

INTRODUCTION AND SUMMARY OF FINDINGS

This report presents a detailed analysis of tax exemptions for major Washington state and local taxes. The term "exemption" is used broadly to include a wide variety of tax preference items which confer reduced tax liability upon a certain class of taxpayers. It includes exclusions, deductions, preferential tax rates, deferrals and credits. The exemption study is updated every four years pursuant to RCW 43.06.400 (see Appendix 1). The report does not include a discussion of the theoretical considerations of tax exemptions, nor does it contain any recommendations as to the retention or removal of existing exemptions. It is intended only to fulfill the statutory requirement of providing a "listing" of current exemptions.

The current study analyzes 503 different exemptions found principally in Titles 82 and 84 of the Revised Code of Washington. In some instances, similar statutes are considered together as a single exemption, e.g., retail sales and use tax exemptions for the same product or activity. In other cases, a single statute may be divided into separate exemptions to better illustrate the impacts, e.g., the property tax exemption for public property is discussed separately for the various governmental jurisdictions (federal, state, city, county, etc.).

It must be emphasized that the revenue impacts presented herein reflect the estimated savings to taxpayers and do not necessarily indicate the potential revenue which might accrue to governmental jurisdictions in the absence of the exemptions. Constitutional prohibitions against taxing certain activities, property tax rate limits, the overall state limitation on spending (Initiative 601), issues of tax administration, and even the likelihood of changes in

taxpayer behavior combine to limit the potential revenue. Further, the estimates are in terms of accrued tax liability and the actual cash receipts during a particular biennium might be lower as a result of initial compliance factors. A later section of this introduction discusses the degree to which revenue might be realized in the absence of these exemption statutes.

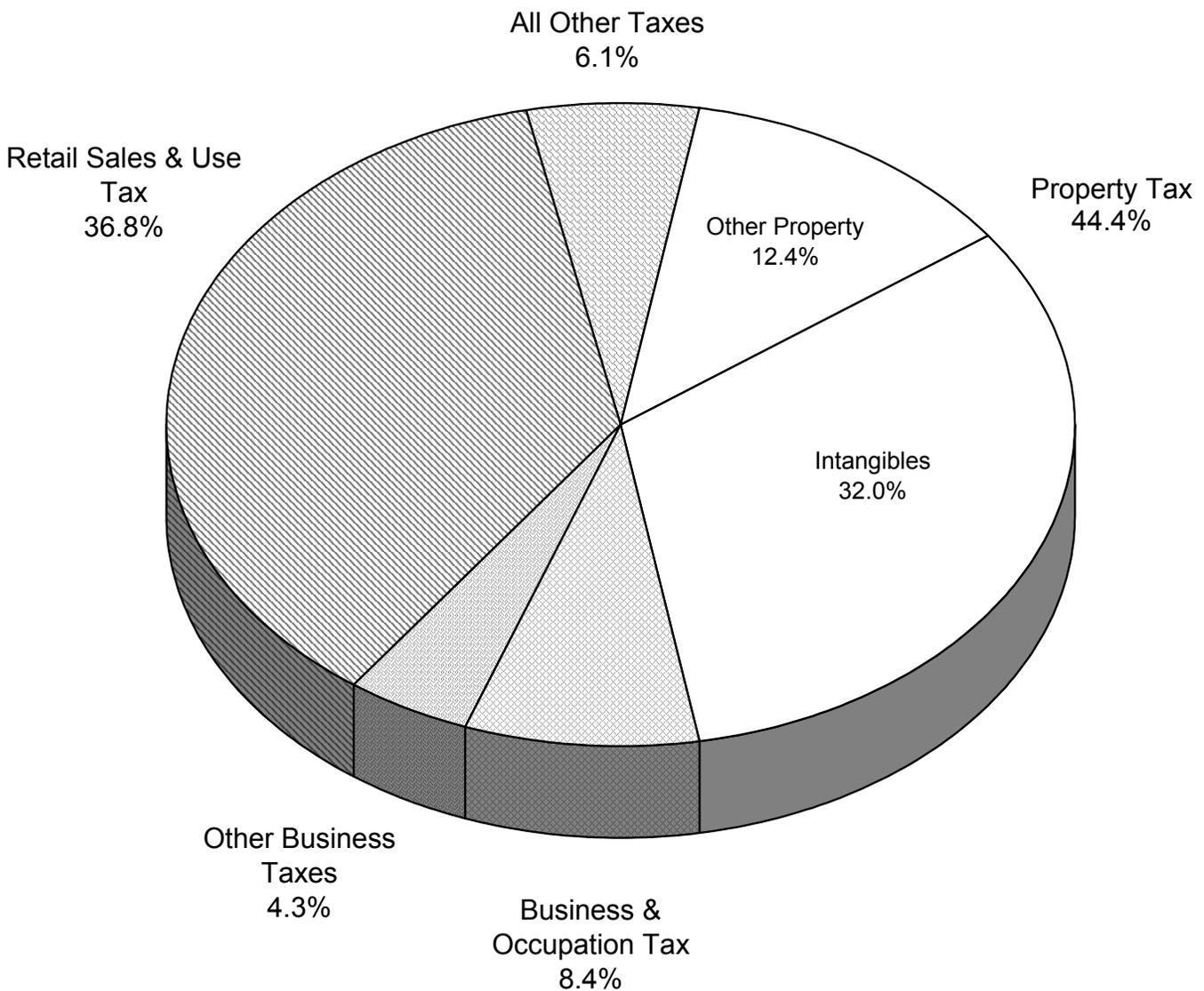
Table 1
SUMMARY OF TAX EXEMPTIONS BY TAX SOURCE
Estimated Savings to Taxpayers
2003-05 Biennium (\$000,000)

Tax Source	Number of Exemptions	State Taxes	Local Taxes	TOTAL
Property Tax	101	\$ 6,127.8	\$22,591.3	\$28,719.1
In Lieu Excise Taxes	39	36.5	15.5	52.0
Business & Occupation Tax	133	5,462.8	---	5,462.8
Public Utility Tax	26	876.6	---	876.6
Other Business Taxes	39	1,893.7	---	1,893.7
Retail Sales & Use Tax	140	18,506.2	5,313.1	23,819.3
All Other Taxes	25	3,756.5	106.2	3,862.7
TOTAL	503	\$36,660.1	\$28,026.1	\$64,686.2

Chart 1

DISTRIBUTION OF TAX EXEMPTIONS BY TAX SOURCE

**Estimated Taxpayer Savings for 2003-05 Biennium
Percentage of \$64,686 Million Total State/Local Tax Savings**



As seen in Table 1, the aggregate state and local impact of the 503 exemptions amounts to an estimated savings for taxpayers of \$64.7 billion for the 2003-05 biennium. About 57 percent of the total or \$36.7 billion is represented by exemptions from state taxes; exemptions from local government taxes amount to \$28 billion. One-half of the state impact is associated with retail sales/use tax exemptions. Property and business and occupation (B&O) tax exemptions also account for a large share of the state impact. By far the largest share of local exemptions impacts relates to the property tax; nearly all of the remainder is attributable to local sale tax exemptions.

In terms of tax sources, the property tax is attributable for the largest savings for taxpayers - \$28.7 billion or 44 percent of the total for all taxes. Within the property tax category, the exemption of intangibles amounts to more than \$20 billion in tax savings; such a large impact dominates the remainder of the tax exemption impacts. The retail sales and its companion use tax total \$23.8 billion in tax savings. Among the larger sales/use tax exemptions are constitutionally required exemptions for interstate sales, the exclusion of personal and professional services, and the exemption of food for off-premises consumption. The third largest group of exemptions are for the state B&O tax; exemptions for employee wages and salaries and the investment income of nonfinancial businesses represent the largest B&O tax exemptions.

Exemptions vs. Revenues

Table 2 and Chart 2 compare the estimated taxpayer savings resulting from exemptions for major state tax sources with the forecasted revenues for those same sources. (Local taxes are excluded due to the lack of revenue projections.) In the aggregate, the exemptions amount to \$31.3 billion for the 2003-05 biennium, while the projected revenues for these state sources total only \$21

billion. For all of these state taxes except the real estate excise tax, the amount exempted exceeds the actual amount of expected revenue. The estimated amount of taxpayer savings equals nearly 150 percent of the amount of revenue derived from these state taxes. Stated another way, the amount of taxpayer savings is nearly 60 percent of the potential tax base, if all of these exemptions were eliminated.

Table 2
COMPARISON BETWEEN EXEMPTIONS AND REVENUES
Selected Major State Tax Sources
2003-05 Biennium (\$000,000)

State Tax Source ¹	Total Taxpayer Savings Resulting from Exemptions	Projected Tax Revenues ²	Exemptions as a Percent of Revenue	Exemptions as a Percent of Potential Tax Base ³
State Property Tax Levy	\$6,127.8	\$ 2,718.5	225.4%	69.3%
State B&O Tax	5,462.8	4,122.9	132.5	57.0
Public Utility Tax	876.6	521.0 ⁴	168.3	62.7
Retail Sales/Use Tax	18,506.2	12,689.5	145.8	59.3
Real Estate Excise Tax	295.6	975.5	30.3	23.3
TOTAL	\$31,269.0	\$21,027.4	148.7%	59.8%

¹ Major sources only; does not include local government taxes or state nongeneral fund taxes.

² Economic and Revenue Forecast, Forecast Council, November 2003.

³ The total taxpayer savings from exemptions compared with the total exempt amount plus the projected revenue, i.e., exemptions compared with the total potential revenue if the exemptions did not exist.

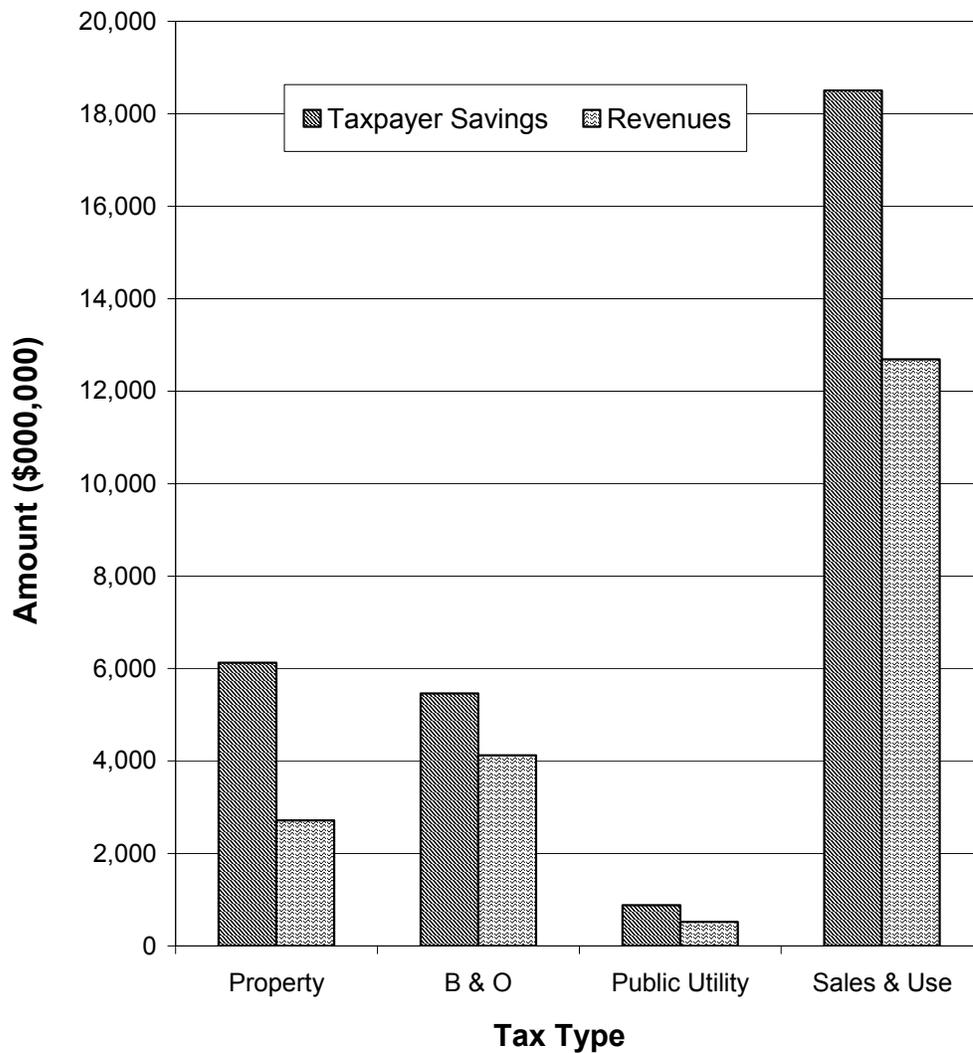
⁴ General fund portion only.

Chart 2

COMPARISON BETWEEN EXEMPTIONS AND REVENUES

Taxpayer Savings and Projected Revenue Collections
For Major State Taxes (Does Not Include Local)

2003-05 Biennium (\$000,000)



Categorical Analysis

Tax exemptions are established for a variety of reasons. In an attempt to present more meaningful data for the various types of exemptions, 14 categories were developed and each of the exemptions was assigned to the category which most closely represents its general purpose or type of beneficiary (recognizing that many exemptions serve multiple purposes). A brief description of the exemption categories appears below:

Tax Base

This category includes activities which were not intended by the Legislature to be included in the original tax base. For example, the state B&O tax is intended to tax the privilege of engaging in business. Working for an employer as an employee is not considered as engaging in business, because employees typically do not have the same degree of responsibility for, or benefit from the success of, a firm as does the owner of the business. Thus, there is a specific statutory exemption (RCW 82.04.360) to assure that employees are not subject to B&O tax, even though it was never the intention that the tax apply to salaries and wages.

Government

Governmental jurisdictions include the federal government, the state of Washington, local governments and foreign countries. In some instances these entities may be taxed, e.g., state and local jurisdictions pay retail sales tax on the acquisition of tangible personal property. Even the federal government is indirectly taxed through the use tax liability of contractors who install tangible personal property pursuant to federal construction contracts. However, for some other taxes, subjecting publicly owned property and governmental activities to tax would simply amount to a transfer of funds among jurisdictions. Particularly in the case of property taxation, valuation of public property would significantly increase the cost of administering the tax.

Commerce

The U.S. Constitution prohibits direct taxation of interstate commerce. As a result, certain exemptions have been enacted to assure that Washington does not violate this requirement.

Intangibles

Wealth that is represented by intangible assets, such as money, stock and bonds, bank deposits and other securities, is exempt from property taxation. Because of its unique nature and the difficulty of distinguishing between intangibles that are owned by individuals and businesses, a separate category has been assigned to this major exemption which dominates the fiscal impact totals.

Services

A major exclusion from the base of the retail sales tax is represented by services. Initially, the sales tax applied only to tangible personal property (i.e., goods). But over the years the base has been extended to certain other activities such as construction and repair services. If the sales tax is considered as a broad-based tax upon consumption, then purchases of personal and professional services consumed by individuals and businesses could logically be subject to tax. However, this would represent a major new direction in state tax policy.

Nonprofit Organizations

There are a variety of property, B&O and sales tax exemptions allowed for nonprofit organizations. This report further categorizes these exemptions according to the specific type or function of the organization:

- "H" - Health or social welfare organization
- "C" - Charitable or religious organization
- "A" - Arts or cultural organization
- "O" - All other nonprofit groups.

Individuals

These exemptions generally benefit people, as opposed to businesses or other entities. Some exemptions in this category are directed toward a certain group of people such as senior citizens.

Business Incentives

Some exemptions are "targeted" to encourage particular activities by businesses. Most often, these are intended to attract or retain a specific industry to Washington and create employment opportunities in this state. Other exemptions seek to encourage businesses to behave in a certain fashion, e.g., locate or expand in rural counties, invest in pollution control equipment, etc.

Other Exemptions for Businesses

Many other exemptions are provided for firms without specifically expecting a particular behavior, e.g., deductions for cash discounts and credit losses. These are generally enjoyed by most business entities. Broadly speaking, exemptions for businesses can be assumed to benefit individuals in the long run, since firms typically pass on their tax liability to customers, employees, or owners of the business.

Agriculture

Many exemptions have been adopted to assist the agricultural industry. It must be remembered that the bulk of Washington's current excise taxes were adopted in the 1930s when the Great Depression was adversely impacting many industries, in particular the farming community.

Other Exemptions

Some exemptions do not fit conveniently into another grouping, so these are considered together in the "Other" category.

Table 3 summarizes the results of the categorical analysis. The largest single exemption is the property tax exemption for intangibles, amounting to \$20.7 billion in taxpayer savings which accounts for nearly one-third of the total. Exemptions for individuals represent one-quarter of taxpayer savings. Among the larger items in this category are the property tax exemption for household goods; use tax exemption for imported personal property of nonresidents; and sales tax exemptions for food, prescription drugs, motor vehicle fuel (recognizing that businesses also purchase gasoline), trade-ins and local residential telephone service. The share of total exemptions for individuals would be much greater if it included their portion of the taxpayer savings for intangibles and services.

Table 3**TAX EXEMPTIONS BY CATEGORY****2003-05 Biennium (\$000,000)**

Category	Number of Exemptions	State and Local Taxpayer Savings	Percent of Total
Tax base	61	\$ 5,883.2	9.1%
Government	69	4,568.5	7.1
Commerce	20	4,982.4	7.7
Intangibles	1	20,725.7	32.0
Services	3	6,892.9	10.7
Nonprofit organizations:			
Health or social welfare	31	371.0	0.6
Charitable or religious	12	151.5	0.2
Arts or cultural	6	15.0	--
Other organizations	24	125.5	0.2
Individuals	41	15,868.4	24.5
Business incentive	80	745.7	1.2
Other business	75	1,955.8	3.0
Agriculture	55	2,273.2	3.5
Other	25	127.0	0.2
TOTAL	503	\$64,686.2	100.0%

Exemption categories over which the Legislature has the least discretion are Tax Base and Commerce. Exemptions in these categories are either required for constitutional reasons or would involve a significant departure from current tax policy to eliminate them. Those in the Government category, likewise, have little potential for repeal. Taken together, the exemptions in these three categories represent nearly one-quarter of the total taxpayer savings.

Two classes of exemptions reflect long-standing and fundamental tax policy: the property tax exemption for intangibles and the sales tax exemption for services. Significant revision in either category would involve a major tax policy change.

Exemptions for businesses are assigned to one of three groupings: Business Incentives, Other Business or Agriculture. There are 80 exemptions in the first category, 75 in the second, and 55 in the third. Together, these account for 7.7 percent of the total taxpayer savings. However, it should be noted that the impact of some of the recently-enacted business tax incentives is not reflected in the 2003-05 biennial totals, since they are contingent upon future investment activity by eligible firms. Dominating the business tax exemptions are the property tax exemption for inventories and the sales tax exemption for manufacturing machinery.

The 73 exemptions provided for nonprofit organizations account for a very small portion, approximately 1.0 percent, of the total taxpayer savings. Finally, the 25 exemptions assigned to the Other category represent only 0.2 percent of the taxpayer savings.

Table 4
TAX EXEMPTIONS BY YEAR OF ENACTMENT

State/Local Tax Savings for 2003-05 Biennium (\$000,000)

Year Adopted	Number	Current Savings	Year Adopted	Number	Current Savings
1854	4	\$ 863.1	1940	2	\$ 53.5
1871	1	754.6	1941	1	0.1
1886	1	64.6	1943	3	290.4
1889	5	3,057.8	1945	5	34.0
1890	3	3.8	1947	4	21.3
1891	2	7.3	1949	7	236.8
1911	1	87.5	1951	2	403.6
1915	3	28.4	1955	4	2.3
1923	3	1,254.6	1957	3	13.3
1925	2	83.7	1959	4	26.0
1929	1	1.0	1961	4	14.1
1931	4	20,943.8	1963	4	4.8
1933	5	1,823.7	1965	8	123.5
1935	41	23,507.4	1967	16	518.6
1937	3	122.5	1970	12	184.3
1939	1	4.2	1971	12	1,822.6

Table 4 - Continued
TAX EXEMPTIONS BY YEAR OF ENACTMENT

State/Local Tax Savings for 2003-05 Biennium (\$000,000)

Year Adopted	Number	Current Savings	Year Adopted	Number	Current Savings
1972	1	\$ 2.2	1989	18	\$ 548.4
1973	5	159.2	1990	1	0.5
1974	3	1,554.0	1991	9	29.5
1975	10	310.0	1992	5	5.1
1976	11	43.4	1993	10	340.3
1977	6	1,815.3	1994	5	144.4
1979	15	291.5	1995	18	508.6
1980	12	10.0	1996	11	121.8
1981	6	21.7	1997	22	30.5
1982	3	124.3	1998	23	149.6
1983	16	228.8	1999	8	20.4
1984	7	406.3	2000	9	1,129.9
1985	8	67.7	2001	22	21.2
1986	7	7.2	2002	5	124.6
1987	15	22.5	2003	38	89.8
1988	3	0.5			

Exemption History

Table 4 on the previous two pages traces the evolution of tax exemption statutes starting in Washington's territorial days. The same information is presented graphically in Chart 3. The current dollar value of exemptions in terms of taxpayer savings is largely attributable to exemptions enacted in the 1930s, when the present tax structure was formulated. Over 70 percent of the current taxpayer savings is represented by exemptions which date from the 1930s. The property tax exemption for intangibles was initially adopted in 1931 (with clarifications added in 1997). The 41 exemptions which define major excise tax bases contained in the Revenue Act of 1935 represent the most new exemption statutes in a specific year.

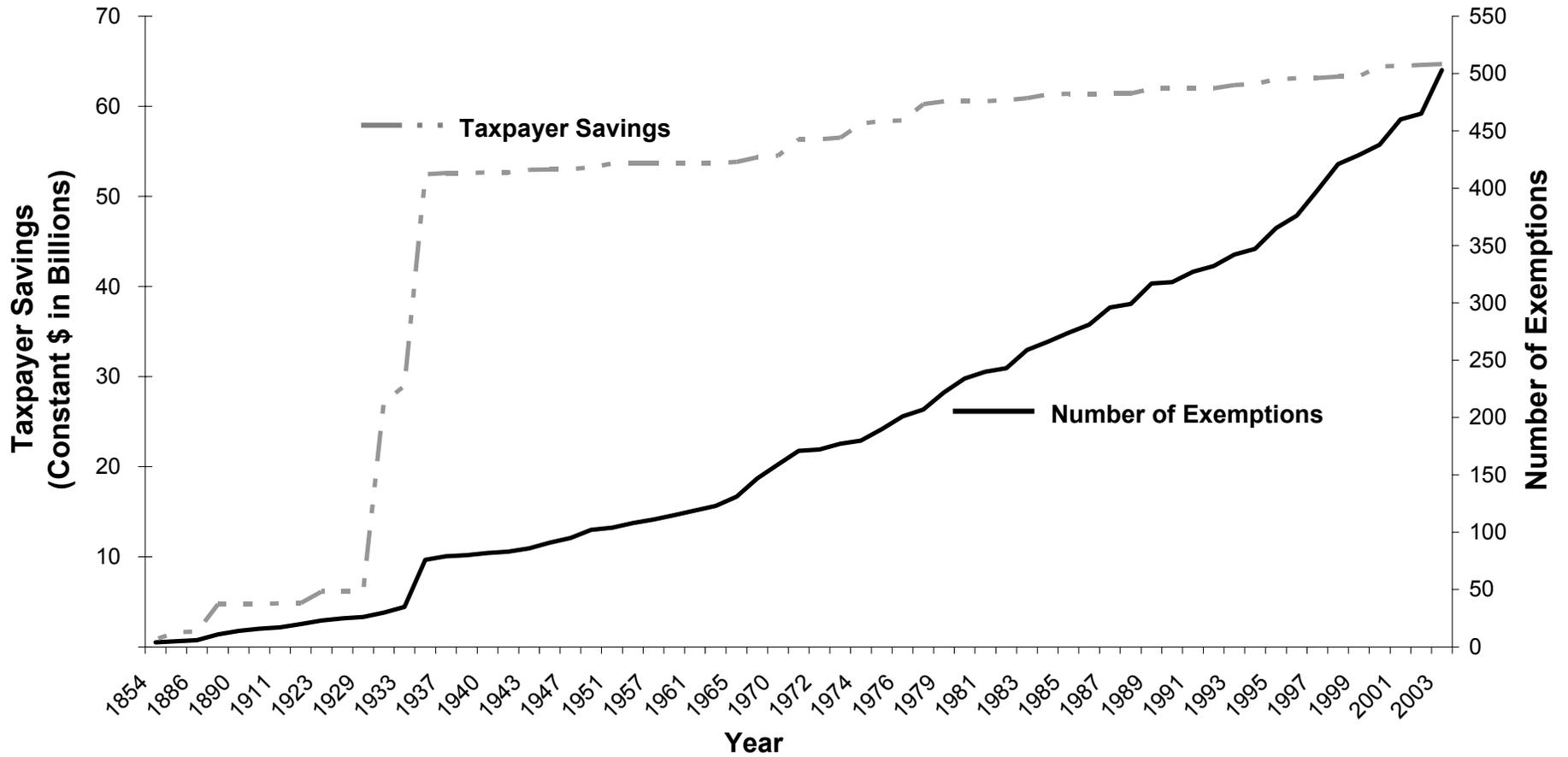
Relatively little took place in the field of tax exemptions during the three decades from the mid-1930s to the mid-1960s. Then activity increased as major new tax policies were instituted, including constitutional amendments allowing exemptions for senior citizens, current use assessment of farm and open space lands, limitation on the growth rate of property tax levies (not really an exemption), and the exemption of food for off-premises consumption - the first major exemption enacted by initiative of the voters.

The latest decade since 1993 has witnessed the adoption of many new exemptions, averaging 15.5 new statutes every year, culminating in the 38 new exemptions added in 2003 - the second most new exemption statutes established in any one year. The dollar value of most newly enacted exemption statutes is comparatively small. However, as noted above, the full impact of several of the major new business incentives is not yet included in the current taxpayer savings

Chart 3

TOTAL NUMBER AND VALUE OF TAX EXEMPTIONS
ACCRUED BY YEAR OF ENACTMENT

Value of Tax Exemptions Represent State and Local Taxpayer Savings
for 2003-05 Biennium



figures, because the investment that triggers these exemptions will largely take place beyond the four-year period covered by this study.

Some of the exemptions enacted during the 1990s can be attributed to the state expenditure limitation, Initiative 601, enacted by the voters in 1993. Under this limit on overall state spending, there was more incentive to return "excess" revenues to the taxpayers, since they could not be directly spent on current programs. One convenient method for returning such revenue to taxpayers was via new exemption programs. More recently still, with the state economy in the doldrums and revenue collections lagging previous growth rates, there has been an attempt to help jump-start the economic recovery through the enactment of targeted tax incentives.

Would Revenue Be Realized?

Readers will notice that following the taxpayer savings estimates presented for each of the 503 tax exemptions discussed in the body of this report there appears a question: "If the exemption were repealed, would the taxpayer savings be realized as increased revenues?" The responses are intended to help readers understand the degree to which the figures represent foregone state or local government revenues. Certainly, for many of the excise taxes there is a one-to-one relationship between the amount that taxpayers save and the amount that government gives up in potential revenues. Other exemptions might elicit a behavioral response by taxpayers which could restrict the potential revenue that might be realized. Some exemptions might require a considerable administrative effort and expense on the part of tax collection agencies (e.g., any attempt to tax intangibles, either as a property tax or under an income tax, would necessitate a

**Table 5
WOULD REVENUE BE REALIZED?**

**Potential Amount of State/Local Revenue
If Exemptions Were to be Repealed
2003-05 Biennium (\$000,000)**

Tax Source	Number of Exemptions	Current Taxpayer Savings	<u>Degree to Which Revenue Might be Realized if Exemptions were Repealed</u>			
			No	Unlikely	Possibly	Yes
Property Tax	101	\$28,719.1	\$ 7,986.5	\$20,725.7	\$ 0	\$ 6.9
In Lieu Excises	39	52.0	1.2	19.7	0	31.0
B&O Tax	133	5,462.8	3,149.4	468.4	39.1	1,806.1
Other Business Taxes	65	2,770.3	877.3	1,763.8	9.4	119.8
Retail Sales/Use Tax	140	23,819.3	669.4	11,445.1	104.4	11,600.4
All Other Taxes	25	3,862.7	3,342.3	--	499.3	21.1
TOTAL	503	\$64,686.2	\$16,025.9	\$34,422.7	\$652.2	\$13,585.4

major budgetary commitment). The entire property tax exemption field presents a special case of exemption impacts, the result of which is to rule out these exemptions as a source of potential new revenue, as long as limitations exist on the amount of regular levy receipts for taxing districts. While removal of a property tax exemption would broaden the tax base, it would also produce a commensurate reduction in tax rates, so that taxing district revenues remain at the level required by the limitations. (To be sure, this would reduce property taxes for existing taxpayers, but it would not generate additional receipts for most taxing districts.) Finally, as indicated above, many exemptions exist because of constitutional reasons or simply to help define the intended tax base. Neither of these categories can be relied upon as the source of potential new governmental revenue.

The discussion of the potential revenue associated with the exemptions has been summarized in Table 5. Less than \$7 million in property taxes would be anticipated if these exemptions were eliminated. The potential receipts associated with taxes in lieu of property tax totals \$31 million. The state B&O tax exemptions represent over \$1.8 billion in additional revenues, while the public utility tax and other business taxes imply about \$120 million in new revenue. By far the source with the largest revenue potential is the retail sales/use tax. In total, more than \$11 billion might be produced if these exemptions were repealed. **Overall for all taxes considered in this study, the total taxpayer savings of \$64.7 billion for the 503 exemptions represents only about \$13.6 billion of potential state or local government revenue.**