State of Washington

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September 26, 2012

To: Citizen Commission for Performance Measurement of Tax Preferences

From: Keenan Konopaski, Legislative Auditor

Re: Questions on Pew Center's Report on State Efforts to Evaluate Tax Preferences

At the August 24, 2012, Tax Preference Commission meeting, Jeff Chapman from the Pew Center for the States made a presentation about his organization's recent report titled "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth."

Subsequent to the meeting, Chairman Longbrake has asked me two questions about the report. I am providing a copy of the questions and my responses for all the Commissioners in this memorandum.

Question: Do JLARC staff feel the Pew Center's characterization of Washington State's effort to evaluate tax preferences is accurate?

<u>Legislative Auditor's Response</u>: Yes - at the time their report was released (April 2012), I think the Pew Center correctly characterized our state when it concluded we were one of thirteen states "leading the way" in efforts to evaluate tax incentives for jobs and growth.

Specifically, the Pew Center identified that we were "leading the way" in three out of four criteria: *informing policy choices; including all tax incentives; and drawing clear conclusions*. I agree our state's processes in these areas have been informative and comprehensive. Only one state in the nation (Oregon) was identified as having met all four criteria.

The fourth criteria the Pew Center used was *measuring economic impact*. The Pew Center report indicated we had mixed results in this area. I agree this was an accurate characterization at the time their report was prepared.

Like two-thirds of the states, prior to the release of our 2012 reviews this July we had not completed a rigorous analysis of the economic impact of a specific preference. This is because many preferences reviewed previously had either not been intended for economic development, or they were too small or had insufficient data to attempt a rigorous economic analysis.

Commissioners will recall we conducted such an analysis this year on the high technology research and development tax credit, with the assistance of expert economic consultants.

Measuring economic impacts like this in the future will require additional resources for similar consulting assistance. I anticipate that some of the aerospace-related reviews that begin in 2014 will be preferences where complex economic analysis can be performed if JLARC receives funding to assist with this.

Question: What are my office's views on the six key questions the Pew Center posed for measuring economic impact?

Legislative Auditor's Response: I agree that the six key questions identified by the Pew Center for measuring economic impact are appropriate to pursue. The ability for JLARC to answer them will depend upon whether we can identify reliable data for analyzing them, and whether JLARC has resources available when additional technical assistance is needed.

These questions below, though appropriate for evaluation, can be extremely challenging to accurately answer. I agree with the statement in the Pew Center report that, "There is no simple way to isolate the impact of tax incentives…."

The questions posed by the Pew Center are:

1. Cause and effect: To what extent did tax incentives change businesses' decisions, and how much did they reward what would happen anyway?

2. Winners and losers: To what extent did the incentive benefit some businesses or individuals at the expense of others?

3. Unintended beneficiaries: How much of the benefit of the incentive flowed across state borders?

4. Timing: When will the costs and benefits of the incentive occur, and how long will they last?

5. Indirect impacts: To what extent do the investment of companies receiving incentives filter into the broader economy, causing further economic gains?

6. Economics of budget trade-offs: What were the adverse economic impacts of the tax increases or spending cuts made to fund the incentive? Do the benefits of the incentive outweigh those impacts?

Our 2012 analysis of the high technology credit incorporated the impact of the first five of the Pew Center's questions.

The sixth question on budget trade-offs is an especially complex issue. The State Legislature also expressed interest in the topic and posed a similar question for JLARC staff in 2011 legislation amending the tax preference review process.

As directed by the Legislature, JLARC staff attempted to estimate this trade-off for the high technology credit using budget information and the Office of Financial Management's (OFM) Input-Output Model. The Input-Output Model can be used to simulate the possible economic effect of a tax preference.

However, upon careful review JLARC staff determined the Input-Output Model was not designed to reflect the economic effect of public sector spending in the same way that it reflects private sector spending. Since both sectors must be treated consistently for an accurate trade-off analysis, we determined it was not possible to do this analysis with the current Input-Output Model.

Our 2012 Tax Preference report includes a recommendation for OFM to estimate the cost of modifying their Input-Output Model to allow such an analysis. OFM has concurred with this recommendation, and we will update the Commission when they have completed their estimate.