State of Washington
Joint Legislative Audit and Review Committee (JLARC)

Tax Preference Performance Review: Beef Processors

Report 07-7

March 21, 2007

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The Joint Legislative Audit and Review Committee (JLARC) carries out oversight, review, and evaluation of state-funded programs and activities on behalf of the Legislature and the citizens of Washington State. This joint, bipartisan committee consists of eight senators and eight representatives, equally divided between the two major political parties. Its statutory authority is established in RCW 44.28. This statutory direction requires the Legislative Auditor to ensure that performance audits are conducted in accordance with Government Auditing Standards as applicable to the scope of the audit.

JLARC staff, under the direction of the Committee and the Legislative Auditor, conduct performance audits, program evaluations, sunset reviews, and other policy and fiscal studies. These studies assess the efficiency and effectiveness of agency operations, impacts and outcomes of state programs, and levels of compliance with legislative direction and intent. The Committee makes recommendations to improve state government performance and to correct problems it identifies. The Committee also follows up on these recommendations to determine how they have been implemented. JLARC has, in recent years, received national recognition for a number of its major studies.

Tax Preference Performance Review: Beef Processors

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REPORT DIGEST

MARCH 21, 2007

STATE OF WASHINGTON

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STUDY MANDATE

In 2006, the Washington Legislature enacted EHB 1069 which mandated performance reviews of Washington's tax preferences. This legislation also created the Citizen Commission for Performance Measurement of Tax Preferences (Commission) (Chapter 43.136 RCW). One of the Commission's primary roles is to develop a schedule for JLARC to review all tax preferences at least once every ten years. The first annual report of reviews will be delivered later this year to assist legislators in the 2008 Legislative Session.

However, one tax preference, the business and occupation tax deduction for certain beef processors due to U.S. beef bans, will expire before the 2008 Legislative Session. This business and occupation tax deduction was enacted in response to importing countries' bans on U.S. beef exports. This tax preference has an expiration clause of the earlier of December 31, 2007, or the month following when Japan, South Korea, and Mexico have eliminated their import ban on U.S. beef. Since this tax deduction will expire before the 2008 Legislative Session begins, JLARC decided to prepare a special audit report for consideration by the 2007 Legislature.

BACKGROUND

In 2004, the Legislature enacted HB 2929, which provided a business and occupation tax deduction for certain beef processors. The purpose of this legislation was to provide temporary tax relief to Washington beef processors due to import bans on U.S. beef. These bans were imposed by several countries in response to the discovery of Bovine Spongiform Encephalopathy (BSE) in a dairy cow on a farm in Washington on December 23, 2003. Only certain beef processors, with qualifying wholesale activities, are allowed to claim this business and occupation tax deduction.

In 2005, the Legislature adopted HB 1407 which placed an expiration date of December 31, 2007, (RCW 82.04.4336) on this tax preference. Although the importing countries referenced in statute (Japan, South Korea, and Mexico) have relaxed their bans on U.S. beef, they have not completely removed their import bans. As of February 2006, Mexico has opened its market to U.S. bone-in beef and bone-in beef products from animals less than 30 months of age. As of July 2006, Japan has opened its market to U.S. beef from cattle 20 months of age and younger. As of September 2006, Korea has opened its market to U.S. boneless beef from cattle less than 30 months of age.

FINDINGS

Highlights of the findings from this JLARC study include:

Public Policy Objectives and Beneficiaries

- The beneficiaries of the tax deduction were six beef processors in 2004 and 2005 and five beef processors in 2006. This tax deduction has contributed to the achievement of public policy objectives by providing temporary relief to beef processors when they slaughter their own cattle and sell their beef at wholesale.
- The Legislature did not require the beneficiaries to be exporters to foreign markets. Not all beef processors that claimed the tax deduction were registered by USDA as eligible exporters.
- Since one of the public policy objectives was to provide temporary relief to beef processors, continuing the beef processors' tax deduction beyond 2007 would not be consistent with this objective of the tax deduction.
- Businesses with beef slaughtering and processing activities are the companies claiming the tax deduction and there was no evidence of unintended benefits provided to businesses not targeted by the Legislature.
- JLARC was not able to quantify the impact of the tax deduction on business practices in Washington's beef industry for the time period in which the tax preference was in place.
- Trends in the health of Washington's beef industry revealed that economic indicators, like Washington commercial red meat production and U.S. wholesale prices for beef and Washington cattle prices, have rebounded back and exceeded the pre-beef ban levels.

Economic and Revenue Impacts

- The past revenue impact from this tax deduction for beef processors was -$1.1 million for three quarters in 2004, -$1.6 million for all of 2005 and -$0.54 million for two quarters in 2006. The future revenue impact of this deduction is -$1.1 million each year.
- There will be very minimal negative statewide economic impact from having this tax preference eliminated in 2008 since the total tax loss from this tax preference is so small compared to Washington's Total General Fund state cash receipts of $27.4 billion in the 2005-07 Biennium.

Other States

- No other U.S. states have enacted legislation to compensate beef processors for loss in revenue from import bans on U.S. beef.

RECOMMENDATION

1. **The Legislature should retain the current law expiration date of December 31, 2007, which means the tax preference will terminate at the end of 2007.**

At its February 23, 2007 meeting, the Citizen Commission for Performance Measurement of Tax Preferences unanimously approved the following motion:

> *"The Commission acknowledges receipt of the preliminary JLARC report on the beef processors tax preference, has provided a forum for discussion and public comment thereon, and endorses the JLARC report recommendations."*

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CHAPTER ONE – BACKGROUND

STUDY MANDATE AND PROCESS

Enacted in 2006, EHB 1069 directed JLARC to conduct performance reviews of tax preferences. A special audit report was also to be completed of tax preferences that were set to expire before the next legislative session. The only tax preference set to expire before the 2008 Legislative Session is the beef processors' tax preference due to bovine spongiform encephalopathy[1] (BSE) beef import bans.

Consistent with the scope and objectives for this performance review (see Appendix 1), JLARC staff analyzed the following: (1) trends in key economic indicators for the Washington and U.S. beef processing industries; (2) Department of Revenue business and occupation tax return data pertaining to wholesaling activities of beef processing industries and the taxpayers claiming this tax deduction; (3) public policy objectives of this tax preference; (4) economic and revenue impact studies of BSE beef import bans and the tax deduction; and (5) other states' laws to identify any similar tax preferences. In addition, JLARC has developed findings and a recommendation for this tax preference.

STUDY OVERVIEW

This report is divided into five chapters. In addition to the study mandate and an overview of the full report, Chapter 1 includes background on recent events of BSE, the beef processing industry, and trends in key economic indicators related to the beef industry in Washington State and the U.S. Chapter 2 provides an analysis of the beef processors' tax preference's public policy objectives. Chapter 3 outlines the beneficiaries of this tax deduction. Chapter 4 discusses the revenue and economic impacts of this tax deduction, BSE beef import bans and other states' similar tax preferences. The report ends with a summary of findings and recommendation for this performance review in Chapter 5.

BACKGROUND – RECENT EVENTS OF BOVINE SPONGIFORM ENCEPHALOPATHY (BSE)

For nearly two decades, countries have been impacted by disease outbreaks like bovine spongiform encephalopathy (BSE) and related trade restrictions imposed for health reasons. The first outbreak of BSE in a cow in the United States was in Washington State on December 23, 2003. Even though this was the first occurrence of BSE in the U.S., other countries had previously found BSE in cattle, including Canada, having their first occurrence of BSE in cattle seven months earlier in May 2003. BSE is a neurological disease in cattle that was first discovered in Britain in 1986. Current research confirms that BSE infects the brain, spinal cord, and retina of the eyes of the cattle. The primary means by which animals become infected is through the consumption of feed contaminated with the infectious BSE agent. Until 1996, this disease was thought to affect only cattle until the British Government announced a possible link to a new human variant of Creutzfeldt-Jacob Disease which

[1] Bovine Spongiform Encephalopathy (BSE), also know as "mad cow disease" is a neurological disease in cattle that has a link to a human variant of the disease.

elevated the animal health concern to a human health concern. Since 1997, the United States and Canada have banned feeding mammalian tissue to ruminants.[2] The U.S. government has taken safety measures to reduce the risk to the food system, with the intent of minimizing human health risks.

Figure 1 on the following page provides a timeline of the incidences of BSE in cattle in different countries and the reaction of key importing countries. Since the first case of BSE in cattle in the U.S. in December 2003, there have been two other U.S. cases. In Canada, since the discovery of the first case in May 2003, there have been eight confirmed Canadian cases. As of December 8, 2006, Japan confirmed their 31st case of BSE in cattle. Most European countries have confirmed cases of BSE in cattle, with the United Kingdom having by far the largest number of cases at 184,453 cases of BSE as of September 30, 2006.[3]

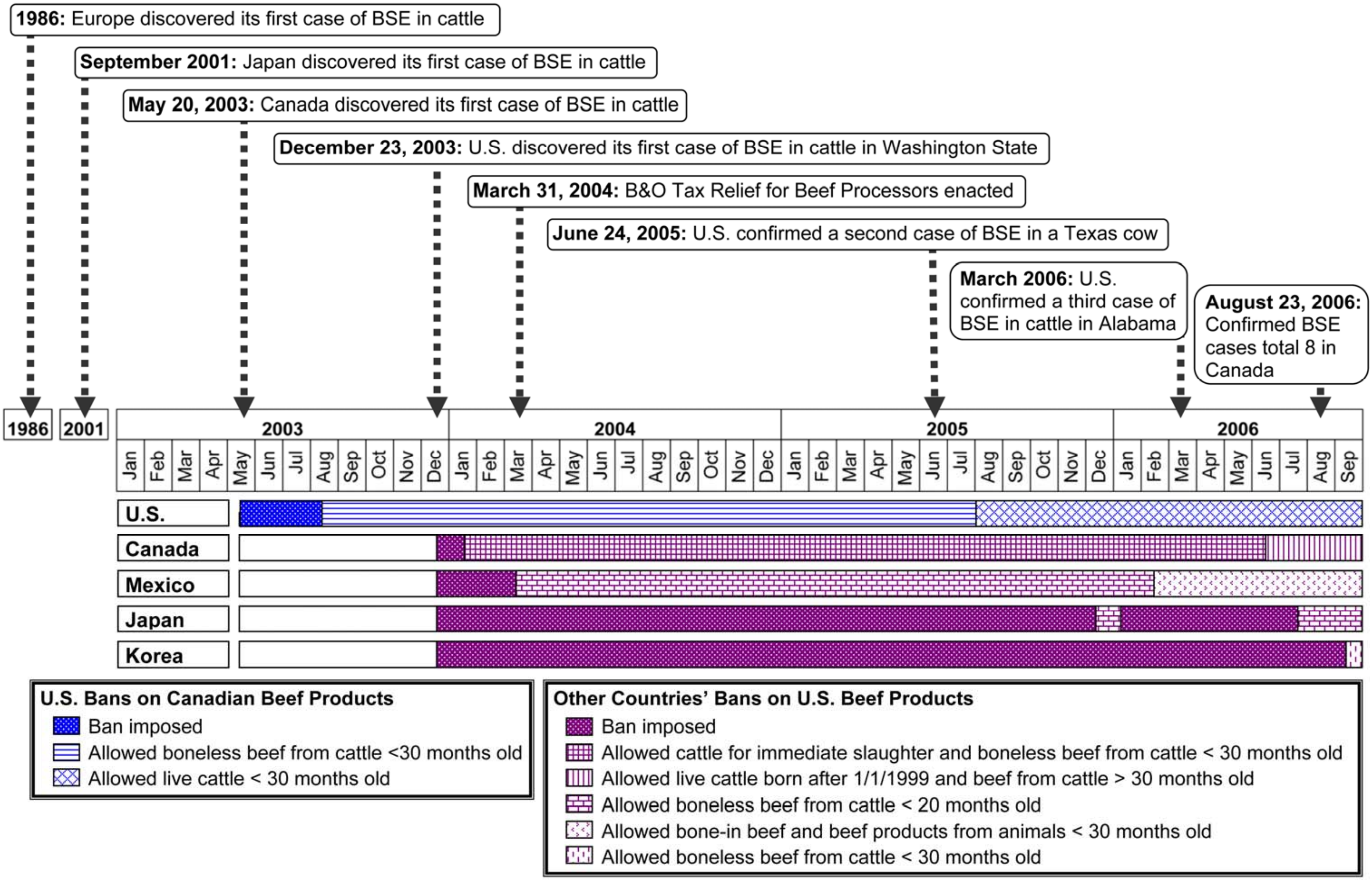
For both Canada and the U.S., the first case of BSE in cattle in 2003 had the largest impact of any subsequent cases on the Washington economy and consumer confidence. While both Canada and Mexico imposed bans after the discovery of the first U.S. case, they were two of the first countries to remove their import bans on U.S. beef. Then, when the U.S. had its second and third cases of BSE in June 2005 and March 2006, respectively, Canada and Mexico did not re-impose their import bans on U.S. beef again. The second and third cases of BSE in cattle in the U.S. did make it more difficult to convince concerned importers that the U.S. had safe beef to import. Other import markets, like Japan and Korea, were slow to open up their markets to U.S. beef. Having other cases of BSE in the U.S. after 2003, decreased foreign consumer confidence in U.S. beef and added to the complex negotiations to open foreign markets. Both Japan and Korea have relaxed their complete beef import bans and are now allowing in U.S. beef but under certain conditions.

Economic Impact of BSE Import Bans on Beef

Prior to the discovery of BSE in North America, the U.S. and Canada traded freely with one another in cattle, beef, and beef products. The number of head of cattle in Canada had been trending upward, and the number of head of cattle in the U.S. had been declining. Canadian cattle production exceeded its slaughter capacity. From 1998-2002, Canada exported on average 1.2 million head to the U.S.[4] After Canada discovered its first case of BSE in cattle in May 2003, all importing countries banned imports of live cattle and beef products from Canada. This came at a time in the U.S. when the U.S. beef price was already high, and this ban decreased the supply of beef pushing the price of beef up further. By October 2003, the U.S. grain-fed beef supply situation had resulted in record-setting cattle and beef prices. Then on December 23, 2003, with the discovery of the first case of BSE in cattle in the U.S., some 70 countries, including Canada, Japan, Korea, and Mexico, imposed import bans on U.S. beef and cattle. The value of U.S. processed beef exports declined from $3.1 billion in 2003 to $0.5 billion in 2004 which represented a decline of 84 percent in a single year. The value of Washington processed beef exports declined even faster, from $241.3 million in 2003 to $10.2 million in 2004 or 96 percent. The U.S. beef industry depended on exports for 9-10 percent of total beef production. In 2003, the Washington State beef processing industry

[2] Ruminant – four-footed, hoofed, even-toed, and cud-chewing mammals such as cattle, buffalo, goat, and deer.
[3] World Organization of Animal Health "Number of cases of bovine spongiform encephalopathy (BSE) reported in the United Kingdom" data as of September 30, 2006.
[4] "Economic Consequences of BSE for the North American Cattle and Beef Industries" Keith Collins, Chief Economist USDA, USDA Fact Sheet June 9, 2005.

Figure 1: Timeline of BSE Incidences



Sources: "An Economic Chronology of Bovine Spongiform Encephalopathy in North America," Kenneth Mathews, Jr. Monte Vandeveer and Ronald A. Gustafson: USDA Economic Research Service Outlook Report June 2006.
USDA – Foreign Ag. Service news release No. 0341.06 on September 7, 2006, and news release on February 1, 2006.
USDA – Office of Communications news release on July 27, 2006, and Release No. 0314.06 on August 23, 2006.
USDA – Animal and Plant Health Inspection Service Newsroom article BSE Trade Status as of July 28, 2006, and article BSE in North America.

exports comprised 16 percent of beef production. In 2004, after the foreign import bans on U.S. beef, Washington's beef exports comprised 0.6 percent of total beef production.

The first cases of BSE in the U.S. and Canada impacted the beef industry in numerous ways. First, the U.S. banned the Canadian imports of live cattle which reduced the supply of cattle to be slaughtered in Washington beginning in May 2003. The U.S. import ban on Canadian cattle imports was imposed until August 2005. This caused Washington cattle prices to increase due to the decreased supply of cattle. The foreign import bans that were placed on U.S. cattle and beef after the case of BSE in December 2003, caused beef production to decrease in 2004, but production did recover in 2005 due in part to opening up the U.S. market to Canadian cattle imports. On the demand side, the discovery of BSE in cattle in the U.S. decreased U.S. and foreign consumer confidence in the safety of U.S. beef. The drop in consumer confidence was only temporary in the U.S. The U.S. consumer confidence in the safety of the domestic beef industry was restored quite quickly in large part to actions taken by the U.S. government to safeguard the human food supply from BSE. The economic impact from the foreign import bans on beef in Washington State was more significant than for the U.S. as a whole since the Washington beef market was more dependent on exports than the U.S. beef market.

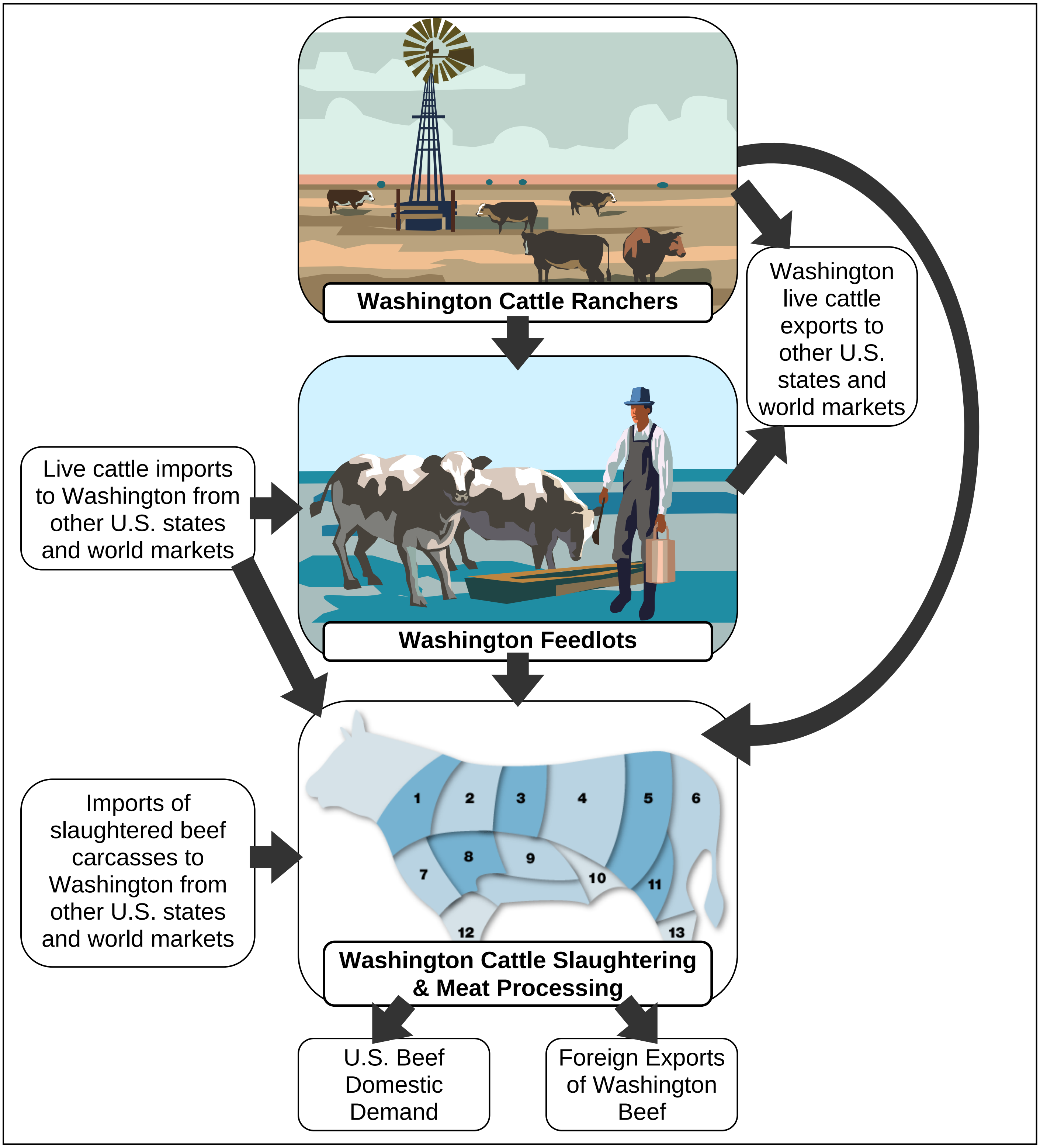
Background – Washington Beef Industry

The beef processing industry in Washington State has many forward and backward linkages to other industries within Washington, the U.S., and the rest of the world economy. Figure 2 illustrates some of the key linkages in Washington's beef industry. Washington ranchers as well as imports of live cattle from other U.S. states and other countries like Canada and Mexico provide the cattle supply for the beef processors here in Washington. Due to the current partial ban on Canadian cattle, Washington's imports of cattle from Canada must be slaughtered right away or developed at a feed lot. Washington can not import calves that are not ready to be slaughtered or developed at a feedlot. Mexican cattle imports typically are sold to feedlots to be developed.

Cattle ranchers decide to sell their cattle to feedlots or directly to a slaughter house. The large majority of Washington cattle are sent to feedlots for development. These decisions about when and where to sell cattle is based on several factors including the inventory of cattle, price of cattle, price of feed, and the current and future projected demand and price of cattle. The quantity of cattle on Washington feedlots ready to be slaughtered is one key component in determining the supply of cattle to be slaughtered. Feedlots consider the input price of feeder corn, their profit margins per cow and the output price for grain-fed cattle in determining how many head of cattle to raise and sell.

The amount of beef production in Washington is not only a result of the quantity of head of live cattle slaughtered here, but also includes the processing of beef from imports of beef carcasses from other U.S. states and other countries. Finally, Washington beef production is either consumed here in Washington or in other U.S. states or abroad. The demand for Washington beef both in the U.S. and in other countries is a function of consumers' income, per capita beef consumption, retail price, dietary tastes and preferences, and confidence in the safety of U.S. beef. The foreign import bans on U.S. beef eliminated a portion of Washington beef processors' demand for their products as well as the foreign export market for live cattle by ranchers and feedlots.

Figure 2: Washington Beef Industry



Source: JLARC.

Washington Beef Export and Imports

Prior to the foreign import bans on U.S. beef in 2003, Washington's top three export markets for beef were Japan, Mexico, and South Korea. Those countries comprised 94 percent of all beef exports with Japan importing 72 percent of all beef imports alone. In 2004 and 2005, Washington's exports were only between $10 and $11 million with Mexico being the only country of Washington's top three foreign markets that had re-opened to U.S. beef. In 2006, both Japan and South Korea have partially lifted their beef import bans. As a result, Washington's total exports increased to $16.7 million in 2006 with the Japanese market starting to import Washington beef again.

Washington is a net importer of cattle with our largest source of live cattle coming from Canada. Prior to the foreign export bans on U.S. cattle and beef in 2003, Washington's exports of live cattle totaled $2 million. Prior to the discovery of BSE in cattle in Canada, Washington State had been the largest market for Canadian live cattle imports. In 2002, the value of Washington's imports of live cattle totaled $179 million and then it declined to $81 million in 2003 and $0 in 2004. Since the import ban on live cattle from Canada was partially relaxed in August 2005, Washington's imports have exceeded pre-import ban levels. In 2006, Washington's imports of live cattle from Canada totaled $414 million.

For further discussion on Washington's beef exports and Canadian cattle imports, see Appendix 3.

Eligible Suppliers

If U.S. beef processors want to sell their products in foreign markets, the U.S. has established a process by which businesses can get approval to supply agricultural products and services to foreign markets.[5] USDA has the Quality System Assessment Program which approves certain suppliers to sell their products according to the importing countries' requirements so the foreign customers can be assured of consistent quality products and services. It is limited to programs where specified product requirements are supported by a documented quality management system. The extent of controls included in these programs may include all phases of production and marketing. USDA has an export verification program for beef, and they approve suppliers and publish lists of eligible suppliers for their Export Verification Programs.

As of December 7, 2006, Washington State had four eligible export suppliers of bovine to various importing countries. All four companies were eligible suppliers to Mexico, but only two companies were eligible exporters to Korea and Japan.

Production

In 2005, cattle and calf production ranked number three in total value of production among agricultural commodities in Washington State. The value of cattle and calf production was $601,336,000, which represented 9 percent of total value of Washington agricultural production in 2005.[6] The quantity of commercial red meat production was 618 million pounds which represents approximately 1.4 percent of the U.S. total commercial red meat production in 2005. Initially after the U.S. foreign beef bans were imposed, Washington commercial red meat production declined from 598 million pounds in 2003 to 488 million pounds in 2004 which represents a decline of 18 percent. Then red meat production rebounded back to pre-foreign import ban levels of 618 million

[5] USDA – Agricultural Marketing Service USDA Quality System Assurance (QSA) Program document.
[6] USDA – National Agricultural Statistics Service 2006 Washington Annual Agriculture Bulletin.

pounds in 2005, and in 2006 red meat production exceeded 750 million pounds. This is the highest red meat production level in Washington State in the last ten years, and the second highest production level in the last 30 years. For a further discussion of Washington's beef production, see Appendix 3.

Employment

The Washington beef industry has more than 13,000 ranchers and cattlemen[7] and 3,782 employees in the industries of animal slaughtering and meat processing in 2005.[8] The Washington Employment Security Department statistics indicate that there are statewide a total of 66 firms in animal slaughtering and red meat processing industries in the first quarter of 2006. This employment data in Figure 3 reveals a decline in the number of red meat processing firms in Washington from 81 in 2001 down to 66 in the first quarter of 2006. Since the U.S. beef export ban beginning in 2004, the number of Washington firms in the red meat processing arena has dropped from 77 businesses down to 66, a 14 percent decline. Total employment in these two industry sectors has remained nearly the same. In 2001, there were 3,778 employees throughout the state, and in the first quarter of 2006, there were 3,819. This represents an overall increase of 1 percent.

Figure 3: Employment Trends in the Red Meat Processing Industries
(Animal Slaughtering and Red Meat Processing from Carcasses)

	Average Number of Firms	**Average Employment**	**Average Wages**
Year	**Total**	**Total**	**Total**
2001	81	3,778	27,675
2002	82	4,129	26,486
2003	77	4,101	27,795
2004	72	4,082	27,262
2005	69	3,782	30,338
2006 Q1 [9]	66	3,819	36,571

Source: Washington Employment Security Department Covered Employment Data.

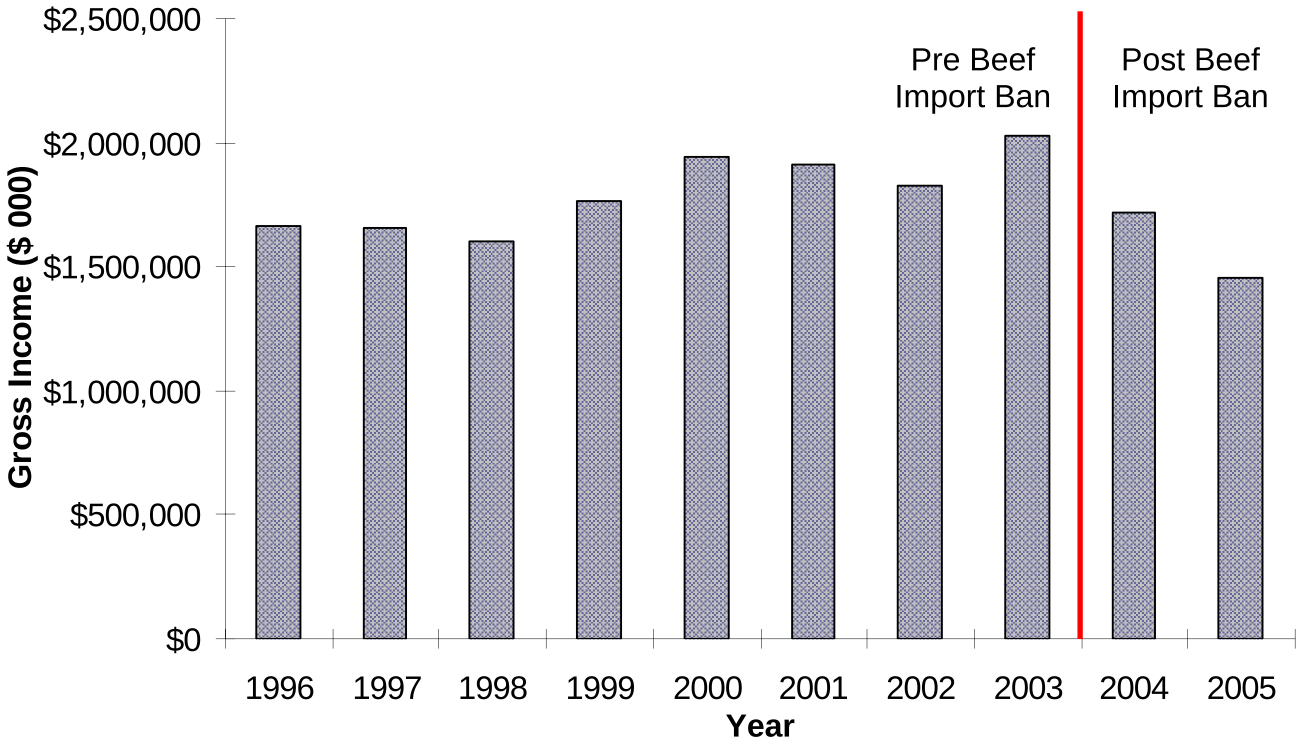
As the number of employees remained constant over the last five years, the average annual wages per employee has risen from $27,675 in 2001 to $36,571 in the first quarter of 2006 which is an increase of 32 percent (see Figure 9). This strong growth in wages reveals a positive outlook for workers in this industry. For additional information on Washington beef processing firms see Appendix 3.

[7] Washington State Beef Commission website information last updated May 2006.
[8] Washington State Employment Security Department Covered Employment for 2005.
[9] Q1 2006 is annualized for the averages for firms, employment and wages.

Business and Occupation Tax

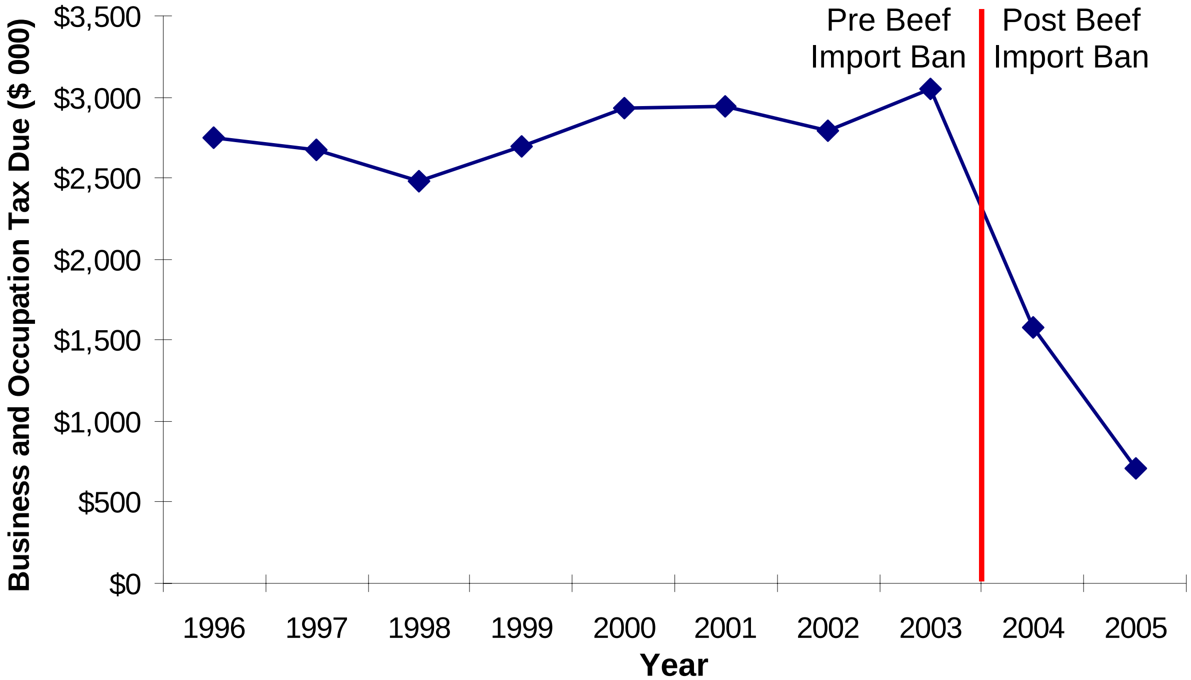
In examining ten years of the Department of Revenue's data on gross business income and business and occupation tax due, it is revealed that this business sector's gross income was rising from 1998 until 2004 when it fell significantly due to the U.S. beef export ban (see Figure 4 below). The wholesaling activities of beef processing is assessed at a business and occupation tax rate of .138 percent. The trends in the business and occupation tax due for this beef processing industry had similar trends as gross business income as it also was growing until 2004 when the U.S. beef export ban went into effect. Figure 5 on the following page reveals that, prior to the beef processors' tax deduction, these beef processors doing business in Washington had been paying nearly $3 million in business and occupation tax since 2000. In 2004, the tax paid dropped to $1.5 million, and in 2005, the tax due declined to under $1 million. The decline in gross business income between 2003 and 2004 was not as significant as the decline in business and occupation tax due to the new beef processors' tax deduction.

Figure 4: Washington Animal Slaughtering and Red Meat Processing Industries: Gross Income From 1996-2005



Source: Washington Department of Revenue Business and Occupation Tax Data (adjusted by JLARC staff for deductions claimed as exemptions).

Figure 5: Washington Animal Slaughtering and Red Meat Processing Industries: Business and Occupation Tax Due From 1996-2005



Source: Washington Department of Revenue Business and Occupation Tax data.

Additional information on recent trends of other economic statistics pertaining to the beef industry is included in Appendix 3. The key economic statistics highlighted in the appendix are the following:

- Washington beef processing industries employment and wages
- Washington beef export markets
- Washington imports of Canadian cattle
- Washington cattle prices
- Washington value of cattle production
- Washington cash receipts from marketings
- Washington commercial red meat production
- U.S. wholesale prices for beef
- U.S. consumption of beef

CHAPTER TWO – ANALYSIS OF TAX PREFERENCE'S PUBLIC POLICY OBJECTIVES

This chapter provides an overview of the public policy objectives of this tax preference. It also answers the public policy questions outlined in Chapter 43.136 RCW. This beef processors' tax preference is located in RCW 82.04.4336, which appears in Appendix 4. HB 2929, which first created the tax deduction for beef processors, had a clear public policy stated in the intent section of the bill. This public policy intent states:

"The legislature finds that the recent occurrence of bovine spongiform encephalopathy and the resulting bans on beef imports from the United States have had severe economic impact on the state's beef processing industry. The legislature intends to provide temporary business and occupation tax relief for Washington beef processors."

The tax deduction was to remain in place until either the import bans on U.S. beef were eliminated by Korea, Mexico, and Japan, or until December 31, 2007, whichever comes sooner. The specific expiration date of December 31, 2007, was added in the 2005 Legislative Session in HB 1407.

What are the public policy objectives that provide a justification for the tax preference?

The key components of the intent of this tax preference are the following:

- This preference was enacted in response to the negative impact from import bans placed on U.S. beef exports from first case of BSE in Washington State;
- The Legislature recognized the negative impact that the U.S. beef export bans were having on Washington State's beef processing industry;
- This tax deduction was targeted for beef processors only; and
- This tax deduction was to provide temporary business and occupation tax relief.

The public policy objectives of this tax deduction are further defined in the section of law on the computation of this tax. The law states that the required business activity initially must be cattle slaughtering, and the slaughtered cattle may be further broken and processed into perishable and nonperishable beef products that must be sold at wholesale in order to qualify for the tax deduction. The requirement that the business has to slaughter its own cattle and sell the beef products at wholesale restricts the firms which can qualify for the tax deduction. For example, if a beef processor imports slaughtered beef carcasses from another U.S. state or country, then further processes the beef in Washington State, that processing activity would not qualify for the beef ban tax deduction because the beef processed in Washington State was not slaughtered by the taxpayer. In designing this tax preference, the Legislature targeted those beef processors doing business in Washington who are slaughtering their own cattle and further processing and packing the beef in Washington and selling their products at wholesale. The Legislature's public policy objective was to provide a tax incentive to retain this type of Washington business activity within the state since they were negatively impacted from the discovery of BSE in a cow in Washington State.

Another objective of this particular tax preference was that it was to provide temporary business and occupation tax relief. With the enactment of HB 2929, it was stated in the intent section of the bill that this was to be temporary tax relief. This was further emphasized in the following session with the passage of HB 1407, which placed an expiration date of December 31, 2007, on the tax preference, reinforcing the intent that this tax deduction was temporary through 2007.

In summary, the public policy objectives of the tax deduction for beef processors due to the U.S. beef export ban are the following:

1. Provide temporary relief to Washington beef processors who were negatively impacted by the U.S. beef export ban due to the case of BSE in a cow in 2003; and

2. Encourage the continuation of business activities of slaughtering and processing of beef in Washington State and selling the products at wholesale.

What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

This tax deduction has been utilized by beef processors slaughtering their own cattle within Washington State for more than two years now. According to the Department of Revenue's business and occupation tax returns, six beef processors took the deduction in 2004 and 2005. In 2006, five beef processors claimed the deduction. Figure 6 on the following page reveals the wholesale gross income, tax deduction, and business and occupation (B & O) tax loss from the deduction for the beef processors claiming this deduction. This table reveals that for three quarters in calendar year 2004, the reduction in B & O tax from this deduction totaled $1.1 million. For four quarters in calendar year 2005, the reduction in B & O tax totaled $1.6 million. This tax deduction has provided temporary business and occupation tax relief to beef processors who are slaughtering cattle and selling the beef carcasses or other further processed beef products at wholesale.

The intent section of this bill states that the reason for this tax deduction is for tax relief for beef processors for the negative impact from BSE discovery in the U.S. After comparing the taxpayers who claimed the deduction in 2004 and 2005 with the eligible suppliers approved by USDA for export markets, it was found that two out of the six taxpayers claiming the deduction were eligible export suppliers in Washington State.[10] Beginning in 2006, the tax deduction was claimed by one eligible export supplier of beef in Washington. The design of this tax preference does not require a direct connection between claiming the beef processors tax deduction and experiencing direct import market losses from the import bans on U.S. beef exports.

[10] USDA Official Listing of Eligible Suppliers to the USDA Bovine EV Programs.

Figure 6: Quarterly Gross Business Income of Wholesaling Activities and Estimated Tax Loss for Beef Processors Claiming Deduction: Quarter 2: 2004 - Quarter 2: 2006

Quarter/Yr	Wholesaling Gross Income ($ 000)	Est. Tax Deduction ($ 000)	Est. B&O Tax Loss ($ 000)
qt204	302,122	287,946	397
qt304	293,045	283,733	392
qt404	268,826	258,498	357
Total Calendar Year 2004 Tax Loss =			1,146
qt105	303,857	292,834	404
qt205	305,252	292,304	403
qt305	297,333	286,978	396
qt405	315,243	303,726	419
Total Calendar Year 2005 Tax Loss =			1,623
qt106	209,982	197,579	273
qt206	210,011	193,791	267

Source: Department of Revenue Business and Occupation Tax Returns.

Determining the degree to which a tax preference has encouraged the continuation of certain business activities, like the slaughtering of cattle and beef processing in Washington State is more difficult to measure. Certainly the tax deduction for beef processors has provided the business with a lower tax liability, but how much of that tax savings has really translated into maintaining production or employment levels by the businesses receiving the benefits is difficult to determine. From a newspaper report, one of Washington's large beef processors decided to eliminate one shift and lay off workers in Washington beginning the last quarter of 2006.[11] This evidence of employment layoffs of a Washington beef processor appears to indicate there are other factors present in Washington, U.S., and the world economy that may have a greater influence on employment and production decisions. Identifying the amount of influence each factor has separately from the tax preference is unknown.

There are numerous factors which have played an important role in determining production and employment levels in the beef processing industry in Washington State since the enactment of this tax preference. Certainly the tax deduction for beef processors has provided several businesses with a lower tax liability, but how much of that tax savings has really translated into higher or even retained production or employment levels by those businesses receiving the benefits is difficult to determine.

Economic indicators revealing the trends in the health of Washington's beef processing industry have been examined in Chapter 1 and Appendix 3 of this report and a summary of those trends is listed in Figure 7. The trend for most economic indicators were down in the first year after the U.S. import ban on Canadian cattle and foreign importing countries' ban on U.S. cattle and beef.

[11] Tri-City Herald "Tyson workers begin search for new jobs" October 6, 2006.

Figure 7: Trends in the Health of Washington's Beef Industry

Economic Indicator	Figure No.	One Year After the Beef Bans (2003-2004)	Two Years After the Beef Bans (2003-2005)
Number of Washington Beef Processors	Figure 3	-6%	-11%
Total Employment in Beef Processing	Figures 3 and 8	-0.4%	-7%
Washington Exports of Beef	Figure 11	-96%	-95%
Washington Imports of Canadian Cattle	Figure 14	-100%	96%
Cash Receipts from Marketings	Figure 17	-3%	22%
Wholesale Prices	Figure 18	-2%	1%
Washington Red Meat Production	Figure 19	-18%	3%
Average Wages in Beef Processing	Figures 3 and 9	2%	9%
Washington Cattle Prices	Figure 15	12%	23%
Value of Washington Cattle Production	Figure 16	0%	26%
U.S. Beef Consumption	Figure 20	3%	3%

Source: JLARC.

In examining the indicators outlined in Chapter 1 and Appendix 3, it is evident that the import ban that the U.S. placed on Canadian cattle had a very significant impact on the beef processing industry because it reduced the supply of cattle to be slaughtered and it raised the price of cattle which is a significant cost for beef processors. When the supply of cattle is low, then the slaughter plants have excess capacity, and this also adds costs and lowers the beef processors' profit margins. The decrease in demand for U.S. beef from importing countries did decrease the overall demand for beef, but the U.S. domestic consumption held fairly constant. Domestic U.S. demand was only temporarily negatively impacted by the discovery of BSE in cattle in the U.S. Average wages, cattle prices, value of cattle production and U.S. beef consumption were the four economic indicators that did not fall after the foreign beef import bans were imposed.

After the first year of the beef import bans, most of the trends in the economic indicators are improving or at least remaining fairly constant, but beef processing employment and the number of beef processors in the state slightly declined from 2004 to 2005. All other key economic indicators like Washington's production of red meat, beef consumption, wholesale prices and imports of Canadian cattle are all growing and showing positive signs that the beef industry in Washington is improving.

To what extent will continuation of the tax preference contribute to these public policy objectives?

Continuation of the beef processors tax deduction will only partially fulfill the public policy objectives outlined in law of providing temporary relief to beef processors who were negatively impacted from import bans due to BSE in the U.S. That is because continuing the tax preference beyond 2007 would be extending the tax deduction beyond "temporary." In addition, it is unclear how effective the tax preference has been at improving beef production. One beef exporter has already eliminated a shift of its production in Washington. Given the other influences on this industry, it seems unlikely that continuing the tax preference alone will bring back that one shift of production to Washington State.

After examining the trends in Washington's beef industry, the negative impact from the foreign import bans is diminishing over time. In particular, red meat production in Washington State has been increasing since 2004 and has in 2006, exceeded the pre-beef ban level in 2003 by 25 percent. The other economic indicators have also exceeded pre-beef ban levels, like U.S. wholesale prices of beef and U.S. consumption of beef. This indicates that even though some of the foreign import markets may not have reached the pre-beef ban levels, Washington's beef industry production has recovered from the temporary downturn from the occurrence of the first case of BSE in cattle in the U.S. Since one of the main objectives of this tax preference was to provide relief to beef processors for the negative economic impact from the foreign import bans, continuing this tax preference would violate that public policy objective of this tax deduction.

Under current law forecasts, the federal government (USDA) is already projecting a rise in U.S. commercial beef production and total exports each year through 2016.[12] U.S. beef exports are projected to rise over the next ten years by 51 percent which corresponds to an annual growth rate of approximately 5 percent. The export forecasts for Japan, South Korea, and Mexico are all increasing, with the Mexican beef import market projected to rise the fastest at 10 percent a year over the next ten years. The Japanese and South Korean beef imports are projected to rise by 2 and 7.4 percent each year respectively from 2007 to 2016. U.S. beef exports as a percent of production is expected to rise from 4 percent of production in 2006 to 8 percent of production by 2016.

These rising projections of U.S. export markets and beef production indicates that, even without a continuation of the beef processors' tax deduction in Washington State, the projections for the U.S. beef industry overall are rising.

If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment or recapture of the tax benefits?

This tax deduction is fulfilling the public policy objective of providing tax relief to beef processors slaughtering their own cattle. If the tax deduction is further modified and extended, then the public policy objective of providing temporary tax relief would not be achieved.

[12] USDA Agricultural Baseline Projections to 2016, February 2007.

CHAPTER THREE – ANALYSIS OF THE BENEFICIARIES OF THE TAX PREFERENCE

OVERVIEW – BENEFICIARIES

There are two main questions, outlined in Chapter 43.136 RCW, pertaining to the beneficiaries of the beef processors' tax preference and they will be answered in this chapter.

Who are the entities whose state tax liabilities are directly affected by the tax preference?

The beneficiaries of this tax preference are businesses which slaughter their own beef and sell that beef or further process their slaughtered beef into other perishable or nonperishable beef products and sell these products at wholesale. After examining the Department of Revenue business and occupation tax data, six taxpayers were identified as claiming this tax deduction in 2004 and 2005 and five taxpayers in 2006. All of these businesses claiming the tax deduction are identified as having their primary business activity as animal slaughtering, processing meat from carcasses or wholesaling. Only their gross income reported as wholesaling activity qualifies for the tax deduction for beef processors.

This tax preference is written in law as a tax deduction, yet there were some businesses which claimed this tax deduction as a tax exemption. Claiming a business and occupation tax deduction versus a tax exemption has the same business and occupation tax relief, the tax on that qualifying business activity is zero. The difference between a business and occupation tax deduction and exemption is how it is reported to the Department of Revenue on the business and occupation tax return. Businesses claiming a tax exemption reduce their total gross income by the value of the qualifying business activity income and do not report the total business income that qualifies for the tax preference. In contrast, businesses claiming a tax deduction will report their total gross income, including the value of the qualifying business income for the tax deduction and also report the income value of the tax deduction as well to the Department of Revenue on the business and occupation tax return. This makes estimating the magnitude of the tax deduction much easier than a tax exemption because the business has accurately reported their total gross income and tax deduction. If businesses have claimed a tax exemption instead of a tax deduction on their business and occupation tax return, then JLARC staff must estimate the actual value of the tax deduction during a performance review audit, and this can lead to larger estimation errors in the fiscal impact from this tax preference.

To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?

From this evaluation of the beneficiaries of the tax deduction from the Department of Revenue tax return data, the companies claiming the deduction have come from the animal slaughtering and meat processing from carcasses industry sectors. One drawback to the accounting of this tax deduction on the business and occupation tax return is that this deduction is reported as an

"Other" deduction and grouped with a number of tax deductions.[13] For this analysis, all business and occupation tax returns in the animal slaughtering and meat processing from carcasses industry sectors were examined to determine if those taxpayers claimed the deduction. No information was discovered in this audit that would indicate that any firms other than those targeted in the animal slaughtering and meat processing industry sectors were utilizing this deduction. In summary, there does not appear to be any unintended benefits provided to businesses not targeted by the Legislature in designing this tax deduction, and if other firms were utilizing this deduction, it would need to be discovered during an audit of that firm.

[13] The Department of Revenue has asked the taxpayer to write in the comment section of the form "Beef Ban" so they can identify which "Other" deduction the business is claiming. If the business fails to write in "Beef Ban" then the Department cannot identify which "Other" deduction the businesses are claiming. According to the Department of Revenue, sometimes the businesses will write the appropriate statute references to identify which "Other" deduction they are claiming.

CHAPTER FOUR – REVENUE AND ECONOMIC IMPACTS AND EXPERIENCE OF OTHER STATES

OVERVIEW – REVENUE AND ECONOMIC IMPACTS

Measuring the revenue and economic impacts of this tax preference alone in Washington State's economy is difficult. Typically, revenue and economic impact studies are conducted for large policy changes that have a significant impact on the statewide economy. Since this tax preference was enacted to compensate beef processors for negative impacts from import bans on U.S. beef due to the discovery of BSE in cattle in the U.S., it is interesting to summarize two of those studies and reveal the results that were found from those studies. Next, the important questions outlined in Chapter 43.136 RCW, pertaining to revenue and economic impacts of this tax preference will be answered, and third, the experience from other states within the U.S. will be reviewed.

STUDIES ON THE ECONOMIC IMPACT OF IMPORT BANS DUE TO BSE IN CATTLE

There have been two economic impact studies on the U.S. and regional economies from the U.S. beef export ban and U.S. import ban on Canadian cattle due to the discovery of BSE in North America. The two studies' results will be highlighted in this chapter: one by Washington State University[14] and another by Kansas State University,[15] because they both illustrate the linkages among industries in the overall beef industry and the effects of import bans.

The Washington State University study analyzed the economic impact of losing 90 percent of the U.S. beef export demand due to the foreign import bans from the discovery of BSE in a cow in the U.S. and the possible demand declines from the BSE outbreak. The study used a computable general equilibrium model to simulate the economic impacts on the U.S. economy from 90 percent reduction in the export market for beef. In this scenario of a 90 percent decline in U.S. exports and no change in the domestic U.S. demand for beef, the declines in domestic production and prices were less for the wholesale beef producers than for feeder cattle and ranch and range cattle producers. The results indicate that domestic production for ranch and range cattle and feeder cattle would be reduced by -7 percent versus -6 percent for wholesale beef producers, and the price decline for ranch and range cattle and feeder cattle would be -7 and -8.5 percent respectively and -5.8 percent for wholesale beef. The revenue losses for the ranch and range cattle and feeder cattle would be -14 and -15 percent respectively and -12 percent for wholesale beef. These results reveal that in considering the loss in U.S. export market from importing countries' bans, all sectors of the beef industry are affected, and wholesale beef producers are not impacted as significantly as ranchers and range cattle and feeder cattle. This result is due partially to the ranch and range cattle and feeder cattle industries experiencing their own losses in foreign import markets as well as the decline in demand from the wholesale beef processors from the closing of foreign import markets.

[14] "The Economic Impact of Loss of the Beef Export Market Due to Mad Cow Disease: National and Regional Analysis," David Holland, Leroy Stodick, Stephen Devadoss and Joydeep Ghosh in 2004 published by Washington State University.
[15] "Impacts on U.S. Beef Packers, Workers and the Economy of Restricted Cattle Trade Between Canada and the U.S.," Ted Schroeder and John Leatherman published by Kansas State University December 28, 2004.

The Washington State University study did not incorporate the impact of the U.S. ban on Canadian imports of live cattle which did have a significant impact on the beef processing industry in the U.S. Overall, this study found that the import bans do not have a large impact on the U.S. economy as a whole since the U.S. beef industry only exports 10 percent of its production of beef. Regional economies, like Washington State, could have a larger impact because the region's beef industry depends more heavily on exports.

The Kansas State University study focused on evaluating the impact that the U.S. import ban on Canadian live cattle was having on the U.S. meat packing industry and other related industries. The study found that Canadian imports represented 19 percent of Washington's cattle slaughtered in 2002. This was the second highest of any state within the U.S. besides Utah, which had 30 percent of its cattle slaughter total being Canadian imports. Washington was one of five states that imported more than 100,000 head of Canadian for slaughter and processing in 2002. Washington was one of four states each with more than $100 million in total sales in 2002 from Canadian slaughtered cattle. This study emphasized that some regions and states in the U.S. had been affected in different ways by the import restriction. Utah, Washington, Idaho, Nebraska, Pennsylvania, and Wisconsin appear to have had the largest impact from the U.S. ban on Canadian live cattle imports. This report made a case study of Washington State and analyzed the economic impact of the U.S. import ban on Canadian cattle.[16] This study found a range of total income loss in Washington State from the U.S. import ban on Canadian cattle to be in the range of -$15 million up to -$45 million depending on what assumptions were made about the ability of the U.S. processors to substitute away from Canadian cattle imports and the projected level of Canadian imports of cattle to Washington State absent the import ban. The range of employment losses in Washington ranged from -302 jobs to -906 jobs from the import ban. Again, the range is based on the assumptions made about the ability of the U.S. processors to substitute away from Canadian cattle imports and the projected level of Canadian imports of cattle to Washington State absent the import ban.

What are the past and future tax revenue and economic impacts of the tax preference if it is continued?

The past tax impacts from this business and occupation tax deduction are provided in Figure 6 on page 13. The value of the business and occupation tax deduction was $830 million in gross business income and the tax loss was estimated at $1.1 million for 2004 for three quarters.[17] In 2005, the annual business and occupation tax deduction was $1.17 billion in gross business income, and the tax loss or taxpayer savings was estimated at $1.62 million. The future tax loss would be $1.1 million per year due to the fact that one of the large beef processors, who used to qualify for the deduction, has changed its production process such that they no longer slaughter their own beef in Washington, and thus the revenue impact from continuing the tax deduction has been reduced to $1.1 million per year.

The average total employment of the six firms claiming the tax deduction in 2005 was 2,416. The employment of these six beef processing firms declined 9 percent between 2003 and 2005, and this was a very similar trend to all beef processing in Washington during this same time period. (See

[16] This Kansas State University study utilized U.S. and Washington State IMPLAN data to simulation the economic impacts for this study.
[17] The business and occupation tax rate for wholesaling activities is .138 percent of gross business income.

Figure 3.) The annual wages for these firms totaled $69.62 million with an average annual salary per employee of $28,818 in 2005.

If the tax preference is allowed to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?

If the tax preference is eliminated, the taxpayers, who are currently benefiting, would lose -$1.1 million annually in tax savings. The higher business and occupation taxes from eliminating this tax deduction will have nearly no change on price, quantity produced, or employment statewide from this policy change alone. Since the total tax loss from this tax preference is so small compared to Washington's total General Fund state cash receipts of $27.4 billion in the 2005-07 Biennium, there would be minimal negative economic impact statewide resulting from the elimination of this tax preference. All Washington statewide changes to prices, quantity produced, or employment would be less than .1 percent from the initial base year.[18] As can be seen from the previous studies on the revenue and economic impact from having a ban on U.S. exports of beef or a U.S. import ban on Canadian imports of cattle, these two foreign policy changes had a much larger economic impact on the Washington State economy than the $1 million tax change from the elimination of this tax deduction.

If the tax preference is allowed to be terminated, what would be the effect on the distribution of liability for payment of state taxes?

Since this deduction is on the business and occupation taxes paid by businesses, direct shifting of tax liability from one group of taxpayers to another will not occur. If a new business and occupation tax deduction is enacted, then there is a decline in that tax revenue to the state, and vice versa if a business and occupation tax deduction is eliminated.

OTHER STATES

Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?

Washington is the only state in the U.S. that enacted a tax preference for beef processors specifically to compensate them for the foreign import bans on U.S. beef due to the cases of BSE in the U.S. Even though two other states, Texas and Alabama, had cases of BSE in cattle after Washington State in December 2003, they did not enact legislation to compensate their beef processors for their beef export losses due to import bans. JLARC staff reviewed summaries of recently enacted tax legislation in other states and contacted the National Conference of State Legislatures (NCSL) to verify that no other state in the U.S. had a tax preference for beef processors due to foreign import bans on U.S. beef and cattle.

[18] These economic impact results were based on a computable general equilibrium model for Washington State based on IMPLAN data for 2004.

CHAPTER FIVE – FINDINGS AND RECOMMENDATIONS

FINDINGS

This review of the beef processors' tax deduction due to import bans on U.S. beef exports has evaluated various economic indicators, data on the utilization of the tax preference, employment of those businesses claiming the deduction, and the effect of allowing the tax deduction to be eliminated. The following nine findings were determined through this audit:

Public Policy Objectives and Beneficiaries

- The beneficiaries of the tax deduction were six beef processors in 2004 and 2005 and five beef processors in 2006. This tax deduction has contributed to the achievement of public policy objectives by providing temporary relief to beef processors when they slaughter their own cattle and sell their beef at wholesale.
- The Legislature did not require the beneficiaries to be exporters to foreign markets. Not all beef processors that claimed the tax deduction were registered by USDA as eligible exporters.
- Since one of the public policy objectives was to provide temporary relief to beef processors, continuing the beef processors' tax deduction beyond 2007 would not be consistent with this objective of the tax deduction.
- Businesses with beef slaughtering and processing activities are the companies claiming the tax deduction, and there was no evidence of unintended benefits provided to businesses not targeted by the Legislature.
- JLARC was not able to quantify the impact of the tax deduction on the business practices in Washington's beef industry for the time period in which the tax preference was in place.
- Trends in the health of Washington's beef industry revealed that economic indicators, like Washington commercial red meat production and U.S. wholesale prices for beef and Washington cattle prices, have rebounded back and exceeded the pre-beef ban levels.

Economic and Revenue Impacts

- The past revenue impact from this tax deduction for beef processors was -\$1.1 million for three quarters in 2004, -\$1.6 million for all of 2005 and -\$0.54 million for two quarters in 2006. The future revenue impact of this deduction is -\$1.1 million each year.
- There will be very minimal negative statewide economic impact from having this tax preference eliminated in 2008, since the total tax loss from this tax preference is so small compared to Washington's total General Fund state cash receipts of \$27.4 billion in the 2005-07 Biennium.

Other States

- No other states within the U.S. have enacted legislation to compensate beef processors for loss in revenue from import bans on beef.

RECOMMENDATION

In the course of the study, there were indications that the beef processing industry in Washington State is improving due in a large part to the relaxing of the U.S. import ban on Canadian cattle. In light of our findings and potential future changes in the beef industry, JLARC's recommendation for this tax preference is as follows:

Recommendation 1

The Legislature should retain the current law expiration date of December 31, 2007, which means the tax preference will terminate at the end of 2007.

Legislation Required:	None
Fiscal Impact:	$0 due to expiration date already being in current law; $1.1 million per year in additional business and occupation tax revenue
Reporting Date:	N/A

Due to the intent of the Legislature that this tax deduction be temporary and the fact that all three countries that are specified in statute (Mexico, Japan, and Korea) have each relaxed their initial complete import ban on U.S. beef, and the trends in the health of this industry as well as the projections for these foreign markets that they will increase U.S. beef imports, the expiration date on this tax deduction should remain in place. The economic indicators for this industry sector are improving, like Washington production, consumption, beef processing industry wages, and the wholesale beef prices since the foreign import bans were imposed on U.S. beef. In addition, with the U.S. having opened up its market to imports of Canadian cattle, this helped alleviate the cattle inventory shortage in Washington State and Washington's imports of Canadian cattle have exceeded the pre-beef ban level.

AGENCY RESPONSES

We have shared the report with the Citizen Commission for Performance Measurement of Tax Preferences, the Department of Revenue, and the Office of Financial Management. Their written comments are included as Appendix 2.

ACKNOWLEDGEMENTS

We appreciate the assistance provided by the Department of Revenue, Office of Financial Management, Employment Security Department and legislative committee staff.

Ruta Fanning
Legislative Auditor

On March 21, 2007, this report was approved for distribution by the Joint Legislative Audit and Review Committee.

Representative Ross Hunter
Chair

APPENDIX 1 – SCOPE AND OBJECTIVES

2007 Beef Processors' Tax Preference Due to BSE Beef Import Bans Performance Review

Scope and Objectives
January 2007

STATE OF WASHINGTON
JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM

LIZBETH MARTIN-MAHAR

GARY BENSON

LEGISLATIVE AUDITOR

RUTA FANNING

Copies of Final reports and Digests are available on the JLARC website at:

www.leg.wa.gov/jlarc

or contact

Joint Legislative Audit & Review Committee
506 16th Avenue SE
Olympia, WA 98501-2323
(360) 786-5171

(360) 786-5180 FAX

STUDY MANDATE

In 2006, the Washington Legislature enacted EHB 1069 which mandated audit reviews of Washington's tax preferences. This legislation also created the Citizen Commission for Performance Measurement of Tax Preferences (Citizen Commission) (Chapter 43.136 RCW) and its primary role is to develop a schedule for the performance review of all tax preferences at least once every ten years. In addition, this legislation requested a special audit report of tax preferences which were set to expire before the next legislative session (Chapter 43.136.065(2) RCW).

The one tax preference that will have a 2007 special audit completed is the business and occupation tax deduction for certain beef processors due to U.S. beef bans. This business and occupation tax deduction was enacted in response to importing countries' bans on U.S. beef exports. It has an expiration clause of the earlier of December 31, 2007 or the month following when Japan, South Korea and Mexico have eliminated their import ban on U.S. beef. Since this tax deduction will expire before the 2008 legislative session begins, a special audit report is necessary in order for the 2007 Washington Legislature to have sufficient time to review the JLARC report and take legislative action if necessary.

BACKGROUND

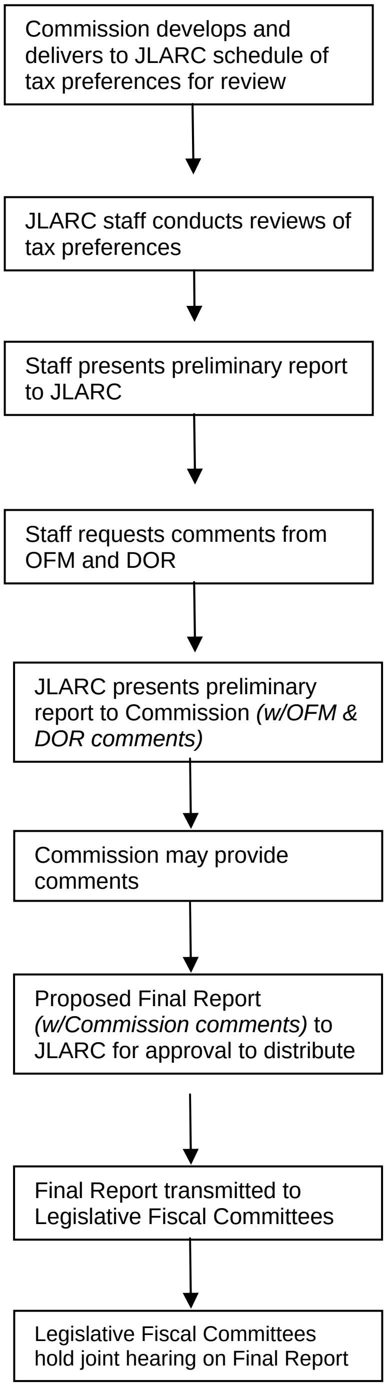
In 2004, the Washington Legislature enacted HB 2929 which provided a business and occupation tax deduction for certain beef processors. The purpose of this legislation was to provide temporary tax relief to Washington beef processors due to import bans on U.S. beef in response to the discovery of Bovine Spongiform Encephalopathy (BSE) in a diary cow on a farm in Washington on December 23rd, 2003. Only certain beef processors, with qualifying wholesale activities, are allowed to claim this business and occupation tax deduction.

In 2005, the Washington Legislature adopted HB 1407 which placed an expiration date of December 31, 2007 (Chapter 82.04.4336 RCW) on the tax preference. Even though the three importing countries (Japan, South Korea and Mexico) have relaxed their bans on U.S. beef, they have not completely removed their import bans. As of February 2006, Mexico has opened its market to U.S. bone-in beef and bone-in beef products from animals less than 30 months of age. As of July 2006, Japan has opened its market to U.S. beef from cattle 20 months of age and younger. As of September 2006, Korea has opened its market to U.S. boneless beef from cattle less than 30 months of age.

STUDY SCOPE

This tax preference performance review will evaluate the beef processors' business and occupation tax deduction specified in RCW 82.04.4336.

Tax Preference Review Process



STUDY OBJECTIVES

The objective of the audit is to answer the following questions, for the Beef Processors' Tax Deduction Due to the U.S. Beef Bans:

Public Policy Objectives:

1. What are the public policy objectives that provide a justification for the tax preference?
2. What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?
3. To what extent will continuation of the tax preference contribute to these public policy objectives?
4. If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment or recapture of the tax benefits?

Beneficiaries:

5. Who are the entities whose state tax liabilities are directly affected by the tax preference?
6. To what extent is the tax preference providing unintended benefits to entities other than those the legislature intended?

Revenue and Economic Impacts:

7. What are the past and future tax revenue and economic impacts of the tax preference if it is continued?
8. If the tax preference is allowed to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?
9. If the tax preference is allowed to be terminated, what would be the effect on the distribution of liability for payment of state taxes?

Other States:

10. Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?

Timeframe for the Study

A preliminary audit report will be presented in February 2007 at a JLARC meeting and a meeting of the Citizen Commission. The final report will be presented to JLARC in May 2007.

JLARC Staff Contact for the Study

Lizbeth Martin-Mahar (360) 786-5123 martin-mahar.lizbeth@leg.wa.gov
Gary Benson (360) 786-5618 benson.gary@leg.wa.gov

APPENDIX 2 – TAX PREFERENCE COMMISSION AND AGENCY RESPONSES

- Citizen Commission for Performance Measurement of Tax Preferences
- Department of Revenue
- Office of Financial Management

State of Washington

E-mail: hennessy.lisa@leg.wa.gov
www.citizentaxpref.wa.gov

Citizen Commission for Performance Measurement of Tax Preferences

February 26, 2007

At its February 23, 2007 meeting, the Citizen Commission for Performance Measurement of Tax Preferences unanimously approved the following motion:

> "*The Commission acknowledges receipt of the preliminary JLARC report on the beef processors tax preference, has provided a forum for discussion and public comment thereon, and endorses the JLARC report recommendations.*"

STATE OF WASHINGTON

DEPARTMENT OF REVENUE

OFFICE OF THE DIRECTOR

P.O. Box 47454 Olympia, Washington 98504-7454 360-753-5574

February 19, 2007

Ms. Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee
506 16th Avenue SE
Olympia, WA 98501-2323

Dear Ms. Fanning:

The Department has reviewed the preliminary report on the review of the beef processors exemption prepared by the Joint Legislative Audit and Review Committee. We read the document to identify any technical and public policy concerns. We find that the report is technically accurate and complete. We believe the findings are well-documented, make appropriate use of the Department's taxpayer data, and reflect an accurate understanding of the tax law and intent of the exemption legislation. We believe the scope and objectives of the study mandate to have been met.

RECOMMENDATION	AGENCY POSITION	COMMENTS
The Legislature should retain the current law expiration date of December 31, 2007, which would allow the tax exemption for beef processors to expire at the end of 1007.	Concur	The intent of the 2005 legislation was to provide temporary relief to beef processors in response to bans imposed by Mexico, South Korea and Japan after discovery of Bovine Spongiform Encephalopathy in a dairy cow in Washington in 2003. While these bans have not been completely relaxed, the report documents trends that show the beef industry in Washington and the U.S. to have increased to pre-foreign import beef ban levels. Therefore the exemption appears to have achieved its purpose.

If you have questions or need additional information, please contact me at (360) 586-3462.

Sincerely,

Cindi Holmstrom

Cindi Holmstrom
Director

cc: Irv Lefberg, Chief of Forecasting, Office of Financial Management
Jim Schmidt, Senior Forecasting Coordinator, Office of Financial Management

STATE OF WASHINGTON
OFFICE OF FINANCIAL MANAGEMENT
Insurance Building, PO Box 43113 • Olympia, Washington 98504-3113 • (360) 902-0555

February 19, 2007

TO: Ruta Fanning, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: Victor A. Moore, Director V.A.M.

SUBJECT: PRELIMINARY REPORT – TAX PREFERENCE PERFORMANCE REVIEW: BEEF PROCESSORS

Thank you for giving the Office of Financial Management (OFM) the opportunity to review JLARC's preliminary report on the Tax Preference Performance Review: Beef Processors.

At this time, the original beef importing bans have been partially lifted or are in the process of being lifted. According to the U.S. Department of Agriculture, on February 1, 2006, Mexico announced it would resume U.S. bone-in beef imports from cattle less than 30 months of age. On December 11, 2006, Japan announced it would resume U.S. bone-in and boneless beef imports from cattle less than 21 months of age. However, an ineligible shipment of beef in January 2007 has caused Japan to "temporarily" reinstate its ban. South Korea has initiated a process for resuming U.S. boneless beef imports.

Here is our response to your individual recommendation.

Recommendation	Agency Position	Comments
1. Retain the current law expiration date of December 31, 2007, which means the tax preference will terminate at the end of 2007.	Concur	OFM agrees there will be very minimal negative statewide economic impact from having this tax preference eliminated in 2008 due to the small utilization and tax loss from this tax preference.

In addition, we would like to note that the original tax preference contained no sunset. The 2005 Legislature added the expiration date.

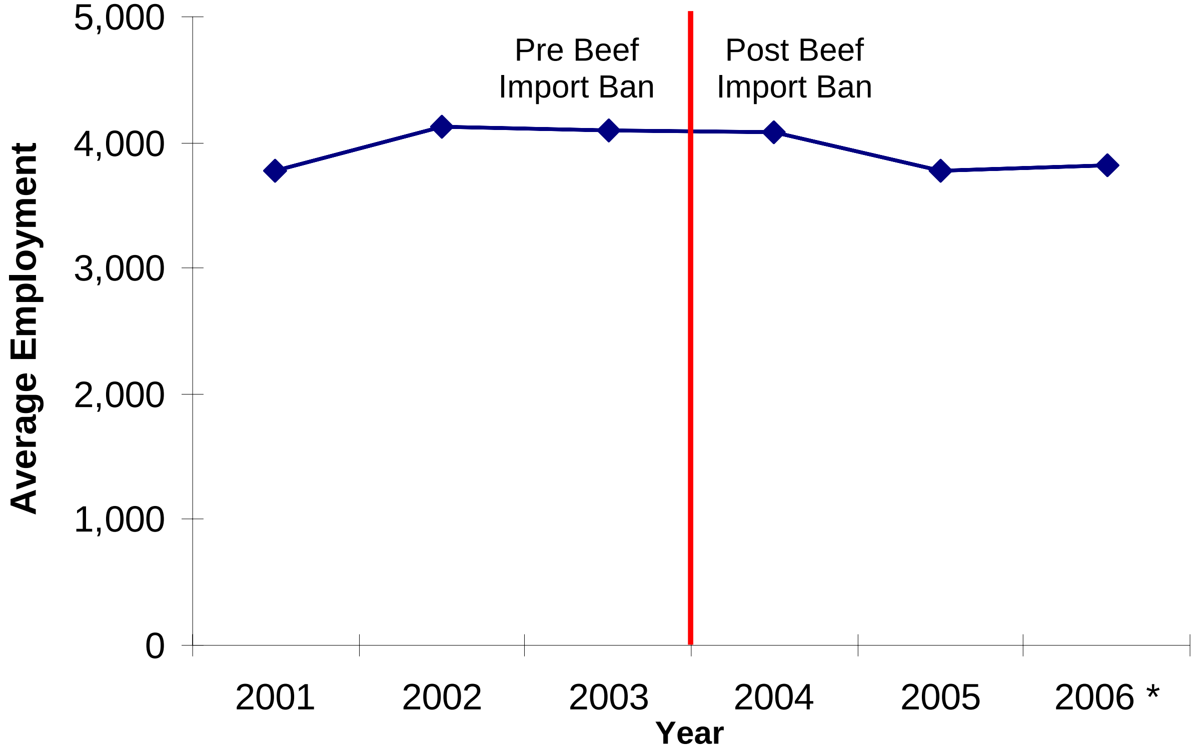
If you have any questions, please contact Jim Schmidt at (360) 902-0595.

APPENDIX 3 – WASHINGTON AND U.S. BEEF PROCESSING INDUSTRIES

Employment

In the two primary industry sectors comprising beef processing in Washington State, animal slaughtering and red meat processing from carcasses, the Washington Employment Security Department statistics indicate that total employment in these two industry sectors has remained nearly the same (see Figure 8). In 2001, there were 3,778 employees throughout the state, and in the first quarter of 2006, there were 3,819. This represents an overall increase of just 1 percent.

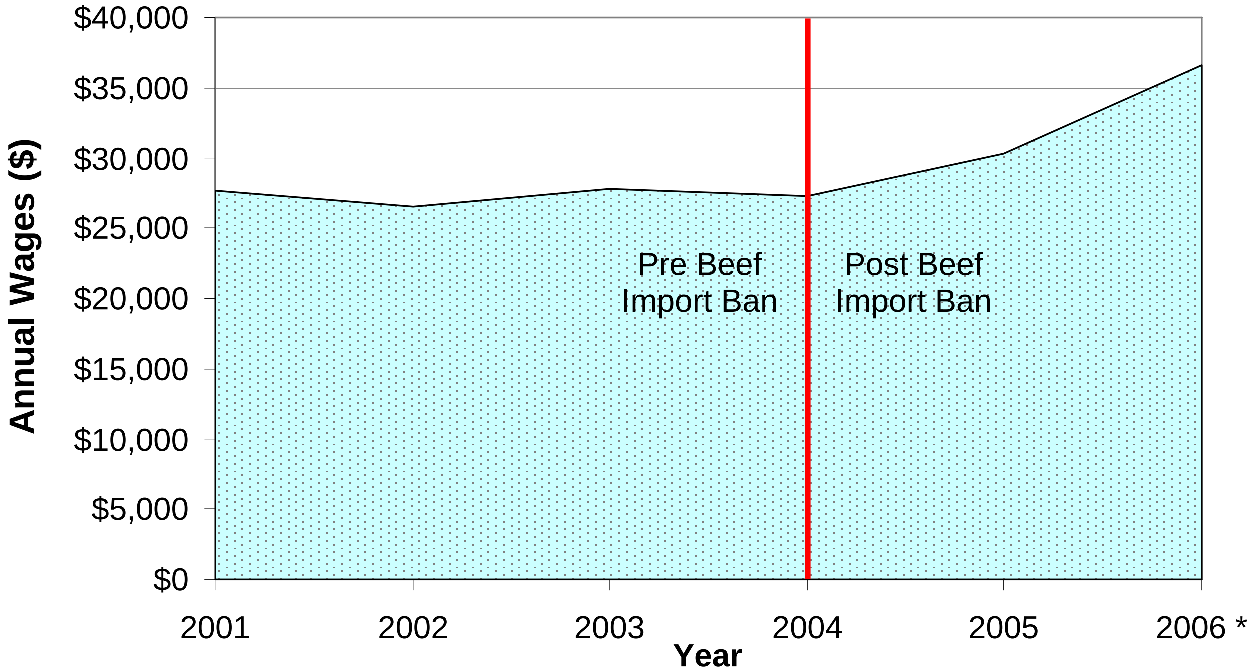
Figure 8: Washington Beef Processing Employment Trends in Animal Slaughtering and Red Meat Processing Industries 2004-2005



Source: Washington Employment Security Department Covered Employment Data.

As the number of employees remained constant over the last five years, the average annual wages per employee has risen from $27,675 in 2001 to $36,571 in the first quarter of 2006 which is an increase of 32 percent (see Figure 9). This strong growth in wages reveals a positive outlook for workers in this industry.

Figure 9: Washington Beef Processing Wage Trends: From 1996 – 1st Quarter 2006



Source: Washington Employment Security Department Covered Employment Data.
* Average based on first quarter of 2006.

The Washington Employment Security Department data on the size of firm for the red meat processing sectors reveals that there are a total of 67 firms and total employees of 3,829 in the first quarter of 2006 (see Figure 10). The majority, 55 percent, of the businesses are small businesses with less than four employees. There are only a couple of large firms in the red meat processing industries in Washington State. Those six large red meat processing firms, with more than 100 employees each, account for 85 percent of all employees in the state for these industry sectors.

Figure 10: Number of Washington Red Meat Processing Firms Categorized by Size of Firm – 1st Quarter 2006

Size of Firm	Number of Businesses	Percent of Total Businesses	Number of Employees	Percent of Total Employees
Less than 4 employees	37	55.2%	82	2.1%
4-19 employees	18	26.8%	168	4.4%
20-99 employees	6	9.0%	321	8.4%
100+ employees	6	9.0%	3,258	85.1%
TOTAL =	67	100.0%	3,829	100.0%

Source: Washington Employment Security Department Size of Firm data for Q1 2006.

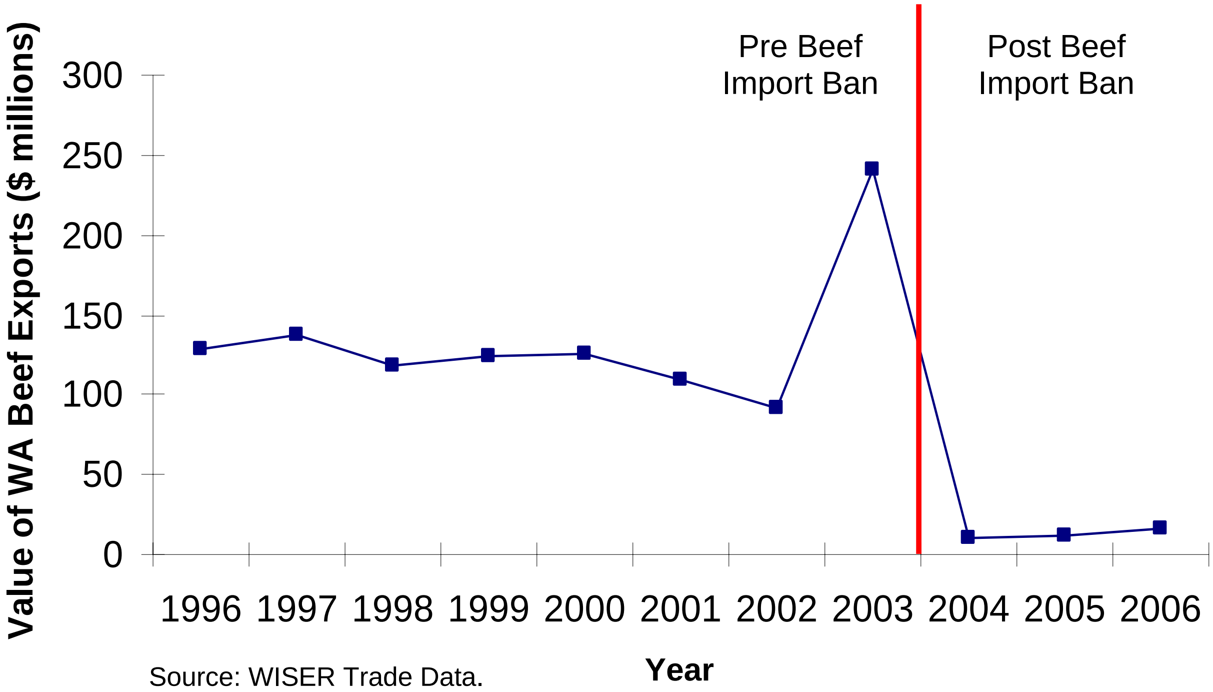
Washington Beef and Livestock Exports/Imports

In 2003, U.S. beef exports were valued at $3.95 billion, and five countries: Japan, Mexico, South Korea, Canada, and Hong Kong, received 90 percent of U.S. beef exports.[19] In 2003, the last year before the import ban on U.S. beef exports, the U.S. beef industry exported nearly 10 percent of the U.S. domestic production overseas.[20] Washington State was more heavily reliant on exports of processed beef as it is estimated that in 2003 Washington beef exports comprised 16 percent of production.[21] U.S. beef exports declined from a high of $3.07 billion in 2003 to $528 million in 2004. This was a decline of 83 percent in one year due to the U.S. beef export ban imposed by importing countries due to the first case of BSE in cattle in the U.S.

Washington State saw a drop in its processed beef exports by 96 percent from $241 million in 2003 down to $10 million in 2004.[22] Prior to the ban on U.S. beef exports, the Washington beef market had exports valued at an average of $140 million between 1996 and 2002 (see Figure 11 on following page). Washington exports in 2003 jumped significantly as a result of the closure of the Canadian processed beef and cattle markets due to Canada finding their first case of BSE in cattle in May 2003. Washington State was able to increase its exports of processed beef to Canada's Asian import markets. Japan was the largest importer of Washington processed beef in 2003.

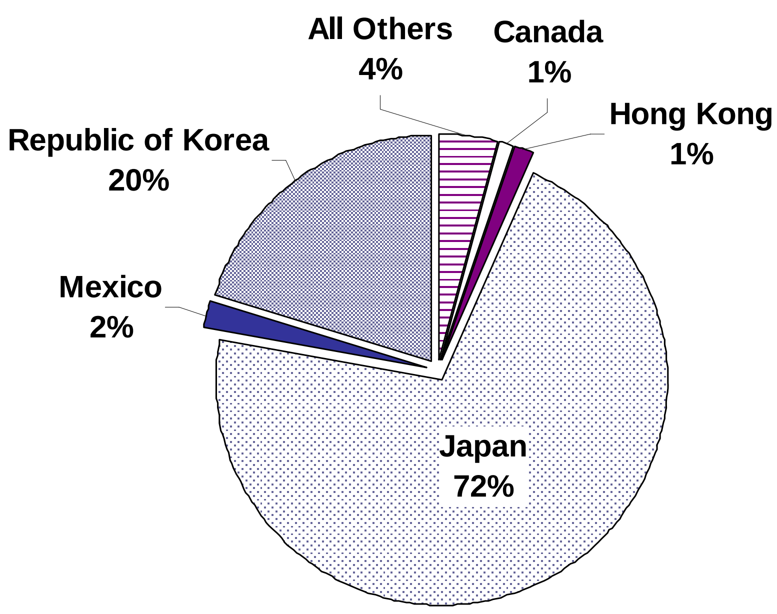
[19] Source: "K-State Study :Puts Beef Export Market Loss Related to BSE in Range of $3.2 to $4.7 billion" Kansas State University Research and Extension News.
[20] Source: USDA ERS data on U.S. red meat and poultry forecasts and U.S. Department of Commerce, Cumulative U.S. Meat and Livestock Trade.
[21] IMPLAN data for 2003 and 2004 and World Institute for Strategic Economic Research (WISER) WISER Trade data for Washington exports of bovine fresh or chilled or frozen.
[22] World Institute for Strategic Economic Research (WISER) WISER Trade data for U.S. and Washington exports of bovine fresh or chilled or frozen.

Figure 11: Value of Washington Processed Beef Exports ($ millions)



Source: WISER Trade Data.

Figure 12: Composition of Washington State's Top 5 Beef Export Markets: 2003
(Total Value = $241 million)

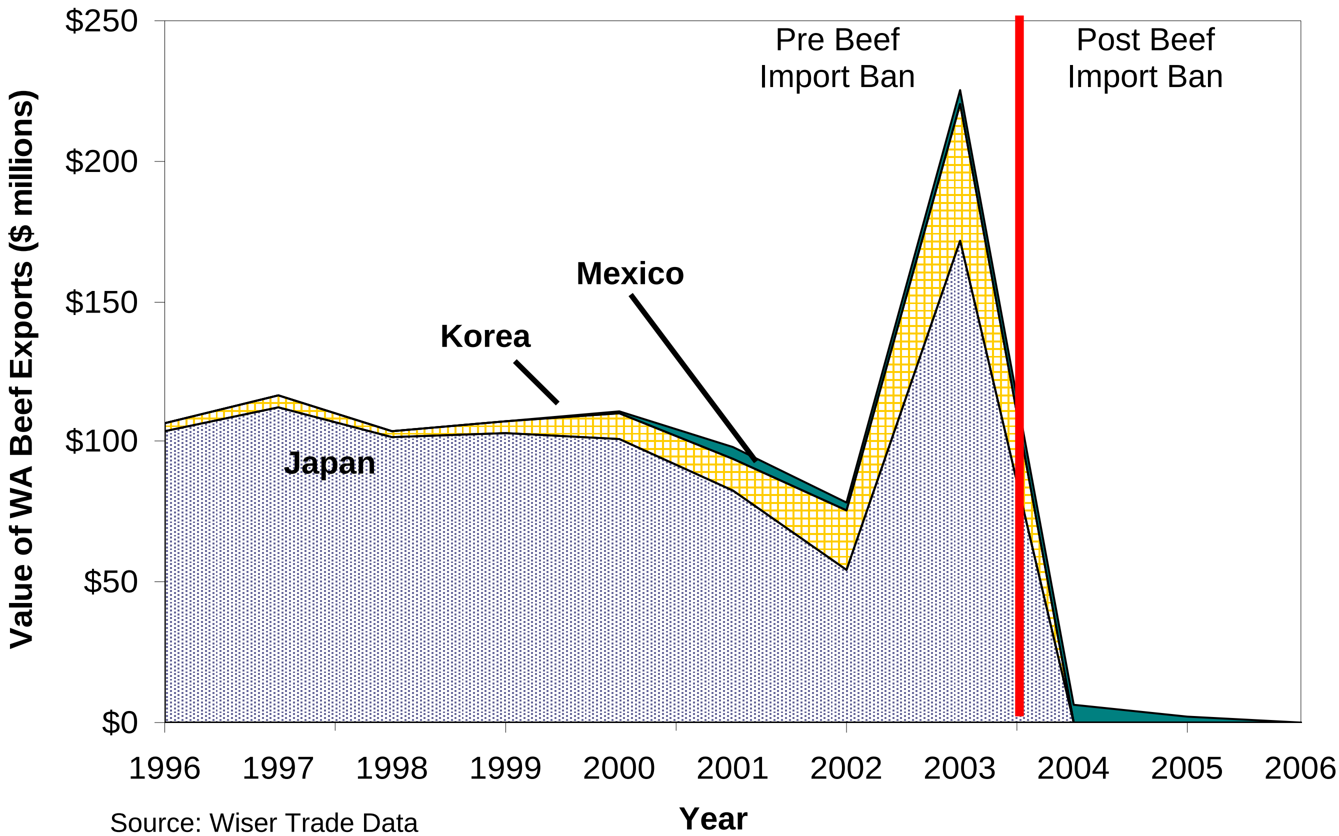


Source: WISER Trade Data.

In addition, the top five export markets for Washington beef made up 96 percent of total Washington beef exports of $241 million in 2003 (see Figure 13). By contrast three years later, in 2006, the composition of Washington beef exports had changed significantly, and the value had declined to $17 million. By 2006, the biggest export market for Washington beef was the Philippines at 25 percent, Canada at 18 percent, and Hong Kong and Taiwan each at 14 percent.

In examining the import trends of the top five export markets for Washington beef prior to the import ban, it is revealed how significant Japan and Korea had become to the Washington beef export market, especially in 2003 after the Canadian beef market had been banned. Since the U.S. beef import ban was imposed at the end of 2003, both of these markets have partially lifted their beef ban but not until 2006, so this change in the ban is not reflected in Figure 13. Mexico has shown an increase in its imports of Washington beef from 1998 until 2004. Mexico's import ban on U.S. beef was one of the first bans to be relaxed after the discovery of BSE in cattle. Japan's imports of beef have started to grow again in 2006 with the complete ban on U.S. beef relaxed, so they are importing boneless beef of young cattle beginning towards the end of 2006. Korea had no reported imports of Washington beef in 2006 even though their complete ban on U.S. beef had been relaxed to allow in boneless beef of young cattle.

Figure 13 – Value of Washington's Exports to Korea, Mexico and Japan



Source: Wiser Trade Data

Washington State is a net importer of live cattle. Prior to the U.S. ban on Canadian imports of live cattle, Washington State was the largest importer of Canadian cattle in 2002, and these imports accounted for 15 percent of all Canadian live cattle exports. Figure 14 provides a summary of the trends in cattle imports from Canada. In 2002, Washington's imports of Canadian cattle was valued at $179 million, and it declined to $81 million in 2003 from the seven months of cattle import ban put into place in May 2003. Since the U.S. opened up its market to allow the import of live cattle from Canada under certain restrictions in August 2005, Washington imports of live cattle has already exceeded the import level in 2002 prior to the BSE ban. In 2005, the imports of live cattle from Canada were valued at $158.8 million, and this represented five months of imports. For 2006, Washington's imports of Canadian cattle was valued at $414 million which is a little more than 130 percent increase in value from the import level in 2002 prior to the U.S. BSE import ban.

Figure 14: Washington's Imports of Canadian Cattle – Before and After the U.S. Import Ban on Cattle from Canada

Year	Value of cattle imports from Canada ($ millions)	Number of Months of Imports
Before U.S. import ban on Canadian Cattle and Beef		
2002	$179	12 months
Post U.S. import ban on Canadian Cattle and Beef		
2003	$81	5 months
2004	$0	0
2005	$159	5 months
2006	$414	12 months

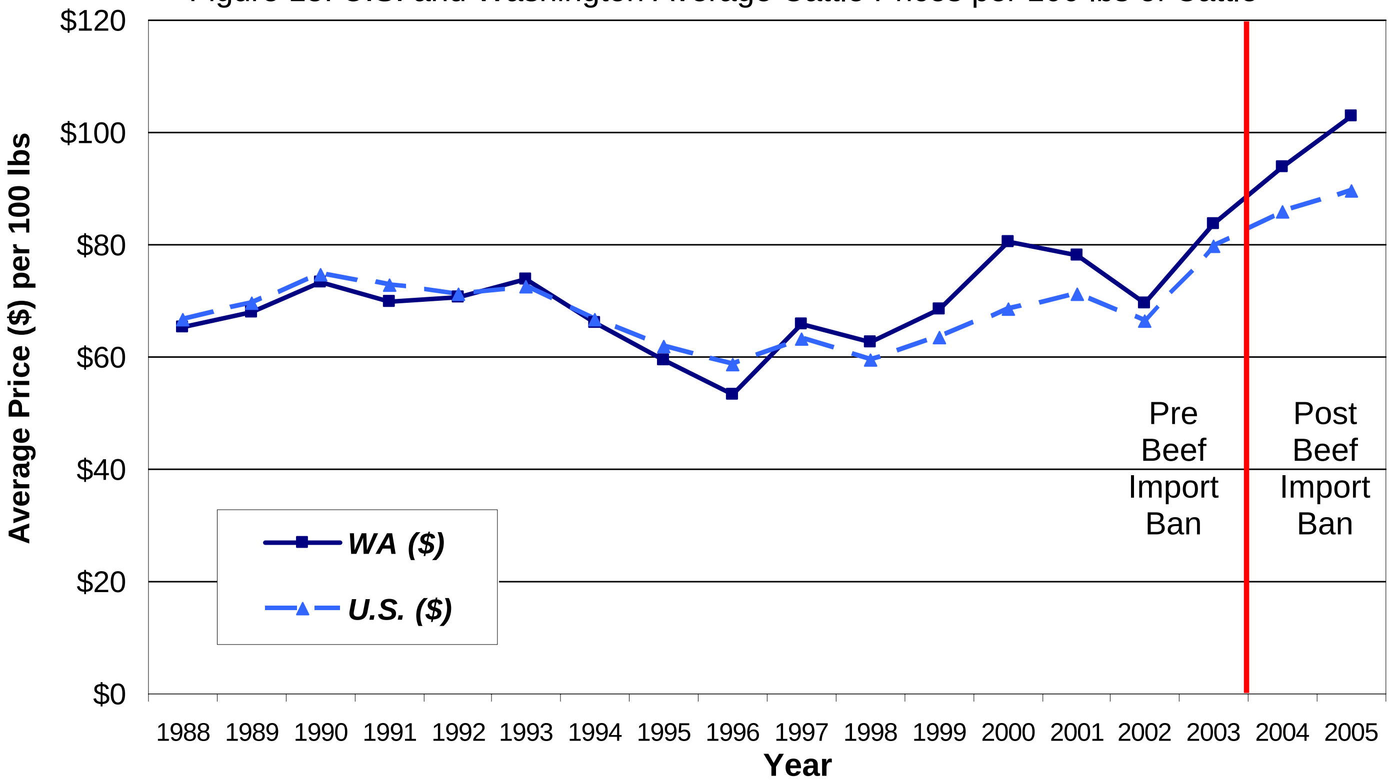
Source: WISER Trade Dataset.

Canadian processed beef exports also declined from the import ban from $1.3 billion in 2002 to $969 million in 2003. The U.S. is the largest single importer of Canadian beef. Some other countries, which were also importing Canadian beef, switched to importing U.S. beef instead after the discovery of BSE in Canada in May 2003. In 2002, Canada exported $33.54 million in beef to Japan, and in 2003, it had declined to $22 million and declined to $0 by 2004. In 2002, South Korea imported $27.5 million of beef from Canada, and that market declined $14 million in 2003 and $0 by 2004. In 2003, Washington's exports to Japan and South Korea in particular increased significantly due to the closed Canadian beef market. The U.S. opened up its markets to processed Canadian beef in August 2003 so the impact on the Canadian market could have been significantly higher if the U.S. had not opened up its market quickly to certain processed beef.

Cattle Prices and Value of Production

The price of cattle in Washington and the U.S. is important to examine over time as it dictates the value of ranchers' income and the cost of an important input for the feedlots and slaughter house and packers. Figure 15 on the following page reveals the annual price per 100 pounds of cattle for the value of production in Washington State and the U.S. since 1988. During 1988 through 1995, the Washington price of cattle has closely mirrored the U.S. average cattle price. Cattle prices have been on a faster rising trend in Washington State than in the U.S. since 1996. Since Washington State cattle prices have exceeded U.S. average cattle prices for nine years, it indicates that ranchers in Washington receive higher cattle prices than the U.S. average, and cattle as an input into beef production is more expensive in Washington than in the U.S. on average. The U.S. ban on Canadian imports of cattle in 2003 caused a drop in cattle prices in Canada, but in the U.S. the price of cattle rose. Annually on average, in 2002, the Washington cattle price was $70 per 100 lbs of cattle, and it rose 20 percent to $84 per 100 lbs of cattle in 2003. With the discovery of BSE in the U.S. in December 2003, the price of cattle fell in the U.S. temporarily, but the overall annual average price for cattle in Washington still grew between 2003 and 2004 by 35 percent to $94 per 100 pounds of cattle. For this same time period, the U.S. average cattle price grew by only 8 percent from $80 per 100 pounds of cattle to $86 per 100 pounds of cattle. This large increase in the Washington price for cattle was due to the heavier reliance on Canadian imports of cattle in Washington State versus the U.S. market as a whole had much smaller dependence on Canadian imports. Since the U.S. has relaxed its ban on Canadian live cattle in August 2005, this policy change should put downward pressure on the Washington price of cattle in 2006. The value of Washington's production of cattle fell in 2002 to $451 million, and has been increasing for the past three years to $601 million in 2005. Even with a ban on U.S. beef, Washington cattlemen have not

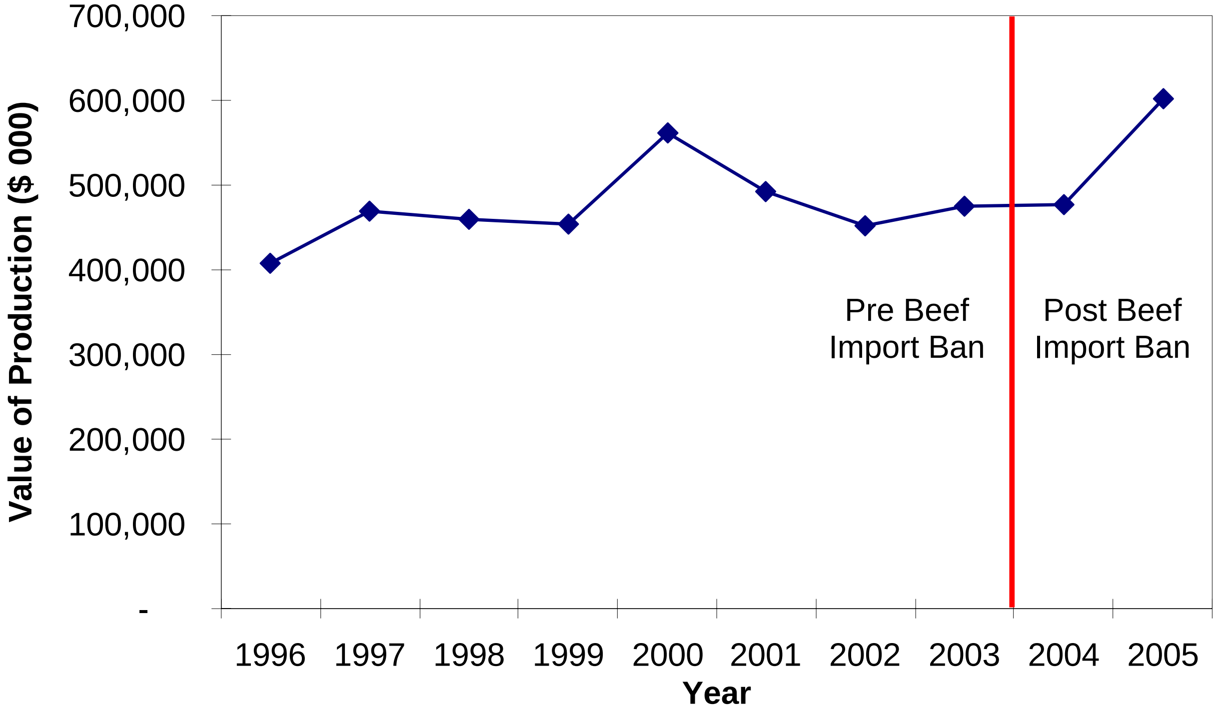
Figure 15: U.S. and Washington Average Cattle Prices per 100 lbs of Cattle



Source: USDA National Agricultural Statistics Service for U.S. and Washington.

seen a drop in the total value of their cattle production. This has been due to small reliance by Washington cattlemen on exports of live cattle and to the strong domestic demand for cattle to produce beef since the U.S. had closed its market to Canadian imports of live cattle until August 2005. This shortage of cattle to slaughter in the U.S. caused further increases in the price of cattle in recent years.

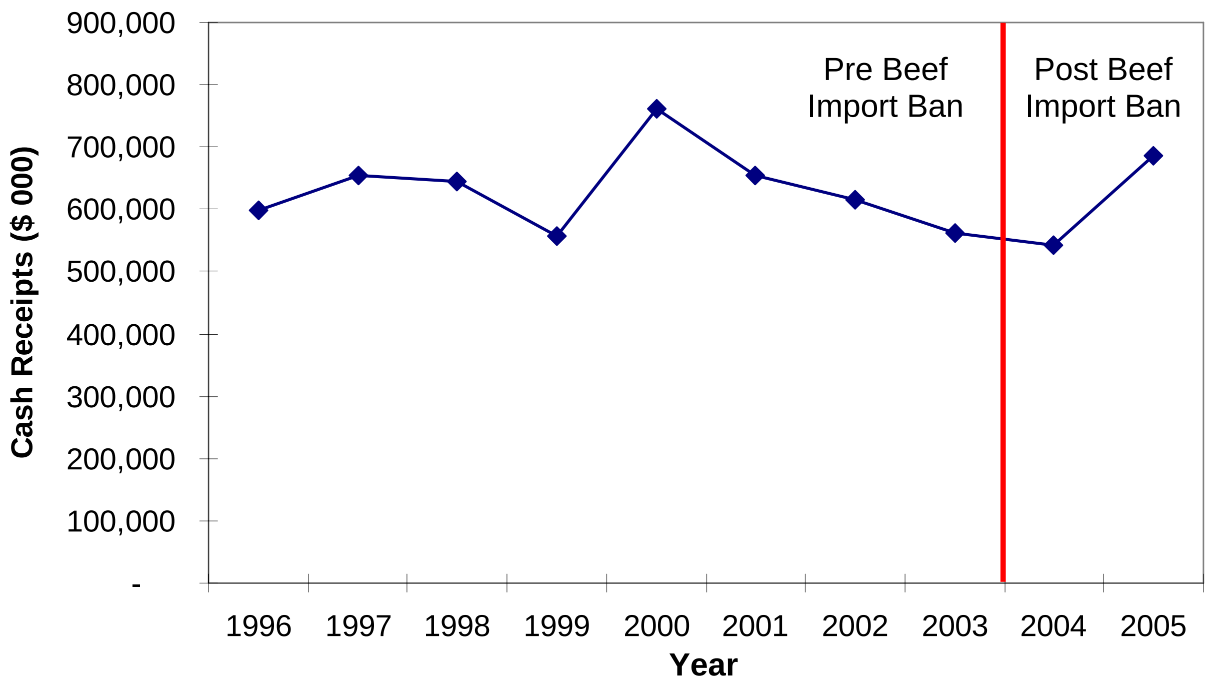
Figure 16: Value of Washington's Cattle Production: 1996 - 2005



Source: USDA National Agricultural Statistics Service for Washington.

For owners of Washington's feedlots, the cash receipts of marketings dropped to $543 million in 2004 after the foreign beef import ban on U.S. beef and the U.S. ban on live cattle imports from Canada (see Figure 17 below). Marketings include animals for the slaughter market and younger animals shipped to other states for feedings and breeding purposes. Cash receipts from marketings in Washington have rebounded in 2005 to $685 million. Washington's 2005 value of cash receipts was the second highest in the past ten years.

Figure 17: Washington's Cash Receipts from Marketings: 1996 - 2005

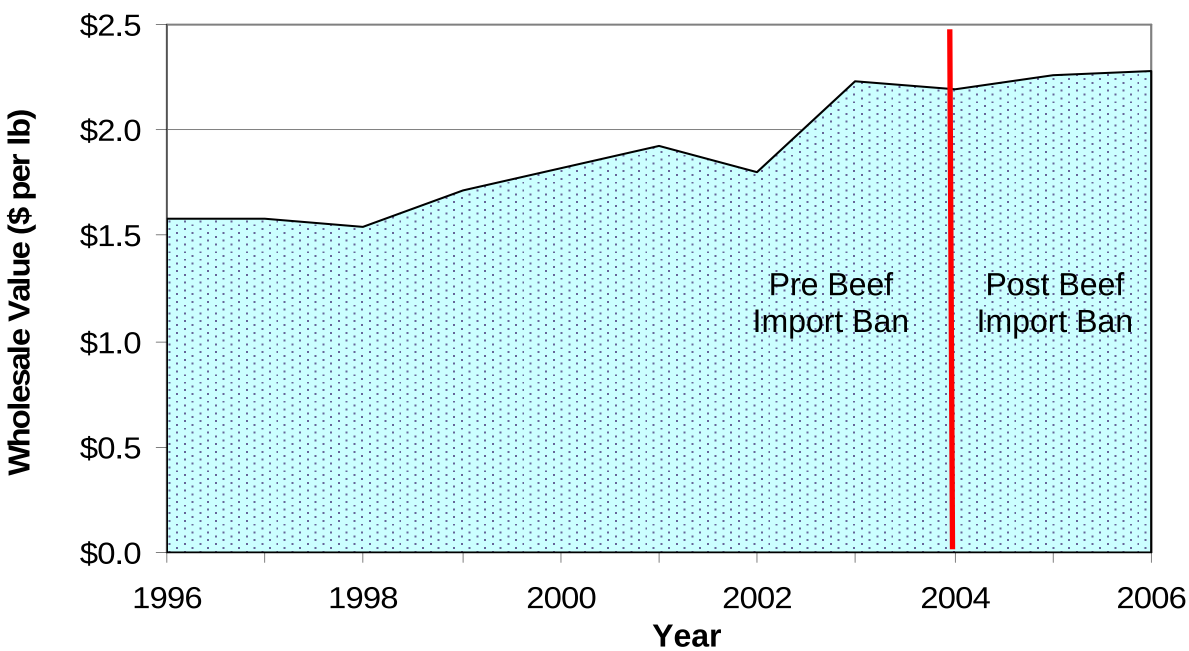


Source: USDA National Agricultural Statistics Service for Washington.

Wholesale Prices

Besides cattle prices, wholesale prices for U.S. beef is an indicator of the output price that slaughter houses and packers will receive for their finished product (see Figure 18 below). There are no published state-level wholesale prices so the U.S. beef choice price is examined. The U.S. wholesale price has ranged between $1.50 and $2.00 per pound from 1996 until 2002. In 2003, the wholesale price rose above $2 per pound and has not fallen below $2 per pound in the last three years. The U.S. wholesale price rose in 2003 due to the U.S. import ban on Canadian live cattle which caused a shortage of cattle to be slaughtered in the U.S. As input prices such as cattle prices rise, so does the wholesale price. In 2004, the average annual wholesale price fell by -2 percent, due to the foreign import bans on U.S. cattle and beef, but the price decline was only temporary. The domestic demand for beef was not permanently impacted. Therefore, in 2005, the U.S. average wholesale price increased 1 percent above the pre-beef ban price in 2003. In 2006, the U.S. wholesale price had risen slightly and is maintaining this higher price level since the first discovery of BSE in North America in 2003.

Figure 18: U.S. Average Wholesale Beef Prices: 1980 - 2006



Source: USDA Economic Research Service.

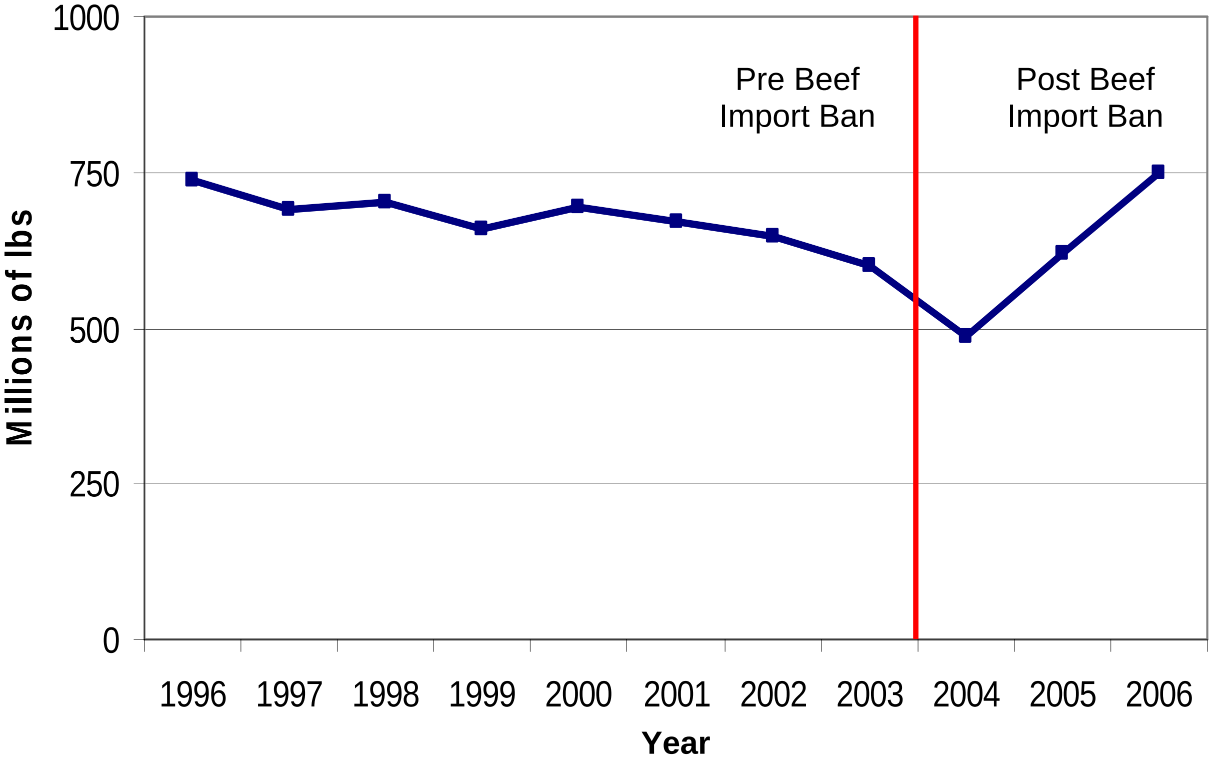
Beef and Red Meat Production

Red meat production is examined in this report as an indicator of beef production because USDA does not report beef production only at the state level.[23] Since 1996, commercial red meat production in Washington has fluctuated between 500 and 750 million pounds (see Figure 19 on the following page). Red meat production prior to the foreign import bans on U.S. beef was 598 million pounds in 2003. The first year after the foreign import bans were put in place, red meat

[23] On average between years 2000-2005, Washington's commercial red meat production ranged from having between 95-100 percent beef production. Washington's commercial production of other non-beef red meat (pork, sheep, and goats) is very minor annually.

production fell 18 percent in 2004. Then red meat production rebounded in 2005 to 618 million pounds and exceeded the pre-beef ban red meat production level in 2003 by 3 percent. The 2006 red meat production total is 750 million pounds which is the highest production level in the past ten years and the second highest production in the past 30 years. Washington's portion of total U.S. red meat production had been declining from 1.5 percent in 2000 to 1.1 percent in 2004. Since 2004, Washington's share of red meat production has been rising. In 2006, the average Washington red meat production was 1.6 percent of U.S. red meat production. This trend signals that Washington's production of red meat since the ban on U.S. beef exports is growing faster than the U.S. average growth in all red meat production.

Figure 19: WA Commercial Red Meat Production: Annual Total (millions of lbs)



Source: USDA National Agricultural Statistics Service – Washington State 2006 Annual Agriculture Bulletin.

U.S. Domestic Beef Consumption

U.S. domestic demand for beef has been growing despite having the first cases of BSE in cattle in North America (see Figure 20 below). Over the past eight years, average beef consumption has grown by 4 percent from 26.9 to 28 billion pounds. Beef consumption in the U.S. is now at the highest level in the past eight years, exceeding the consumption level prior to the cases of BSE in cattle in North America. On a per capita basis, U.S. consumers in 2005 and 2006 each consumed approximately 66 pounds of beef.

Figure 20: U.S. Total and Per Capita Beef Consumption and Washington Estimated Total Beef Consumption

Year	Beef Consumption (million lbs)	% Change	Per capita Consumption
1999	26,936		68
2000	27,338	1%	68
2001	27,026	-1%	66
2002	27,878	3%	68
2003	27,000	-3%	65
2004	27,750	3%	66
2005	27,751	0%	66
2006*	28,041	1%	66

Source: USDA-ERS Agricultural Outlook Statistical Indicators U.S. Meat Supply & Use various issues.

* 2006 is a preliminary estimate from USDA-ERS.

Appendix 4 – Law Outlining the Tax Preference for Beef Processors

RCW 82.04.4336

(1) In computing tax there may be deducted from the measure of tax those amounts received for:

(a) Slaughtering cattle, but only if the taxpayer sells the resulting slaughtered cattle at wholesale and not at retail;

(b) Breaking or processing perishable beef products, but only if the perishable beef products are derived from cattle slaughtered by the taxpayer and sold at wholesale only and not at retail;

(c) Wholesale sales of perishable beef products derived from cattle slaughtered by the taxpayer;

(d) Processing nonperishable beef products, but only if the products are derived from cattle slaughtered by the taxpayer and sold at wholesale only and not at retail; and

(e) Wholesale sales of nonperishable beef products derived from cattle slaughtered by the taxpayer.

(2) For the purposes of this section, "beef products" means the carcass, parts of carcass, meat, and meat by-products, derived exclusively from cattle and containing no other ingredients.

(3) The deduction allowed under this section is allowed only for tax liability incurred after March 31, 2004, and until the first day of the month following the date on which the bans on the importation of beef and beef products from the United States of America by Japan, Mexico, and the Republic of South Korea have all been lifted.

(4) The department must provide notice, on the department's web site, of the date on which this deduction is no longer available. The notice required by this section does not affect the availability of the deduction under this section.

(5) This section expires December 31, 2007.

[2005 c 150 § 1; 2004 c 235 § 2.]

Notes:

Finding -- Intent -- 2004 c 235: "The legislature finds that the recent occurrence of bovine spongiform encephalopathy and the resulting bans on beef imports from the United States have had a severe economic impact on the state's beef processing industry. The legislature intends to provide temporary business and occupation tax relief for Washington's beef processors." [2004 c 235 § 1.]

Effective date -- 2004 c 235: "This act is necessary for the immediate preservation of the public peace, health, or safety, or support of the state government and its existing public institutions, and takes effect immediately [March 31, 2004]." [2004 c 235 § 3.]