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Revenue Committee's Subcommittee on Tax Expenditure Budgets

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Thank you for the opportunity to talk to you today about tax expenditure budgets. I am an economist with considerable background in economic policy, including tax policy and policies affecting low-income families and individuals. While I do not often write on tax policies now, I was the research director for the Legislature's Special Commission on Tax Reform in 1987 and 1988. I also worked as the research staff for Taxation Committee for State Senator John Olver in 1986 and part of 1987. Since 1988, I have been a professor of economics at University of Massachusetts Boston. For the last 15 years, I have taught a master's level course in public affairs on state and local governments. In that course I include a good deal of information about Massachusetts' revenue system, with a good deal of attention to the tax expenditures and the Tax Expenditure Budget (TEB).

I am delighted to share my accumulated wisdom on this topic with you, something I usually can only inflect on my students. Providing this testimony also gave me the opportunity to dust off three 20+ year old reports from the Tax Commission that specifically addressed tax expenditures.

Tax expenditures as a fundamental component of state tax policy.

In 1987, I and my co-authors at the Massachusetts Special Commission on Tax Reform wrote:

There has never been a thorough review of the 153 state tax expenditures identified in the TEB or of local tax expenditures. Some tax expenditures have been in place for more than thirty years and no longer serve their purpose. Others demonstrate the power of special interests at the expense of sound tax policy. Many are useful and based on equitable principles but require an updated approach to remain responsive to current economic and technological realities. One thing is certain: tax expenditures represent substantial revenue foregone and a significant redistribution of public funds (Albelda, Mann and Yachetta. 1987, pp. 1-2).

A review of tax expenditures is well overdue and I applaud the Committee on Revenue's attention to them.

Size of tax expenditures

Precisely because tax expenditures represent substantial foregone revenue, they deserve scrutiny to assure that they meet tax policy goals. Sales tax revenues in FY09 were \$3.869 billion, sales tax expenditures were more than three times that amount -- \$12.393 billion. Personal Income tax revenues were \$10.584 billion, while personal income tax expenditures amount to \$4.695 billion. Corporate Excise tax collections were 1.549 billion, with expenditures amounting to almost the same amount -- \$1.285 billion (FY2010 TEB and DOR June 2009 Tax Collection Summary, http://www.mass.gov/Ador/docs/dor/News/PressReleases/2009/June09_tax_summary.pdf). Total state tax collection in FY09 of \$18.259 were only slightly less than total state tax expenditures of \$18.373 billion.

FY09 Personal Income, Corporate Excise, Sales Tax, and Other Tax Collections and Tax Expenditures

	Tax Collected (in billions)	Estimated Tax Expenditure (in billions)
Personal Income	\$10.584	\$4.695
Corporate Excise	\$1.549	\$1.285
Sales	\$3.869	\$12.393
Other tax collections	\$2.257	\$0
<i>Total tax collections</i>	<i>\$18.259</i>	<i>\$18.373</i>

Source: FY2010 TEB and DOR June 2009 Tax Collection Summary

Why Tax Expenditures?

When used well, tax expenditures can be a vital tool in achieving the goals of generating a sound revenue system. They can make a particular tax less onerous on low-income taxpayers. They can avoid the problem of “double taxation” and can ease tax compliance. However, tax expenditures can also make a tax system less sound if they merely reflect successful lobbying of narrow interests, are used to create unproven incentives, or remain in place despite tax or other structural changes that make them no longer effective. Even when implemented for sound reasons, tax expenditures can violate criteria of good tax policy and reduce the tax base, so their benefits need to be weighed against their costs.

Addressing what makes for sound tax expenditure policies means understanding what makes for sound tax policies. Therefore, it is useful to understanding some underlying principles and criteria that are usually promoted as good ways for states to structure their tax and revenue systems.

Underlying economic principles of taxation

All economic theories see a role for governments to provide goods and services (they disagree on how many and which ones). So, governments need to raise revenues to pay for these. The issue then becomes how to raise those revenues and here is where theories part. The two overarching tax principles, which derive directly from opposing economic theories, are the “benefit” and “ability-to-pay” principles. The **benefit principle** argues that those who receive the government services should be the ones who pay the taxes for those services. According to this argument, in the same way that people who buy services in the market pay for them, people who use the services should pay for them, with government acting as a close substitute for the market. Implementing this principle is to apply user fees and charges whenever possible or a “head tax” – a lump sum from individuals in the jurisdiction in which services are provided. This principle corresponds to the neoclassical economic model, which is most associated with libertarian and conservative economic views. The **ability to pay principle** argues that those with the most material resources (such as income or wealth) can afford to pay more in taxes and therefore should. This position derives from the economic understanding that our market system creates unfair inequalities and unequal access to resources that are not based in individual attributes. Taxes can be used to redistribute income and to provide the necessary sets of goods and services to those who cannot afford to purchase them in the market (such as health care). This principle corresponds to Keynesian and other more liberal economic models.

These principles are at direct odds with one another. One argues that those who benefit from the public good or service should pay for it, regardless of income. The other argues that who have the most, regardless of who benefits, should pay. State and local governments end up using revenue raising instruments that apply both principles and in some cases do neither. For example, user fees and charges

(such as public university fees and tuition, turnpike tolls, and gasoline excise taxes earmarked for highway transportation) apply the benefit principle (although in many cases the state subsidizes some portion of these through other revenue streams). The income tax is the closest tax the Commonwealth has to a tax that follows the ability to pay principle, although this is limited by the Constitutional requirement to apply a single tax rate on income. Sales taxes follow neither principle – it is regressive (i.e. takes a larger percentage of income from lower income taxpayers) and receipts are used for general purposes which in many cases are not enjoyed by those who pay sales taxes.

Criteria applied in tax policy

Not surprisingly, tax systems do not always adhere to strict economic principles. Still, there are underlying sound and desirable criteria that states can apply in structuring their revenue systems. Some of these flow from these theories, some from a desire for efficient administration, others from pragmatic concerns.

Below are the widely accepted criteria of a “good” taxation.

1. Fairness: Taxes should have components of horizontal and/or vertical equity. Vertical equity corresponds to ability to pay. Horizontal equity means that taxpayers with similar resources (income and wealth) should be taxed similarly.
2. Linking benefits received to taxes paid: This is the benefit principle, implying that government facilitates markets and should use same rules as markets.
3. Economic efficiency/Neutrality: The imposition of the tax should not cause taxpayers to act differently.
4. Simplicity of administration: tax should be easy to comply with and not be costly to administer.
5. Revenue stability: tax should not vary tremendously over the business cycle.
6. Revenue adequacy: tax structure should keep up with structural changes in the economy and provide sufficient revenues for sets of goods and services provided.

There are other criteria that are appealing to policy makers, but are not necessarily accepted as good tax policy, because they reduce resistance to paying taxes regardless of how they are raised.

7. Link spending and taxing: Understanding the links between paying taxes and the sets of goods and services received often makes taxpayers less resistant to paying taxes.
8. Tax invisibility: Smaller payments and less visible ways of collecting revenue makes people less resistant to paying taxes.
9. Exportability: Imposing a larger portion of the tax on non-residents is desirable for residents.

Finally, there is one other criteria that has become increasingly popular over the last several decades, even though it violates #3 above and there is often no evidence that it works.

10. Using the tax code to promote particular behavior: Providing incentives for corporate and individual behaviors through “sin taxes” or tax deductions, exemptions and credits. This is in direct opposition to criteria #3 above.

Tax expenditure as a tool for implementing criteria

Tax expenditures can be used to achieve many of the above goals. For example, tax expenditures help policy makers address the issue of fairness in most major tax instruments. For example, the personal income tax system exempts some portion of income that corresponds with being able to meet minimum living costs (e.g. personal exemptions, child deductions and non-tax status), includes an earned income tax credit for low-income earners, and allows for property-tax credit for seniors. Similarly in the corporate excise tax, the cost of doing business or earning income is typically exempted. Several sales taxes expenditures are structured to avoiding double taxation and exempt most necessities. Similarly each of the three major tax instruments in the state use tax expenditures to promote certain economic activity. The Massachusetts personal income tax is full of tax exemptions that are intended to promote savings, investment, employer-sponsored benefits, and energy efficiency. The corporate excise tax similarly contains tax credits for research and development, economic expansion in certain geographic areas, historic building rehabilitation, and for targeted industries. The sales tax is used less for this purpose, but some exemptions. Like those on containers or cement mixers, may have at some point been implemented for this reason.

Tax expenditures' balancing act

Tax policy criteria often create a dilemma for policy makers because some of them contradict one another. For example, implementing a tax credit for the film industry to provide incentives for that industry to develop in Massachusetts, violates most of the criteria of good taxation including: economic efficiency criteria (#3) as it does cause taxpayers (film industry) to act differently; making the corporate excise tax harder to administer (#4); reducing revenue adequacy without a corresponding increase in tax base or rate (#6); and introduces horizontal inequity by treating corporations with similar income very differently. Even widely accepted tax expenditures violate several criteria of good taxation. For example the tax expenditure on the sale of non-prepared food reduces revenue adequacy, makes administration more complex, and makes the sales tax less stable than it would be otherwise. Many tax expenditures violate the simplicity criteria because they create "exceptions to the rule" which can be confusing to taxpayers and complex for tax administrators. Tax expenditures tend to violate horizontal equity since because all taxpayers with the same level of income may not have the type of income exempted or may consume more (or less) of the item exempt. There is no way to avoid these conflicts. However, that does not mean tax expenditures cannot be evaluated.

Evaluating tax expenditures

Using criteria specified in one of the interim reports written for the 1980s Special Commission on Tax Reform, James Wooster (1987) poses four questions that evaluators can pose about the efficacy of particular tax expenditures.

- 1) What was the original motivation for the tax expenditure and does it achieve that goal? Even in achieving that goal, what are the unintended or undesirable affects?
- 2) Who benefits from the tax expenditure and what are the overarching distributionary effects? A corollary question is: Are the beneficiaries the intended target?
- 3) How much does the tax expenditure cost and does the cost outweigh the benefits? Costs should include foregone revenue but also costs caused by changed behavior as a result of the expenditure.
- 4) What are the interdependencies among various tax expenditures? For example, increasing some income tax deductions may result in some taxpayers not benefiting from other income tax expenditures (because their taxable income is below the no-tax threshold).

Categorizing tax expenditures

One tool that might be helpful in evaluating tax expenditures is to categorize them by their initial rationale/criteria for enacting them. In doing so, it may become more apparent which ones do not fit

neatly into any of the state's tax criteria, including those which one no longer meet their original intention. Three separate reports from the 1980s Special Commission on Tax Reform did this. I have brought my copies of these reports and am happy to lend these to committee to make copies. The categories and their original rationale are summarized below.

<u>Personal Income Tax Expenditure Categories</u>	<u>Likely Rationale</u>
<i>Expenditures with Direct Federal Counterparts</i>	
Exclusions from Gross Income	Simplicity (conforming to federal code)
Costs of Earnings Income	Simplicity /fairness
Income Prohibited from Taxation	Legal prohibition from state taxation
Miscellaneous	Various or none
 <i>Massachusetts Specific Expenditures</i>	
Used to be federal tax expenditures	Various (equity/incentives)
Those with no federal counterpart	Various
 <u>Corporate Excise Tax Expenditures</u>	
<u>Likely Rationale</u>	
<i>Expenditures with Direct Federal Counterparts</i>	
Capital Expenditures	Cost of doing business
Charitable deductions	Incentives
Miscellaneous	Various incentives
 <i>Massachusetts Specific Expenditures</i>	
Miscellaneous	Incentives/Double taxation
 <u>Sales Taxation</u>	
<u>Likely Rationale</u>	
Basic Necessities	Vertical equity
Business Inputs	Double taxation
Services	Historical/fairness
Transactions Involving Real Property	Vertical equity
Tax-Exempt Organization	Historical
Items Subject to other Taxation	Double taxation
Miscellaneous	Various or none

Local Tax Expenditures

Neither the Commonwealth nor municipalities are legally required to estimate the value of local tax expenditures. Most local tax expenditures are imbedded in property taxation. For example, localities are legally required to exempt some property from taxation (e.g. state-owned land, properties owned by certain non-profit organizations). These deserved to be reviewed as well, even if they are not compiled annually by the Department of Revenue. There is a section on local tax expenditures in the Special Commission Report "A Review of Tax Expenditures" (Albelda, Mann and Yachetta, 1987).

Valuing Tax Expenditures

The Department of Revenue is required to estimate the costs of tax expenditures and does so through its' annual Tax Expenditure Budget. Authors of this document provide several caveats to their estimates. Having an accurate sense of the value of tax expenditures can help in deciding which expenditures might be reformed. I am not familiar with the exact methods they use. I imagine the subcommittee can speak with staff at DOR about this. I have been recording sales tax expenditures (using the categories above) for about a decade for classroom use. In reviewing my spreadsheet, it is clear that some expenditure estimates have changed dramatically over the years, while others have not (e.g. expenditure for tax-exempt non-profits has fallen by over a third). I did not keep hard copies of any TEBs (my original

source) so am reluctant to pass this information on to you as it may not be accurate. TEBs from FY99 are available on-line and each one contains an estimate for that fiscal year and the previous two fiscal years. (<http://www.mass.gov/?pageID=dorsubtopic&L=5&L0=Home&L1=Tax+Professionals&L2=News+and+Reports&L3=State+Budget+Documents&L4=Tax+Expenditure+Budget&sid=Ador>). In performing a quick check of my numbers against those in the FY99 and FY00 TEBs, I discovered different estimates for the same expenditure in the same fiscal year depending on which TEB I examined (and none corresponding to my numbers!). If the subcommittee is interested in the valuation of tax expenditures and how they change over time, staff or an intern might look more closely at the values for selected expenditures in TEBs over time and work with DOR staff to understand why they vary.

Reforming Tax Expenditures

The economic exercise of identifying which tax expenditures make sense and which one do not is much easier than the political exercise of eliminating any. Special Tax Commission staff made recommendations for eliminating some tax expenditures. Additionally, the Commission voted on recommendations for eliminating several expenditures. Revisiting those recommendation may be useful for the subcommittee in its deliberations. The ones I am most familiar with are the sales tax expenditures and would be happy to continue this conversation around reforming tax expenditures.

However, I would like to make my own personal recommendations about how to proceed with reforming tax expenditures. Because of the importance of the public sector in providing human and social infrastructure and the historical and continuing structural impediments to economic well-being for certain groups, I highly favor and promote applying the criteria of revenue adequacy and vertical equity. A recent report I co-authored found that almost 60 percent of state and local revenues go to care work -- our human infrastructure (K-12 education, health care and the care of young children, the disabled and elderly). Private markets do a bad job of allocating these services, but they are far too important to not have. Government is the only sector that can make sure we as a Commonwealth have the proper investment in our past, present and future. In order to do this, state and local governments need an adequate base of revenues. Tax expenditures that serve historical or no purposes reduce that base. Other recent research on low-income families who combine earnings and government supports finds that, the road to self-sufficiency is littered with roadblocks, potholes and detours. Most often the difficulties people face have little or nothing to do with individual motivation or even ability, but instead are based on long-standing vestiges of labor market inequalities, housing segregation and lack of valuing paid and unpaid care work. Market mechanisms at worst perpetuate these inequalities and at best are very slow at correcting them. Therefore, there are sound economic reasons to work hard to structure our revenue system around ability-to-pay principles. Short of implementing marginal income tax rates, Massachusetts can make its revenue collection system more progressive through targeted tax expenditures.

Sources:

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