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

Tax reform is not just about changing the base and the rates of particular taxes. 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 reforms 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 corporations. 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 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.
- 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.

As a result, tax expenditures often turn out to be very expensive programs for which there is little oversight. 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 budgets**. These are simply a listing of tax breaks and how much they cost.

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 levied by a state—including tax breaks (like exemptions of services from state sales taxes) that are not explicitly written in the tax code.
- **Estimates of the state and local revenue loss** from each tax expenditure, including estimates of how much the tax break is likely to cost in the future.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policy makers 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 policy makers 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 policy makers should be able to evaluate tax expenditure side-by-side with conventional spending.

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 analysis 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.

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 policy makers jittery about the role of the tax in funding services. Some lawmakers have advocated making income taxes less progressive to help ensure the long-term adequacy of state revenues.

This is, however, a red herring. 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 to devote to shoring 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 at right 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 deposits**
- ✔ **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 and low-income tax relief. 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 now 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. One example of these limits 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 may 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 states' recent experience with homeland security expenditures attest 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. And Colorado policymakers are now engaged in a heated debate over whether their TABOR limit should be modified or repealed entirely.

Across the nation, state lawmakers are facing painful decisions 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.

Good Choices, Bad Choices

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.