

# **Performance Auditing of Tax Preferences for the Legislature**

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# What's a Tax Preference?

## Defined statutorily:

- ◆ Exemptions
- ◆ Exclusions
- ◆ Deductions
- ◆ Credits
- ◆ Deferrals
- ◆ Preferential Rates

## Defined informally:

- ◆ Tax Breaks
- ◆ Tax Incentives
- ◆ Loopholes
- ◆ Industry Stimulus
- ◆ Subsidies
- ◆ Tax Expenditures

Over 600 tax preferences in WA statute

# What's a Tax Preference?

- In his 2002 budget President Bush warned
  - "...the Administration believes the meaningfulness of tax expenditure estimates is uncertain..."
- (OMB 2002)
- He promised a “more meaningful presentation” of federal tax preferences
- Most states have struggled to meaningfully analyze and present their state tax preferences

# What's the Problem in Reviewing Them?

- Almost *everybody* benefits from *some* tax preference
  - ◆ Which preferences get reviewed first?
  - ◆ Are any preferences safe from review?
  - ◆ Who's going to review them?
  - ◆ How does the review process avoid becoming political?
- An effort in 1982 fell apart because lawmakers couldn't agree which preferences to review

# What Was the Solution (24 Years Later)?

- Review preferences in order of enactment, over a 10 year schedule
- Some politically sensitive preferences omitted from review (e.g., sales tax exemption for food)

## Legislative Auditor

- ♦ Conducts the reviews
- ♦ Uses audit standards
- ♦ Non-partisan, credible, and independent

## Citizen Commission

- ♦ Sets the schedule
- ♦ Comments on reviews
- ♦ Governor and 4 caucuses each appoint a member

# Other Challenges We've Encountered

## 1 What was tax preference meant to do?

- ♦ Determining public policy objective (criteria)

## 2 Did the tax preference work?

- ♦ Showing a causal relationship between the preference and outcomes

## 3 Will the Legislature act?

- ♦ Legislative follow through on recommendations

# What Was the Tax Preference Meant to Do?

- Determining public policy objective
  - ◆ Not often stated
  - ◆ When stated, objective is often broad, sweeping, and without targets – “create family wage jobs”
  - ◆ May be an outdated public policy objective

# Example: Fuel Tax Deduction



- Enacted in 1939 to allow for 1% of fuel lost to evaporation.
- Now fuel evaporation loss is limited to 0.012% by law.
- Deduction no longer tracks with fuel loss.
- JLARC recommended terminating the deduction.
- Legislature considered a bill to eliminate the deduction, but it died in committee.

## 2 Did the Tax Preference Work?

- Data on performance is often not reported or self-reported
- Washington has many tax incentives, often too small to have a measurable economic impact
- If the goal is to create jobs, would the jobs have been created anyway?
  - ◆ JLARC hired consultants to conduct statistical modeling of high technology tax credit to estimate job creation

## 2 Did the Tax Preference Work?

- Empirical evidence around the US suggests:
  - ◆ Most preferences foster their targeted activities
  - ◆ For each dollar granted in preferences, states usually collect less than one dollar in new tax revenue
  - ◆ Don't compare evaluations over time or across states unless methodologies are close to identical

Source: Federal Reserve of Boston

# Example: High Tech Tax Credit



- Enacted in 1994 to create “quality” jobs
- Economists estimated the credit added 450 jobs during the life of the program
- Tax preference cost \$45,000 per job each year - estimated economic impact of \$25,000 in wages per job each year

## 2 Did the Tax Preference Work?

- Some other methodological challenges when evaluating effectiveness:
  - ◆ What is the appropriate baseline tax?
  - ◆ How do preferences interact?
  - ◆ How to capture indirect or “spill-over” benefits?
- Some innovative methodologies to consider:
  - ◆ Propensity score matching
  - ◆ “Dynamic scoring”
  - ◆ Input-Output modeling

### 3 Will the Legislature Act?

- Voting to terminate a tax preference interpreted as voting for a tax increase
- Even when public policy objective is not being achieved, difficult to eliminate the preference
  - ◆ In 180 reviews, JLARC recommended termination 8 times – none have been eliminated
  - ◆ In 50 actionable recommendations, the Legislature has implemented 17 and introduced legislation for another 25

# Tax Preference Reporting

- What are the key components of an effective state tax preference report?

<b>Accessibility</b>	Published regularly and available
<b>Scope</b>	Should include all explicit and implicit preferences
<b>Detail</b>	Identifies statutory basis, current and future costs, beneficiaries, state AND local revenue loss
<b>Analysis</b>	Identifies purpose and evaluates effectiveness

- A few states – WA, MN, OR, CT – produce reports that meet most of these criteria; most don't

Source: Center on Budget and Policy Priorities

# Be Careful What You Ask For. . .

- ESSB 5882 (2013, 2<sup>nd</sup> Sp. Session)
  - ♦ Extended, expanded, or created 17 preferences
- **But also**
- Established **new expectations** for transparency and accountability for any new, expanded, or extended tax preference after August 1, 2013
- **Performance statements** required on all new, extended, or expanded preferences

# Legislature Takes a New Approach to Tax Preferences

- Accountability and transparency for beneficiaries
- Serious effort to measure the effect of the preference
  - ◆ What was the specific intent?
  - ◆ Did it **achieve** the intent? Must be able to **measure** its impact
  - ◆ Determine the actual cost of the preference and provide information back to the Legislature

# Performance Statement: What's the Intent?

New or changed preferences categorized into one of 6 general purposes:

- 1** Induce certain behaviors
- 2** Improve industry competitiveness
- 3** Create or retain jobs
- 4** Reduce tax structure inefficiencies
- 5** Provide tax relief for certain taxpayers
- 6** “Other”

# Performance Statement: Evidence, Please!

- Must specify “clear, relevant, and ascertainable metrics and data requirements”
  - ◆ Allow JLARC and Legislature to measure effectiveness in achieving stated purpose
- What are the metrics and data?
  - ◆ Legislative Auditor to report in January 2014
  - ◆ Depends on particulars of preference
  - ◆ DOR to recommend changes to statutorily required annual reports and surveys by 12/2013

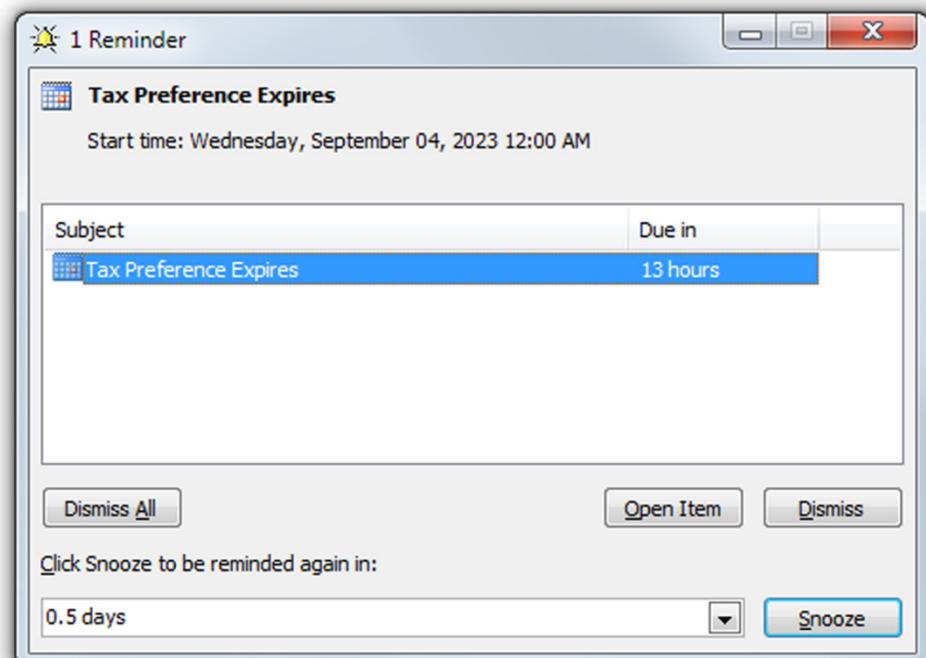


# Accountability – Show Us the Money!

- Taxpayers using preference to report the amount of tax preference they use on tax returns or addendums
  - ◆ Previously, no way to track some exemptions, simply not reported
- Legislature stated it wants to compare actual cost of tax preference with estimate provided in fiscal note
  - ◆ Previously, no real follow-up

# Expiration Dates for All!

- Each new, expanded, extended preference to have an expiration date
  - ♦ If none stated, assumed to be temporary; expires in 10 years
- Currently, out of 600+ preferences, 65 have expiration dates



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