium.⁵

Others

- A sales tax exemption and B&O rate reduction is available for business activity related to environmental remediation. This program is scheduled to expire in July of 2003. Extending this program is estimated to cost the state General Fund \$4.3 million in FY 2004.
- A B&O tax credit available to rural help desk services is due to expire in December of 2003. Help desk services are defined as businesses providing electronic or telephone communication to assist customers with installation, maintenance, diagnostics, repair, training and upgrading of computer software and hardware. Extending this program is estimated to cost \$137,000 in FY 2004.
- A B&O credit available for software programming and manufacturing jobs created in rural areas will expire in December 2003. Continuing this program is estimated to cost \$15,000 for the 2003-05 biennium.
- Continuing a tax exemption for small water providers due to expire in July of 2004 will cost the state approximately \$230,000 per year.

¹ Lefberg, Irv and Chris Haugen, *Changing the Rules of the Game: Washington Fiscal Developments Before and After Initiative 601*, Institute for Public Policy and Management, University of Washington
<http://www.ofm.wa.gov/fiscal/i-601/doc99/99study.htm>

² High Tech R&D Incentives Study, Final 2000 Version Washington Department of Revenue
http://dor.wa.gov/Docs/Reports/High_Tech_RandD_Study/Contents.htm

³ High Tech R&D Incentives Study, Final 2000 Version Washington Department of Revenue

⁴ Fiscal Note for Senate Bill 5531

⁵ Fiscal Note for Senate Bill 5614