

JANUARY 20, 2011

Reforms Needed to Bring Greater Scrutiny to “Tax Expenditures”

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Summary

Every year Kentucky loses billions of dollars in revenue through special tax preferences and breaks for individuals and businesses that are written into the tax code. Yet there is very little understanding or awareness of these provisions, which are known as tax expenditures, and almost no review and assessment of their effectiveness. Tax expenditures receive far less scrutiny than spending in the state budget, and once put into the tax code tend to stay there. When many vital state services are being reduced in tough economic times, as is the case today, tax expenditures tend to escape such cuts. A series of common-sense reforms would shed greater light on the purpose, impact and effectiveness of the state’s tax expenditures and help Kentucky make better choices about key priorities in the future.

Tax expenditures and budget priorities

Budgeted spending for education, health care, transportation and other public systems are the subject of growing interest in transparency in Kentucky, including legislation that would provide detailed information about state spending accessible to the public through searchable online databases and the Executive Branch’s creation of a website called “Kentucky’s Open Door.” However, these new efforts for greater government transparency largely

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normal tax policy designed to benefit a particular group of individuals or businesses or promote an activity or purpose. They reflect decisions about spending priorities just like appropriations in the state budget.

Kentucky defines tax expenditures as “provisions such as special exemptions, exclusions, deductions, credits, deferrals, and preferential rates in tax law that result in a loss of tax revenue.”¹ Tax expenditures are departures from

Tax expenditures are growing at both the state and federal levels. Decision makers often like the perceived political benefits of tax expenditures because they can claim to both cut taxes and address important public policy issues. For example, a tuition grant program and a tuition tax credit can both be promoted as ways to improve the affordability of education. However, only a tuition tax credit can also be called a tax cut.²

Tax expenditures also are growing because rules typically favor them over on-budget spending, including:

- Tax expenditures are permanent (except in the cases in which they contain an expiration date), and therefore don't have to be defended through each budget cycle;
- The cost of tax expenditures is usually unlimited, unlike on-budget programs that receive a specific appropriation;
- Tax expenditures come "off the top" before budget decisions are made, giving them automatic preference;
- After they are enacted, tax expenditures generally lack the public and lawmaker scrutiny that normal appropriations regularly receive through budget subcommittee hearings and media coverage of budget debates.³

These biases are recognized by the Kentucky Office of the State Budget Director, which notes:

Unlike direct appropriations, which must be continuously reviewed and approved by the General Assembly to remain in effect, state tax expenditures are usually not included in the review process. As a result, programs funded through tax expenditures receive priority funding over all other programs. In all probability, many "tax expenditure" programs would not receive the same priority if they had to compete on equal footing during the biennial appropriations process.⁴

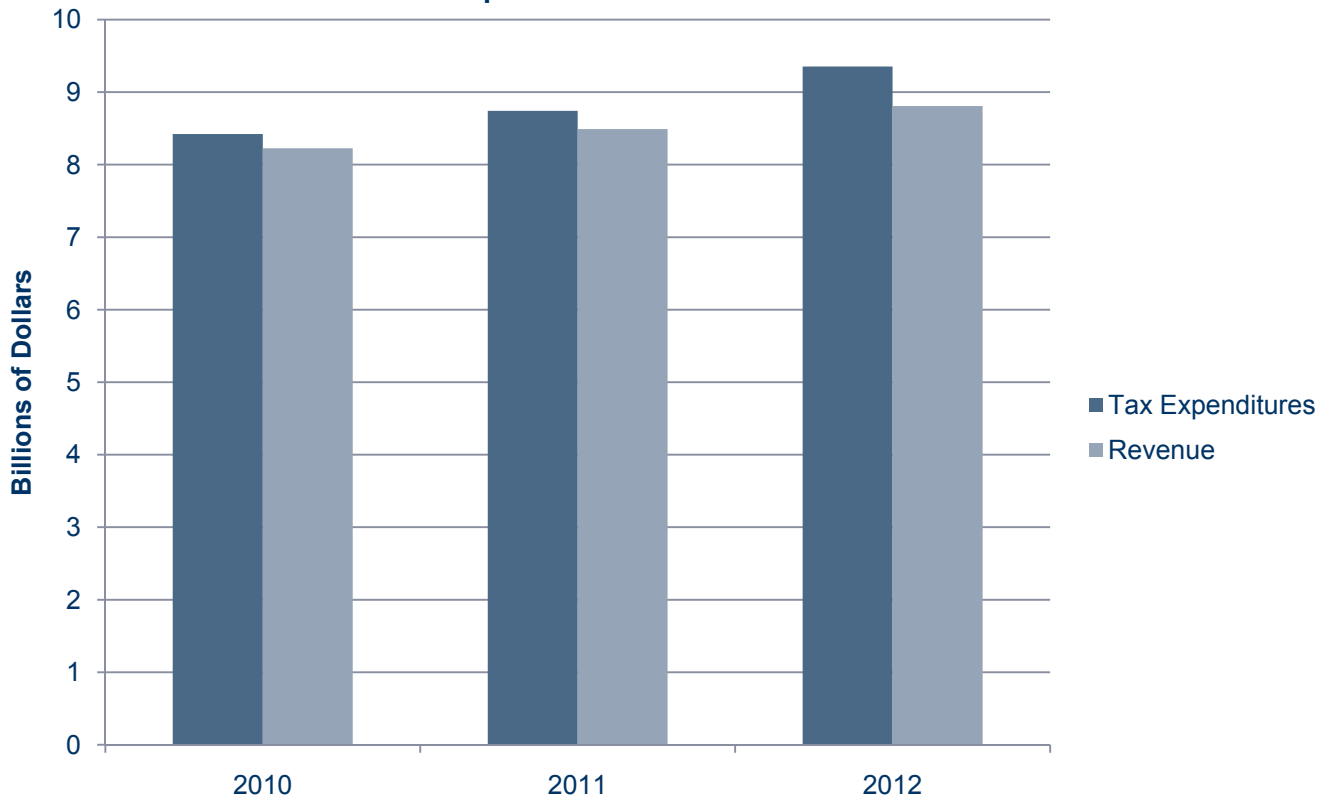
Biases create an uneven playing field that advantages tax expenditures over budgeted appropriations. That leads to the growth of tax expenditures and an accompanying decline in public or even lawmaker awareness of the full budget picture.

The size and growth of tax expenditures in Kentucky

Tax expenditures are a significant source of lost revenue in Kentucky. As indicated in Figure 1, the aggregate value of General Fund tax expenditures as estimated by the state is \$8.4 billion in 2010, an amount greater than the General Fund revenue collected that year.⁵ That value is estimated to grow 11 percent over the biennium, while General Fund revenue is expected to grow only 7 percent. The recognized number of tax expenditures has also been growing. While there were 235 tax expenditures listed in the state's 2000-02 tax expenditure report, there are 287 listed in the 2010-2012 report. The legislature commonly adds a few new tax expenditures each session; during the recent budget session in June 2010 the General Assembly passed a bill adding or expanding five tax expenditures at the same time it was making dramatic cuts to the budget.

Tax expenditures exist across a variety of taxes, as can be seen in Table 1. Most tax expenditures concern the state's two largest taxes: the sales tax and individual income tax. In recent years, the state has begun to categorize tax expenditures by function or purpose, which can be seen in Table 2. The five biggest categories of tax expenditures are the exclusion of services from the sales tax followed by tax expenditures targeting existing businesses, health care, income maintenance and retirement.

Figure 1: Lost Revenue from General Fund Tax Expenditures Compared to General Fund Revenue



Sources: Office of the State Budget Director, Tax Expenditure Analysis FY 2010-2012; Budget of the Commonwealth FY 2010-2012

Important trends and themes concerning the state’s use of tax expenditures include the following:

1. The growing use of tax expenditures in the name of economic development

Decision makers routinely justify new tax expenditures for their assumed economic development benefits. Economic development tax expenditures take two forms: company-by-company tax incentive programs and broad business-based tax expenditures.

Tax incentive programs are company-specific awards of tax credits and other benefits used as a tool to promote recruitment and investment. Kentucky’s use of tax incentives has grown considerably since 1992, when the state created a new, semi-independent Partnership Board to oversee its Cabinet for Economic Development and put in place a set of new tax incentive programs. In a 2009 special session, the legislature consolidated those programs and further expanded their eligibility. The lost revenue associated with these programs is approximately \$165 million in 2012.

A second form is broad tax exemptions or preferences that apply to certain industries or types of business investment. Examples include the tax credits for ethanol, investment in pollution control facilities, sales to motion picture companies, mining thin seams of coal, railroad improvements and updates, and location in a Foreign Trade Zone. There are a wide range of such exemptions and preferences targeting such industries as agriculture,

Table 1: Tax Expenditures by Tax Type

	FY 10	FY 11	FY 12
Sales and Use Tax (Including Exempted Services)	4,035	4,167	4,306
Individual Income Tax	2,787	2,883	2,986
Property Tax	695	716	739
Corporation Income and License Taxes	335	386	412
Limited Liability Entity Tax	202	315	521
Motor Vehicle Usage Tax	74	52	56
Special Fuels Tax	72	75	78
Inheritance and Estate Tax	64	62	65
Earmarked Funds	51	57	64
Coal Severance and Processing Taxes	24	24	24
Gasoline Taxes	14	14	15
Natural Resources Severance and Processing Tax	8	8	8
Other Taxes	4	4	4

Millions of dollars. Source: Office of the State Budget Director

horses, coal, manufacturing and health care. Rather than being awarded on a company-by-company basis, these tax advantages are broadly available to businesses who meet the eligibility requirements.

Economic development tax expenditures have been growing, but the evidence of their benefits are in serious question. Researchers at the University of Kentucky’s Center for Business and Economic Research (CBER) conducted analysis of the cost-effectiveness of Kentucky’s incentive programs several years ago. They found a small, positive effect from the incentives, but at a much higher cost when compared to a job training program.⁶ A follow-up CBER study looked at why Kentucky’s growth has been slower than other southern states like North Carolina and Georgia. The report identified Kentucky’s deficit in education and workforce development as the major factor explaining the difference, and noted that some of the states that have out-performed Kentucky rely less on tax incentives than Kentucky does. The report says that those more successful states “have adopted a much more expansive view of economic development than we have adopted in Kentucky.”⁷

2. The eroding sales tax base

The exclusion of most services from the sales tax base is a tax expenditure that is of growing concern. Kentucky taxes only six of 40 household services identified by the Center on Budget and Policy Priorities using a survey by the Federation of Tax Administrators, and only 28 of 168 total services currently taxed by at least one state.⁸ Kentucky ranks among the states with the fewest services included in the sales tax base.

This exclusion is a growing problem because an increasing share of the economy is in services. Kentucky’s sales tax base has fallen from about 54 percent of state personal income in 1979 to approximately 41 percent in 2008.⁹ According to the state’s tax expenditure report, Kentucky lost up to \$1.653 billion in revenue in 2010 from the exclusion of services, and the Center on Budget and Policy Priorities has estimated a gain of up to

Table 2: Tax Expenditures by Purpose

	FY 10	FY 11	FY 12
Excluded Services	1,764	1,786	1,818
Existing Business Support	973	1,004	1,324
Health Care Support	840	865	892
Income Maintenance	761	749	767
Retirement Support	702	728	757
Charitable Organization Support	482	500	521
Housing Development	471	488	508
Energy Development and Coal Industry Support	415	465	514
Family Support	412	421	430
State and Local Government Support	393	409	425
Agricultural Development	288	301	314
Job Development	129	146	143
Economic Development	100	111	135
Transportation Industry Support	83	91	99
Environmental Conservation and Historic Preservation	55	61	67
Earmarked Funds	51	57	64
Education Support	36	42	45
Equine Industry Support	36	36	37
Military Support	32	33	35
Community Development	15	22	20
Intergovernmental Transfers	11	12	12
Natural Resource	11	11	11
Federal Government Support	8	8	9
Banking Support	7	8	9

Millions of dollars. Source: Office of the State Budget Director

\$1.092 billion from expansion of the tax to a feasible set of services.¹⁰ Lack of a sales tax on services results in lost revenue equaling between 10 and 20 percent of the state’s General Fund.

A range of other sales tax exemptions exist in the Kentucky tax code. Some are likely good ideas, such as the exemption on food purchases for equity reasons. Others benefit some industries over others in a questionable fashion or incentivize certain types of spending or investment. Governor Fletcher’s tax modernization bill, passed by the legislature as House Bill 272 in the 2005 General Assembly, included a requirement that the Legislative Research Commission produce a study of the effectiveness of sales tax exemptions by December 1, 2006.¹¹ However, that study was never produced.

3. The significance of income tax expenditures

An important aspect of Kentucky's income tax is its relationship to the federal income tax. Kentucky is one of 27 states that generally follow federal rules for including itemized deductions when calculating an individual's taxable income. As noted in a recent report by the Institute on Taxation and Economic Policy (ITEP), these itemized deductions disproportionately benefit higher-income Kentuckians, and many low- and middle-income Kentuckians are not able to itemize deductions at all. ITEP's report shows that by repealing itemized deductions and doubling Kentucky's standard deduction, the state could raise \$151 million in revenue while making Kentucky's income tax more progressive.¹² Indiana, Illinois, West Virginia and seven other states disallow itemized deductions; Rhode Island passed legislation to disallow them starting in 2011.

By more closely tying itself to the federal tax code in the individual and corporate income tax as well as other taxes, Kentucky is also vulnerable to changes made at the federal level that can create new tax expenditures for Kentucky through no deliberate state action. Recent and current federal tax changes to business taxes have or will lower state taxes unless Kentucky "decouples" (severs the link) from those changes.

Another theme is exclusions from the income tax that benefit particular groups. Retirees are one group that receives favorable tax treatment in Kentucky. The first \$41,110 of income from private pensions and Individual Retirement Accounts is exempt from the income tax in Kentucky—no matter how much overall income a retiree is receiving. That exclusion results in \$235 million in lost revenue in 2011—an amount that will grow considerably because of expected demographic changes. And that exclusion is just one of several tax advantages for retirees, including the homestead property tax exemption which is based on age (and disability), not on ability to pay.

4. The role of Kentucky's property tax limitation, House Bill 44

In the late 1970s, Kentucky enacted a limitation on revenue growth in the real property tax (the property tax on land and improvements including buildings) to no more than 4 percent a year.¹³ The limit has forced the state real property tax rate down from 31.5 cents per \$100 prior to 1979 to 12.2 cents per \$100 in 2009, meaning \$413 million less in state property tax revenues in 2011. Not only does this impact state property tax revenues, but also amounts spent on schools through the combination of the state Seek Educational Excellence in Kentucky (SEEK) formula and local school board revenues. School real property taxes are also subject to HB 44 measures including the possibility of recall for real property tax revenue growth greater than 4 percent. Local government taxes are also affected. HB 44 created an arbitrary limit on revenue growth from the property tax that has no relationship to growth in the cost of public services and necessities. If the intended goal of such limits is to address the ability to pay property taxes when property values are rising, a "circuit breaker" is a much more targeted and appropriate policy. Circuit breakers provide refunds for property taxes when their cost exceeds a specified share of income, and exist in many states.¹⁴

State reporting of tax expenditures

Like 43 other states, Kentucky produces a tax expenditure analysis. Kentucky's report is released in October of each odd-numbered year—a few months prior to the even-year legislative sessions when budgets are established. A recent analysis of state tax expenditure reports around the country by the Center on Budget and Policy Priorities identified the characteristics of a good tax expenditure report. Kentucky's report includes a number of those characteristics, including that it:

- 1) is published at least every two years;
- 2) can be found online;
- 3) covers all major taxes;
- 4) includes low-cost and highly-targeted items;
- 5) includes the cost of exempting services from the sales tax;
- 6) includes the costs of federal conformity with the tax code.

In addition, Kentucky's report includes some important details about tax expenditures, including:

- 1) not only current costs but also forward-looking estimates (the next two years in Kentucky's case);
- 2) a brief description of how each tax expenditure works;
- 3) a legal citation to the relevant statute;
- 4) the year of enactment.

As mentioned previously, the report also helpfully sorts tax expenditures into program categories.¹⁵

Outside the tax expenditure report, Kentucky has instituted some additional disclosure of information about economic development tax expenditures for incentive programs operated by the Cabinet for Economic Development. The Kentucky Financial Incentives Project Database provides information by incentive program about projects as incentives are awarded, including the maximum amount of credits companies can utilize, the number of jobs expected to be created and the expected average wage of those jobs.¹⁶ Previously, such information was available only through open records requests. The database does not include performance-based information about the use of incentives after they are awarded.

Better decisions through improved tax expenditure accountability

Kentucky's existing efforts are important first steps toward greater tax expenditure accountability. However, additional measures should be taken to improve the transparency and scrutiny of tax expenditures. Added reforms can remove some of the unwarranted biases that favor tax expenditures and help the state make better decisions about spending priorities.

Needed improvements to the rules governing the establishment of tax expenditures and the reporting and review of those expenditures include:

1. Increase clarity about the intent around tax expenditures

- Require a clear statement of purpose for each new tax expenditure in legislation enacting the expenditure, a description of indicators that could be used to measure its effectiveness, and a justification of why its purpose is better served through a tax expenditure than a spending program;
- Require inclusion of cost caps for some tax expenditures in order to prevent dramatic cost overruns and limit their impact on the state budget. Some recently-enacted tax expenditures have included cost caps, but there is no systematic requirement.

2. Improve reporting of the impact of tax expenditures

- Include information about new changes made to tax expenditures, including newly-enacted ones, in the biennial tax expenditure report in order to better clarify trends in the use of tax expenditures (changes and new tax expenditures were once included in the report but have been removed);
- Identify and describe who benefits from a particular tax expenditure, including the number of beneficiaries, the distribution of benefits by income level for individual tax expenditures, and the distribution of benefits by industry and company size in the case of business tax expenditures;
- Include separate reporting of cost to localities, if any;
- Identify the purpose or rationale for each existing tax expenditure; if the purpose or rationale cannot be identified, then indicate so;
- Identify and describe the results of any evaluation or analysis that has been done of each tax expenditure;
- Put the publishing of the tax expenditure report into permanent statute (currently the requirement to produce a report is included in the budget bill as a regular practice, but could be abandoned with each new budget);
- Include the tax expenditure report as a document in the state budget.

3. Create regular review processes around tax expenditures

- Institute a regular review process for tax expenditures such that they are re-visited at least once a decade utilizing either a new tax expenditure review committee or an existing legislative committee like Program Review and Investigations;
- Enact expiration dates on tax expenditures in accordance with the review process;
- Require the Executive Branch to include recommendations about recently-reviewed tax expenditures as part of the budget process, including whether to allow them to expire, to continue or to continue in a modified form.

Improving understanding around the impact of tax expenditures through the above recommendations will require the state to collect more data about tax expenditures. For example, in the area of economic development incentives there is no systematic public reporting of performance-related data after companies are awarded tax incentives, and therefore no clear way to understand whether benefits outweigh costs. As noted above, Kentucky only reports tax incentive information when subsidies are awarded and does not go back to report performance information after the fact.

In 2006, the state held a Tax Expenditure Summit that included discussion of ways to improve how the state dealt with tax expenditures. The event summary captures a number of ideas that merit further exploration: cost-benefit analysis of tax expenditures; coordinated reviews of tax expenditures with related spending programs (for example, reviewing housing tax expenditures alongside housing spending programs); inclusion in the Governor's budget document; and identification of the geographic location of tax expenditures.

Other states have begun to make these changes. Oregon and Nevada have put in place expiration dates (sometimes called “sunsetting”) for tax expenditures; Washington State has led the way in establishing a performance review system; Missouri and Iowa have expanded use of cost caps; and Minnesota, Oregon and Connecticut produce high-quality tax expenditure reports. Kentucky has also taken tentative steps forward. In the most recent session, the legislature lowered or put in place caps on a few tax expenditure programs: the film tax credit, the reinvestment in manufacturing facilities credit, the incentive for domestic production and the new home tax credit. When the state created its enterprise zone program many years ago, it included twenty-year expiration dates on the zones, and completed evaluations of the program at the time of expiration. When the program’s effectiveness was questioned by the evaluations, the state let the original program expire.

Conclusion

Kentucky’s future depends on making smart public investments that can pave the way to greater prosperity. It is critical that efforts to more closely scrutinize the budget include the huge amount of revenue that is lost through provisions in the state tax code. Common-sense reforms that increase transparency and accountability and lessen existing biases that favor tax expenditures will help Kentucky make better decisions about its fiscal and economic future.

The Kentucky Center for Economic Policy (KCEP) was founded in 2011 with the purpose of conducting research, analysis and education on important state fiscal and economic policy issues. KCEP seeks to create economic opportunity and improve the quality of life for all Kentuckians. The center is an initiative of the Mountain Association for Community Economic Development (MACED) and is supported by foundation grants and individual donors. Please visit KCEP’s website at www.kypolicy.org.

¹ Commonwealth of Kentucky Tax Expenditure Analysis Fiscal Years 2010-2012, p. 7, http://www.osbd.ky.gov/NR/rdonlyres/DBC47EB8-FE21-4429-A283-7357388BF39B/0/1012TEA_TaxExpenditureDoc.pdf.

² Carl Davis, “How to Enact (and Maintain) Tax Reform,” Citizens for Tax Justice, October 26, 2010, <http://www.ctj.org/pdf/maintainingtaxreform.pdf>.

³ Davis, “How to Enact (and Maintain) Tax Reform.” Carl Davis, “Judging Tax Expenditures: Spending Programs Buried Within the Nation’s Tax Code Need to be Reviewed,” Citizens for Tax Justice, November 13, 2009, <http://www.ctj.org/pdf/judgingtep1109.pdf>.

⁴ Commonwealth of Kentucky Tax Expenditure Analysis Fiscal Years 2010-2012, p. 8.

⁵ The aggregate lost revenue from tax expenditures is included in this report to help illustrate the extent of the fiscal impact of tax expenditures. However, it is important to note that the aggregate estimated value of individual tax expenditures in terms of lost revenue does not equal the amount of revenue that would be raised if tax expenditures were eliminated. This is because the estimates do not take into account the interaction between the repeal of more than one tax expenditures or changes in taxpayer behavior that may result. As noted in the 2010-2012 Tax Expenditure Analysis, “This analysis should not be viewed as an estimate of the impact of repealing one or more tax expenditures since the estimated cost of the expenditure(s) may not necessarily equal the increased revenue resulting from repeal. Similarly, the costs of two or more expenditures cannot be added together to produce the impact of simultaneous repeal, because each was computed without regard to the others. Due to graduated rates and other factors, the combined impact may be more or less than the sum of the individual tax expenditure amounts.” p. 9. Also, the values reported for tax expenditures here do not include the values for those expenditures whose lost value is labeled “minimal” or “substantial” in the tax expenditure report.

⁶ William Hoyt, Christopher Jepsen and Kenneth R. Troske, “An Examination of Incentives to Attract and Retain Businesses in Kentucky,” University of Kentucky Center for Business and Economic Research, January 18, 2007, http://cber.uky.edu/Downloads/BusinessIncentives_Final%20Report_01182007.pdf.

⁷ Christopher Jepsen, Kenneth Sanford and Kenneth R. Troske, “Economic Growth in Kentucky: Why Does Kentucky Lag Behind the Rest of the South?” University of Kentucky Center for Business and Economic Research, January 2008, http://cber.uky.edu/Downloads/CBER_Econ_Develop_Report_final_Jan2008.pdf.

⁸ Michael Mazerov, “Expanding Sales Taxation of Services: Options and Issues,” Center on Budget and Policy Priorities, July 2009, <http://www.cbpp.org/files/8-10-09sfp.pdf>. Federation of Tax Administrators, “Sales Taxation of Services: 2007 Update,” July 2007, <http://www.taxadmin.org/fta/pub/services/btn/0708.html#table>.

⁹ William Fox, “Kentucky Taxes: Is There Need for Reform,” presentation at Martin School for Public Policy and Administration Tax Policy Symposium, January 13, 2010.

¹⁰ Commonwealth of Kentucky Tax Expenditure Analysis, p. 18. Mazerov, "Expanding Sales Taxation of Services," p. 5.

¹¹ Acts of the 2005 Regular Session, Chapter 168 (HB 272), Section 161, <http://www.lrc.ky.gov/Statrev/ACTS2005/0168.pdf>.

¹² Institute on Taxation and Economic Policy, "'Writing Off' Tax Giveaways: How States Can Help Balance Their Budgets By Reforming or Repealing Itemized Deductions," August 2010, <http://www.itepnet.org/pdf/itemize0810.pdf>.

¹³ The limitation applies to existing property, thus excluding new property.

¹⁴ Karen Lyons, Sarah Farkas, and Nicholas Johnson, "The Property Tax Circuit Breaker: An Introduction and Survey of Current Programs," Center on Budget and Policy Priorities, March 21, 2007, <http://www.cbpp.org/files/3-21-07sfp.pdf>.

¹⁵ Jason Levitis, Nicholas Johnson, & Jeremy Koulish, "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center on Budget and Policy Priorities, April 2009, <http://www.cbpp.org/files/4-9-09sfp.pdf>.

¹⁶ Database is accessible at <http://www.thinkkentucky.com/fireports/fintro.aspx>.