State of Washington

Citizen Commission for Performance Measurement of Tax Preferences

William A. Longbrake, Chair
Governor's Council of Economic Advisors

Stephen B. Miller, Vice Chair
Washington Education Association

James Bobst
Pacific Fibre Products, Inc.

Ruta Fanning
Retired Legislative Auditor

Paul Guppy
Washington Policy Center

NON-VOTING MEMBERS:

Senator **Craig Pridemore**
Chair, Joint Legislative Audit & Review Committee

Brian Sonntag
State Auditor

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October 3, 2012

TO: Members of the Citizen Commission for Performance Measurement of Tax Preferences

FROM: Keenan Konopaski, Legislative Auditor

SUBJECT: Materials for the October 9, 2012, Commission Meeting

The agenda for our October meeting covers three areas: 1) approval of minutes; 2) approval of the 2013 Commission meeting schedule; and 3) discussion/adoption of Commission comments on 2012 tax preference reviews. Items in this packet are arranged in these three areas.

Please remember that the meeting will start at 2:00 p.m., in Senate Hearing Room 3 of the John A. Cherberg Building, in Olympia.

1. *APPROVAL OF MINUTES*

   Draft minutes from the September 14, 2012, meeting are included in this packet for approval at the meeting.

2. *2013 COMMISSION MEETING SCHEDULE*

   Enclosed is the proposed meeting schedule. Note that meeting start times have been moved to 1:00 p.m.

   At the meeting a motion will be in order to adopt the 2013 meeting schedule.

3. *DISCUSSION/ADOPTION OF COMMISSION COMMENTS*

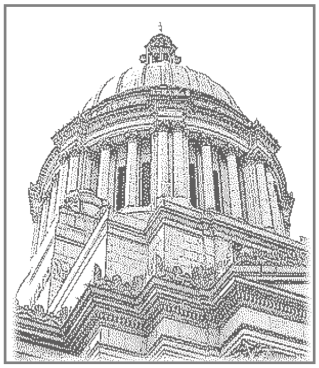
   Attached are the comments provided by Chair Longbrake and Vice Chair Miller. You will note that they are incorporated into a document that also describes the process for discussing the proposed comments and subsequent finalization and adoption. As with previous years, comments are grouped and begin (on page 3) with tax preferences where JLARC staff recommended continue and there are no proposed Commission comments.

If you have any questions about these materials or the agenda, please contact me at 360-786-5187.

cc: Stacia Hollar, Assistant Attorney General
Brad Flaherty, Director, Department of Revenue
Vikki Smith, Deputy Director, Department of Revenue
Kathy Oline, Assistant Director, Research, Department of Revenue
Stan Marshburn, Office of Financial Management

STATE OF WASHINGTON

CITIZEN COMMISSION FOR PERFORMANCE MEASUREMENT OF TAX PREFERENCES



COMMISSION MEMBERS

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AGENDA

Tuesday, October 9, 2012
2:00 p.m.
John A. Cherberg Bldg.
Senate Hearing Rm. 3
Olympia, WA

*1. Approval of September 14, 2012, Commission Meeting Minutes

*2. Adoption of 2013 Commission Meeting Schedule

*3. Discussion/Adoption of Commission Comments on 2012 Tax Preference Reviews

General public comment period immediately following regular Commission business

** Action Item*

Please Note:
The Commission reserves the right to move agenda items as needed.

State of Washington

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EXPANDED AGENDA

October 9, 2012
2:00 p.m.

John A. Cherberg Bldg.
Senate Hearing Rm. 3

2:00 – 2:05 * 1. Approval of September 14, 2012, Commission Meeting Minutes

*A **motion** is in order to approve the September 14, 2012, Commission meeting minutes.*

2:05 – 2:20 * 2. Adoption of 2013 Commission Meeting Schedule

The Commission will discuss a proposed 2013 meeting schedule.

*A **motion** is in order to approve the 2013 Commission Meeting Schedule.*

2:20 * 3. Discussion/Approval of Commission Comments on 2012 Tax Preference Reviews

The Chair will refer to Commissioners' written comments received to date and solicit any additional proposals or comments from Commissioners.

***Motions** are in order to approve Commission comments on the 2012 Reviews.*

Public Comment Period
General public comment period immediately following regular Commission business.

* *Action Item*

State of Washington

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Citizen Commission for Performance Measurement of Tax Preferences

1

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Citizen Commission for Performance Measurement of Tax Preferences
Meeting Minutes

September 14, 2012
John A. Cherberg Bldg.,
Senate Hearing Rm. 3
Olympia, WA

Members Present:

William A. Longbrake	Stephen Miller
James Bobst	Ruta Fanning
Sen. Craig Pridemore	

Members Absent:

Paul Guppy	Brian Sonntag

Staff:

Keenan Konopaski	John Woolley
Mary Welsh	Dana Lynn
Peter Heineccius	Eric Tietz
Curt Rogers	Suzanne Kelly
Stacia Hollar, AG's Office	

DRAFT

WELCOME

Commission Chair Bill Longbrake welcomed those in attendance and called the meeting to order at 2:04 p.m.

APPROVAL OF MEETING MINUTES

MOTION: A motion was made to approve the August 24, 2012, meeting minutes.

The motion was seconded and carried.

APPROVAL OF 10-YEAR TAX PREFERENCE REVIEW SCHEDULE

John Woolley, JLARC staff, reminded commissioners that they finalized the 2012 10-Year Review Schedule at the August meeting. After the meeting, staff revised the 10-Year Schedule to reflect the Commission's modifications at the August meeting and also made a number of technical changes (e.g., name changes and updated savings amounts). In addition, preferences enacted in the 2012 session were added to the schedule. (See TVW recording at 0:00:44)

MOTION: A motion was made to adopt the 2012 10-Year Schedule, as revised by JLARC staff.

STAFF RESPONSES TO QUESTIONS RAISED AT THE AUGUST MEETING

John Woolley, JLARC staff, responded to questions raised by the Commission at the August meeting. JLARC will make minor modifications to the 2012 Tax Preference Reviews to clarify the methodology used to arrive at certain estimates regarding the credit for High Technology R&D (B&O Tax). Staff informed the Commission that there is no tax preference for financial institutions similar to the insurance guarantee fund preference. Staff informed the Commission that determining the profit margins of the stevedoring industry across the states would take considerable staff resources and would not be pursued at this time. However, staff will provide existing national average information about profit margins that is available from the federal government.

Commissioner Fanning asked staff whether the Commute Trip Reduction beneficiaries included public entities. Staff responded that the public sector was included in those taking advantage of the program. Commissioner Fanning clarified that the public sector does not pay the B&O Tax, and thus does not benefit from the credit. (See TVW recording at 0:03:23)

PUBLIC COMMENT

Scott Hazlegrove, representing the Pacific Merchant Shipping Association, testified in support of the preferential rate for Stevedoring and International Charter and Freight Brokers (B&O Tax). (See TVW recording at 0:15:55)

Bill Stauffacher and Dan Holst, representing the Independent Insurance Agents & Brokers of Washington, testified in support of the preferential rate for Insurance Providers, Title Insurance Agents, and Surplus Line Brokers (B&O Tax). (See TVW recording at 0:30:35)

Brent Dippie, representing Zetron Incorporated, testified in support of the credit for High Technology R&D (B&O Tax). (See TVW recording at 0:46:40)

Patti McKinnell Davis, representing the Washington Biotechnology & Biomedical Association, testified in support of the credit for High Technology R&D (B&O Tax). (See TVW recording at 0:57:20)

Andrew Nicholas, representing Washington State Budget and Policy Center, testified in opposition to the credit for High Technology R&D (B&O Tax). (See TVW recording at 1:16:04)

Dick Nelson, former Washington State Representative, testified about recommendations to the Commission and the Legislature of ways to improve the tax preference review process. (See TVW recording at 1:19:45)

PROCESS FOR PROPOSING COMMISSIONER COMMENTS

Keenan Konopaski, Legislative Auditor, briefed Commissioners on the procedure for proposing written comments on the 2012 Tax Preference Reviews, as well as comments on three preferences reviewed in 2010 that the Commission indicated it may wish to revise.

Chair Longbrake recommended that Commissioners identify as soon as possible any reviews where JLARC recommended "Continue" that a Commissioner wants to make a comment or discuss further at the October meeting. Staff informed the Commission that written comments should be submitted to staff by October 1, 2012, for distribution to the other Commissioners. (See TVW recording at 1:30:25)

Chair Longbrake adjourned the meeting at 3:50 p.m.

DRAFT

Citizen Commission for Performance Measurement of Tax Preferences

2013 Meeting Schedule

Date/Time/Location	Agenda
Friday **May 17, 2013** **1:00 p.m.** **SHR3, Olympia**	2013 Legislative Session Update **2013 Reviews** Notification of Any Adjustments to 2013 Schedule Presentation of 2013 Expedited Report **2014 Reviews** Commission selects 22 preferences for 2014 JLARC review (DOR available for questions) Approve 2014 10-Year Schedule
Friday **August 16, 2013** **1:00 p.m.** **SHR3, Olympia**	JLARC Presentation of 2013 Reviews Election of Officers
Friday **September 20, 2013** **1:00 p.m.** **SHR3, Olympia**	Public Hearing on 2013 Reviews
Friday **October 18, 2013** **1:00 p.m.** **SHR3, Olympia**	Commission Comments on 2013 Reviews 2014 Commission Meeting Schedule

10/9/2012

DRAFT

OVERVIEW

Process for Commission Action on 2012 Tax Preference Reviews

October 9, 2012

2012 Reviews are placed into one of five groups based on the JLARC recommendation. Each group will be addressed using the steps noted below. Following discussion of the 2012 reviews, Commission members will then address three reviews from 2010, and conclude with an opportunity to add more general comments.

<u>Group A: Continue – endorse without comment</u>

First, the Commission will consider 9 reviews that have no proposed comments.

- Commissioners will be asked if they would like to adopt individual comments for any preferences from Group A.
- If there are any, those preferences will be moved to Group B (see below).
- The Commission will then entertain a motion to act on those remaining in the Group A list.
- Any Commissioner can ask to add a minority report reflecting their individual comments. (*See <u>Citizen Commission Citizen Commission for Performance Measurement of Tax Preferences Bylaws, Article VII: Minority Reports</u> on back of this page*)

<u>Groups B Through E</u>

The Commission will then consider adopting additional comments for preferences in Groups B through E, in order.

- Action on the remaining specific preference reviews will be considered in order of the following groups. For each of these the Commission will determine whether to endorse or not endorse, and adopt any additional comments. These groups are organized based on the JLARC recommendation:
    - **GROUP B:** <u>Continue – endorse or not endorse; consider whether to provide a comment</u>
    - **GROUP C:** <u>Review or Clarify – endorse without comment</u>
    - **GROUP D:** <u>Review or Clarify – endorse or not endorse; consider whether to provide a comment</u>
    - **GROUP E:** <u>Terminate – endorse or not endorse; consider whether to provide a comment</u>
- Each preference and any associated Commission comments will be discussed individually.
- The Commission will then entertain a motion to act on each individual preference.
- Any Commissioner can ask to add a minority report reflecting their individual comments.

Article VII: Minority Reports

Section 1: Minority Report(s): Any Commission member may request a minority report for any motion that has been approved by a vote of the Commission. Requests must be made to the Chair at the meeting, following the approval of the motion. The Chair shall ensure that minority reports requested by members are registered in the record of business for the Commission meeting.

GROUP A: Continue- endorse without comment

1. *There are 9 tax preferences with no proposed Commission comments*

Tax Preference		Comment
1	Annuities (Insurance Premiums Tax) (pg. 15)	No proposed Commission comments
2	Business Inventories (Property Tax) (pg. 33)	
3	Condominium and Homeowner Maintenance Fees (B&O Tax) (pg. 55)	
4	Health Insurance by State Pool (Insurance Premiums Tax) (pg.79)	
5	Insurance Guaranty Funds (Insurance Premiums Tax) (pg. 101)	
6	Leases Under $250 per Year and Short Term Leases (Leasehold Excise Tax) (pg. 117)	
7	Natural and Manufactured Gas (Sales and Use Tax) (pg. 133)	
8	Special Fuel Use Exemptions (Fuel Tax) (pg.165)	
9	Urban Passenger Transit Fuel (Sales and Use Tax) (pg. 195)	

2. *If a Commissioner would like to have individual comments adopted on any of these preferences, we will defer discussion of those preferences to Group B. Do any Commissioners have comments on individual preferences they would like to discuss later with Group B?*

3. *Is there a motion for the Commission to take action on the remaining reviews in Group A?*

4. *Potential motion language:*

"The Commission acknowledges receipt of the 2012 JLARC Tax Preference Reviews of [preferences being discussed]. The Commission has provided a forum for discussion and public comment on these recommendations. The Commission <u>endorses</u> the JLARC recommendations for these preferences. The Commission <u>does not have additional comments</u> to append to the 2012 JLARC reports related to these preferences."

GROUP B: Continue- endorse or not endorse; consider whether to provide a comment

1. *There is one tax preference review in Group B with a proposed Commission comment*

Tax Preference		Comment
1	Ferry Boats (Sales and Use Tax) (pg. 61)	Audit staff recommendation: The Legislature should continue the preference because it is meeting the inferred public policy objective of reducing the cost to state and local government entities of building, maintaining, and repairing ferry vessels they own and operate. Possible comment: The Commission does not endorse the recommendation to continue the preference and encourages the Legislature to review and clarify the public policy intent of the preference. Rationale for comment: The JLARC staff study infers the public policy objective is to support state and local governments by reducing the cost of building and repairing ferry vessels owned and operated by state or local government entities. The principal beneficiary of this preference is Washington State Ferries. If the preference were terminated, state and local government entities that operate ferries in Washington would have to pay sales and use tax, which presumably would be a burden on state and local entities' finances. However, because state and local entities that operate ferries charge fees to users of ferries, it would be possible for those entities to raise user fees to recover the amount of sales and use tax. Thus, in effect, this preference is a subsidy that reduces the fees paid by users of ferries. The Commission recommends that the Legislature review and clarify the public policy objective of this preference and determine whether the intent of the preference is to subsidize public use of ferries. If that is not the public policy intent, the Legislature should consider terminating this preference.

2. *Is there any discussion on each of the above preferences?*
3. *Is there a motion for the Commission to take action on these reviews?*
4. *Potential motion language:*

"The Commission acknowledges receipt of the 2012 JLARC Tax Preference Review of [preferences being discussed]. The Commission has provided a forum for discussion and public comment on these reviews. The Commission (endorses) OR (does not endorse) the JLARC recommendation(s) for this review, (subject to the following additional comments.) OR (and does not have additional comments.)"

GROUP C: Review and clarify – endorse without comment

1. *There are three tax preference reviews in Group C with no proposed Commission comments:*

	Tax Preference	Comment
1	Fish Tax Differential Rates (Enhanced Food Fish Tax) (pg. 69)	No Proposed Commission Comment
2	Precious Metals and Bullion (B&O Tax, Sales and Use Tax) (pg. 143)	
3	Solar Energy and Silicon Product Manufacturers (B&O Tax) (pg. 155)	

2. *We will now take action on each of the preferences in Group C.*
3. *Is there any discussion on the above preference?*
4. *Is there a motion for the Commission to take action on this review?*
5. *Potential motion language:*

   "The Commission acknowledges receipt of the 2012 JLARC Tax Preference Review of [preferences being discussed]. The Commission has provided a forum for discussion and public comment on these reviews. The Commission (endorses) OR (does not endorse) the JLARC recommendation(s) for this review, (subject to the following additional comments.) OR (and does not have additional comments.)"

GROUP D: Review and clarify – endorse or not endorse; consider whether to provide a comments

1. *There are six tax preference reviews in Group D with proposed Commission comments:*

Tax Preference		Comment
1	Biotechnology Manufacturing Deferral/Waiver (Sales and Use Tax) (pg. 21)	Audit Staff recommendation: The Legislature should review and clarify this tax preference to determine if progress toward its biotechnology manufacturing objectives is sufficient and to consider identifying targets for investment and employment. Possible comment: The Commission does not endorse the recommendation that the Legislature should review and clarify this tax preference and recommends that the Legislature take no action and allow this preference to expire in 2017, as scheduled. Rationale for comment: The JLARC audit staff was unable to determine the impact, if any, this preference has had on encouraging investment and creating jobs. Additionally, there is no evidence that this industry needs this preference for unique competitive conditions. No testimony was provided by beneficiaries in support of continuing this tax preference.
2	Commuting Programs (B&O Tax, Public Utility Tax) (pg. 43)	Audit Staff recommendation: The Legislature should review and clarify this preference, because while it is providing a credit to businesses that provide financial incentives to their employees who participate in commute trip reduction activities, it is unclear whether the preference is meeting the broader public policy objective of increasing participation in commute reduction programs. Possible comment: The Commission endorses the recommendation that the Legislature should review and clarify the public policy objective of the preference and determine whether it is necessary any longer to encourage trip reduction activities. If the Legislature determines that this preference no longer is essential to achieve the implied public policy objective to encourage businesses to provide financial incentives to their employees to participate in trip reduction programs, the Legislature should terminate this preference. Rationale for comment: The Legislature did not specify a public policy purpose for this preference. JLARC staff inferred from the record that the implied public policy purpose is to encourage businesses to provide financial incentives to their employees who participate in commute trip reduction programs. This preference may no longer be essential to achieve the implied public policy objective because many businesses offer trip reduction financial incentives to employees as a standard component of their employee benefit programs. In 1994, the Department of Revenue stated that many firms already had commute trip reduction programs in place and tax credits were not expected to generate significantly higher participation in such programs. The Commission believes that termination of this preference would be unlikely to result in a material reduction in businesses' provision of trip reduction financial incentives to employees.

<table>
<tr><th colspan="2">Tax Preference</th><th>Comment</th></tr>
<tr><td>3</td><td>High Technology R&D Deferral/Waiver (Sales and Use Tax) and Credit (B&O Tax) (pg. 85)</td><td><u>Audit Staff recommendation</u>: The Legislature should review and clarify this tax preference to determine if progress toward its high technology R&D objectives is sufficient and to consider identifying targets for investment and employment.

<u>Possible comment:</u> The Commission does not endorse the recommendation that the Legislature review and clarify this tax preference and recommends that the Legislature allow the B&O tax credit and sales and use tax deferral/waiver to expire in 2015, as scheduled.

<u>Rationale for comment</u>: The JLARC audit staff study provided substantive evidence that these tax preferences created approximately 454 new jobs between 2004 and 2009 at an overall cost in terms of foregone tax revenue of approximately $20.5 million per year or $45,000 per job. However, new earnings per job were estimated to amount to $25,000. Even allowing for measurement errors, it is clear that the cost of these preferences greatly exceeds the estimated benefits. Industry representatives provided general information in support of these tax preferences. However, they did not provide tangible evidence to refute the findings of the JLARC staff study nor did they provide alternative evidence of a direct link between these tax preferences and significant job creation.

Industry representatives testified that competition from other states to attract high technology R&D companies is intense, but provided no evidence that investment in high technology R&D would decline meaningfully if this tax preference were terminated.

An industry representative testified that these preferences are important for industry profitability. However, since most participants in this industry are neither fledgling nor facing unique short-term competitive pressures, financially supporting the industry through these tax preferences appears to be of little or no value.

The Legislature’s objective to create “quality” employment opportunities in the state might be achieved more cost effectively in other ways such as partnering with the high technology R&D industry to provide educational and training programs that develop human resources skills needed by the industry.

In addition, a case could be made for providing a tax preference to new start-up companies in this industry during the first five years of their existence. However, the Legislature should study this type of limited tax preference for firms in this industry as a separate issue.</td></tr>
</table>

Tax Preference		Comment
4	Insurance Producers, Title Insurance Agents, and Surplus Line Brokers (B&O Tax) (p. 107)	Audit Staff recommendation: The Legislature should review and clarify the preferential tax rate for insurance commissions because it is unclear why the Legislature is providing different tax treatment to businesses with similar agent/sub agent relationships; and because the inferred objectives related to the inability of passing on rate increase and of consolidating rates may no longer apply. Possible comment: The Commission endorses the recommendation that the Legislature should review and clarify the public policy purpose of the preference and unless there is a compelling reason for a differential rate, the Legislature should increase the tax rate to provide equivalent tax treatment with businesses with similar agent/sub-agent relationships. Rationale for comment: The JLARC staff study documents numerous changes in this tax preference between its initiation in 1935 and the most recent change in 2009. Beginning in 1995 the Legislature has reduced the tax rate on insurance commissions from 1.172% of insurance commissions to 0.484%. The Legislature provided no economic or competitive rationale for the reductions in the tax rate. Over the same time period, the Legislature has reduced the tax rate on real estate commissions from 2.13% to 1.80%. It should be noted that pyramiding of B&O taxes applies to insurance agents but not to real estate agents, pursuant to a 1992 state Supreme Court case that ruled that insurance agents are not entitled to the same exemption that removed tax pyramiding for real estate agents. Adjusting the current insurance commissions tax rate for pyramiding results in a combined B&O tax rate of 0.726% compared to 1.80% for real estate services. In public testimony, representatives of insurance agents pointed out that commission rates are established by insurance companies. Thus, there are limitations on how agents can recover costs directly from policyholders if there is an increase in the insurance commissions B&O tax rate. However, no evidence was provided for why a lower tax rate relative to similar agent/sub-agent relationships in other industries is appropriate.

Tax Preference		Comment
5	Stevedoring and International Charter and Freight Brokers (B&O Tax) (pg. 175)	Audit Staff recommendation: The Legislature should review and clarify these two preferences because: 1) the public policy objective for why the Legislature chose the particular current preferential B&O tax rate for stevedoring and associated activities is unclear; 2) the public policy objective for providing the preferential B&O tax rate for international freight/charter brokers is unclear; and 3) the objective to consolidate B&O tax rates and classifications may no longer apply. Possible comment: "The Commission does not endorse the JLARC staff recommendation to review and clarify these two preferences and recommends that the Legislature should terminate both of these preferential tax rates." Rationale for comment: The apparent original intent of providing a preferential tax rate in 1979 was to maintain an equivalent tax burden after a U.S. Supreme Court decision eliminated the tax exemption of certain stevedoring activities. While the industry has argued that the preferential rate is justified for competitive reasons, the industry has never provided substantiation for this claim. In testimony provided to the Commission by a representative of these industries, no substantive evidence was provided that elimination of this preference would harm the competitiveness of Washington's ports materially. In response to a question during public testimony, an industry representative acknowledged no competing west coast ports in the U.S. receive a similar tax break. The JLARC staff study indicated that it is unclear that the preferential B&O tax rate has had any role in making Washington's ports more competitive. Therefore, the Commission recommends that the Legislature stop supporting these industries financially by terminating the preferential tax rates.
6	Travel Agents and Tour Operators (B&O Tax) (p.187)	Audit Staff recommendation: The Legislature should review and clarify the preferential tax rate for travel agents and tour operators because it is unclear whether the inferred public policy objectives of reducing the financial impact of DOR's 1975 rule change, providing equitable tax treatment with air carriers, and achieving administrative simplicity still apply in light of the changes to the industry since the time of enactment. Possible comment: "The Commission does not endorse the JLARC audit staff recommendation and recommends that the Legislature terminate the preferential tax rate for travel agents and tour operators." Rationale for comment: JLARC audit staff documented that circumstances in the travel industry have changed since this preference was established. Based on the JLARC staff analysis, it appears there are no longer competitive reasons to continue the preference and thus retention of the preference simply increases commissions for travel agents. Moreover, administrative considerations, which prompted the Department of Revenue to request the Legislature extend the preference to tour operators, no longer exist. Because there is no apparent compelling reason any longer for preferential tax treatment, the Legislature should terminate this preference.

2. *We will now take action on each of the preferences in Group D.*

3. *Is there any discussion on each of the above preferences: [proceed with the first item above]?*
4. *Is there a motion for the Commission to take action on these reviews?*
5. *Potential motion language:*

"The Commission acknowledges receipt of the 2012 JLARC Tax Preference Review of [preferences being discussed]. The Commission has provided a forum for discussion and public comment on these reviews. The Commission (endorses) OR (does not endorse) the JLARC recommendation(s) for this review, (subject to the following additional comments.) OR (and does not have additional comments.)"

GROUP E: Terminate – endorse or not endorse; consider whether to provide a comments

1. *There is one tax preference review in Group D with a proposed Commission comment:*

Tax Preference		Comment
1	Minor Final Assembly Completed in Washington (B&O Tax) (p.125)	Audit Staff recommendation: The Legislature should terminate the tax preference because of changes in federal import regulations, imported truck components are no longer being assembled at Washington ports, and there are no known beneficiaries of this deduction for minor final assembly. Possible comment: The Commission endorses the JLARC staff recommendation.

2. *We will now take action on each of the preferences in Group E.*
3. *Is there any discussion on each of the above preferences: [proceed with the first item above]?*
4. *Is there a motion for the Commission to take action on these reviews?*
5. *Potential motion language:*

"The Commission acknowledges receipt of the 2012 JLARC Tax Preference Review of [preferences being discussed]. The Commission has provided a forum for discussion and public comment on these reviews. The Commission (endorses) OR (does not endorse) the JLARC recommendation(s) for this review, (subject to the following additional comments.) OR (and does not have additional comments.)"

Additional Comments on Certain 2010 Tax Preference Studies and Commission Recommendations

<table>
<tr><th colspan="2">Tax Preference Reviewed in 2010</th><th>2010 Recommendation and Comments, Followed by 2012 Additional Commission Comment</th></tr>
<tr><td>1</td><td>Through Freight in Interstate Transportation (Public Utility Tax)</td><td><u>2010 Audit Staff recommendation</u>: Because this preference is no longer necessary constitutionally, the Legislature should terminate the preference providing a public utility tax deduction for intrastate portions of interstate shipments of goods under a through freight rate where the shipment is stopped in Washington to store, manufacture, or process the goods, then continues to the final destination.

<u>2010 Commission Comment</u>: The Commission does not endorse the recommendation. Although the existing preference is no longer constitutionally necessary, affected taxpayers have structured competitive activities in reliance on continuation of the preference. Because termination of the preference may have unintended deleterious consequences for taxpayers and more generally for the State, the Commission recommends that the Legislature direct either the Office of Fiscal Management-Department of Revenue or the Economic Revenue Forecast Council to conduct an economic impact study of the effects of termination on the competitiveness of affected taxpayers and the primary and secondary tax revenue impacts of termination. The Commission also recommends that Legislature consider whether the economic impact study should identify policy options, and the revenue impacts of such options, for restructuring the public utility tax for affected taxpayers.

The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review.

<u>2010 Commission Rationale for non-endorsement and recommendation for economic impact study</u>: Public testimony identified the potential for significant unintended adverse economic consequences for taxpayers and possibly for the State if the preference is terminated. Although very limited factual evidence was presented, there is a possibility that termination could result in loss of employment and other sources of State tax revenue that could exceed the amount of revenue raised by the public utility tax as a result of termination. While this possibility is uncertain, public testimony indicated a high likelihood that termination could lead to potentially serious disruptive consequences. Because of the uncertainty and absence of substantial factual information about potential impacts, the Commission believes that it would be prudent to conduct an economic impact study. The Commission believes the current tax preference is outdated, but rather than terminating the preference, consideration should be given to structuring the public utility tax for the affected taxpayers in ways that are tax efficient and enable tax payers to be competitive on an interstate basis. If the Legislature prefers to have an economic impact study conducted by a neutral party, it should direct the Economic Revenue Forecast Council to conduct the study; otherwise the study could be conducted by the Office of Fiscal Management-Department of Revenue.

<u>2012 Commission Additional Comment:</u> The Commission notes that the Legislature took no action on the Commission’s recommendation. The Commission reiterates its 2010 recommendation for the Legislature to mandate an economic</td></tr>
</table>

Tax Preference Reviewed in 2010		2010 Recommendation and Comments, Followed by 2012 Additional Commission Comment
		impact study. If the Legislature determines that conducting such a study is not desirable or cost effective, the Commission recommends that the Legislature terminate this preference as originally recommended in the JLARC staff study.
2	Instate Portion of Interstate Transportation (Public Utility Tax)	**<u>2010 Audit Staff recommendation</u>:** Because the U.S. Constitution no longer prohibits the instate portion of interstate transportation from being taxed, the public utility tax should be imposed on these activities. In order to implement this, the Legislature should provide specific authorization to the Department of Revenue to develop a method of apportioning transportation income generated from activities within the state. **<u>2010 Commission Recommendation</u>**: The Commission does not endorse the recommendation because it believes it is premature to authorize the Department of Revenue to develop an apportionment methodology. Although the existing preference is no longer constitutionally necessary, affected taxpayers have structured competitive activities in reliance on continuation of the preference. Because termination of the preference may have unintended deleterious consequences for taxpayers and more generally for the State, the Commission recommends that the Legislature direct either the Office of Fiscal Management-Department of Revenue or the Economic Revenue Forecast Council to conduct an economic impact study of the effects of termination on the competitiveness of affected taxpayers and the primary and secondary tax revenue impacts of termination. The Commission also recommends that Legislature consider whether the economic impact study should identify policy options, and the revenue impacts of such options, for restructuring the public utility tax for affected taxpayers. The study should also include recommendations for how to structure an apportionment methodology that complies with the guidelines established by the U.S. Supreme Court. The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review. **<u>2010 Rationale for Commission's non-endorsement and recommendation for economic impact study.</u>** The rationale is the same as that stated above for "Through Freight in Interstate Transportation Public Utility Tax Deduction". **<u>2012 Commission Additional Comment:</u>** The Commission notes that the Legislature took no action on the Commission's recommendation. The Commission reiterates its 2010 recommendation for the Legislature to mandate an economic impact study. If the Legislature determines that conducting such a study is not desirable or cost effective, the Commission recommends that the Legislature direct the Department of Revenue to develop an apportionment methodology for transportation income, as originally recommended in the JLARC staff study.

Tax Preference Reviewed in 2010		2010 Recommendation and Comments, Followed by 2012 Additional Commission Comment
3	Shipments to Ports for Interstate or Foreign Transportation (Public Utility Tax)	**2010 Audit Staff recommendation**: Since this tax preference is no longer required by the Constitution, the original public policy objective is no longer applicable. Statutory changes in 1949 and 1967, however, imply that the Legislature may have had additional policy objectives. Because the Legislature did not identify its objectives at those times, the Legislature should reexamine and clarify this preference to identify what, if any, public policy objectives still exist and how best to address them. **2010 Commission Comment**: "The Commission endorses the recommendation but suggests the Legislature conduct its reexamination of the intent of this preference in conjunction with an economic impact study that the Commission recommends be conducted to examine the potential impacts of the Audit Staff recommendations for "Through Freight in Interstate Transportation Public Utility Tax Deduction" and "Instate Portion of Interstate Transportation." The Legislature should specify that the study should be completed by December 31, 2011, to inform a decision during the 2012 Legislative Session. After the 2012 session, if the Legislature has taken no action, the Commission intends to determine whether it should schedule this preference for another review. **2010 Commission's Rationale for Comment**: Results of an economic impact study should assist the Legislature in determining whether and in what ways to clarify this tax preference and would enable consistent response to all of the 2010 recommendations involving the public utility tax. **2012 Commission Additional Comment:** The Commission notes that the Legislature took no action on the Commission's recommendation. The Commission reiterates its 2010 recommendation for the Legislature to mandate an economic impact study. If the Legislature determines that conducting such a study is not desirable or cost effective, the Commission recommends that the Legislature implement the JLARC staff recommendation to identify what, if any, public policy objectives still exist for retaining this preference.

1. *We will now take action on each of the 2012 additional comments above.*
2. *Is there any discussion on each of these additional comments: [proceed with the first item above]?*
3. *Is there a motion for the Commission to take action on these comments?*
4. *Potential motion language:*

"The Commission notes that the Legislature took no action on three recommendations from 2010: Through Freight in Interstate Transportation Public Utility Tax Deduction; Shipments to Ports for Interstate or Foreign Transportation Public Utility Tax Deduction; and Shipments to Ports for Interstate or Foreign Transportation Public Utility Tax Deduction. The Commission reiterates its 2010 recommendations for the Legislature to mandate an economic impact study of each preference. If the Legislature determines that conducting such studies is not desirable or cost effective, the Commission recommends (each of the 2012 additional comments above.)"

Possible General Comments

1. 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, Commission Chairman Longbrake asked the Legislative Auditor, Keenan Konopaski, two questions about the report.

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

<u>Question:</u> What are the Legislative Auditor's office's views on the six key questions the Pew Center posed for measuring economic impact?

<u>Motion:</u> The Commission requests that the Legislative Auditor's responses to Chairman Longbrake's questions be incorporated as part of the 2012 report to the Legislature.

The Pew Center Report: http://www.pewstates.org/research/reports/evidence-counts-85899378806

The Legislative Auditor's letter responding to the Chair's questions:
http://www.citizentaxpref.wa.gov/documents/PewReportQuestionsOct2012.pdf

2. Suggestions to improve the effectiveness in using of tax preferences to encourage job creation, economic development and growth.

Washington State is facing an ongoing challenge to fund critical programs. Simply put, program needs exceed revenue sources. For example, the Washington State Constitution declares it is the paramount duty of the state to provide ample education for all children. This last winter the Washington State Supreme Court ruled the state had failed in its paramount duty. The Court ordered the state to determine the actual cost of providing an education for all children that meets high academic standards. Most experts estimate it will take over $1 billion in new spending to reverse over 30 years of neglect of education and comply with the Supreme Court's order.

In this context, it is more important than ever to determine whether a tax preference is providing benefits to the state in terms of quality educational opportunities, job creation, economic development and growth that exceed the cost in terms of tax revenues foregone.

The legislative charge to the JLARC audit staff and to the Commission is to review tax preferences individually over a ten-year period and provide analysis and recommendations to the Legislature. Because of resource limitations, analysis of individual tax preferences to date generally has been limited to those which have the greatest monetary impact on tax revenues, although the analyses also often include an assessment of economic impacts.

Certain enhancements to the evaluation of tax preferences have been suggested to the Commission. Generally, these suggestions extend beyond the Commission's legislative charge and implementation would require additional resources.

The Commission believes that the following suggestions for enhancing the evaluation of tax preferences have merit and encourages the Legislature to give them consideration:

- The Commission should collaborate with other organizations, such as the Economic Development Commission, which are involved in evaluating tax preferences, to provide a more comprehensive assessment of the costs and benefits of tax preferences.

- A side-by-side analysis of tax preferences and expenditures for programs under the direction of the Department of Commerce, the Department of Employment Security, the Board for Community and Technical Colleges, the Washington Technology Center, and other organizations could uncover opportunities for increased program and tax efficiency. The question of interest is one of whether a policy objective can be better achieved by a tax preference, a program expenditure, or some combination of both.
- The Legislature should consider a *needs test* when enacting a tax preference. For example, an R&D tax credit may be very effective in promoting the development of innovative start-up firms but be relatively ineffective when made available to larger, established firms.
- The Legislature should consider requiring return on investment and net benefit analyses to evaluate the effectiveness of certain tax preferences. For such a mandate to be effective, sufficiency and quality of data are important. The Pew Center Report, "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth," stated: "*No state ensures that policy makers rely on good evidence about whether these investments deliver a strong return.*"
- Federal tax incentives and programs need to be understood and assessed to determine whether they are complimentary or a substitute for state tax preferences.
- There exists an extensive and growing number of national economic studies regarding the impacts of various types of tax preferences. The general conclusions of these studies should be useful in determining whether to enact new tax preferences and in evaluating existing tax preferences.

3. JLARC staff recommendations to the Department of Revenue and the Office of Financial Management

In a supplement to the High Technology R&D preference review, JLARC staff identified the need to improve the annual survey that the Department of Revenue uses to collect and report beneficiary information and the Office of Financial Management's Washington input/output model.

For the annual survey, JLARC staff recommended the Department of Revenue convene a work group to address how to improve the reliability and the accuracy of the information collected in the annual survey and reported to the Legislature and the public. For the input/output model, JLARC staff recommended the Office of Financial Management estimate the cost of including state government and local government as separate sectors within the Input-output model.

Motion: The Commission concurs with the JLARC staff recommendations to the Department of Revenue and the Office of Financial Management.