

**Citizen Commission for Performance Measurement of Tax Preferences
Chair's Proposed Consolidated Comments
October 13, 2014**

GROUP A: Continue – endorse without comment

1. Electric Power Exported or Resold (Public Utility Tax)

Legislative Auditor recommendation: Continue

Because the preference is achieving the inferred public policy objectives.

2. Sales Subject to Public Utility Tax(Sales Tax/Sales Use Tax)

Legislative Auditor recommendation: Continue

Because the preferences are meeting the inferred public policy objectives of avoiding double taxation and the more narrow sales and use tax preference is ensuring Washington tax statutes conform with the National Streamline Sales and Use Tax Agreement.

GROUP C: Review and Clarify – endorse without comment

3. Electricity Power Exported or Resold (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because 1) the Legislature may want to consider adding reporting or other accountability requirements to provide better information on use of the preference; 2) it is unclear whether the preference is still needed to keep electricity marketers from moving out-of-state due to 2010 changes in how service businesses calculate their taxable income; and 3) it is unclear whether the Legislature intended the preference to apply to commission or fee income from electricity brokering.

GROUP D: Review and Clarify – endorse with comment

4. Aerospace Industry Tax Preferences (package of 8 preferences)

Legislative Auditor recommendation: Review and Clarify

Because providing additional detail in the tax preference performance statement such as a measure of the desired increase in jobs would facilitate future reviews of these preferences.

Citizen Commission Comment: The Legislature should establish specific economic development metrics and reporting mechanisms that facilitate determination of whether the intended public policy objectives are being met.

Citizen Commission Rationale: The competition for Washington's aerospace firms is intense. Given this intensity, and the state's need to maintain its job base following the Great Recession, these preferences mitigated some near- and medium-term risk for Washington's economy. However, testimony indicated that these preferences suffer from some significant long-run "moral hazard" problems. Moral hazard problems occur when the recipient of an economic benefit is incited to behave in a way inconsistent with the welfare of those granting the benefit. For example, this is common with deposit insurance. Evidence suggests that deposit insurance (an insurance benefit) in the absence of bank examinations (i.e. prudential supervision) encourages banks to take excessive risk since bank owners and depositors are, to varying degrees, insulated from the bank's lending decisions. In effect, without bank examinations, risk is shifted to agents such as the bank's employees, creditors, and ultimately taxpayers.

In the case of the aerospace industry, the lack of verifiable metrics that measure the extent to which the public policy objectives of the tax preference are being met may encourage firms to move employment out of state to gain the benefit of more favorable labor costs, while still benefiting from the tax preferences. However, the establishment of verifiable metrics will need to balance compliance and monitoring costs with the benefits received by the firms. Testimony noted that firms may forego taking advantage of tax preferences with onerous reporting standards, possibly to the detriment of economic development in the state.

In addition to compliance and monitoring costs, it is challenging to determine how to measure whether employment objectives are being met over time. Some employment changes may not be related to the tax preferences. For example, depending upon the industry, technological change can be a significant driver of changes in employment. To isolate the impact of a tax preference on employment levels, changes in technology need to be taken into consideration.

Finally, as with most tax preferences, there is also lack of transparency on how the preferential benefits should be established. Although making all discussions between the state and the industry public is not practical for a variety of reasons, there is still a public interest in additional transparency in how the state and industry determine the preferential benefits. The public should be given information about why a particular preferential benefit structure was chosen. This might include information on costs and competitive pressures faced by an industry, or the influence of competing preferential benefits offered by other states. Given the amounts involved in the aerospace preferences, all of these issues deserve careful consideration by the Legislature. It would be helpful to examine how other states are structuring preferences and performance metrics to achieve public policy objectives.

5. Certified Aircraft Repair Firms (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because providing additional detail in the tax preference performance statement such as a measure of the desired increase in jobs would facilitate future reviews of these preferences.

Citizen Commission Comment: The Legislature should establish specific economic development metrics and reporting mechanisms that facilitate determination of whether the intended public policy objectives are being met.

Citizen Commission Rationale: Same as that contained in the “Rationale” section of the “Aerospace Industry Tax Preferences.”

6. Commercial Airplane Part Place of Sale (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because it seems to run counter to the Legislature’s stated policy objective of reducing the cost of doing business in Washington compared to locations in other states. In addition, the Legislature may want to consider adding reporting or other accountability requirements that would provide better information on out-of-state manufacturers’ use of this preference.

Citizen Commission Comment: The Legislature should establish specific economic development metrics and reporting mechanisms that facilitate determination of whether the intended public policy objectives are being met.

Citizen Commission Rationale: Same as that contained in the “Rationale” section of the “Aerospace Industry Tax Preferences.”

7. Dairy Product Processors Deduction and Preferential Rate (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because the Legislature indicated extension of the expiration date was directly related to jobs but has not yet identified job-related performance metrics, the Legislature should: 1) identify performance targets and metrics for the number and quality of jobs in the dairy processing industry; and 2) establish criteria for when to transition from the deduction to the preferential rate. To clarify, before the preference takes effect, whether the Legislature intends there to be parity among all the different food processor manufacturing and sales activities.

Citizen Commission Comment: Although the preference appears to be meeting its public policy objective, the dairy industry is subject to technological change that reduces the need for labor. Therefore, in the long-run, it is unclear how effective this preference will be in preventing job losses in the dairy industry.

8. Fruit and Vegetable Processors Exemption and Preferential Rate (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because the Legislature indicated extension of the expiration date was directly related to jobs but has not yet identified job-related performance metrics, the Legislature should: 1) identify performance targets and metrics for the number and quality of jobs in the fruit and vegetable processing industry; and 2) establish criteria for when to transition from the deduction to the preferential rate. To clarify, before the preference takes effect, whether the Legislature intends there to be parity among all the different food processor manufacturing and sales activities.

Citizen Commission Comment: Although the preference appears to be meeting its public policy objective, the fruit and vegetable industry is subject to technological change that reduces the need for labor. Therefore, in the long-run, it is unclear how effective this preference will be in preventing job losses in the fruit and vegetable industry.

9. Seafood Product Processors and Certain Sellers-Exemption and Preferential Rate (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

Because the Legislature indicated extension of the expiration date was directly related to jobs but has not yet identified job-related performance metrics, the Legislature should: 1) identify performance targets and metrics for the number and quality of jobs in the seafood processing industry; and 2) establish criteria for when to transition from the deduction to the preferential rate. To clarify, before the preference takes effect, whether the Legislature intends there to be parity among all the different food processor manufacturing and sales activities.

Citizen Commission Comment: Although the preference appears to be meeting its public policy objective, the seafood industry is subject to technological change that reduces the need for labor. Therefore, in the long-run, it is unclear how effective this preference will be in preventing job losses in the seafood industry.

10. International Investment Management Services (B&O Tax)

Legislative Auditor recommendation: Review and Clarify

To determine if the preference is still necessary, since Washington's adoption of an economic nexus and apportionment standard has reduced the competitive disadvantage for international investment management businesses located in-state as compared to those located out-of-state. If the Legislature determines it wants to maintain this tax preference, then the Legislature should consider clarifying the law to identify which businesses qualify for the preference and what income is subject to the preferential rate.

Citizen Commission Comment: The Legislature in its review of this preference should take into consideration the Department of Revenue's findings from its review of approximately 70 refund requests, which will take some time to complete. In addition, the Legislature should consider the financial and competitive impact this preference has on beneficiaries resulting from the typical business structure involving use of multiple affiliates in the international investment management services business.

Citizen Commission Rationale: The Department of Revenue issued an Excise Tax Advisory on International Management Services on February 28, 2014, which clarifies eligibility and what income is taxable. The Department is currently reviewing approximately 70 refund requests and has completed one-third of these reviews. It will take additional time to complete the remaining reviews. It is the Commission's understanding that these reviews will not resolve all of the issues surrounding who is eligible for the preferential rate and what income is taxable. While the Excise Tax Advisory addresses many of the issues revolving around who is eligible for the preferential rate and the Department of Revenue has a position on what income is taxable, not all taxpayers agree.

The Commission received testimony from a beneficiary that described how the B&O tax, which applies both to inter-affiliate transactions as well as to the gross receipts of the parent company, poses an undue tax burden compared to taxation methodologies in other states. This burden arguably could be reduced by merging affiliates; however, the affiliate business structure is a standard feature of businesses involved in international investment management services for other reasons. In states that tax income rather than receipts, the consolidated income of the parent is typically taxed, not the income of each individual affiliate. This issue arises from the structure of the B&O tax and is not unique to the international investment management services business. However, it is possible that the B&O tax structure results in a larger tax burden for companies in the international investment services business than an alternative tax methodology, such as a tax on consolidated net income. If this is the case, it would discourage firms doing this kind of business from locating in Washington. The beneficiary that testified did not provide quantitative comparative information which would permit a determination of whether Washington's tax structure discourages companies from doing business in Washington. The large number of companies applying for a refund, while hardly definitive, could imply that the tax burden is manageable.

GROUP E: Terminate – endorse without comment

11. Aircraft Parts Prototypes (Sales/Use Tax)

Legislative Auditor Recommendation: Terminate

Because the tax preferences are not being used and have not contributed to the stated public policy objectives.

GROUP F1: Expedited Preferences – expire July 1, 2015

- **Biodiesel and Alcohol Fuel Production Facilities (Leasehold Excise Tax) Pg. 10**
- **Biodiesel and Alcohol Fuel Production Facilities (Property Tax) Pg. 11**

Legislative Auditor Recommendation in 2008: Continue and modify expiration date

Citizen Commission in 2008: Endorsed Legislative Auditor recommendation without comment

Legislature's Action: Extended expiration date to July 1, 2015

Legislative Auditor Recommendation in 2014: None

Citizen Commission Recommendation: The Legislature should determine whether these preferences continue to meet their public policy objective. If they do, the Legislature should modify the expiration date; if they do not, the Legislature should allow the preferences to expire.

GROUP F2: Expedited Preferences – expire July 1, 2015, no beneficiaries

- **Wood Biomass Fuel Production Facilities (Leasehold Excise Tax) Pg. 64**
- **Wood Biomass Fuel Production Facilities (Property Tax) Pg. 65**

Legislative Auditor Recommendation in 2008: Continue and modify expiration date.

Citizen Commission in 2008: Did not endorse Legislative Auditor recommendation and recommended that these preferences allowed to expire because there were no beneficiaries.

Legislature's Action: Extended expiration date to July 1, 2015.

Legislative Auditor Recommendation in 2014: None

Department of Revenue Information: Neither preference has beneficiaries.

Citizen Commission Recommendation: Do not modify the expiration date and allow the preference to terminate.

Citizen Commission Comment: According to the Department of Revenue there still are no beneficiaries for these preferences and no information was provided to the Commission that any entity intends to take advantage of either of these preferences.

GROUP F3: Expedited Preferences – no beneficiaries

- **Aluminum Master Alloy Producers (B&O Tax) Pg. 7**

Legislative Auditor Recommendation: None

Department of Revenue Information: There are no known firms who utilize this exemption.

Citizen Commission Recommendation: The Legislature should consider terminating the preference.

Citizen Commission Comment: No public testimony covering this preference was submitted.

GROUP F4: Expedited Preferences – no beneficiaries and expires July 1, 2015

- **Bad Debts (Fuel Tax) Pg. 8**

Legislative Auditor Recommendation: None

Department of Revenue Information: No fuel distributor has taken this credit since it was enacted in 1998.

Citizen Commission Recommendation: The Legislature should consider terminating the preference.

Citizen Commission Comment: No public testimony covering this preference was submitted.

GROUP F5: Expedited Preferences – no savings (Property Tax)

- **Multi-Unit Urban Housing (Property Tax) Pg. 36**
- **Nonprofit Developmentally Disabled Housing (Property Tax) Pg. 41**
- **Prewritten Computer Software (Property Tax) Pg. 45**

Legislative Auditor Recommendation: None

Department of Revenue Information: No savings would be realized; if the preferences are terminated, other taxpayers would experience reduced taxes.

Citizen Commission Recommendation: None

Citizen Commission Comment: The Legislature could review whether these preferences are meeting their public policy objectives. If any of them is not, the Legislature should consider modifying or terminating the preference because other taxpayers are bearing the tax burden if the preference is continued.

GROUP F6: Expedited Preferences – Second Tacoma Bridge preferences that are no longer operative

- **Second Narrows Bridge (Leasehold Excise Tax) Pg. 50**
- **Second Narrows Bridge (Property Tax) Pg. 51**
- **Second Narrows Bridge (Public Utility Tax) Pg. 52**
- **Second Narrows Bridge (Real Estate Excise Tax) Pg. 53**

Legislative Auditor Recommendation: None

Department of Revenue Information: Because the bridge does not entail any private funding or ownership of the property, termination of these preferences would not result in taxpayer savings and none is contemplated.

Citizen Commission Recommendation: None

Citizen Commission Comment: These preferences were enacted in 1998 and anticipated the possibility of private funding, ownership, or lease of the bridge. These preferences are inoperative because that possibility was not pursued. For this reason the Legislature could consider terminating them.

GROUP F7: Expedited Preferences – interstate taxation

- **Multiple Activities Credit - Interstate (B&O Tax) Pg. 34**

Legislative Auditor Recommendation: None

Department of Revenue Information: This credit assures that gross proceeds of sale or the value of products determined by such gross proceeds are taxed only one time when activities occur in Washington. Until 1987 businesses were taxable under the B&O tax only under a single classification for income associated with a particular activity or product. In that year, the U.S. Supreme Court ruled that Washington could not discriminate against firms operating on an interstate basis – intrastate activities were taxed only once whereas interstate activities could potentially be taxed twice. Part of the solution was to subject products produced and sold in the state to tax under both the production and selling categories, but to allow the tax on the production activity to be credited against the selling tax.

Citizen Commission Recommendation: Continue the preference.

Citizen Commission Comment: This preference is a structural provision of the B&O tax necessary to comply with a ruling of the U.S. Supreme Court interpreting the U.S. constitution.

GROUP F8: Expedited Preferences – avoid double taxation

- **Natural Gas Subject to Public Utility Tax (Use Tax) Pg. 37**

Legislative Auditor Recommendation: None

Department of Revenue Information: Eliminates double taxation of the same fuel. Gas purchased via brokers is generally not subject to public utility tax, which is the reason that the brokered natural gas tax was originally adopted.

Citizen Commission Recommendation: Continue the preference.

Citizen Commission Comment: The preference is meeting its public policy objective.

GROUP F9: Expedited Preferences – public testimony submitted

- **Baseball Stadiums (Leasehold Excise Tax) Pg. 9**
- **Football Stadium and Exhibition Center Parking (Sales Tax) Pg. 22**
- **Football Stadium (Leasehold Excise Tax) Pg. 23**

Legislative Auditor Recommendation: None

Department of Revenue Information: The leasehold excise tax preferences were enacted by the Legislature as components of comprehensive financing packages and involve only public and entertainment areas of the stadiums; the sales tax preference was enacted because the Legislature considered imposing both the local parking tax and retail sales tax would be too onerous for parking customers.

Citizen Commission Recommendation:

Option 1: Continue the preferences

Option 2: Review and clarify the preferences

Option 3: Terminate the preferences

Citizen Commission Comment:

Option 1: (Leasehold Excise Tax) Detailed written public testimony indicates that these preferences are meeting their public policy objectives and that both the baseball and football stadiums have provided

substantial economic benefits. (Sales Tax) This preference eliminates a double taxation burden on individuals who utilize football stadium and exhibition center parking.

Option 2: The baseball stadium preference was enacted in 1995 as part of a comprehensive package to finance construction of Safeco Field and the football stadium preference was enacted in 1997 as part of a comprehensive package to finance construction of Century Link Field. Because nearly 20 years has passed, the Legislature should consider reviewing these preferences to determine whether they are continuing to meet their public policy objectives.

Option 3: (Leasehold Excise Tax) The stadium preferences have met their public policy objectives of retaining major league sports teams. Thus, private interests should no longer receive state subsidies. (Sales Tax) The state should not subsidize individuals who utilize football and exhibition center parking.

GROUP F10: Expedited Preferences – all others not mentioned in Groups F1 through F9

Legislative Auditor Recommendation: None

Citizen Commission Recommendation: Review and continue, review and modify, or review and terminate preferences in this group

Citizen Commission Comment: The Citizen Commission solicited public testimony for all expedited preferences. No public testimony was submitted for any of the expedited preferences in this group. Tax revenue is a public asset that should be utilized in the best overall interests of citizens of Washington State.

The Commission requested beneficiaries to provide responses to the following four questions:

1. Is there evidence that the tax preference achieved its purpose, as noted in the 2014 tax preferences reports? *Please provide any relevant evidence.*
2. Does the preference provide benefits in addition to those stated in its intended or implied purpose?
3. Does the economic activity stimulated by this tax preference exceed the loss of revenue to the state?
4. Does this preference have negative consequences? For example, were other industries, workers, or the environment harmed by activities stimulated by this tax preference?

Because beneficiaries of tax preferences in this group did not respond to these questions and assuming they were aware of the opportunity to provide public testimony, the failure of beneficiaries to respond to these questions creates doubt that these preferences are serving bona fide public policy objectives. The Commission notes that some, but not all, of these preferences apply to not-for-profit entities.

The Commission encourages the Legislature to examine these preferences and gather responses to the four questions posed by the Commission from beneficiaries and then determine whether to continue, modify, or terminate each preference.

Commission Recommendation to the Legislature to Adopt More Specific Economic Development Performance Standards and Reporting Mechanisms

The Commission received written testimony from Good Jobs First, which is a non-partisan, non-profit research center located in Washington, DC. Good Jobs First tracks best practices in economic development in all 50 states. According to Good Jobs First, Washington State ranks 10th in the nation in terms of transparency on economic development subsidies. Washington's ranking was boosted considerably by the Legislature's adoption of SB 5882 in 2013, which required disclosure on B&O tax preferences.

Good Jobs First tracks and evaluates Megadeals intended to spur economic development (workforce development, education, transportation, and infrastructure, etc.) through tax preferences. In many cases the package of tax preferences granted to an industry has lacked rigorous accountability standards. In the case of the Washington State aerospace industry, the package of tax preferences has an estimated value of \$8.7 billion value but, according to Good Jobs First, was not accompanied by strong standards and money-back guarantees, if those standards were not met.

Best practices for assessing benefits and costs to taxpayers when enacting tax preferences include one or more of the following:

- Establish specific performance standards, especially for job creation and job quality (wages and benefits)
- Require substantial transparency on beneficiary performance relative to the established standards – this requires establishing data collection vehicles and enabling data analysis
- Establish money back requirements if standards are not met
- Establish performance-based requirements which require a beneficiary to meet a performance standard or benchmark before the tax preference is activated

Citizen Commission Recommendation: The Citizen Commission recommends that the Legislature consider enacting legislation requiring specific performance standards and information reporting for new tax preferences and for preferences whose expiration dates are extended. In establishing performance standards and reporting requirements, compliance and reporting cost burdens on beneficiaries should be considered relative to the magnitude of the tax preference and size of individual firms. The Legislature should also consider whether to establish standards and reporting for beneficiaries of significant existing tax preferences.