

## How to Enact (and Maintain) Tax Reform

In Oklahoma, the first \$600 won in a competitive livestock show is tax deductible.<sup>1</sup> In Hawaii, residents can deduct up to \$3,000 on their state income taxes to care for a tree that a certified arborist has deemed to be “exceptional.”<sup>2</sup> In Louisiana, you can buy binoculars tax free during the “Second Amendment Sales Tax Holiday,” but only if you plan to use them for hunting — not bird-watching.<sup>3</sup> In South Carolina, your home is exempt from property tax if you received the Medal of Honor, or if you were captured by the enemy in World War I, World War II, the Korean War, or the Vietnam War.<sup>4</sup> And in Arkansas, you can buy an automobile tax free every two years if you are a blind veteran — regardless of which war you fought in and whether or not you were ever captured by the enemy.<sup>5</sup>

None of these provisions may be that significant. But surely, none of them belong in any state’s tax code. In fact, their mere existence indicates that the bar for enacting and perpetuating spending programs styled as “tax expenditures” has been set far too low. It’s time to raise the bar.

### I. TAX EXPENDITURE BIASES

State codes are increasingly being riddled with special breaks because of two advantages enjoyed by lawmakers seeking to enact or expand tax expenditures: political biases and procedural biases.<sup>6</sup>

Political biases include the ability of lawmakers to claim that a tax expenditure both cuts taxes *and* addresses some important policy issue.<sup>7</sup> For instance, although a tuition grant program and an identically designed tuition tax credit can both be defended as ways of improving access to education, only the tax credit can be touted as a way of cutting taxes. Usually, enacting a new program involves a trade-off related to the public’s view of the appropriate size of government. Tax expenditures, however, are rarely discussed in these terms, and as a result they are able to garner support from lawmakers across the political spectrum with undeserved ease.

Procedural biases include the permanent duration and unlimited size of most tax expenditures. Unlike a tuition grant program, a tuition tax credit is usually allowed to continue indefinitely and to grow without limitation (except in the rare cases where the legislation enacting the credit is explicitly

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<sup>1</sup> 68 O.S. Sec. 2358.E.23.

<sup>2</sup> Hawaii Rev Stat Sec. 235-19.

<sup>3</sup> Louisiana Rev Stat Sec. 47:305.62.A(3).

<sup>4</sup> SC ST SEC 12-37-220(43).

<sup>5</sup> AR Code Sec. 26-52-415.

<sup>6</sup> For more detail, see Carl Davis, “Judging Tax Expenditures,” *Tax Notes*, Nov. 9, 2009, p. 678-9, *Doc 2009-22504*.

<sup>7</sup> Similarly, opponents of a tax expenditure can be labeled as supporting higher taxes and neglecting the issue addressed by the tax expenditure.

written to prevent these outcomes). The disproportionate power given to tax-writing committees and, in many states, the supermajority requirement needed to eliminate a tax expenditure are procedural biases as well. Other examples include the general assumption of confidentiality when it comes to the identity of tax expenditure beneficiaries, the exclusion of tax expenditures from budget presentations, and the fact that tax expenditures are typically exempt from government performance reviews. These last three factors each provide automatic protections from future scrutiny if lawmakers decide to pursue their favored goals through tax expenditures.

These biases have led not only to complicated and unfair state tax codes, but also to a reduction in overall government efficiency. This is because tax expenditure biases have created an unwarranted preference for forgoing traditional spending programs in favor of tax expenditures. Opportunities for bringing about more rational state tax codes *and* more sensible state policy debates in general could be increased by enacting reforms aimed at addressing these biases

## **II. MAKING REFORM STICK**

Political and procedural biases have resulted in strong incentives for lawmakers to repeatedly rely on state tax codes as tools for passing legislation. Regardless of whether a lawmaker is most passionate about renewable energy, homeownership or economic growth, a tax break is usually the easiest way to gather support for the cause. The result has been an unmistakable long-term trend toward more tax expenditures — a phenomenon sometimes referred to as “tax deform.”<sup>8</sup>

Undoing the damage done by this trend is the job of tax *reform*. At the federal level, reforms designed to prune out the special interest goodies buried in Internal Revenue Code have been enacted roughly once every twenty years. Many states have also enacted tax reforms for the same reason. But as odd as it may sound, even the most comprehensive tax reform is nothing more than a Band-Aid on a system that heavily favors tax deform. Systematic changes are needed if future tax reforms are to have any chance of lasting more than a fleeting moment.

## **III. PROCEDURAL REFORM MUST COME FIRST**

Although political biases are likely the more important contributor to the tax expenditure addiction afflicting so many state lawmakers, procedural biases must be addressed first.<sup>9</sup> Addressing political biases today in a meaningful way is simply too daunting — requiring the media and the public to become aware of the fact that a tax break, or tax expenditure, is not always the same thing as a “tax cut.”<sup>10</sup> Convincing politicians of this point is not enough to eliminate political biases, since the

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<sup>8</sup> Federal tax expenditure data provide the clearest evidence of the trend toward tax deform, though the same general forces are at work in the states. See Thomas L. Hungerford, “Tax Expenditures and the Federal Budget,” (Congressional Research Service, 2008), at 5; Edward D. Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” *Tax Notes*, May 18, 2009, p. 929-32, *Doc 2009-10867*.

<sup>9</sup> This “addiction” language was inspired by Missouri State Senator Matt Bartle’s (R) admission that he is a “recovering tax credit addict.” See Virginia Young, “Mo. Lawmakers Try to Rein in Tax Credit Programs,” *available at* Missouri Senate Newsroom, <http://www.senate.mo.gov/snc/2009/02-February/021809.doc>.

<sup>10</sup> Somewhat encouragingly, opinion pieces arguing that tax expenditures should be viewed with skepticism (and are in need of comprehensive reform) have recently been published with increasingly regularity in some of the nation’s largest newspapers. But the likelihood of these articles bringing about a meaningful reduction in the public’s affection for tax expenditures is remote at best. See, e.g., Len Burman, “Let’s freeze more than chump change,” *The Washington Post* (Feb. 2, 2010), *available at* <http://www.washingtonpost.com/wp-dyn/content/article/2010/02/01/AR2010020103072.html>; Martin Feldstein, “The ‘Tax

advantages of ignoring this truth while campaigning will remain irresistible unless the public has caught on to this dishonest rhetoric.

Rather than attempting to shift popular opinion on this esoteric issue, a much more productive course of action is to convince politicians that existing legislative procedures unduly privilege tax expenditures, and that the long-term welfare of their states can be enhanced by ending these privileges. Many state budget and tax analysts in the public, private and non-profit sectors are already aware of these facts. What remains to be done, then, is to relay those concerns to politicians in a way that inspires them to enact meaningful procedural change.

Moreover, changing the procedural rules governing tax expenditures could provide a teachable moment in which the public could learn about the unique challenges posed by these policies. In this way, it is reasonable to expect that procedural reform could result not only in reduced procedural biases, but in reduced political biases as well.

#### **IV. EXAMPLES OF PROCEDURAL REFORMS**

What steps can states take to slow the downward spiral toward tax deform? Fortunately for enterprising tax and budget analysts, as well as students of the legislative process, there is still plenty of room for creative thinking on this subject.

One sensible starting point is to seek out procedural reforms designed to treat tax expenditures and direct expenditures as similarly as possible. Technical differences between tax expenditure and direct expenditure policies often make it impossible to treat them identically, but second-best solutions can still be found to equalize their treatment.

Arguably, however, simply equalizing the procedural rules governing tax and direct expenditures is not enough. Modest procedural biases *against* enacting and expanding tax expenditures may in fact be justified, since political biases will continue to result in an overabundance of tax expenditures even within a reformed procedural environment.

In any case, what is clear is that the procedures governing tax expenditure enactment, expansion, and continuation should not be *more* favorable than those pertaining to direct spending, as is often the case today. A number of the most prominent proposals for addressing this problem are listed below.<sup>11</sup> None of these proposals are mutually exclusive, and adequately addressing procedural biases will undoubtedly require more than one type of reform.

**A. End supermajority requirements to eliminate tax expenditures.** Sixteen states make it more difficult to repeal a tax expenditure than to eliminate a traditional spending program by requiring that supermajority support be gathered in the legislature in order to “raise taxes.”<sup>12</sup> In these

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Expenditure’ Solution for Our National Debt,” The Wall Street Journal (July 20, 2010), *available at* <http://online.wsj.com/article/SB10001424052748704518904575365450087744876.html>.

<sup>11</sup> In some states, enacting some of these proposals in a binding manner may require a constitutional amendment. This is often due, among other reasons, to prohibitions on one legislature acting to restrict the authority of future legislatures. In these circumstances, if enacting a constitutional amendment is not a realistic option, it can still be beneficial to implement these reforms in a non-binding manner in order to provide a list of best practices to which the media and the public can attempt to hold future legislatures.

<sup>12</sup> Bert Waisanen, “State Tax and Expenditure Limits – 2008,” (National Conference of State Legislatures, 2008).

states, this is the single most important, and least defensible, procedural bias in favor of tax expenditure policy. To address this problem in Washington State, legislation has recently been introduced to exclude the repeal of a tax expenditure from the state's definition of "raises taxes."<sup>13</sup>

**B. Create a tax expenditure performance review system, or bring tax expenditures into existing government performance review systems.** Numerous states, and the federal government, have systems in place for evaluating the effectiveness of government programs in achieving their intended goals. But most of these systems exclude tax expenditures from their scope. One exception is Washington State, which possesses the most sophisticated tax expenditure review system in the country.<sup>14</sup> Implementing an effective review system requires lawmakers to put serious thought into its design, and to provide funding for the effort. California, Connecticut, Delaware, Iowa, Louisiana, Oregon, New Jersey, and Wisconsin have each experimented with the idea of tax expenditure review, though a lack of adequate direction and funding from each state's legislature has resulted in these reviews being performed half-heartedly, if at all.<sup>15</sup>

**C. Cap and sunset tax expenditures in order to mimic the appropriations process.** The appropriations process allows state governments to budget their resources responsibly by ensuring that most spending programs are limited to a specific size and duration. Tax expenditures are almost never included within the appropriations process, and are rarely subject to either of these limitations through other means. While it would be difficult to include many types of tax expenditures within the appropriations process, utilizing caps on the size of individual tax expenditures (or on groupings of tax expenditures), and making use of sunset provisions (i.e. expiration dates) could produce a similar result. Admittedly, neither of these approaches is appropriate for all tax expenditures. Capping the overall cost of the exclusion for employer-provided health insurance, for example, would be quite difficult. And sunseting the mortgage interest deduction would be unwise absent transitional rules, given the important impact of the deduction on many families' long-term financial decisions. Nonetheless, these two approaches can be useful in many circumstances. Oregon recently enacted legislation requiring most of its tax credits to sunset every six years, and Nevada's constitution requires that all new tax exemptions be created with a sunset provision.<sup>16</sup> Caps are often used for specific tax expenditures — most commonly business tax credits — in many states and at the federal level.

**D. Distribute responsibility for tax expenditures among the relevant legislative subject matter committees.** By virtue of their ability to raise tax revenue *and* enact a tax break aimed at almost any purpose imaginable, tax-writing committees have essentially become their own mini-legislatures within the broader state legislatures in which they exist.<sup>17</sup> This lopsided distribution of power has contributed enormously to the proliferation of tax expenditures. Members of the tax-writing committees have predictably enjoyed exercising their unique powers with great frequency; and other members of the legislature are often far too willing to stand idly by. Distributing the authority over tax expenditures among the relevant subject matter committees could help to place these programs on a more even footing with the direct spending programs

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<sup>13</sup> See HB 2212 of Washington's 2009-10 legislative session.

<sup>14</sup> See *supra* note 6, at 688.

<sup>15</sup> See *supra* note 6, at 687; Cheryl Fulmer, "A Report on Tax Expenditures in New Jersey," (New Jersey Department of the Treasury – Division of Taxation, 2010), at 3.

<sup>16</sup> HB 2067, 2009 Or. Leg. Reg. Sess.; Nev. Const. art. 10, section 6.

<sup>17</sup> Kleinbard, *supra* note 8, at 926.

already under the jurisdiction of these committees.<sup>18</sup> By reforming state legislatures in this way, tax-writing committees would no longer serve as one-stop-shops for lobbyists interested in a government subsidy, and the subject matter committees would finally be endowed with the authority to decide on the relative merits of related tax and direct expenditures.

**E. Enact, or improve upon tax expenditure reports.** Nearly every state requires the regular publication of a tax expenditure report. These reports are designed to provide information on the number and size of tax expenditures contained within these states' tax codes — information that is often otherwise absent from state budget presentations. Alabama, Alaska, Indiana, Nevada, New Mexico, South Dakota, and Wyoming are the only states that still lack such a requirement, though many other states have tax expenditure reports that are in desperate need of improvement.<sup>19</sup> Thorough tax expenditure reporting is a bare minimum requirement for even beginning to bring tax expenditures on a more even footing with direct spending.

**F. Require increased disclosure of business tax expenditure beneficiary data.** Typically, the assumption of confidentiality surrounding tax returns prevents the disclosure of information regarding the identities of tax expenditure recipients. This is appropriate for individual tax return information, and for some business tax information, but not for most information related to business subsidies received through the tax code. Releasing company-specific information related to business tax expenditures can help to bring these types of subsidies on a more even footing with other types of more visible subsidies. This, in turn, will result in fewer perverse incentives for industry lobbyists and “business-friendly” lawmakers to favor tax expenditures over other forms of policy. Disclosure of the names of companies, dollar amounts received via tax breaks, jobs created, and other important information associated with the receipt of business tax expenditures is already required for at least some tax breaks in many states.<sup>20</sup>

**G. Require that additional information be provided in bills seeking to enact, expand, or continue tax expenditures.** One of the most common problems encountered during the course of Washington State's tax expenditure performance reviews is a lack of clarity regarding each expenditure's intended purpose. In order to avoid this problem, legislation creating, expanding, or continuing a tax expenditure could be required to include an explicit statement of the expenditure's purpose, and a discussion of the types of data and performance indicators that analysts should rely on in judging its effectiveness. In order to address the ongoing political biases in favor of tax expenditures, lawmakers seeking to enact, expand, or continue a tax expenditure could also be required to submit an explanation of why they believe the provision can be administered more effectively and efficiently as a tax expenditure, rather than as a direct spending program. New procedural rules similar to these have been proposed in California, and at the federal level, in recent months.<sup>21</sup>

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<sup>18</sup> For a detailed explanation of how to accomplish this at the federal level, see Edward D. Kleinbard, “Tax Expenditure Framework Legislation,” (USC Center in Law, Economics, and Organization, Research Paper No. C10-1, 2010). Also at the federal level, HR 5752 of the 111<sup>th</sup> Congress seeks to endow the subject matter committees with some authority over tax expenditures.

<sup>19</sup> For detail on current and best practices in tax expenditure reporting, see Jason Levitis, Nicholas Johnson, and Jeremy Koulisch, “Promoting State Budget Accountability Through Tax Expenditure Reporting,” (Center on Budget and Policy Priorities, 2009).

<sup>20</sup> One of the more notable examples is Illinois' corporate accountability website, available at <http://www.ilcorpacct.com/corpacct/>. For a summary of state disclosure practices related to a variety of different types of subsidies, see Philip Mattera et al., “The State of State Disclosure: An Evaluation of Online Public Information About Economic Development Subsidies, Procurement Contracts, and Lobbying Activities,” Good Jobs First (rev. Nov. 2007).

<sup>21</sup> In California, SB 1272 of the 2010 legislative session would have required all new personal and corporate tax credits to include a statement of their purpose and relevant performance indicators. The bill would also have required that all new tax credits be set

## V. CAUSE FOR OPTIMISM

Enacting procedural reform in the states could be less difficult than it sounds. The frequency with which temporary tax reform commissions are being appointed across the country may indicate that state lawmakers are already aware that the procedural hurdles to enacting tax reform (and the procedural biases in favor of tax reform) are too daunting to be dealt with through traditional channels. Admittedly, this understanding may not yet be articulated clearly in the minds of many lawmakers, as evidenced by the fact that these commissions are rarely asked to spend any portion of their time exploring options for procedural reform.<sup>22</sup> Nonetheless, there seems to be an understanding that current procedures are deficient.

While temporary commissions do slightly lower the procedural hurdles to tax reform, few lawmakers would claim that they are the ideal means of bringing about such reform. Addressing these hurdles more directly, and on a permanent basis, through the types of reforms outlined in the previous section is the next step.

## VI. CONCLUSION

Tax reform is important and desirable, but too often short-lived. Absent action to address the political and procedural biases in favor of tax expenditures, state lawmakers have almost no chance of maintaining a reformed tax code for long, nor do they have much chance of being able to impartially decide whether new government programs should be implemented as tax expenditures or direct expenditures. Because the procedural biases in favor of enacting tax expenditures are arguably easier to correct, and because reducing or eliminating procedural biases will provide new opportunities for combating political biases, procedural reforms of the type outlined in this article should be the starting point for reining in state lawmakers' unhealthy obsession with tax expenditures.

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to sunset after seven years. Governor Schwarzenegger vetoed the bill because of the sunset requirement. At the federal level, HR 5752 of the 111<sup>th</sup> Congress would require that all new tax expenditures include “a clear statement of the purpose of the tax expenditure, including a justification of why this purpose is best achieved through the tax system rather than as an outlay.”

<sup>22</sup> Iowa's recent Tax Credit Review panel, appointed in the wake of a highly publicized scandal involving the state's film tax credit, offers one exception. By taking a broad perspective in its investigation into the “oversight, accountability, transparency, public reporting, [and] cost-benefit” of Iowa's tax credits, the Panel was able to use its platform to recommend some procedural reforms. Most notably, the Panel recommended the systematic use of caps and sunset provisions. Other states' commissions — such as the newly formed Missouri Tax Credit Review Commission, which exists precisely because growth in Missouri's tax credits is wildly out of control — would do well to offer similar, systematic recommendations. See Tax Credit Review Panel, “State of Iowa Tax Credit Review Report,” available at Iowa Department of Management, [http://www.dom.state.ia.us/tax\\_credit\\_review/files/TaxCreditStudyReviewReportFINAL1\\_8\\_2010.pdf](http://www.dom.state.ia.us/tax_credit_review/files/TaxCreditStudyReviewReportFINAL1_8_2010.pdf). Information on the Missouri Commission is available at <http://tcr.mo.gov/>.