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Every Dollar Counts: Why it's Time for Tax Expenditure Reform

By Andy Nicholas

Introduction

The Great Recession has exposed a key flaw in Washington's state budget process: our failure to systematically account for billions of dollars spent each year on the hundreds of special tax exemptions, credits, preferential rates, and other tax preferences or "tax expenditures." Now more than ever, effective management of our state resources requires that lawmakers review and prioritize all forms of state spending — from direct spending on education and health care to hidden spending on tax subsidies for various businesses and individuals.

This year, policymakers have an opportunity to enact common-sense tax expenditure reforms that would bring greater accountability and transparency to our state budget process. Without long-term tax expenditure reform, policymakers will not have the flexibility or the tools needed to make practical and balanced choices as our state rebuilds from the worst economic crisis of the post-World War II era.

Key reforms that would allow policymakers to routinely balance the costs and benefits of tax expenditures against other public priorities include:

- ***Establishing routine oversight by requiring expiration dates for all tax expenditures:*** Forcing tax expenditures to expire or "sunset" periodically would ensure they receive thorough and regular reviews by the legislature — a dynamic that is missing from the current budgeting process.
- ***Improving fiscal management by allowing tax expenditures to be modified via a simple majority in the legislature:*** The current budgeting process in our state requires tax expenditures to be modified or eliminated through a supermajority (two-thirds) vote in the legislature, while eliminating spending on public services only requires a simple majority vote. Treating these forms of spending differently undermines policymakers' ability to make balanced and rational decisions about public priorities. Removing this disparity would lead to improved management of our scarce state resources.
- ***Fostering transparency through an executive tax expenditure budget:*** Every two years, the Governor develops a biennial budget proposal that sets the stage for spending priorities in the coming bien-

nium. Missing from this proposal are the billions of dollars spent on tax expenditures. Requiring the Governor to submit a tax expenditure budget — detailing all tax expenditures and their ongoing costs — with her budget proposal would help create a more complete view of state spending during the budget process.

- ***Ensuring tax expenditures are cost-effective by enhancing audit and review structures:*** Enlarging the scope of tax expenditures subject to state audits, granting greater flexibility to our existing audit agencies, and requiring the legislature to act on tax expenditure performance evaluations would allow policymakers to weed out wasteful, ineffective, or obsolete tax expenditures. Doing so would free up resources needed for more pressing priorities, such as maintaining investments in education, programs for seniors, and other community services.
- ***Enforcing accountability by enacting strict eligibility requirements for businesses that receive tax expenditures:*** Washingtonians should not subsidize businesses that ship jobs to other states or countries. At the very least, businesses receiving tax expenditures should be required to maintain a minimum number of employees and facilities in Washington state. Just as our state imposes stringent eligibility requirements on workers and families that receive basic public supports — such as child care assistance, housing vouchers, and state-supported health care services — businesses that receive tax subsidies should also be held accountable to taxpayers.

During the current legislative session, policymakers have an opportunity to reform Washington's unbalanced budgeting process. The reforms listed above would bring clarity and transparency to the billions of dollars spent each year on special tax expenditures. These reforms would provide a more holistic view of our state budget and would give elected officials the necessary tools to make sound, balanced decisions during future recessions and other state emergencies.

Tax Expenditures: Spending by Another Name

There are at least 567 tax expenditures in Washington state, which include a range of exemptions, credits, preferential rates, deferrals, and other tax preferences.[1,2] In aggregate, tax expenditures cost Washington state taxpayers billions of dollars in foregone resources each year.[3] While they are commonly thought of as tax cuts, most economists and public finance experts agree tax expenditures should be treated as state spending or as subsidy programs. This is because tax expenditures — also referred to as tax subsidies or tax preferences — have the same fundamental attributes as direct state spending on education, health care, and other public services. Some of these shared attributes include:

- **Tax expenditures have the same impact on the state budget:** Tax expenditures impact the state budget in the same way direct spending programs do — that is, they reduce available state resources that could be used for other public priorities. For example, $1 million in business and occupation (B&O) tax credits for research and development has the same impact as a $1 million appropriation to state universities for the same purpose.
- **Tax expenditures can benefit specific groups:** Like direct spending programs, such as health care for lower-income families, tax expenditures can be targeted to benefit a narrow array of businesses or individuals. For example, in 1997 a sales tax exemption on purchases of coal was approved for coal-fired facilities that generate electricity (coal-fired power plants). The exemption was written so narrowly that it can only be claimed by a single coal-fired facility located outside the city of Centralia.

- **Narrow tax expenditures impose higher costs on the majority of taxpayers:** The costs of spending programs for specific populations — such as supports for foster children or services for disabled seniors — must be paid by other taxpayers. The same is true of tax expenditures, which is why most economists view them as tax subsidy programs. Figure 1 shows that our general sales tax rate must be higher to compensate for the costs of tax expenditures. As the graph shows, without reducing revenues needed to fund basic public services, the current 6.5 percent sales tax rate could be lowered to 5.3 percent by eliminating the sales tax exclusions on personal and professional services. The rate could be further lowered to 4.2 percent by ending all business tax expenditures.

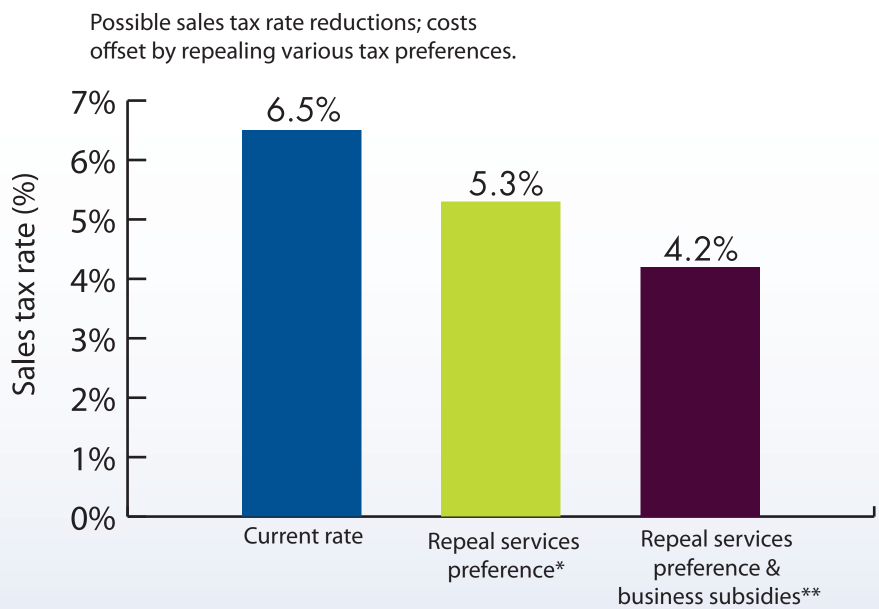
Economists and public policy experts along all points of the political spectrum share the notion that tax expenditures are properly viewed as state spending programs. Box 1 provides quotes from both progressive and conservative public finance experts about the need for tax expenditure reform.

Tax Expenditures Lack Transparency

Even though they have a large impact on the state budget, tax expenditures in Washington state are largely exempt from the accountability and transparency structures applied to other forms of state spending. As a result, during the current biennium spending on tax subsidies has remained virtually untouched while core public services — from education to public safety — have weathered excessively deep and painful cuts. The lack of tax expenditure transparency is due to the following factors:

- **Tax expenditures are not part of the state budget process:** State spending on education, health care, public safety, and other services is rigorously exam-

Figure 1: Overall tax rates must be higher due to tax expenditures



Source: Budget & Policy Center calculations of data from DOR.
*Sales tax exemption on personal and professional services. Assumes the B&O rate for services is reduced to the retailing rate.
**All business tax incentives and preferences.

Box 1: A bi-partisan consensus: tax expenditures are spending programs.

Public finance experts on both ends of the political spectrum agree that tax expenditures are spending programs that warrant the same scrutiny and transparency as all other forms of spending.

According to the conservative Tax Foundation:

"Tax expenditures are properly viewed as government spending or subsidies funneled through the tax code instead of through appropriations bills and direct spending programs.[...]Unfortunately, they rarely receive the same scrutiny as direct spending and are effectively hidden away from taxpayers. This violates transparency and distorts the actual size of government. If these activities truly deserve to be subsidized by taxpayers then they should be subjected to the same scrutiny as direct spending programs." [a]

The progressive Center on Budget and Policy Priorities concludes:

"[T]ax expenditures — which can cost the state tens, perhaps hundreds, of billions of dollars per year in forgone revenue — are likely to cause fiscal problems if they are not treated in ways that are parallel to direct expenditures.[...] Public finance experts generally agree that tax expenditures should be viewed in much the same light as direct spending. Indeed, tax expenditures are often said to be spending masquerading as tax cuts." [b]

Martin Feldstein, former chief economic advisor to President Ronald Reagan and current professor of economics at Harvard University, details the effect tax expenditures have on the federal deficit:

"[T]ax expenditures increase the deficit by hundreds of billions of dollars a year, more than the total cost of all non-defense programs other than Social Security and Medicare. [...Reducing tax expenditures] would increase revenue without reducing incentives to work, save or invest." [c]

a. Lawrence Summers, "The Hidden Side of Government Spending in the Limelight", Tax Foundation, July, 2010.

b. Jason Levitis, et al, "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center on Budget and Policy Priorities, April, 2009.

c. Martin Feldstein, "How to cut the deficit without raising taxes," The Washington Post, November, 2010.

ined during the biennial budget process. Each line of the state budget is thoroughly and transparently reviewed by state agencies, the Office of Financial Management (OFM), legislators and legislative committee staff, and various state audit agencies. Because they are excluded from the budget process, tax expenditures receive nowhere near the same level of public scrutiny.

- **Tax expenditures are open-ended:** While spending on public services must be re-appropriated every two years, most tax expenditures have no effective termination date. Once enacted, they remain in place for years or decades; their ongoing costs receiving little or no attention from policymakers. Figure 2 shows that only 37 (12 percent) of the 301 tax expenditures that would raise revenue if repealed have been given an expiration or "sunset" date. The open-ended nature of tax expenditures also means their costs can grow out of control. See Box 2 for more details.

- **Excessive restraints make tax expenditures difficult to modify:** Spending on essential services like education and health care can be cut with a simple majority vote in the legislature. Tax expenditures, however, can only be modified or repealed via supermajority (two-thirds) vote. This inconsistent treatment of otherwise like forms of spending greatly undermines policymakers' ability to allocate scarce state resources efficiently and productively.

- **Policymakers are not required to act on tax expenditure audit recommendations:** Currently, the Joint Legislative Audit Committee (JLARC) is required to conduct performance evaluations of most tax preferences over a ten-year period. Elected officials, however, are not required to act on JLARC's recommendations. Of the 95 tax pref-

Box 2: Lack of tax expenditure oversight leads to uncontrolled costs.

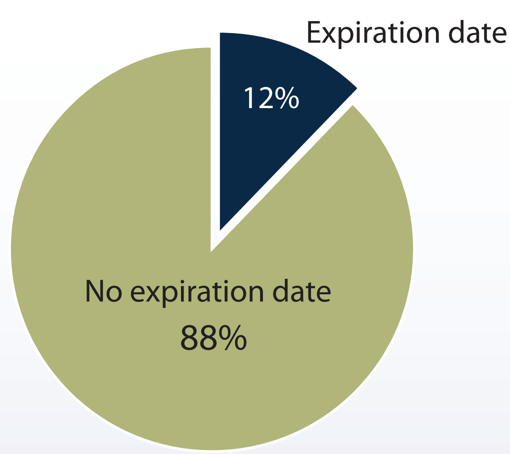
Without routine legislative oversight, tax expenditures that have been in place for decades (many since the 1930's) have grown well beyond their original intent. In part, this is because old tax expenditures have never been updated to account for decades of technological and economic progress. As a result, once narrow tax preferences have since grown to encompass a host of advanced products and services unheard of in previous generations.

For example, in 1974 a broad sales tax exemption on all prescription drugs was created. Certainly, there are valid reasons to exempt medically essential prescription drugs like heart medications, cancer drugs, antibiotics, and others from taxation. But this exemption now includes nonessential or purely cosmetic prescription drugs developed after 1974 – such as sexual enhancement drugs like Viagra, or hair loss medications like Propecia.

The Department of Revenue estimates the broad exemption on prescription drugs will cost taxpayers approximately $390 million in the current fiscal year – a cost that will continue to rise as more cosmetic and nonessential prescription drugs are developed in the coming years.[a]

[a] The Department of Revenue, "Tax Exemptions – 2008: A Study of Tax Exemptions, Exclusions, Deductions, Deferrals, Differential Rates and Credits for Major Washington State and Local Taxes," January 2008.

Figure 2: Only 37 of 301 tax expenditures have an expiration date*



Source: Budget & Policy Center calculations of 2008 tax expenditure data from DOR.
*All tax preferences that would raise revenue if repealed.

erences reviewed to date, JLARC has recommended that 24 be terminated, or clarified by the legislature. In aggregate, these 24 tax expenditures cost taxpayers an estimated $314 million per year.[4] So far, the legislature has not terminated or clarified a single tax preference reviewed by JLARC.

The factors detailed above have created a distorted and incomplete budget process in our state. While many tax expenditures have a valid public purpose, the barriers that surround them impede lawmakers' ability to make rational choices about state investments. These barriers prevent policymakers from curtailing or eliminating wasteful tax subsidies and reallocating those dollars to more productive uses, like investments in higher education or worker retraining programs.

What Policymakers Can Do

The Great Recession — and the huge toll it has taken on our vital public systems — has shown that Washingtonians can no longer afford our narrow and distorted state budget process. The five long-term reforms detailed below would shed much-needed light on the immense, but largely hidden, costs of tax expenditures in Washington state. These long-term reforms would improve fiscal management by creating a more complete view of total state spending.

Apply Sunset Dates

Establishing regular expiration or "sunset" dates for all existing, reenacted, and newly proposed tax expenditures would do much to improve our state budget process. Ideally, all tax expenditures should be directly integrated into the state budget. Practical and legal constraints would make this extremely difficult for many tax expenditures, however. An effective alternative would be to establish routine sunset dates for all tax expenditures. Applying sunset dates would:

- **Establish regular reviews by elected officials:** In deciding whether to renew expiring tax expenditures, officials would be forced to examine how their merits and costs align with other state spending priorities — a dynamic that is absent from our current budget process.
- **Provide opportunities to modify, clarify, or eliminate tax expenditures:** With routine sunset dates in place, wasteful or ineffective tax expenditures could be allowed to expire, freeing up resources for more efficient uses. In addition, this approach would allow officials to update or clarify the many older tax expenditures that have no stated intent or public purpose — i.e. job creation or reducing taxes for poor or elderly populations.
- **Create parity with other spending programs:** At least once every two years, advocates for education, health care, and other public services must defend funding for these programs before the legislature and the public. There is no such requirement for businesses and individuals that benefit from most tax expenditures. Once created, the recipients of tax expenditures are rarely required to justify these public expenditures at legislative hearings. Establishing sunset dates would end this disparity by requiring recipients of tax expenditures to regularly explain and defend their use of public funds.

Other states have taken the lead

In 2009, the state of Oregon established sunset dates for most existing corporate and personal income tax credits. Under House Bill 2067B, Oregon state tax credits were assigned one of three sunset dates, the last of which occurs on January 1, 2016. The measure also created a default sunset date for new tax credits, forcing them to expire six years after enactment unless specified otherwise. Similarly, the Nevada State Constitution stipulates that all newly enacted tax expenditures include an expiration date.[5]

Policymakers in Washington should take similar steps to improve tax expenditure transparency in our state. Officials should build on the approaches taken in Oregon and Nevada by routinely applying expiration dates to all existing, reenacted, or newly proposed tax expenditures.

Modify the Supermajority Requirement

Under the onerous supermajority requirement, it is extremely difficult for policymakers to eliminate or modify wasteful tax expenditures. While spending on education and other services can be cut with a simple majority vote in the legislature, cutting tax expenditures requires a two-thirds (supermajority) vote or a vote of the people. This disparity distorts rational decision-making, placing an inappropriate amount of power in the hands of a small minority of lawmakers. The requirement means that a mere handful of legislators, who favor a particular tax preference, can derail efforts to reinvest those funds in more pressing or efficient uses.

Allowing tax expenditures to be cut via a simple majority vote would give policymakers greater flexibility in constructing future budgets.

Create a Tax Expenditure Budget

Every two years, the Governor develops and presents a budget to the Legislature that allocates state spending based on what is determined to be the priorities of our state. Missing from this budget proposal is the inclusion of any tax expenditures. Requiring the Governor to develop a tax expenditure budget along with her standard biennial budget would improve tax expenditure accountability and transparency. Executive tax expenditure budgets are routinely produced in at least six states (many others produce detailed tax expenditure reports) and typically include detailed information on tax preferences — including policy goals, current and projected costs to the state and local governments, and relevant performance information.[6]

Though the Department of Revenue currently produces a tax exemption report, these reports are produced only once every four years and are not part of the formal executive budget proposal. Because it would be created as part of the Governor's routine budget development process, a true tax expenditure budget would more closely align the cost of tax expenditures with direct spending on state programs.

Introduced in 2007, House Bill 1827 would have created an executive tax expenditure budget in Washington.[7] This bill would serve as an ideal template for legislation in the current year. The tax expenditure budget in this measure would:

- Include a listing of all tax expenditures, categorized by the function or program they support;
- Contain tax expenditure performance information from the Joint Legislative Audit and Review Committee (JLARC) and the Citizen Commission for Performance Measurement of Tax Preferences (Citizen Commission); and
- Require the Governor to recommend whether tax expenditures scheduled to expire in the coming biennium should be continued, allowed to expire, or modified.

Enhance Tax Expenditure Audits

The Joint Legislative Audit and Review Committee (JLARC) conducts performance evaluations of most tax preferences over a 10 year period. JLARC's evaluations are overseen by a Citizen Commission. Many tax expenditures were created without a clearly defined public purpose, however. And JLARC cannot effectively evaluate tax expenditures that have no explicit policy goals. In addition, policymakers seldom act on JLARC's recommendations. (JLARC has recommended that 26 tax preferences be terminated or clarified; the legislature has not acted on a single one of these recommendations.[4]) The following policy changes would enhance JLARC's ability to conduct tax expenditure evaluations and would ensure its findings are considered by elected officials.

- **Allow JLARC to examine all tax expenditures:** Under current law, JLARC is prohibited from reviewing a number of costly tax expenditures — such as the sales and use tax exemptions for manufacturing equipment, research and development, food, and prescription drugs; property tax relief for seniors; and others. While these expenditures have justifiable public purposes, excluding them from review makes it difficult for policymakers to review their ongoing costs and benefits. Excluding them also undermines officials' ability to update tax expenditure laws as our economy changes. Accordingly, policymakers should allow JLARC to systematically review all tax expenditures.
- **Require the legislature to act on JLARC's recommendations:** When JLARC recommends that tax expenditures be terminated, allowed to expire, or clarified by the legislature, those expenditures should automatically expire at the end of the current fiscal year. Alternatively, policymakers could enact legislation that automatically sunsets all tax expenditures reviewed by JLARC each year. Both approaches would ensure that the legislature acts affirmatively on tax expenditure audit findings.
- **Give JLARC and the Citizen Commission greater flexibility to conduct and schedule reviews:** Current law requires the Citizen Commission and JLARC to schedule tax expenditure reviews based on the year in which they were enacted. They are also required to perform more detailed audits on tax expenditures that cost more than $10 million per biennium. Given the limited resources available to conduct evaluations, these arbitrary requirements should be modified to allow for a more efficient review process. As recommended by a Task Force on Tax Preferences, which convened in the Summer and Fall of 2010, JLARC and the Citizen Commission should be allowed to efficiently schedule reviews in groupings, such as by industry type or by policy goals. Policymakers should also allow JLARC and the Citizen Commission to determine the appropriate level of review for each tax expenditure.[8]

Expand Performance-Based Requirements

Businesses that receive tax expenditures should be held accountable for their use of taxpayer dollars. Families in our state who receive child care, health care, and other state supports are subject to strict reporting and eligibility requirements. Businesses that work with the state are subject to strict performance based contracts to ensure they meet goals set out by our state. But many business tax expenditures do not include similarly stringent accountability measures. The following proposals would ensure that businesses are using tax expenditure dollars to efficiently achieve public goals:

- **Develop objectives and performance criteria for business tax expenditures:** Many business tax expenditures have no stated public purpose or policy objective. Lawmakers should update the tax code and establish a well-defined public purpose, along with a set of evaluation criteria, for each tax expenditure. For example, tax expenditures enacted to create jobs should stipulate a minimum number of jobs to be created, average salary and benefit levels of those jobs, and a maximum cost to the state per job created.
- **Expand the use of preconditions for business tax expenditure recipients:** All newly enacted business tax expenditures should include minimum eligibility requirements — such as an agreement to build new facilities in Washington, hire new employees, or invest a minimum amount of capital in projects located here.
- **Expand upon and enforce ongoing eligibility requirements:** Washingtonians should not subsidize businesses that move jobs out-of-state. In addition to filing annual surveys and reports detailing their use of tax expenditure dollars, businesses should remain eligible for tax subsidies only

if they continually maintain a minimum number of employees in Washington, continue using Washington-based facilities (especially those built with tax expenditure dollars), and make future investments in Washington.

Though policymakers have expanded the use of eligibility requirements in recent years, most business tax expenditures are not subject to these accountability conditions. While a basic survey or report is required in order to claim 31 tax subsidies, only 10 of 147 business tax expenditures include more substantial eligibility conditions — such as a threshold level of investment or a minimal number of jobs to be maintained in Washington state.[9]

Conclusion

As Washington slowly emerges from the worst recession of the post-World War II era, policymakers have a significant and historic opportunity to enact much-needed reforms to our state budget process. For decades, the billions of dollars spent each year on tax expenditures have escaped routine public scrutiny. The reforms detailed here would bring clarity and transparency to Washington's numerous tax expenditures. As our state begins to rebuild following the Great Recession, these reforms would give policymakers the flexibility needed to make balanced decisions about important public priorities — such as providing a high-quality education to all students and ensuring our communities are clean, vibrant, and healthy.

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Endnotes

1. The Department of Revenue, "Tax Exemptions – 2008: A Study of Tax Exemptions, Exclusions, Deductions, Deferrals, Differential Rates and Credits for Major Washington State and Local Taxes," January 2008, http://dor.wa.gov/docs/reports/2008/Tax_Exemptions_2008/Tax_exemptions_2008.pdf#page=5.

2. The latest comprehensive data on tax expenditures are from 2008. Since then, several new tax expenditures have been enacted and several have been terminated or allowed to expire.

3. The Department of Revenue does not measure actual revenue lost; it measures total taxpayer savings associated with each tax expenditure. In many cases taxpayer savings are a good proxy for lost revenues. In some cases revenues cannot be realized due to administrative constraints, constitutional prohibitions, or state and local property tax levy limits. DOR estimates 301 of 567 tax expenditures would generate revenue if repealed. Total taxpayer savings of these 301 expenditures amount to $6.5 billion per year.

4. Budget & Policy Center analysis of tax expenditure review data from JLARC. The legislature has allowed four tax preferences reviewed by committee to expire. Allowing tax expenditures to expire requires no affirmative action on the part of the legislature.

5. Citizens for Tax Justice, "How to Enact (and Maintain) Tax Reform," October, 2010, http://www.ctj.org/pdf/maintainingtaxreform.pdf.

6. Jason Levitis, Nicholas Johnson, and Jeremy Koulish, "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center on Budget and Policy Priorities, April 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2772.

7. House Bill 1827, 2007, http://apps.leg.wa.gov/billinfo/summary.aspx?bill=1827&year=2007.

8. Task Force on Tax Preference Reform, "Final Report to the Governor and the Legislature," November 30, 2010, http://www.taxpreftaskforce.leg.wa.gov/TaskForceFinalReport.pdf.

9. Washington State Budget & Policy Center analysis of data from the Department of Revenue. All business tax expenditures that would raise revenue if eliminated.