



PB 11-05  
April 5, 2011

## CLARIFYING THE ROLE OF TAX PREFERENCES

### BRIEFLY

Many tax preferences serve to reduce distortions in the tax system and thereby level the playing field.

As the legislature struggles to write a budget for the 2011–13 biennium, advocates for various spending programs are calling for the state to raise additional tax revenues by closing “loopholes” in the tax system. Particularly targeted are tax preferences—a less pejorative term than loopholes—that benefit businesses.

Washington businesses already bear among the nation’s heaviest tax burdens. Ernst & Young calculates that businesses paid Washington’s state and local governments \$14.7 billion in taxes during the 2009 fiscal year. This was 51.2 percent of all taxes the 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 for 13th highest and six tenths of a percentage point greater than the 4.7 percent national average (Ernst & Young 2010).

The business tax burden would be considerably higher if it were not for a number of tax preferences: exemptions, deductions, deferrals, credits and special rates. In addition to lowering the overall tax burden of business, preferences play special roles in normalizing the tax structure. Although they are

sometimes described as incentives, more often than not they serve to offset disincentives that our tax system would otherwise create against the economic development. This is especially the case with respect to preferences related to sales taxes on business input purchases and the business and occupation (B&O) tax, which together account for nearly one-half of the business tax burden.

State tax systems ought to be judged according to five criteria of good taxation: economic neutrality, fairness, administrative simplicity, transparency and stability (WRC 1998). Economic neutrality, the principle that tax systems should be designed to minimize distortions in

economic decision making, is especially important for evaluating tax preferences: many preferences are intended to reduce distortions in the tax system and thereby level the playing field.

### Critics Begin with State Tax Exemptions Report

The primary resource in the hunt for funds is the Department of Revenue’s quadrennial publication *Tax Exemptions*. Unfortunately, the DOR inventory has a serious defect as a framework for reviewing the state’s tax exemptions and preferences. The problem here lies less in the *Tax Exemptions* inventory itself and more with the misapplication of the information it contains.

The terms tax exemption, tax preference and tax expenditure are used interchangeably by legislators.

RCW 43.06.400: “As used in this section, ‘tax exemption’ means an exemption, exclusion, or deduction from the base of a tax; a credit against a tax; a deferral of a tax; or a preferential tax rate.”

RCW 43.136.021: “As used in this chapter, ‘tax preference’ means an exemption, exclusion, or deduction from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate.”

Senate Bill 5857 (2011): “As used in this section, ‘tax expenditure’ means an exemption, exclusion, or deduction from the base of a tax; a credit against a tax; a deferral of a tax; or a preferential tax rate.”

*Tax Exemptions* is an example of what fiscal policy experts call a “tax expenditure budget.” The tax expenditure concept is attributed to the late Stanley Surrey, a Harvard law school professor who served as Assistant Secretary of the Treasury for Tax Policy in the Johnson Administration.

Essentially, the tax expenditure concept, as applied to an income tax, regards such a tax as composed of two distinct elements. The first element contains the structural provisions necessary for implementation of a normal income tax . . . The second element consists of the special preferences . . . These departures from the “normative” income tax structure essentially represent government spending for the favored activities or groups through the tax system rather than through direct grants, loans, or other forms of government assistance. (Surrey and McDaniel 1979, pp. 227-228)

The same principles—defining the normative system then marking exceptions—apply to business and sales taxes.

### **Key Flaw: Failure to Properly Define Base Tax Structure**

A 2009 report from the Center for Budget and Policy priorities found that 41 of the states prepare some kind of tax expenditure report. (Levitis et al. 2009)

According to Indiana University economist John Mikesell, the most significant flaw states make when preparing tax expenditure budgets involves the manner in which they divide “the tax structure into normal and preference elements; states need greater attention to defining their basic tax structure if they are to have a meaningful tax expenditure budget” (Mikesell 2002).

Ideally, the benchmark normal tax base should be selected by the logic of good tax policy. Mikesell calls this the *conceptual baseline* approach and notes that it requires “a clear statement of what state tax policy actually is—not just an indication of how much money the state wishes to collect, but a conception of how the revenue raised should ideally be distributed across the private sector. It demands close attention to policy fundamentals” (Mikesell 2002, p. 46). For an income tax, the base should be a broad measure of income, such as the comprehensive measures employed by the Office of Management and Budget and Congress’s Joint Committee on Taxation in their analyses federal tax expenditures. For the retail sales tax, Mikesell says, an appropriate base would be total household consumption. West Virginia’s tax expenditure budget, for example, acknowledges household consumption to be the ideal base for the sales tax (see the box to the left).

Washington’s *Tax Exemptions* study uses what Mikesell calls a *reference law baseline* rather than a conceptual baseline. This approach identifies tax expenditures according to statutorily specified exemptions and exclusions rather than deviations from accepted principles of good tax policy. Under the reference law approach, some tax provisions that reduce revenue may be

deemed to be part of the normal or baseline structure of the tax if analysts perceive the provisions define the normal base. The RCW section governing the tax exemption study is reproduced on page 3.

In Washington state’s case, it is particularly important to get the baseline right for sales taxes because Washington state government raises an unusually high share of its general fund revenue from sales taxes (WSTSSC 2002, p. 12). Gen-

#### **From the West Virginia Tax Expenditures Study:**

All Consumers Sales and Service Tax and Use Tax provisions involving exclusions, exemptions, or deductions are analyzed in this report. While several of these provisions constitute government expenditure programs, some provisions are presumably part of a model sales tax structure, and certain others are integral components of a basic sales tax structure. In a tax expenditure study, it is important to differentiate expenditure programs from basic structural components through comparison with a model tax structure. A model sales tax should

1. apply to all consumption expenditures at a uniform rate;
2. apply only to consumption expenditures and not to inputs of production;
3. conform to accepted equity standards of the society;
4. have minimal compliance and administration problems, and
5. provide a stable and growing tax base for the taxing authority.

**RCW 43.06.400**

Beginning in January 1984, and in January of every fourth year thereafter, the department of revenue shall submit to the legislature prior to the regular session 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 listing shall include an estimate of the revenue lost from the tax exemption, the purpose of the tax exemption, the persons, organizations, or parts of the population which benefit from the tax exemption, and whether or not the tax exemption conflicts with another state program. The listing shall include but not be limited to the following revenue sources:

- (1) Real and personal property tax exemptions under Title 84 RCW;
- (2) Business and occupation tax exemptions, deductions, and credits under chapter 82.04 RCW;
- (3) Retail sales and use tax exemptions under chapters 82.08, 82.12, and 82.14 RCW;
- (4) Public utility tax exemptions and deductions under chapter 82.16 RCW;
- (5) Food fish and shellfish tax exemptions under chapter 82.27 RCW;
- (6) Leasehold excise tax exemptions under chapter 82.29A RCW;
- (7) Motor vehicle and special fuel tax exemptions and refunds under chapters 82.36 and 82.38 RCW;
- (8) Aircraft fuel tax exemptions under chapter 82.42 RCW;
- (9) Motor vehicle excise tax exclusions under chapter 82.44 RCW; and
- (10) Insurance premiums tax exemptions under chapter 48.14 RCW.

The department of revenue shall prepare the listing required by this section with the assistance of any other agencies or departments as may be required.

The department of revenue shall present the listing to the ways and means committees of each house in public hearings.

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.

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

eral sales taxes (i.e. the retail sales and use taxes and the B&O tax) provided 69 percent of general fund-state revenue in 2009, while selective sales taxes (e.g. cigarette and liquor taxes) provided another 7 percent.

Note that we have classified the B&O tax as a sales tax. While many legislators believe the B&O is akin to a corporate income tax, public finance experts see it as a sales tax (Musgrave and Musgrave 1984, p. 397; ITEP 2011, p. 14-15). Revenue from the B&O is equal to one-third of the amount received from the retail sales and use taxes (\$2.5 billion versus \$7.2 billion in FY 2009). The value of transactions subject to the B&O is much greater than the value subject to the retail sales tax (\$416.6 billion versus \$100.4 billion in CY 2009).

From the point of view of economic efficiency, the problem with sales taxes is pyramiding. Consider a man's shirt. The state collects sales tax (both retail sales tax and B&O) when a store sells a shirt. Should the state collect sales tax when a shirt maker sells the shirt to the retailer? What about the shirt maker's purchases of cloth, thread and buttons? It is intuitively clear to most people that it is not right to tax a good multiple times as it moves through the chain of production. Washington's sales tax does provide a retail sales tax exemption for goods purchased for resale, and this exemption does apply to the retailer's purchase of the shirt and the shirt maker's purchases of cloth, buttons and thread. These transactions are subject to the B&O, however. The Department of Revenue analysts who prepare the tax exemption study deem the exemption of purchases for resale to be part of the baseline for the retail sales tax and do not list it as an exemption.

Returning to the shirt maker, there are other things she purchases that are critical to the production and sale of shirts—for example, needles, thimbles, paper on which catalogs and invoices are printed, ink and telephone service, which are not physically incorporated into the shirt in the same way that cloth, thread and buttons are. Because these things are not incorporated into the shirt, the resale exemption does not apply, and the shirt maker is forced to pay retail sales tax on them all.

From the point of view of good tax policy, the differentiation the tax code makes between shirt maker's cloth, thread and buttons on one hand and her needles, thimbles and telephone service on the other is a distinction without a difference. All are inputs to the shirt-making business, and all should be exempt from sales tax.

Applying the sales tax to business input purchases is bad because it creates non-uniformity in taxation. Taxes as a share of the final product price will vary between firms producing the same product depending on the degree to

which production is vertically integrated. And it will vary across industries depending on the complexity of production processes.

Tax policy experts generally conceive the sales tax to be a tax on consumption and agree that businesses should not pay sales tax (retail sales or B&O) on input purchases. Mikesell expresses it this way: “Full exclusion of all production inputs from state sales taxation is consistent with ideas of efficiency that should drive tax policy in a market economy” (Mikesell 2001a, p. 557). Similarly, the Institute on Taxation and Economic Policy (ITEP) concludes “the exemption from the sales tax of most purchases made by businesses is actually good policy” (ITEP 2011, p. 20).

The Washington Tax Structure Study Committee said this about the B&O: “Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax on goods as they move through the production chain is a fundamental problem that requires correction” (WSTSSC 2002, p. 30). The Committee’s recommendation that the B&O be replaced by a value added tax (WSTSSC 2002, pp. 39-40) can be read as a statement that the appropriate baseline against which to measure tax expenditures for sales taxes is a value added tax.

Many of the tax preferences that are under attack lessen the amount of pyramiding in the retail sales and use taxes and the B&O tax. They move the taxes towards rather than away from the appropriate benchmark normal tax.

### **Manufacturing Machinery and Equipment**

The existing retail sales tax exemption for machinery and equipment (M&E) directly used in manufacturing is a good example. Because of this exemption, which was put in place in 1995, the shirt maker mentioned above would not pay retail sales tax on the purchase of a sewing machine.

Legislators correctly perceived that imposing sales tax on machinery and equipment provided a disincentive to investment in manufacturing in the state. Mikesell observes “when capital purchases are subject to the sales tax, businesses have less incentive to invest in new equipment, machinery and structures. The reduction in investment retards labor productivity growth and, ultimately, wage growth” (Mikesell 2001a).

One study has estimated that the M&E exemption would increase M&E investment by 22.3 percent over a ten-year period, and add 54,000 jobs. (Urbanchuk 2008)

In a 2001 paper, Mikesell found that 28 states provided a general exemption for machinery and equipment used directly in manufacturing; four states provided exemptions limited to new and expanding industries; and three states provided reduced tax rates for purchases of manufacturing machinery and equipment (Mikesell 2001a, pp. 560-561).

### **Letter of Demands**

A “Letter of Demands” delivered to the Governor and Legislature attributed to the state labor council declared war on business tax exemptions: “Instead of cutting vital services, the legislature should be cutting the billions in wasteful corporate tax breaks that aren’t even being reviewed” (Shannon, 2011; wearewashington, 2011).

The letter explicitly decries “millions in tax breaks for big out-of-state banks. The tax preference at issue here is the B&O tax deduction for interest earned on first mortgage loans for residential property. The problem with eliminat-

ing this deduction is that the additional tax paid by the mortgage holders will be passed on borrowers in the form of higher mortgage interest rates.

A common proposal is to extend the retail sales tax to professional services (e.g. legal, accounting, architectural and engineering services). The problem with this is that purchases by businesses account for 75 percent of in-state sales of professional services. Applying the retail sales tax to these purchases would increase the amount of pyramiding. The Washington Tax Structure Study Committee concluded that professional services are “difficult to tax under a retail sales tax because they would pyramid” and recommended extending the sales tax to consumer services but not to professional services (WSTSSC 2002, pp. 41-42, 74).

Setting aside the pyramiding problem, much of the burden of increased business taxes would be shifted forward onto customers or backward onto workers. Only a small fraction would be borne by the “corporations.”

ITEP (the research arm of the labor-backed Citizens for Tax Justice) notes that sales taxes on business inputs tend to be passed on to customers:

These business-input sales taxes add to the cost of producing goods and services, and therefore [are] mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business inputs will usually hurt low-income taxpayers. (ITEP 2011, p. 13)

A 50-state study presented at the 2009 annual meeting of the national tax association examined the economic incidence of taxes on business. It found when business taxes in Washington are increased by \$100 million, \$52 million of this cost is shifted forward onto in-state consumers, \$29 million is shifted back onto workers, \$1 million is shifted back to in-state capital, and \$18 million is exported. (Cline et al. 2009)

### **Citizen Commission**

None of this is to say that tax preferences should not be carefully examined. The state already has in place a good process to do this.

The 2002 report of the Washington State Tax Structure Study Committee recommended that the Legislature “periodically review exemptions and incentives with the intent of removing those that do not yield the promised benefits or those that have outlived their useful life.” In 2006 the legislature set in motion a measured process to do this: the Citizen Commission for Performance Measurement of Tax Preferences.

The Citizen Commission has 7 members. Five are appointees: two by the House, two by the Senate, and one by the Governor. There are also two non-voting members: the State Auditor and the Chair of the Joint Legislative Audit and Review Committee (JLARC). JLARC staff provides staff work for the Citizens Commission.

The Commission is to review all tax preferences at least once every ten years. Each review is to evaluate whether the public policy objective is being met and provide recommendations to continue, modify, schedule for future review, or terminate the preference. The Commission is now in its fifth year.

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## Discussion

The contention that there are billions of dollars of tax loopholes riddling Washington's tax structure is meritless. A careful analysis of business tax preferences makes clear that the vast majority of them have been adopted to offset disincentives, reduce distortions, avoid "pyramiding," and create a level playing field for instate enterprises. Other preferences described as business tax breaks—the absence of a sales tax on services or a B&O exemption for first mortgage income—directly benefit consumers. As lawmakers have discovered over the years, loophole mining rarely yields much gold.

Of course, the tax code should be regularly evaluated. Systematic, thoughtful and object review of tax preferences, such as that conducted by the Citizen Commission, may indicate that some no longer make good fiscal policy sense. And when they don't, they should be repealed.

Clearly, however, this year's focus on exemption review, as the "Letter of Demands" makes clear, has been driven by a search for more money for the state budget. It has little to do with responsible tax policy. And it comes with considerable risk. A repealed tax preference is a tax increase. And the voters' last year set a high bar for tax increases. At this stage in the economic recovery, that high standard is appropriate. We should be careful about increasing business costs. By raising taxes on business, we will make the recovery, as painfully slow as it has been up to now, even slower.

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