



INCREMENTAL STEPS TOWARD TAX REFORM: DISCUSSION BRIEF #3

Investments for Washington's Future: Closing Selected Tax Breaks and Increasing the Small Business B&O Credit

The problem: Over the past decade, state policy makers have given out an ever-growing number of business tax breaks in the name of economic development, while our education system falls behind and commuters and goods sit mired in traffic. At the end of 2007, Washington had 567 tax breaks on the books. The legislature adopted fourteen new ones in 2008.¹ Some exemptions, such as those on food and prescription drugs, improve the tax system by making it less regressive. But the cumulative results of too many tax breaks are a smaller tax base and not enough revenue for high-quality public services.

Washington also suffers from a regressive and outmoded tax structure. State taxes fall too heavily on low- and middle-income residents. Washington's business and occupation (B&O) tax can also be particularly hard on new and small businesses, because it is charged on gross revenue whether or not the business makes a profit. And yet, public revenues grow more slowly than the need for public investments.

These underlying problems are compounded by the slumping national economy. Like most states, Washington is facing a budget shortfall. Without new revenue, Washington will be forced to cut essential services and postpone important new investments.

A step in the right direction: The economic downturn provides state policymakers the opportunity to embrace a more rational economic development strategy. High-quality public services, especially in education, transportation, and health care, provide the foundations for a flourishing economy with widely shared benefits.² We can expand investments in priority services and strengthen economic growth by:

1. Suspending selected business tax breaks to broaden the tax base and provide new funds (\$400 million in reclaimed revenue).
2. Increasing the small business B&O credit from \$35 to \$100 per month, to encourage small business creation and growth (\$130.5 million revenue loss).³

Net new revenue in 2009-2011: \$269.5 million

¹ See Department of Revenue, *Tax Exemptions 2008*, www.dor.wa.gov; and Marilyn P. Watkins, "Everybody Else Gets One: An Analysis of Tax Breaks in Washington," Economic Opportunity Institute, April 2008, www.eoionline.org. A commission to evaluate tax breaks, created in 2006, has not yet made significant recommendations.

² *Seattle Times*, "Ballmer offers antidote to traffic and education woes," September 30, 2005; "Businesses fear college cuts, higher education already lags," April 15, 2003, <http://community.seattletimes.nwsources.com/>; Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, 2004, <http://www.epinet.org>.

³ For details on the Small Business credit, see DOR, *Tax Exemptions 2008*, p. 144.

SMALL BUSINESS B&O TAX CREDIT OPTIONS: COST TO STATE & BENEFITS TO BUSINESS

Monthly credit amount	Annual income exempt		Cost to state 2009-11	Businesses exempted	% exempted
	(services at 1.5% rate)	(retail at 0.471%)			
\$35 (current level)	\$28,000	\$89,172	0	175,000	48%
\$100 (proposed)	\$80,000	\$254,777	\$130.5 million	263,276	73%

Source: Data provided by legislative fiscal staff.

SELECT TAX EXEMPTIONS AND LIKELY REVENUE IF REPEALED

Exemption	Description	2009-11 Revenue
Pop syrup B&O credit	A \$1.00 per gallon tax on carbonated beverage syrup is dedicated to violence reduction and drug enforcement. A phased-in credit against the B&O tax began in 2006 (25% in FY 2007, 100% in FY 2010.)	\$20.7 million
Tuition fees B&O deduction	Private schools and colleges including kindergartens may deduct tuition, room & board, and other fees.	\$40.1 million
High tech R&D B&O credit	High technology firms in specific fields may credit certain research and development spending up to \$2 million against their B&O tax. Renewed in 2004 and expires in 2015. In 2006, 352 firms used the credit, with Microsoft the only firm claiming the full \$2 million, and no others exceeding \$1 million. ⁴	\$61.2 million
High tech sales tax deferral/exemption on construction	Construction by high tech firms related to R&D or pilot manufacturing is exempt from sales tax. Incentive was renewed in 2004 and expires in 2015. In 2006, 83 firms used the tax break. Microsoft claimed the largest tax break in 2004, 2005, and 2006, taking over \$24 million in each of those years. The next tier of users, including the UW and Immunex, claimed around \$5 million. ⁴	\$111.2 million (state) \$34.5 million (local)
Charter and Freight Broker B&O preferential rate	B&O rates for international activities were lowered in 1979 and 1998. The rate is now 0.275% rather than the usual 1.5% rate for services. About 520 firms benefit.	\$49.5 million
Travel agents B&O preferential rate	B&O rates for travel agents and tour operators was reduced from 1.5% to .275% in 1975. Affects 451 taxpayers.	\$17.4 million
Stevedoring B&O preferential rate	Stevedoring and cargo handling services pay .275% B&O rate rather than 1.5%.	\$20.4 million
Insurance agent B&O preferential rate	Insurance agents and brokers rates have been reduced 3 times, most recently in 1998, to .484%.	\$45.2 million
International investment services preferential rate	Rate lowered from 1.5% to .275% in 1995. 41 firms benefit.	\$35.1 million
Total		\$400 million (state)

Source: Department of Revenue, Tax Exemptions 2008, www.dor.wa.gov.

⁴ Department of Revenue, 2006 Annual High Tech Survey data. Available by request.