

Proposed Final Report:

2018 Tax Preference Performance Reviews

Investment Projects in High Unemployment Counties and Community Empowerment Zones

Legislative Auditor's Conclusion:

Businesses reported creating 87 percent fewer jobs than they originally estimated. The preference likely had a nominal impact on poverty rates. The Legislature should consider adding targets to help determine whether the preference is meeting expectations.

December 2018

Sales and use tax deferral for qualifying businesses that invest in facilities, machinery, or equipment in certain distressed areas

Qualifying businesses located in economically distressed areas do not pay sales or use tax on the following investments:

- New construction, or expansion or renovation of existing facilities.
- New machinery or equipment.

The preference applies to two types of economically distressed areas:

1. A **high unemployment county** designated by the Employment Security Department based on recurring above average unemployment rates.
2. A **community empowerment zone (CEZ)** designated by the Department of Commerce. CEZs are located in cities or unincorporated areas and are characterized by limited employment opportunities and educational services, a lack of affordable housing, and deteriorating infrastructure.

The deferred taxes are waived if businesses continue to use the facilities, machinery, or equipment as intended for a total of eight years.

The preference has no expiration date, but the Department of Revenue cannot issue deferral certificates after July 1, 2020.

Estimated Biennial Beneficiary Savings

\$5.8 Million

Tax Type

Sales and Use Tax

RCWs 82.60.040; 82.60.049

Applicable Statutes

Stated public policy objectives

The Legislature stated its objectives in 2010 when it restructured a previous deferral program to encourage investment in high unemployment counties and CEZs.

Objectives (stated)	Results
Stimulate economic development and job growth in distressed areas	Mixed. Businesses are using the preference in eight out of 22 high unemployment counties and four out of six CEZs. These beneficiaries have created new jobs, but fewer than they originally estimated. It is unclear if the job growth meets legislative expectations.
Reduce poverty in distressed areas	Unclear, but likely nominal impact. JLARC staff estimate the potential reduction to the poverty rate is at most 0.07 percent in qualifying areas.

Recommendations

Legislative Auditor's Recommendation: Review sufficiency of outcomes and add metrics

The Legislature should review the sufficiency of outcomes and add metrics for the preference. While businesses are using the preference in eight high unemployment counties and four CEZs, estimates vary on the extent to which the preference has impacted job growth. Businesses reported creating 87 percent fewer jobs than they originally estimated. It is unclear if the job growth meets legislative expectations.

It is also unclear whether the preference reduced poverty in distressed areas. At most, JLARC staff estimate the potential reduction in the poverty rate to be 0.07 percent in qualifying areas. The data necessary to determine a more precise impact on poverty rates does not exist.

More information is available on the Recommendations Tab.

Commissioners' Recommendation

The Commission endorses the Legislative Auditor's recommendation with comment. Metrics should be designed to capture not only the impact of the preference across all applicable counties and community empowerment zones, but also within each county and community empowerment zone. If the preference is creating new jobs or otherwise having a positive economic impact on one county or zone, then it may be worth maintaining. Specific to metrics, in many rural counties the unemployment rate is based on very small sample sizes. Therefore, the unemployment rate may be an incomplete indicator of economic distress.

REVIEW DETAILS

1. What is the preference?

Sales and use tax deferral for qualifying businesses that invest in facilities, machinery, or equipment in distressed areas

Legislature stated two public policy objectives

The Legislature passed this preference in 2010 with two stated objectives:

- Promote and stimulate economic and new employment opportunities in distressed areas.
- Reduce poverty in distressed areas.

Sales and use tax deferral for construction, new machinery and equipment

Qualifying businesses do not pay sales or use tax on the following investments:

- Building, expanding, or renovating facilities to increase floor space or production capacity.
- Purchasing new machinery or equipment.

The deferral covers materials, labor, and services to plan and construct facilities, and to install machinery or equipment.

Businesses must apply to the Department of Revenue (DOR) for the deferral before they begin construction, take possession of machinery or equipment, or hire employees.

Manufacturing and several other business activities qualify

The preference is limited to businesses performing any of the following activities:

- Manufacturing
- Research and development laboratories
- Commercial testing laboratories
- Conditioning vegetable seeds

Investment projects must be located in a distressed area

For this report, distressed area means one of the following:

- A **high unemployment county**, which is defined as a county with an unemployment rate at least 20 percent higher than the state average for the preceding three consecutive calendar years. The Employment Security Department establishes a list of qualifying counties and updates it every two years.
- A designated **community empowerment zone (CEZ)**. CEZs are located in cities or unincorporated areas. They are characterized by limited employment and educational services, a lack of affordable housing, and deteriorating infrastructure. The Department of Commerce has designated six CEZs in Washington.

Specific hiring requirements for projects in CEZs, none for projects in high unemployment counties

Investment projects in a CEZ must meet the following requirements:

- Hire one permanent full-time employee for each \$750,000 of investment for which a deferral is requested.
- The employee(s) must live in the CEZ or in the county containing the CEZ when hired.
- Hiring must occur after DOR has received the deferral application.
- The position(s) must be filled by the end of the calendar year after the year in which DOR certifies that the project is complete. The business must retain the positions for the entire tax year.

DOR must verify that businesses have satisfied the hiring requirements initially. However, there is no statutory requirement that the new positions be maintained after the date that DOR verifies they were filled.

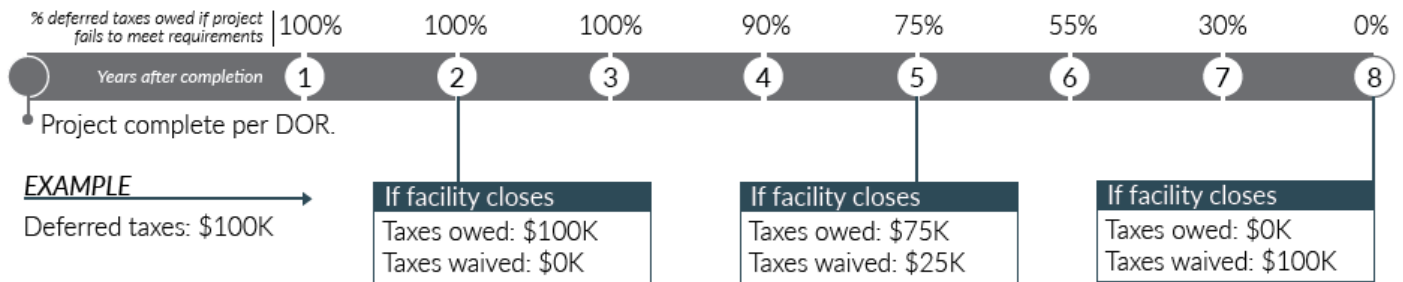
Businesses with investment projects located in high unemployment counties have no statutory hiring requirements.

Deferred taxes are waived if a project meets eligibility requirements for 8 years

If DOR determines a project meets eligibility requirements for eight consecutive years, all deferred taxes are waived. However, if a project no longer meets eligibility requirements within eight years after completion, **all or a portion of the remaining deferred taxes are immediately due**. The amount of taxes owed, and the amount waived, depends on how many years the project remains eligible.

A project becomes ineligible when a business no longer performs one of the qualifying activities. For example, if a business stops manufacturing at the facility, or closes the facility, the project is no longer eligible for a deferral.

Exhibit 1.1: A portion of deferred taxes is waived starting the 4th year after the project is operationally complete



Source: JLARC staff analysis of RCWs 82.60.060(1), 82.60.065(2).

Beneficiaries must file annual tax performance report

Businesses must file an annual tax performance report (annual report) for eight consecutive years after the project is operationally complete to remain eligible for the preference. If a business does not file an annual report or request an extension by the reporting deadline, DOR must bill the business for 12.5 percent (one-eighth) of the total amount of deferred taxes.

Preference is time limited, but has no expiration date

The preference took effect July 1, 2010. The Legislature did not set an expiration date, but did establish that DOR cannot issue deferral certificates after July 1, 2020.

REVIEW DETAILS

2. Legal history

The Legislature has tried different ways to encourage investment in rural, distressed, and high unemployment counties for over 30 years

1972-1982: Early attempts to target sales and use tax deferrals to specific areas were unsuccessful

The Legislature first enacted a sales and use tax deferral program in 1972 for investments in new buildings, machinery, and equipment. The deferral was in response to numerous job reductions in the aerospace industry.

Although initially targeted to certain distressed areas, the deferral was expanded to more areas over time. By 1982, the deferral was available in 37 of Washington's 39 counties. The Legislature repealed the deferral program that year after legislative studies found it to be costly and ineffective in attracting new businesses or increasing production.

1985-2009: Legislature enacted new tax deferral program for distressed areas. Program was expanded and extended over the next 24 years.

In 1985, the Legislature enacted a new sales and use tax deferral program to provide tax relief and incentives for small business development or expansion in certain distressed areas. The program was initially set to expire in 1991 and only applied to manufacturers and certain other business activities in counties with high unemployment rates. The program also initially had project-specific and statewide spending caps. Businesses were required to:

- Create a job for each \$200,000 invested.
- Increase the site's value by 25 percent.

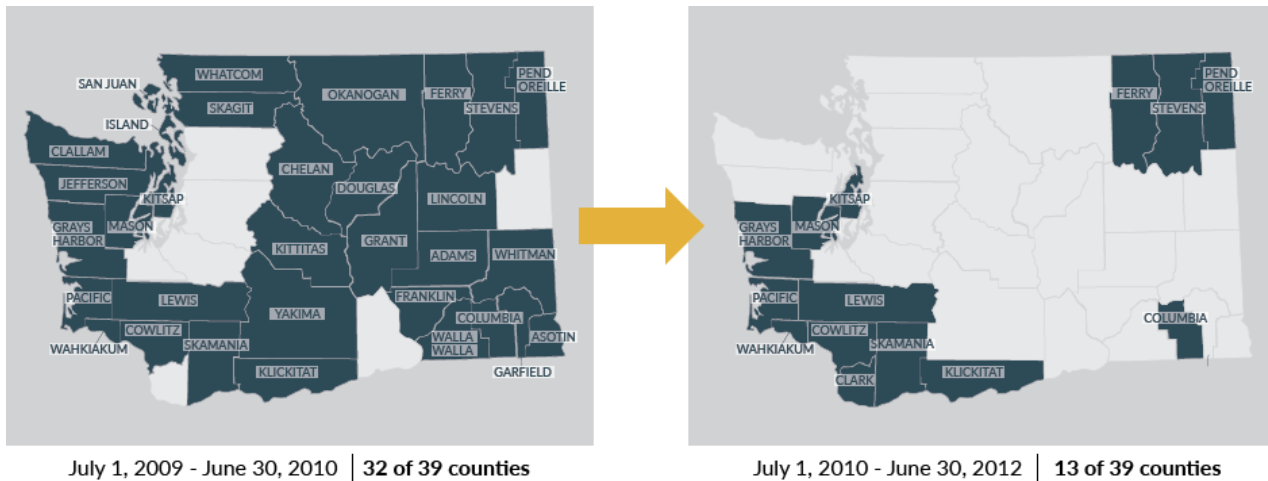
Over time, the Legislature removed the caps, extended the program, and expanded the areas where qualifying businesses could locate. Eventually, 32 out of 39 counties were eligible for the program as well as the state's six community empowerment zones (CEZs). The program closed for new applicants on July 1, 2010.

2010: Legislature restructured deferral program to encourage investment in high unemployment counties and CEZs

Beginning July 1, 2010, the Legislature restructured the deferral program to focus on businesses making investments in high unemployment counties and CEZs.

In 2010, 13 counties and all of Washington's CEZs met the qualifications.

Exhibit 2.1: Legislature restructured deferral program to focus on a smaller number of counties



Source: JLARC staff analysis of Office of Financial Management classification of qualifying distressed and rural counties, 2008-2010 and Department of Revenue Special Notice, May 16, 2016.

The preference has not been substantively changed since 2010. The number of qualifying counties has increased from 13 in July 2010 to 21 as of July 1, 2018. Under current law, the Department of Revenue cannot issue deferral certificates for this program after July 1, 2020.

REVIEW DETAILS

3. What locations qualify for the preference?

High unemployment counties and CEZs qualify for deferral

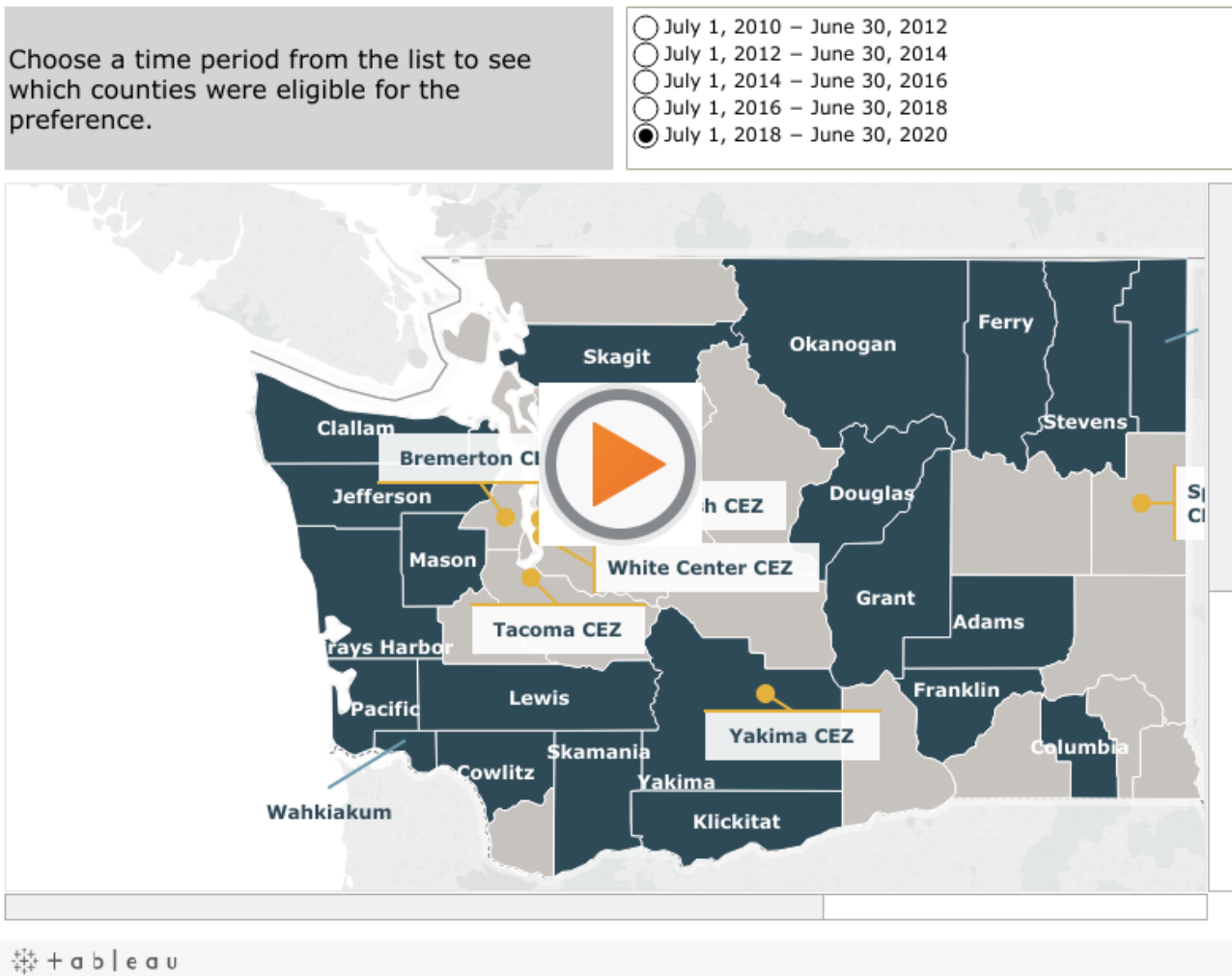
Qualifying businesses must make facility, machinery, or equipment investments in high unemployment counties or CEZs to qualify for a tax deferral.

High unemployment counties determined every two years

Eligible counties must have an unemployment rate at least 20 percent higher than the state average for the preceding three consecutive calendar years. The Employment Security Department (ESD) establishes a list of qualifying counties based on this criteria and updates the list every two years.

The maps below allow you to view the counties that have qualified for each two-year period from July 1, 2010, through June 30, 2020.

Exhibit 3.1: Qualifying high unemployment counties have changed every two years. Twenty-one of Washington's 39 counties will qualify through June 2020.



Source: JLARC staff review of Department of Revenue Special Notice dated May 16, 2016, and analysis of detail provided by Employment Security Department on qualifying high unemployment counties for the period July 1, 2018 through June 30, 2020.

Six CEZs designated as high unemployment, low-income areas

In 1993, the Legislature passed the Community Empowerment Zone (CEZ) Act to encourage community revitalization and reinvestment in certain distressed areas of the state. CEZs are located in cities or unincorporated areas. They are characterized by limited employment opportunities, a lack of affordable housing, low incomes, deteriorating infrastructure, and limited services such as job training and education.

State law directed the Department of Commerce to identify up to six CEZs statewide before 2004. It identified six, and there have been no changes to the list or their geographic boundaries. At this time, Spokane is working with the Department of Commerce to change its CEZ boundaries to more closely align with its current industrial area.

Exhibit 3.2: Washington's CEZs are located within six cities or unincorporated areas



Source: JLARC staff analysis of CEZ locations obtained from Department of Revenue website, viewed March 30, 2018.

REVIEW DETAILS

4. Unclear whether the preference is meeting objectives

Businesses reported creating fewer jobs than they estimated. Preference likely had nominal impact on reducing poverty.

Legislature stated its objectives when it restructured the deferral program

In 2010, the Legislature stated two objectives for the deferral program:

1. Promote and stimulate economic and new employment opportunities in distressed areas.
2. Reduce poverty in distressed areas.

The Legislature noted several areas in the state that were characterized by "very high levels of unemployment and poverty." It indicated that the state needed new policies to promote economic stimulation and new employment opportunities in these distressed areas.

The deferral program is limited to high unemployment counties as identified by the Employment Security Department and community empowerment zones (CEZs) designated by the Department of Commerce.

Objective 1: Stimulate economic development and create jobs in distressed areas

Businesses estimated they would create more new jobs than they actually did

Businesses are required to estimate the number of new jobs that will be created at their qualifying facilities when they apply for the preference. The current beneficiaries estimated they would create 989 new full-time jobs, in addition to the 2,764 people they were already employing. The actual number of net new jobs these same beneficiaries reported in 2016 was 87 percent lower than estimated. There is variation in job changes reported by beneficiaries, with some reporting increases and others reporting decreases compared to their applications. However, businesses overall reported a net total increase of 131 jobs at qualifying facilities.

Forty-four businesses reported using the preference in 2016

The preference was used by 44 businesses in 2016, the latest data available at the time of this report. Most of these businesses are in the manufacturing industry. Since 2010, the preference has been used in eight of 22 counties that have qualified as a high unemployment county, and in four of six CEZs.

The Legislature did not state clear expectations or targets for the level of economic development or number of jobs it hoped to stimulate with the preference. It is unclear if the Legislature's expectations have been met by the number of businesses claiming the preference or the number of jobs reported by beneficiaries.

Economic model shows potential range of net employment changes resulting from preference

Beneficiary data reported to the Department of Revenue (DOR) in 2016 indicates employment at qualifying sites increased by 131 jobs between the year the beneficiaries applied for the preference and 2016.

It is difficult to objectively determine how many of the new jobs were a direct result of the preference (i.e., how many of these new jobs would not exist without the preference). However, it is possible to estimate a range of net employment changes based on different assumptions about how the preference impacted employment. These analyses of net employment changes include estimates of potential jobs gained at project sites minus potential jobs lost due to reduced tax revenues for public sector spending. When beneficiaries claim the tax deferral, there is a loss in state revenue with an assumed corresponding reduction in state spending.

The table below shows the estimated net employment change (including direct, indirect, and induced jobs) under three different scenarios:

Exhibit 4.1: Net gain or loss in employment depends on how many new jobs were created as a direct result of the preference

	Number of new jobs assumed to be a direct result of the preference*	Net employment change statewide **
Scenario 1	If none (0 jobs)	Then net loss of 29 jobs
Scenario 2	If all (131 jobs)	Then net gain of 429 jobs
Scenario 3	If break-even point (8.5 jobs)	Then net change is 0 jobs. Net gain is offset by net loss.

Source: JLARC staff analysis of Department of Revenue high unemployment county application and 2016 annual report data. JLARC staff estimated impact on job loss or creation using REMI economic modeling tool.

*Beneficiaries reported 131 new jobs as of 2016. This column indicates an assumption about how many of those jobs exist solely because of the preference.

** Net employment change is the assumed number of jobs that are a direct result of the preference less the number of job losses due to the loss in state revenue when beneficiaries claim the tax deferral.

Average wages paid by beneficiaries fall between statewide and manufacturing industry averages

For 2016, the current 44 beneficiaries paid an average annual wage of \$62,042. This is slightly above the average annual statewide employee wage but below the statewide average manufacturing industry wage for 2016.

Average Annual Wage (2016)

All Beneficiaries	\$62,042
All Manufacturers	\$74,632
Statewide, All Employers	\$59,090

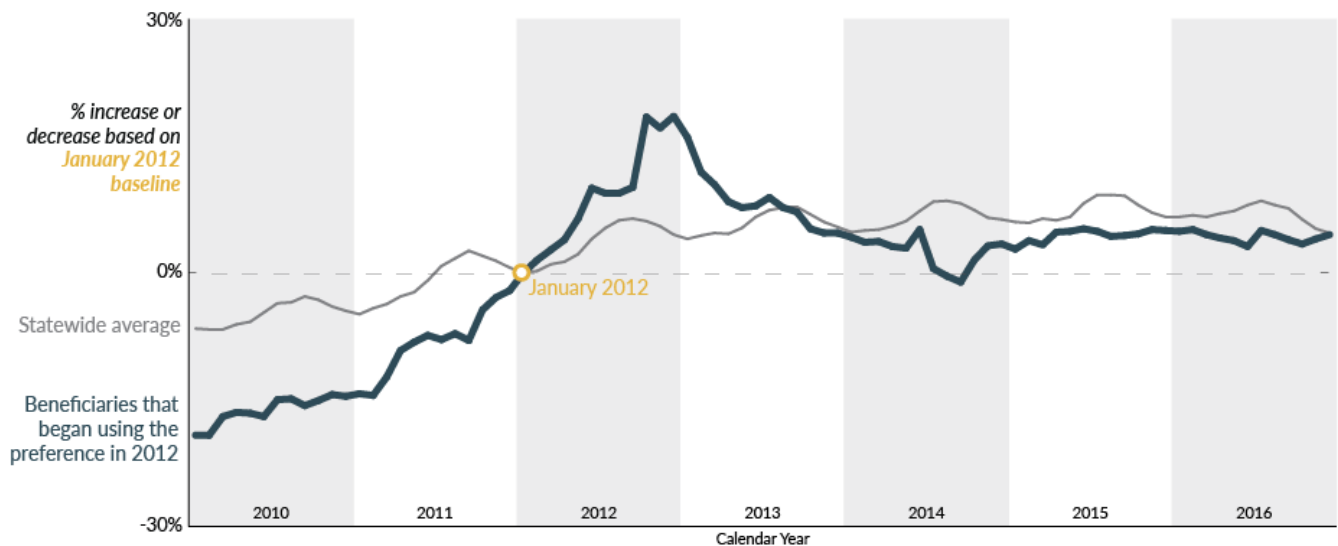
Source: JLARC staff analysis of 2016 Employment Security Department employee wage data for: tax preference beneficiaries filing annual report in 2016, statewide manufacturing industry, and statewide, all industries.

Beneficiaries' employment changes similar to all manufacturers statewide

To determine whether the beneficiaries' employment growth outperformed businesses that did not claim the preference, JLARC staff divided the current beneficiaries into cohorts based on the first year they filed an annual tax performance report (annual report) with DOR. For each cohort, JLARC staff examined the change in employment starting two years before the businesses filed their first annual report through 2016, and compared the change to statewide manufacturing sector employment data for the same time period.

Beneficiaries that filed their first annual report with DOR between 2012 and 2014 had employment changes that were very similar to all manufacturing businesses statewide. The chart below shows the 2012 cohort. The 2013 and 2014 cohort groups also had similar trends in employment changes compared to all manufacturing businesses.

Exhibit 4.2: After 4 years, employment for the 2012 beneficiary cohort increased by 4.5% and manufacturing employment statewide increased by 4.7%



Source: JLARC staff analysis of changes in employment using Employment Security Department wage data for 2012 cohorts and all manufacturers, statewide from January 2010 through December 2016.

Objective 2: Reduce poverty in distressed areas

The preference had a nominal impact on reducing poverty in distressed areas

Using U.S. Census data, JLARC staff estimated the potential impact that the new jobs may have had on poverty rates in qualifying counties and CEZs. These are likely high-end estimates, based on assumptions that allow for the maximum impact on poverty rates, including the following:

- The net gain in employment is 429 new jobs based on scenario 2 in Exhibit 4.1, above.
- Each of these new jobs is filled by a person living in an average-sized family whose members all earned income below the poverty level before the employee began the job.
- Each of these jobs moved the employee and their family out of poverty.

Based on these assumptions, the most optimistic potential reduction in the poverty rate in distressed areas was 0.07 percent. The poverty rate in the distressed areas in 2016 was 16.3 percent.

It is difficult to objectively determine how successful the preference was in reducing poverty in distressed areas for two reasons.

- First, the statute creating the preference does not include a target for reducing poverty.
- Second, and perhaps more importantly, there is little information available about the family incomes of employees who fill the jobs created by beneficiaries.

Exhibit 4.3: Even with the most optimistic assumptions, the preference has a nominal impact on reducing poverty rates in distressed areas

Qualifying Distressed Areas	2016 Population	Population in Poverty	Total Jobs Created by Preference (See Exhibit 4.1 above)	Reduction in People Below Poverty Level (Family)	Reduction in Poverty Rate (Family)
All CEZs and Qualifying Counties	2,045,800	334,400	429	1,360	0.07%

Source: JLARC staff analysis of Department of Revenue High Unemployment County and CEZ deferral applications and 2016 annual report data, as well as U.S. Census data on poverty rates in qualifying locations.

Legislature may want to consider adding job creation or retention and wage targets to better assess performance of preference

If the Legislature wants to extend the preference for new applicants beyond July 1, 2020, it may want to consider adding metrics that will allow for an objective assessment of whether the preference is meeting legislative expectations. These may include:

- Job creation targets for beneficiaries located in high unemployment counties. Currently the only job creation requirement is for beneficiaries located in CEZs. They must create one job per \$750,000 investment.
- Job retention targets for all beneficiaries. Beneficiaries in CEZs must create jobs, but there is no requirement to maintain the job after the tax year in which the employee is hired.

JLARC staff researched economic development and job creation tax incentives offered in other states. We found several programs that require participants to meet targets for job creation and job retention. Additionally, many tax incentive programs in other states require participants to meet certain employee wage levels. See Other States with Similar Preferences tab.

REVIEW DETAILS

5. Beneficiaries

Through 2016, most of the 44 direct beneficiaries were manufacturers expanding their existing operations. Additional qualifying businesses will be completing their projects soon.

Tax preferences have **direct beneficiaries** (entities whose state tax liabilities are directly affected) and may have **indirect beneficiaries** (entities that may receive benefits from the preference, but are not the primary recipient of the benefit).

Through 2016, 44 businesses have reported they directly benefited from the preference

Forty-four businesses currently benefit from the preference and have filed annual reports with the Department of Revenue (DOR) for calendar year 2016. Of those 44 businesses:

- 37 of the 44 reported using the preference for business expansion. The remaining seven used it for new business facilities.

- Most of the 2016 beneficiaries noted they were conducting manufacturing activities.
- The average **annual amount** of sales and use tax deferred was \$27,622 per beneficiary.
- The average **total amount** of sales and use tax owed on the project was \$220,980 (deferred and potentially waived, if business remains eligible).

Cumulative eight-year deferral for 44 beneficiaries is over \$9.6 million

Beneficiaries can receive a tax benefit for up to eight years. The 44 beneficiaries' total deferral amount accumulated across multiple years is \$9,629,349. The total cumulative cost per job for the 131 jobs reported in 2016 is \$73,506.

Additional projects currently in progress

Additional investment projects have been approved and are moving toward project completion. DOR expects 15 new businesses to file their first annual report for calendar year 2017 by the end of May 2018.

Between July 2010 and May 2018, businesses submitted 130 certificate applications to DOR to use the preference. A certificate application is for a specific new construction or expansion project at a facility, or a purchase of new equipment or machinery. Some businesses have submitted multiple certificate applications through the years, so the number of certificates does not match the number of beneficiary businesses.

Of the 130 certificate applications received by DOR:

93 approved applications

54 are held by the 44 businesses that filed 2016 annual reports.

16 (one business has two certificates) will file their first annual report in 2017.

1 will file its first annual report in 2018.

22 have been approved but are not yet complete.

37 not participating

32 were withdrawn by the business or denied by DOR.

4 were determined to have no qualifying purchases.

1 closed the facility after becoming operationally complete and was billed for the full amount of deferred tax.

Beneficiaries are concentrated in a few distressed areas

Eighteen of the 44 businesses using the preference in 2016 were located in Clark County. The next largest concentration of beneficiaries was in Spokane's community empowerment zone (CEZ), with nine businesses. Five businesses were located in either Yakima's CEZ or in Yakima County. The remainder of the beneficiaries are located in other counties or CEZs throughout the state, with no more than two in the same location.

Counties and communities where projects are located may receive indirect benefits

While qualifying businesses directly benefit from the preference, the high unemployment counties and CEZs where they are located also may receive benefits. The economic activity generated by new or expanding businesses can boost economic development and growth in the broader community and create jobs for local residents.

REVIEW DETAILS

6. Revenue and economic impact

Estimated direct revenue impact \$5.8 million in 2019-2021 Biennium

JLARC staff estimate the direct beneficiary savings for fiscal year 2017 is \$1.6 million. The estimated beneficiary savings for the 2019-2021 Biennium is \$5.8 million.

The biennial estimate is based on the following assumptions:

- Several businesses with approved projects in progress will complete their projects in the coming years.
- Additional businesses will submit applications to DOR before the cutoff date of July 1, 2020, and will receive benefits after that date.
- Businesses that began receiving deferrals in 2011 and 2012 will pass the 8-year time period and receive a full waiver of their deferred taxes.

Exhibit 6.1: Estimated direct beneficiary savings from sales and use tax deferral

Biennium	Fiscal Year	Estimated Beneficiary Businesses	Estimated Beneficiary Savings
2015-17 7/1/15-6/30/17	2016	44	\$1.2 Million
	2017	59	\$1.6 Million
2017-2019 7/1/17 - 6/30/19	2018	74	\$2.0 Million
	2019	89	\$2.4 Million
2019-21 7/1/19-6/30/21	2020	104	\$2.9 Million
	No deferral certificates issued after July 1, 2020		
	2021	104	\$2.9 Million
	2019-21 Biennium	104	\$5.8 Million

Source: JLARC staff analysis of annual tax preference performance reports and consultation with Department of Revenue staff on estimated future use.

REVIEW DETAILS

7. Other states with similar preferences

Other top manufacturing states often include job creation and wage requirements in similar tax incentives

JLARC staff reviewed economic development tax incentive programs offered in top manufacturing states as well as Idaho and Oregon, two neighboring states. Staff focused on leading manufacturing states because the majority of beneficiaries of this preference are manufacturers. In 2016, the five states with the greatest concentration of manufacturing jobs were Michigan, Wisconsin, Ohio, Indiana, and Minnesota.



The economic development tax incentives identified in the following table are similar to Washington's high unemployment county and CEZ investment preference in two ways:

- They require a capital investment in facilities, machinery, or equipment.
- They provide incentives to projects located in distressed, high unemployment, or rural areas.

JLARC staff did not find any programs that met the above criteria in Idaho.

Unlike Washington's preference, the other states are different in several areas as well:

- Of the six states, all have programs that include requirements for job creation, retention, and wage levels. Washington's preference only has job creation requirements for projects located in CEZs.
- Of the six states, only Minnesota has a program that offers partial rebates or refunds on purchases rather than a full sales and use tax deferral and waiver.

Exhibit 7.1: Other states offer incentives to encourage development in economically distressed areas

Select an incentive to view its description below

Full State	Type	Incentive	Certain industries targeted	Distressed/ rural areas targeted or gi..	Job and/or wage requirements
Indiana	Income Tax	Community Revitalization Enhancement..	X	✓	X
		Enterprise Zone Incentives	✓	✓	✓
Michigan	Grants or I..	Michigan Community Revitalization Pro..	X	✓	X
	Property Tax	Distressed County Property Tax Relief	✓	✓	X
	Sales and ..	Michigan Business Development Program	X	✓	✓
Minneso..	Property Tax	Border Cities Enterprise Zones Incentiv..	X	✓	✓
	Sales and ..	Greater Minnesota Job Expansion Refu..	X	X	✓
Ohio	Property Tax	Community Reinvestment Area Program	X	✓	X
		Ohio Enterprise Zone Prog	X	✓	✓
Oregon	Property Tax	E-Commerce Zones	✓	✓	X
		Enterprise Zone – Standar	✓	✓	✓
		Strategic Investment Prog	✓	✓	X
	Sales and ..	Long-Term Rural Enterpris	X	✓	✓
Wiscons..	Income Tax	Development Opportunity Zone Program	✓	✓	✓
		Enterprise Zone Jobs Tax Credit	X	✓	✓
		Wisconsin Business Development Credit	X	✓	✓



Incentive: All

Description: All

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Source: JLARC staff analysis of state economic development and tax incentive programs as detailed in online resources for Oregon, Michigan, Wisconsin, Ohio, Indiana, and Minnesota.

REVIEW DETAILS

8. Applicable statutes

Chapter 82.60 RCW provides statutory authority for investment project deferral program

RCW 82.60.010

Legislative findings and declaration.

The legislature finds that there are several areas in the state that are characterized by very high levels of unemployment and poverty. The legislature further finds that economic stagnation is the primary cause of this high unemployment rate and poverty; that new state policies are necessary in order to promote economic stimulation and new employment opportunities in these distressed areas; and that policies providing incentives for economic growth in these distressed areas are essential. For these reasons, the legislature reestablishes a tax deferral program to be effective solely in distressed counties. The legislature declares that this limited program serves the vital public purpose of creating employment opportunities and reducing poverty in the distressed counties of the state.

[[2010 1st sp.s. c 16 § 1](#); [1985 c 232 § 1](#).]

RCW 82.60.040

Issuance of tax deferral certificate. (Expires July 1, 2020.)

(1) The department must issue a sales and use tax deferral certificate for state and local sales and use taxes due under chapters [82.08](#), 82.12, and [82.14](#) RCW on each eligible investment project.

(2) The department must keep a running total of all deferrals granted under this chapter during each fiscal biennium.

(3) This section expires July 1, 2020.

[[2010 1st sp.s. c 16 § 6](#); [2004 c 25 § 4](#); [1999 c 164 § 302](#); [1997 c 156 § 5](#); [1995 1st sp.s. c 3 § 6](#); [1994 sp.s. c 1 § 3](#); [1986 c 116 § 13](#); [1985 c 232 § 4](#).]

RCW 82.60.049

Additional eligible projects.

(1) For the purposes of this section:

(a) "Eligible area" also means a designated community empowerment zone approved under RCW [43.31C.020](#).

(b) "Eligible investment project" also means an investment project in an eligible area as defined in this section.

(2) In addition to the provisions of RCW [82.60.040](#), the department shall issue a sales and use tax deferral certificate for state and local sales and use taxes due under chapters [82.08](#), 82.12, and [82.14](#) RCW, on each eligible investment project that is located in an eligible area, if the applicant establishes that at the time the project is operationally complete:

(a) The applicant will hire at least one qualified employment position for each seven hundred fifty thousand dollars of investment for which a deferral is requested; and

(b) The positions will be filled by persons who at the time of hire are residents of the community empowerment zone. As used in this subsection, "resident" means the person makes his or her home in the community empowerment zone or the county in which the zone is located. A mailing address alone is insufficient to establish that a person is a resident for the purposes of this section. The persons must be hired after the date the application is filed with the department.

(3) All other provisions and eligibility requirements of this chapter apply to applicants eligible under this section.

(4) The qualified employment position must be filled by the end of the calendar year following the year in which the project is certified as operationally complete. If a person does not meet the requirements for qualified employment positions by the end of the second calendar year following the year in which the project is certified as operationally complete, all deferred taxes are immediately due.

[[2010 1st sp.s. c 16 § 7;2004 c 25 § 5;2000 c 106 § 8;1999 c 164 § 304.](#)]

REVIEW DETAILS

Technical Appendix 1: REMI Overview

REMI Overview

JLARC staff used Regional Economic Models, Inc.'s (REMI) Tax-PI software (v.2.1) to model the economic impacts for one tax preference review in the 2018 report: Investment Projects in High Unemployment Counties and Community Empowerment Zones Sales and Use Tax Deferral.

REMI software is used by approximately 30 state governments and dozens of private sector consulting firms, research universities, and international clients.

Model is Tailored to Washington and Includes Government Sector

Tax-PI is an economic impact tool for evaluating the fiscal and economic effects and the demographic impacts of tax policy change. The software includes various features that make it particularly useful for analyzing the economic and fiscal impacts of tax preferences:

- REMI staff consulted with staff from the Office of Financial Management (OFM) and customized a statewide model to reflect Washington's economy.
- The model contains 160 industry sectors, based on the North American Industry Classification System (NAICS) codes.
- In contrast to other modeling software, Tax-PI includes state and local government as a sector. This permits users to see the trade-offs associated with tax policy changes (e.g., effects on Washington's economy from both increased expenditures by businesses due to a tax preference along with decreased spending by government due to the associated revenue loss).
- For current revenue and expenditure data, users can input information to reflect their state's economic and fiscal situation. This allows JLARC staff to calibrate a state budget using up-to-date information from the Economic and Revenue Forecast Council (ERFC) and the Legislative Evaluation and Accountability Program (LEAP).
- The model can forecast economic and revenue impacts multiple years into the future.

Results the Model Provides

The REMI model accounts for the direct, indirect, and induced effects as they spread through the state's economy, which allows users to simulate the full impact of tax policy change over time.

- Direct effects are industry specific and capture how a target industry responds to a particular policy change (e.g., changes in industry employment following a change in tax policy).
- Indirect effects capture employment and spending decisions by businesses in the targeted industry's supply chain that provide goods and services.
- Induced effects capture the in-state spending and consumption habits of employees in targeted and related industries.

The REMI model produces year-by-year estimates of the total statewide effects of a tax policy change. Impacts are measured as the difference between a baseline economic and revenue forecast and the estimated economic and revenue effects after the policy change.

What the Model Includes

The REMI model is a macroeconomic impact model that incorporates aspects of four major economic modeling approaches: input-output, general equilibrium, econometric, and new economic geography. The foundation of the model, the inter-industry matrices found in the input-output models, captures Washington's industry structure and the transactions between industries. Layered on top of this structure is a complex set of mathematical equations used to estimate how private industry, consumers, and state and local governments respond to a policy change over time.

- The supply side of the model includes many economic variables representing labor supply, consumer prices, and capital and energy costs with elasticities for both the consumer and business sectors.
- Regional competitiveness is modeled via imports, exports, and output.
- Demographics are modeled using population dynamics (births, deaths, and economic and retirement migration) and includes cohorts for age, sex, race, and retirement.
- Demographic information informs the model's estimates for economic consumption and labor supply.
- The dynamic aspect comes from the ability to adjust variables over time as forecasted economic conditions change.

While the model is complex and forecasting involves some degree of uncertainty, Tax-PI provides a tool for practitioners to simulate how tax policy and the resulting industry changes affect Washington's economy, population, and fiscal situation.

REVIEW DETAILS

Technical Appendix 2: REMI Analysis

Analysis of employment impacts associated with the sales and use tax deferral for investment projects in high unemployment counties and CEZs

This technical appendix provides background detail and supporting information for the JLARC staff analysis of the employment impacts associated with Washington's sales and use tax deferral for investment projects in high unemployment counties and CEZs. The appendix is divided into three sections:

- Section One titled **REMI Methodology** details how JLARC staff set up and calibrated the Tax-PI program prior to using the model.
- Section Two titled **Jobs for the Manufacturing Industries in REMI** discusses baseline manufacturing employment in the REMI model of the Washington economy, and the observed increase in employment at business sites where beneficiaries have used the preference.
- Section Three titled **Modeling the Impact of the Sales and Use Tax Deferral for the Manufacturing Industry in REMI** describes the scenarios used to estimate the range of potential employment effects of the sales and use tax deferral on statewide employment. The results of this analysis are presented in the "Are Objectives Being Met?" tab.

1) REMI Methodology

User Inputs in REMI

REMI's Tax-PI model allows users to model policy changes and analyze the estimated impacts to the Washington economy, both in terms of economic activity and government finances. (See Technical Appendix 1 for an overview of the REMI model.)

Prior to running modeling scenarios, users must make a series of choices about how to set up the modeling environment by building a state budget and calibrating the model accordingly. JLARC staff used the November 2017 revenue estimates produced by the Economic and Revenue Forecast Council (ERFC) and budgeted expenditures for fiscal years 2016 and 2017, as reported by the Legislative Evaluation and Accountability Program (LEAP) Committee. This data represents the budget and revenue data in the model and serves as the "jump off" point for Tax-PI's economic and

fiscal estimates. Because Tax-PI is a forecasting tool, JLARC staff was unable to model the economic impact of the tax preference beginning in 2010.

In addition to establishing a budget and inputting expected revenue values, users must specify whether government expenditures are determined by demand or revenue. "By demand" imposes a level of government spending in future years that is necessary to maintain the same level of service as the final year in which budget data is entered. "By revenue" ties government expenditures to estimated changes in revenue collections.

Users may also elect to impose a balanced budget restriction or leave the model unconstrained. The balanced budget feedback forces revenue and expenditures to be equivalent and thus may impose some limitations on economic activity.

By setting expenditures to be determined by demand, users avoid making assumptions about how policymakers may alter spending priorities in the future. In addition, users essentially establish the current budget allocation as carry-forward levels for each expenditure category.

JLARC staff ran the reported scenarios with expenditures set to be determined by demand and with the balanced budget feedback option turned on.

Data for the REMI Model

The REMI model comes with historical economic and demographic data back to 1990. The data comes from federal government agencies such as the U.S. Census Bureau, U.S. Energy Information Administration, the Bureau of Labor Statistics, and the Bureau of Economic Analysis. As described above, current revenue and expenditure data for Washington comes from ERFC and LEAP, respectively. The data to build the modeling scenario described in section three is from JLARC staff estimations of beneficiary savings, based on Department of Revenue tax records.

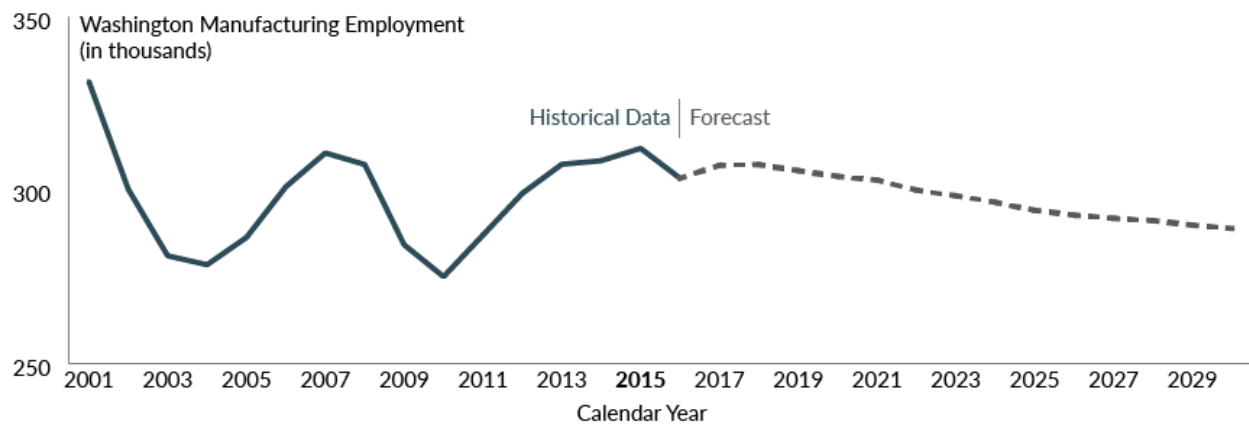
2) Jobs for the Manufacturing Industries in REMI

The majority of businesses that claim the deferral report North American Industry Classification System (NAICS) numbers identifying them as primarily manufacturing businesses. Therefore, JLARC staff modeled the potential employment effects of the preference on baseline employment of businesses in the manufacturing industry (NAICS 31 - 33).

Manufacturing Industry Jobs Fluctuated in Washington between 2001 and 2015

REMI's historical baseline forecast employment data for the manufacturing industry fluctuated from a high of 331,000 in 2001 to a low of 275,000 in 2010. Employment is projected to decline steadily from 312,000 in 2015 to 289,000 in 2030.

Exhibit: REMI Baseline and Forecast Data Shows Statewide Manufacturing Jobs Decline after 2015



Source: JLARC staff analysis of REMI data for jobs using NAICS codes for manufacturing (31 - 33).

Beneficiaries of the Tax Preference Report 131 New Jobs at Qualifying Sites

Data reported to the Department of Revenue shows the 44 businesses that claimed the preference in 2016 increased employment by 131 during 2010-2016, the years the tax preference has been in effect.

3) Modeling the Impact of the Sales and Use Tax Deferral for Investment Projects in High Unemployment Counties and CEZs

JLARC staff followed a two-step approach to modeling the employment impacts of the tax preference:

- Increased employment in all manufacturing sectors included in the REMI model.
- Reduced government spending by an amount equivalent to the taxpayer savings.

JLARC staff modeled three scenarios that illustrate the range of potential employment effects that result from the tax preference. JLARC staff are unable to determine how many of the 131 jobs created at the manufacturing sites of beneficiary businesses were created directly as a result of the preference. Instead, JLARC staff attempted to illustrate lower and upper bounds of potential employment effects based on two assumptions for the share of reported jobs that were directly created as a result of the preference, as well as the point at which the positive employment effects of additional manufacturing employment offset the negative employment effects of reduced government spending.

For each scenario modeled, JLARC staff modeled a change in nominal state government spending in the amount of the estimated beneficiary savings for FY 2016-2030. These amounts are shown below:

Fiscal Year	Estimated Beneficiary Savings
2016	1,203,669
2017	1,631,488
2018	2,046,273
2019	2,461,059
2020	2,875,844
2021	2,875,844
2022	2,876,000
2023	2,876,000
2024	2,876,000
2025	2,876,000
2026	2,461,000
2027	2,046,000
2028	1,632,000
2029	1,217,000
2030	802,000

Scenario 1: Beneficiary Savings Induce No Change in Manufacturing Sector

In the first scenario, JLARC staff assumed **none** of the 131 new jobs were created directly due to the preference. This scenario assumes no manufacturing employment change from the baseline, and includes only the direct, indirect, and induced employment effects of the change in state government spending.

Scenario 2: Beneficiary Savings Induce Reported Job Increases at Manufacturing Sites

In the second scenario, JLARC staff assumed **all** of the 131 new jobs were created directly due to the preference. This scenario assumes the manufacturing employment change from the baseline of 131 jobs, distributed among the 75 manufacturing subsectors in the REMI model, weighted by each subsector's relative output level. The employment changes are applied at the firm (competes locally) level.

Scenario 3: Beneficiary Savings Induce Some Job Increases at Manufacturing Sites, No Net Employment Change in 2016

In the third scenario, JLARC staff assumed **just enough** of the 131 new jobs were created directly due to the preference to offset the employment losses resulting from the reduction in government spending. This scenario involved running REMI scenarios with incrementally increasing manufacturing employment changes until the 2016 employment change from the baseline was zero. In each case, the manufacturing employment change from the baseline was distributed among the 75 manufacturing subsectors in the REMI model, weighted by each subsector's relative output level. The employment changes are applied at the firm (competes locally) level.

JLARC staff used REMI to model how this direct employment change and its indirect and induced effects offset the direct, indirect, and induced employment effects of the change in state government spending.

Exhibit: Three Scenarios Illustrate Range of Possible Statewide Employment Effects of Tax Preference

Scenario #	Description	2016	2017	2018	2019	2020	2021
1	Beneficiary Savings Induce No Change in Manufacturing Sector	-29	-40	-51	-59	-65	-62
2	Beneficiary Savings Induce Reported Job Increases at Manufacturing Sites	429	455	539	532	516	503
3	Beneficiary Savings Induce Some Job Increases at Manufacturing Sites, No Net Employment Change in 2016	0	-8	-12	-20	-28	-26

Source: JLARC staff analysis on future year possible employment changes using REMI economic modeling tool.

Two Employment Data Sources

Different Approaches in Reporting Employment

The employment and wage numbers used in the main report are from administrative data collected and maintained by the Washington Employment Security Department (ESD) and reported to the U.S. Department of Labor's Bureau of Labor Statistics (BLS). This data captures workers covered by state unemployment insurance and federal workers covered by unemployment compensation for federal employees. It omits some workers in the labor market, including self-employed and sole proprietors.

The REMI model, on the other hand, uses employment data from the U.S. Department of Commerce's Bureau of Economic Analysis (BEA). BEA makes a number of adjustments to employment and wage data for occupations not covered by the BLS system (see [BEA's Frequently Asked Questions](#) for further details).

Understanding the distinction between BEA and BLS employment data is important for two reasons. First, the BEA jobs numbers tend to be higher, as they capture a wider selection of employment, including sole proprietors. However, it may count a person holding multiple jobs as a number greater than one, whereas the BLS data counts a person one time regardless of the number of jobs performed. Second, while BEA provides a more comprehensive picture, it has an approximate two-year lag behind BLS data, which is regularly updated throughout the year and receives more attention in the press. According to REMI, BEA employment data operates as a unit of demand related to the tasks a worker performs within a job, rather than a job itself.

RECOMMENDATIONS & AGENCY RESPONSE

Legislative Auditor's Recommendation

Legislative Auditor recommends reviewing the sufficiency of outcomes and adding metrics

The Legislature should review the sufficiency of outcomes and add metrics for this tax preference prior to July 1, 2020. While businesses are using the preference in a few distressed areas, it is unclear whether the amount of new jobs created or the potential impact on poverty rates meets legislative expectations.

- Beneficiaries reported 131 new jobs created. The reported jobs are 87% lower than what the businesses originally estimated when they applied for the preference. There is variation in job changes reported by beneficiaries, with some reporting increases and others reporting decreases compared to their applications.
- Estimates vary on the extent to which the preference has impacted job growth.
- JLARC staff estimate the most optimistic potential reduction in the poverty rate in qualifying areas was 0.07 percent.

The Legislature should consider adding metrics that reflect its expectations for job creation and poverty reduction.

Legislation Required: Yes

Fiscal Impact: Depends on legislative action.



Citizen Commission for Performance Measurement of Tax Preferences

Dr. Grant D. Forsyth, Chair

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Ronald Bueing, Vice Chair

PricewaterhouseCoopers

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Representative Derek Stanford

Chair, Joint Legislative Audit
and Review Committee

Pat McCarthy

State Auditor

October 18, 2018

The Honorable Representative Kristine Lytton
The Honorable Representative Ed Orcutt
The Honorable Representative Timm Ormsby

The Honorable Representative Bruce Chandler
The Honorable Senator Christine Rolfes
The Honorable Senator John Braun

Re: 2018 Tax Preference Reviews

I am pleased to forward to you the comments that the Citizen Commission for Performance Measurement of Tax Preferences unanimously adopted for this year's review of tax preferences.

We adopted the same position as the Legislative Auditor for all seven recommendations issued this year. The full text of our comments, as well as summaries of the JLARC staff's analysis and recommendations are linked [here](#).

Tax preference reviews provide valuable information as the Legislature considers whether specific preferences are meeting the Legislature's policy objectives. With this year's report, there are now 12 years of tax preference evaluations available to the Legislature, comprising over 270 individual reviews.

I urge you to consider this year's and previous years' recommendations and comments on tax preference statutes in the upcoming legislative session.

The Commission is operating on a multi-year review schedule that goes through 2026. Next year's reviews will have an emphasis on the aerospace industry, but also include preferences for multi-family housing and wood waste (hog fuel) used to generate energy. More details on the reviews planned for 2019 are linked [here](#).

As Chair of the Citizen Commission, I would be pleased to discuss the Commission's position and comments with you and any interested legislators. Please feel free to contact me at

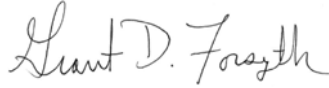
Citizen Commission for Performance Measurement of Tax Preferences

October 18, 2018

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grant.forsyth@leg.wa.gov or the Legislative Auditor, Keenan Konopaski at keenan.konopaski@leg.wa.gov
or 360-786-5187.

Sincerely,



Grant D. Forsyth, Chair

Citizen Commission for Performance Measurement of Tax Preferences

Cc: Members of Washington State Legislature
David Schumacher, Office of Financial Management
Marc Baldwin, Office of Financial Management
Jim Schmidt, Office of Financial Management
Randy Simmons, Washington State Department of Revenue
Gil Brewer, Washington State Department of Revenue
Kathy Oline, Washington State Department of Revenue

RECOMMENDATIONS & AGENCY RESPONSE

Commissioners' Recommendation

The Commission endorses the Legislative Auditor's recommendation with comment. Metrics should be designed to capture not only the impact of the preference across all applicable counties and community empowerment zones, but also within each county and community empowerment zone. If the preference is creating new jobs or otherwise having a positive economic impact on one county or zone, then it may be worth maintaining. Specific to metrics, in many rural counties the unemployment rate is based on very small sample sizes. Therefore, the unemployment rate may be an incomplete indicator of economic distress.



STATE OF WASHINGTON

October 1, 2018

TO: Keenan Konopaski, Legislative Auditor
Joint Legislative Audit and Review Committee

FROM: David Schumacher, Director
Office of Financial Management

Handwritten signature of David Schumacher in black ink.

Randy Simmons, Acting Director
Department of Revenue

Handwritten signature of Randy Simmons in black ink.

**SUBJECT: JLARC PRELIMINARY REPORT ON 2018 TAX PREFERENCE
PERFORMANCE REVIEWS**

The Office of Financial Management and the Department of Revenue have reviewed the Joint Legislative Audit and Review Committee's (JLARC) preliminary report on the 2018 tax preference performance reviews.

We appreciate JLARC's thorough analysis and the detailed assessment provided by the Citizen Commission for Performance Measurement of Tax Preferences. A system that provides for a continuous review of state tax preferences is critical to ensure that the state of Washington maintains a fair and equitable tax system.

While we have no specific comments on the 2018 preliminary report, we continue to support JLARC's recommendations for the inclusion of performance statements and specific public policy objectives for all tax preferences where they do not exist in statute today.

Thank you for the opportunity to provide comments on this material and the recommendations made by JLARC.

Washington Joint Legislative Audit and Review Committee

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