CHAPTER NINE
OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES

Tax reform is not just about making taxes fairer and more sustainable. It's also about making procedural improvements in the way policymakers evaluate their tax system. Lawmakers around the nation have enacted procedural changes in the way tax breaks and proposed tax changes are reported and evaluated, as well as rules governing the way taxes are collected and rebated. This chapter looks at several such efforts and discusses their impact on the quality of state and local tax systems.

Tax Expenditure Reports

Lawmakers often provide targeted tax cuts to particular groups of individuals or businesses. These special tax breaks are called "tax expenditures" because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks.

The main difference between tax expenditures and regular government spending is that under the tax expenditure approach, instead of the government sending out a check to the recipient, the recipient pays less in tax. For example, a government could create a direct spending program to subsidize windmill construction. Or, instead, it could offer a tax expenditure that lets companies building windmills reduce their taxes by exactly the same amount. In theory, it doesn't matter whether a government uses direct spending or a tax expenditure to achieve a policy goal. In either case, the windmill subsidy program will (in theory) have to compete with other government spending priorities when the government makes its budget decision.

In practice, however, tax expenditures differ from direct spending in several important ways:

- Unlike most spending programs, tax expenditures are usually open-ended; they have no built-in budget limits, and generally there is no annual appropriations or oversight process. Anyone who meets the statutory criteria for eligibility can get the subsidy.
- Direct spending usually requires a government agency to weigh the worthiness of an application from any potential beneficiary. In contrast, most tax expenditures require no action other than the filing of a tax return—which means that the benefits of these tax breaks may inadvertently be extended to beneficiaries who might otherwise be deemed unworthy or ineligible.
- Tax agencies typically have little incentive to ensure that tax-expenditure programs are working as they were hoped to. By contrast, government agencies tend to look closely at the effectiveness of their direct spending initiatives.
- Basic facts about who benefits from tax expenditures are often hidden behind the cloak of tax return secrecy, unlike the beneficiaries of conventional spending programs who are usually easy to identify.

As a result of these flaws, tax expenditures often turn out to be very expensive programs for which there is little oversight and review. Once a tax expenditure is put into the law, it usually stays there indefinitely. And typically little is known about what the government is getting—if anything—for its money.

In most states, lawmakers don't know how much is being spent on tax expenditures. Of course, tax collections are lower than they otherwise would be. But how much lower is a mystery.

In recognition of this problem, many states (and the federal government) now publish tax expenditure reports. These are simply a listing of tax breaks and how much they cost. In recent years a growing number of state governments have followed the federal government's lead by publishing tax expenditure reports of variable quality. The best reports include the following:

- A **complete list of all exemptions** from taxes (and tax credits) levied by a state. This means looking not just at the income and sales tax base but at smaller taxes as well. It also means identifying exemptions that are not explicitly written into the tax code. For example, most states exempt personal services (such as haircuts and car repairs) from their sales tax unless they are specifically taxed. These implicit exemptions cost states hundreds of millions of dollars annually— but are usually not visible in the tax code. A good tax expenditure report will identify all such implicit exemptions.
- **Estimates of the annual state and local revenue loss** from each tax expenditure, including estimates of how much the tax break has cost in recent years and how much it is projected to cost in the future. The impact (if any) on local tax revenues should be estimated as well.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policymakers a clearer understanding of the extent to which the federal linkage reduces state revenues.
- A written **evaluation of the effectiveness of each tax expenditure** will help policymakers to understand why each tax break was enacted—and how well it achieves its stated goals.
- A **regular publishing schedule** that coincides with the state budgeting process. State policymakers should be able to evaluate tax expenditures side-by-side with conventional spending— and this requires, good, current estimates of how much each tax break costs. For example, tax expenditure reports that are published every five or ten years are likely to be insufficient as a source for updated cost estimates.

The important insight provided by the tax expenditure concept is that a law that lowers a citizen's tax liability has no different effect than a law that requires a direct payment to the citizen. And if a tax break is designed to accomplish a public policy goal other than the equitable collection of tax revenues, then it should be evaluated according to the standards by which we evaluate spending laws, not the standards by which we evaluate tax laws.

Tax Incidence Analysis

Tax fairness is an important policy goal—and lawmakers frequently make bold claims about the impact of tax reform proposals on tax fairness. However, most states do not currently have the analytical capability to evaluate these claims—so the media, the public and even lawmakers are often left in the dark about the true impact of tax reform proposals. The best tool for evaluating the fairness of state taxes is tax incidence analysis, which measures the impact of various taxes on residents at different income levels. Only three states—Maine, Minnesota, and Texas—have legal requirements mandating the regular use of tax incidence analyses, although other states are currently developing a limited tax incidence analyses capability.

By developing a regularly-used tax incidence model capable of evaluating all of the major taxes levied at the state and local level, state lawmakers can increase the public's understanding of tax policy issues—and can help build public trust in elected officials. But until a regular tax incidence analysis capability is introduced, policymakers and the public will have no easily available basis for evaluating the fairness of important tax policy decisions. This increases the likelihood that lawmakers will be persuaded by false claims about the fairness of various proposals—and also makes it less likely that tax fairness will be a factor in tax policy decisions.

The Institute on Taxation and Economic Policy (ITEP) maintains a sophisticated microsimulation tax model that provides policymakers and advocates with incidence analysis. ITEP's analyses usually divide the population into five groups based on income—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an "income quintile." ("Quintile" simply means one fifth, or 20 percent, of the population.)

The ITEP Model is capable of estimating the impact, both on tax fairness and on overall tax revenues, of virtually any change to the major taxes relied upon by state and local governments. ITEP maintains an up-to-date database of all state and local tax laws. Each year ITEP works with lawmakers and nonprofit groups in over 40 states to help them evaluate the impact of regressive tax plans—and to help them develop their own progressive tax reform plans.

ITEP's analyses also split the very richest 20 percent into three subgroups: the lowest-income 15 percent of the quintile, the next 4 percent and the richest one percent. This is done because families in the top 20 percent have more than half of all personal income in most states. Within this quintile, there are substantial differences in income levels and tax levels between the "poorest" members and the richest members. Incomes in this group range from what might be called upper-middle class, to the richest families in the country.

These analyses have been instrumental in recent state tax policy debates. For example, when residents of Washington State recently evaluated a ballot measure that would have enacted a limited personal income tax, applicable only to upper-income families, ITEP's analysis of the plan's fairness and revenue yield was the most widely cited analysis of the plan's effects, and helped to galvanize progressive support for the plan. And in Missouri, state lawmakers came perilously close to enacting a so-called "Fair Tax" in 2010—a tax plan that would replace the state's income and corporate taxes with a sales tax on virtually everything consumers buy—despite having little concrete information about how the plan would affect tax fairness or even what the required "Fair Tax" rate would be. ITEP's analysis of these questions clarified the public debate over the plan, and helped to ensure that lawmakers had accurate information on the plan's impact at their fingertips when they voted on this issue. Astonishingly, in each of these cases, if ITEP had not conducted these pro bono analyses, there simply would not have been any such information available to policymakers and the public to help them evaluate these plans.

Rainy Day Funds

In the long run, states with progressive personal income taxes will enjoy the most reliable growth in tax revenues. But the recent decline of income taxes in many states has left policymakers jittery about the role of the tax in funding services. Some lawmakers have advocated making allegedly volatile income taxes less progressive to help ensure the long-term adequacy of state revenues. But this is misguided policy.

The real culprit in states suffering from income-tax shortfalls in recent years is the unwillingness of states to save sufficient revenue in good years in order to shore up revenues in lean years. Almost all states now have some form of **"Rainy Day Fund"** designed to achieve this—but the recent economic slowdown has exposed the design flaws of many states' funds. The box on this page shows some of the most important factors differentiating effective and ineffective rainy day funds. Important questions to ask about your state's rainy fund include:

Important Features of Rainy Day Funds

- ✓ Rules for deposit
- ✓ Size limits
- ✓ Rules for withdrawals
- ✓ Rules for replenishing funds

- Under what circumstances must lawmakers deposit revenues into the fund? Requiring annual deposits when revenue growth exceeds a certain threshold is a good approach.
- Is there a limit on the size of the fund? Many states limit their rainy day fund to five percent of annual expenditures or less—a figure that most now agree is too low.
- How hard is it to withdraw funds? Excessive constraints on withdrawals make the rainy day fund less flexible as a fiscal policy tool.
- How quickly must the fund be replenished after a withdrawal? The faster the replenishment rule, the less flexible rainy day funds are in dealing with fiscal shortfalls.

Rainy day funds are a necessary component of a responsible state budget for a simple reason: taxes and public spending operate on different cycles. When the economy slows down, tax revenues slow down too. Declining income means declining income taxes and declining sales taxes as families make fewer purchases. But the need for important public services such as education and transportation does not diminish when the economy declines: declining income actually increases the need for many areas of public spending, such as health care, education, and disability services. Rainy day funds are an important way of allowing states to match up taxes and spending needs over the business cycle. Almost every state has recognized this reality by enacting a rainy day fund—but few states have created a fund that is truly adequate to bridge fiscal shortfalls.

Tax and Expenditure Limits (TELs)

A growing number of states are considering proposals to limit revenue growth by placing strict limits on the annual growth of state or local tax revenues or spending. These limits are collectively known as **tax and expenditure limits**, or **TELs**. TELs take many forms and no two are entirely alike. They include limits on revenue or spending increases tied to some type of index such as population, inflation, or personal income. A few states tie their appropriations to their revenue forecast. More than half the states have some type of TEL in place.[1] In the majority of states that have TELs the spending or revenue limit is embedded in the state's constitution, which makes it difficult to lift these restrictive limits. TELs remove decision-making authority from elected officials, frequently forcing damaging automatic cuts in tax revenue and public infrastructure when both are vitally needed.

One of the most controversial TELs is Colorado's Taxpayer Bill of Rights (TABOR). Colorado's TABOR limits the annual growth in state revenues to the sum of inflation and population growth. So if Colorado's population grows by 1 percent and inflation grows by 2 percent in a given year, Colorado government revenues are allowed to grow by no more than 3 percent in that year. "Surplus" revenues over that limit are rebated directly to taxpayers.

So what's wrong with a TABOR-style limit on state revenues and spending?

- When states collect revenue above the limit, this so-called "surplus" must be rebated to taxpayers. This makes it harder to replenish rainy day funds—which means that when the economy tanks, these states have to enact painful spending cuts to make ends meet.
- Imposing a spending limit assumes that states are already adequately funding public services. Few state lawmakers would assert with a straight face that their public service needs have all been met—but that's one implication of strictly capping the growth rate of a state's spending.
- Spending limits assume that the cost of providing existing services will grow no faster than the limits allow. But many state spending needs grow faster than population and inflation, as any state lawmaker confronting skyrocketing Medicaid enrollment and education expenses can attest. And some public sector spending—spending on corrections facilities, for instance—can grow faster than spending limits for reasons that are beyond the control of lawmakers.
- Spending limits also assume that no new and unanticipated spending needs will emerge. The upcoming expansion of Medicaid, funded in part by states, attests to the constantly changing mix of spending priorities at the state level.

TABOR limits are often described by their proponents as a good-government tool. But state bond rating agencies, arguably the best arbiter of state fiscal health, reject this argument. In 2002, Standard and Poor's downgraded Colorado's bond rating, citing the TABOR spending limits as a reason for this punishment. Moreover, there is evidence that the TABOR limits had unintended consequences far beyond the intentions of its supporters. The Bell Policy Center has shown that under TABOR, health care fees increased, state investment in higher education fell dramatically, and tuition for higher education increased.[2] In a victory for tax justice advocates, in 2005 Colorado voters approved a referendum designed to temporarily suspend the TABOR revenue limit for five years. Coloradans continue to debate whether TABOR should be allowed to expire permanently.

Across the nation, state lawmakers are facing painful choices between further spending cuts and unpopular tax increases. TABOR-style spending caps restrict the ability of lawmakers to make the bread-and-butter decisions about government activities that should be their primary function, forcing the elimination of needed public services at the very time when they are most needed.

Conclusion

Some of the structural reforms outlined in this chapter can have a positive impact on the ability of lawmakers to make reasoned, fully informed decisions about tax fairness and adequacy. Tax expenditure reports are an important tool to help citizens evaluate targeted tax breaks that would otherwise be hidden from public view. Tax incidence analysis makes it possible to accurately judge the fairness of tax reform proposals. And an adequate rainy day fund can allow states to weather the storm of economic recessions without cutting public services to the bone. But the arbitrary tax and spending limits collectively known as TELs actually add a new layer of complexity to the already difficult decision-making process facing legislators, making it much harder for policy makers to provide the services demanded by their constituents.

[1] Waisanen, Bert, "Tax and Expenditure Limits 2008." National Conference of State Legislatures. http://www.ncsl.org/Default.aspx?TabId=12633#typesoflimts

[2] "Ten Years of TABOR." The Bell Policy Center, 2003. http://bellpolicy.org/node/3440