End the Costly R&D Tax Breaks

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Taking Action Making Change

Northwest Federation of Community Organizations (NWFCO)

Invest in Washington's Families

Executive summary

In 1994, Washington state enacted the Business and Occupation (B&O) tax credit for Research and Development (R&D) and the sales tax deferral for R&D (collectively referred to as the R&D tax breaks throughout this report) in order to, among other reasons, stimulate the economy and to increase Washington's competitiveness in high technology business. After nine years and extensive review by the Department of Revenue, it is clear that these tax incentives have not accomplished what they were set up to do.

Now Governor Locke is proposing an extension of these tax incentives at a cost of at least $74 million for the remainder of the 2003-2005 biennium. For the next biennium, the estimate for the cost of the Governor's proposal is nearly $190 million. The budget adopted by the legislature in 2003 included $2.6 billion in budget cuts that slashed public programs such as healthcare and education. Instead of spending millions of dollars on tax breaks that do not provide results, Washington state should restore cuts and invest in public programs. This report provides numerous examples of what $74 million can buy for Washington state.

High-tech research and development tax breaks: high cost, few benefits

Background on R&D high-tech tax breaks

The governor is proposing extending several R&D related tax breaks. The largest tax breaks proposed for extension are the sales tax deferral/exemption for R&D and the B&O tax credit for R&D. Industries that receive these exemptions include: advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology.[1]

The sales tax deferral/exemption for R&D

Enacted in 1994, this tax is due to expire in July 2004. Under this exemption, businesses may defer sales tax payments on R&D facilities and machinery when building a new facility or renovating/expanding an existing one. Originally this sales tax deferral was to be repaid by recipients. This was changed in 1995 to an outright exemption for those recipients who maintain the qualified facilities or equipment for a period of eight years.[2] The exemption begins as a deferral on retail sales or use tax on the construction and furnishing of an R&D facility. If the facility is used for eight years then the deferral is turned into an exemption. If not, then the recipient repays a prorated portion of the sales tax.[3] Since 1995, businesses have taken nearly $324 million in sales tax deferrals.[4]

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The B&O tax credit for R&D

Enacted in 1994, this tax break is scheduled to expire at the end of December, 2004. Businesses that spend at least 0.92 percent on their taxable income on R&D in Washington can take a tax credit of up to $2 million per year on their B&O tax for R&D spending.[5] Since 1995, businesses have taken over $228 million in tax credits.[6]

Governor Locke's proposal for extending these tax breaks is estimated to cost the state $58.9 million for the rest of the 2003-2005 biennium.[7] This estimate is a reduction from the estimate of $75 million in lost state revenue the Department of Revenue provided during the 2003 legislative session.[8] The sales tax exemption also results in lost revenue for local governments-estimated at $18.2 million for the rest of the 2003-2005 biennium.[9]

In addition to the above R&D tax breaks, the Governor is proposing extending some further tax exemptions that focus on rural areas-including a sales tax exemption on construction and manufacturing facilities. The estimated cost for these further exemptions is $15.4 million for the rest of the 2003-2005 biennium.[10]

The total estimated cost of the Governor's proposal to extend R&D tax breaks is $74 million for the rest of the 2003-2005 biennium. For the next biennium, the estimate for the Governor's proposal is nearly $190 million.[11] While the Governor's proposal includes more features than simply extending the tax breaks,[12] this estimate is down from a previous Department of Revenue estimate of $215.7 million provided during the 2003 legislative session.[13]

What results have these tax breaks produced?

The Department of Revenue (DOR) was required to assess these tax breaks in 1997, 2000, and 2003. The analyses were to be an assessment of whether the incentives should be extended based on predetermined criteria. The five areas covered are research and development in biotechnology, electronic device technology, advanced materials, advanced computing, and environmental technology. The assessments focused on job creation in general, jobs created for Washington residents, company growth, movement of companies into the state, growth in research and development, diversifying the economy, and the amount of new products introduced. The justification for these tax incentives was to make Washington competitive in an industry that paid its workers well and provided good benefits, and that fit a sustainable quality of life.[14]

According to the Department of Revenue:[15]

- Washington's portion of high tech jobs has remained relatively stagnant for the past ten years
- Of the businesses that have relocated to Washington during the period of the review "very few" report doing so due to the incentives
- High tech R&D businesses qualify for four other major tax incentives, equaling $441.2 million in the past 12 years[16]
- None of the businesses receiving credits reported relocating to Washington due to the incentives
- Only 3 percent of those receiving exemptions reported the incentives as the reason for relocation

- 90 percent of the recipients of the R&D credit did not report building new facilities during the period of review
- There is no clear increase in geographical diversity due to the tax incentives
  - More than 85 percent of tax credit recipients are in urban locations
  - Rural county high tech employment has declined during the period of reviews[17]

The R&D tax incentives have provided little, if any, return for our state. This makes it difficult, if at all possible, to justify them following such deep budget cuts. According to Scott Klinger, co-director of Responsible Wealth (a group comprised of the top 5 percent wealthiest people in the U.S. who focus on the inequality of income among Americans), "by and large, corporate subsidies drain resources from other social uses. For instance, if businesses are given property tax abatements, while continuing to rely on public services, such as public safety and education for the children of their workers, then the corporate subsidies compete directly with funding for schools or public safety."[18]

Since these tax incentives originated in 1995, 1,322 companies have taken the B&O credit and 393 projects have been given the sales tax deferrals/exemptions. Eighty five percent of the tax deferral/exemption recipients have been located in King County and have accounted for 95 percent of the total deferral.[19] According to the Department of Revenue (DOR), this has resulted in $323.9 million in R&D exemptions/deferrals and $204 million in B&O credits since 1995.[20] This amount can be equated as a loss of $527.9 million in revenue for the state of Washington.[21]

In our present economic crisis this money could, and should, be used in other areas of our community to assist those that are greatly affected by the current recession.

While these R&D tax breaks have been extremely expensive, few jobs have been created and retained as a result. According to the Economic Policy Institute, hundreds of studies have had similar findings:

- No evidence that tax incentives paid for by cuts in public services stimulate economic growth
- Little evidence that the level of taxation is a prominent factor in deciding on business location
- Much evidence that cost and quality of labor and the quality of public services rate higher than tax incentives in deciding where to locate a business
- Much evidence that tax incentives cause state and local governments to lose billions of dollars in revenue annually[22]

The recent deal for $3.2 billion in tax incentives over the next 20 years to secure the Boeing 7E7, is a good example of a large investment with questionable returns. Advocates of the Boeing incentive claim this deal will result in 20,000 new jobs for our state. If this is true, then the state will pay an average of $150,000 per job.[23] Tax incentives are often assumed to stimulate the economy. But businesses, such as Boeing, that receive tax incentives often do not spend the money saved due to tax breaks. Businesses may decide to save their money, or calculate the savings as profit. Businesses hire and spend when demand for their services increase, not due to incentives. Tax cuts given to smaller, local businesses would more likely stimulate the economy than tax cuts to large corporations that span multiple states and who may spend their money elsewhere.[24]

Fund public programs instead of costly corporate tax breaks

Washington state is not experiencing returns on the R&D tax breaks that justify a financial investment as large as Governor Locke proposes to make in the upcoming years.

Focusing on tax spending is critical because tax incentives are debated only in the process of deciding to give them. Seldom are they evaluated, audited, or given time limits. Little information is publicly available on which businesses benefit from tax incentives like the R&D tax breaks. After such deep budget cuts in crucial public programs like education and healthcare, a critical review of all tax incentives should be conducted, and more disclosure and accountability should be required for businesses receiving tax breaks. Washington state grants over $45 billion in tax incentives each biennium; over $27 billion of this amount is in state incentives.[25] They are given to create jobs, stimulate economic growth, and assist certain at risk populations within the community. But these results have not materialized for the R&D tax breaks.

Washington just experienced the largest budget deficit in state history, an estimated $2.8 billion. The state dealt with budget difficulties by slashing public programs, and now proposes continuing R&D tax breaks while overwhelming data shows that tax incentives like the R&D tax breaks are not cost effective and waste billions of state and local revenue.[26]

Percent of potential taxes exempted and collected in Washington
(1999-01 biennium)[27]

State tax source	Total percentage exempted	Total percentage collected
Property	62.8%	37.2%
B&O tax	48.5	51.5
Public Utility Tax	81.4	18.6
Sales/Use Tax	55.4	44.6
Real Estate Excise	26.4	73.6

Cuts to public programs — particularly education and healthcare — hurt Washington residents and decrease the likelihood that companies will stay in Washington state. Businesses depend on public programs as well. For example, if Washington does not have a decent education system then it won't have businesses because they won't stay.[28]

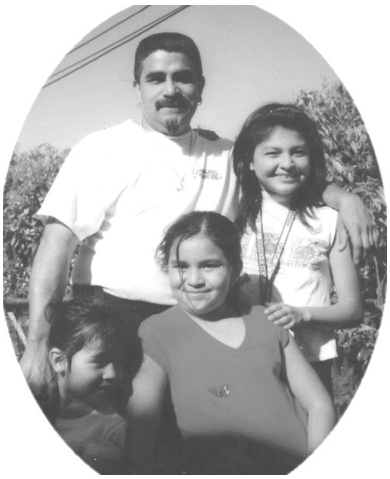
The Washington state legislature can choose not to fund tax incentives that have proven they aren't working and to not to cut funding to programs such as Medicaid and CHIP, which provide needed assistance to at risk populations within our state. Medicaid and CHIP affect more than merely the people who are enrolled in the programs. Studies have shown that programs like Medicaid and CHIP, with their federally matched funding structure, provide crucial economic stimulus to communities.[29]

What money saved from ending R&D tax incentives could buy for Washington

Alternatives for the $74 million that is to be spent by the state in 2004 on the R&D tax incentives:

$74 million could...

- *Hire an additional 1,300 teachers (at an average salary of $44,954); this is the same as an addition of a .62 teacher FTE for every school building in Washington, which has the 3rd largest class size numbers in the nation.*[30]
- *More than double state expenditures on early childhood education.*[31]
- *Cover at least 73 percent of all Head Start and Early Childhood Education Assistance Program (ECEAP) eligible children, expanding service by more than one-third.*[32]
- *Buy job training for 17,390 low-income parents on TANF.*[33]
- *Provide cash grants to 19,980 disabled people on General Assistance for one year.*[34]
- *Stop CHIP premiums from forcing thousands of children to lose their healthcare coverage in the upcoming year, and forcing other families to pay premiums of $10 to $30 a month.*[35]
- *Restore 31,000 people to Basic Health.*[36]
- *Restore dental coverage to 190,000 blind, elderly, and disabled low income adults on Medicaid (at a cost of $23 million*[37]*), AND restore $10 million cut from people with mental health issues and disabilities on General Assistance, AND still have $40 million left to eliminate premiums for children on Medicaid.*[38]
- *Fully reinstate the Medically Indigent Program, which has been cut. In FY 2002 it served 14,274 people*[39] *and cost approximately $26 million in state funds.*[40]
- *Increase funding to local community colleges for higher wages where 70 percent of community college professors are part-time in order to save on salaries and benefits.*[41]



Celestino Rocha — Seattle, WA

Father of Three, Medicaid Family

I'm raising three daughters between the ages of seven and 12. Being a single father is very hard, but I've managed to provide for my family by working jobs ranging from a truck driver to a forklift operator. In February 2002, I severely hurt my back. Suddenly I found myself unable to work at all and along with the job went our medical coverage.

In April 2002, I learned that my daughters and I were eligible for Medicaid.

I am so thankful that we've been able to access care through the program. Without Medicaid, I wouldn't be able to afford all the pain medication my doctor put me on, doctor visits or physical therapy.

My daughters have had health problems, too. My youngest girl just recently had an ear infection. With a medical coupon in my hand I took her to the doctor right away to get her help without worrying about not being able to pay. Without the coupon we would have had to wait, hoping she'd get better, and we probably would have ended up in the ER.

I can't afford regular health insurance. There simply is no room in our budget for private insurance premiums. Without Medicaid, we would be among the millions and millions of Americans who have no choice but to go without health insurance.

We should let the R&D tax breaks expire, and invest these funds in communities

Washington state gives an estimated $45 billion plus in state and local tax incentives every biennium to different sectors of the community in the form of tax breaks, grants, credits, and low-interest loans.[42] They are given to create jobs, stimulate economic growth, and assist certain at risk populations within the community. But the expected results have not materialized for the R&D tax incentives. At this point, a review of all tax incentives needs to be conducted. An assessment would help Washington decide which tax breaks to keep and which to end.

The budget passed in 2003 deeply cut public programs including healthcare and education. Allowing the R&D tax incentives to expire will provide much needed funds that can be invested in public programs. The R&D tax incentives should be allowed to expire and Washington should use that revenue to continue and restore funding for programs that provide the vital public services of healthcare and education.

Endnotes

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11 Jim Schmidt, Washington State Office of Financial Management, Personal communication, January, 2004.

12 Ibid.

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14 Interview with Governor Lowry, December 17, 2003.

15 Washington DOR, *High Technology R&D Tax Incentives Study*. 2003.

16 There are at least four other tax incentive programs (totaling over $441million over the past 12 years) that a majority of the R&D incentive recipients qualify for and take.

17 One of the bases for analysis by the DOR is diversification of the state's economy. Through geographical diversity, our state is able to widen the economical growth margin out to areas that historically experience economic hardship.

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About the organizations releasing this report

Northwest Federation of Community Organizations (NWFCO) is a regional federation of four statewide, community–based social and economic justice organizations located in the states of Idaho, Montana, Oregon, and Washington: Idaho Community Action Network (ICAN), Montana People's Action (MPA), Oregon Action (OA), and Washington Citizen Action (WCA). Collectively, these organizations engage in community organizing and coalition building in 14 rural and major metropolitan areas, including the Northwest's largest cities (Seattle and Portland) and the largest cities in Montana and Oregon. 1265 South Main Street Suite #305, Seattle, WA 98144, Voice: (206) 568-5400, Fax: (206) 568-5444, Web: http://www.nwfco.org.

Washington Citizen Action (WCA) is a statewide, grassroots organization. With over 50,000 members, we are the largest consumer advocacy group in the state. We work on a range of issues with the broad aim of bringing about greater economic justice in our state and the country. Our board represents a coalition of groups, including labor, senior, faith, and community organizations. Our field and telephone canvasses do education, activation, and fundraising with our members. Our strength as an organization depends on our members' involvement. 3530 Bagley Avenue North, Seattle, WA 98103, Voice: (206) 389.0050, Fax: (206) 568.5444, Web: http://www.wacitizenaction.org.