The Critical Link Between Tax Policy and Tax Expenditure Budgets: The Importance of Unresolved Issues for States

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The Bottom Line

- Clear and explicit thinking about tax policy is the necessary first step in preparing a tax expenditure budget.
- Cannot dodge the hard discussions if the tax expenditure budget is to serve its desired purpose.

What's a Tax Expenditure Budget?

- Stanley Surrey, late 1960s: tax structure includes some portions that are developed to distribute the cost of government according to an adopted standard (tax policy) and some portions that are developed to provide relief and subsidization to certain taxpayers (expenditure policy). Others had discussed the idea (e.g., Vickery in 1947), but Surrey was the first to put it into practice.

- OECD definition: tax expenditure budgeting is "a classification exercise: dividing the provisions of the tax system into a benchmark or norm and a series of deviations from that norm." Estimation of costs of latter.

Tax Expenditures in the Fiscal System

- Subsidies can be delivered as direct expenditure or as tax preferences providing relief to particular entities.
- Comparable net fiscal impact on the budget balance, comparable impact on influencing behavior of taxpayers
- Misleading implications for interference of government in market economy – reduce overall tax burden but distort and manipulate taxpayer behavior.
- Control for fiscal discipline and economic efficiency.
- Problem in implementation: not all revenue cutters are tax expenditures.

Tax Expenditures Are Popular with Subsidy Seekers

- Tax provisions are permanent and not subject to the annual appropriation reviews of direct expenditure
- Invisible revenue cost. A fiscal note may estimate the cost when the provision is initially enacted, but the cost is not part of later budget cycles.
- Tax expenditure may be more efficient – individual assistance that is means tested can be delivered without creation of a new bureaucracy.
- For fiscal discipline and fiscal efficiency, tax expenditure review has to be integrated into the budget process.

What Can the Categorization, Estimating, and Reporting of Tax Expenditures Contribute to the Budget Process? Deficit Control & Tax Reform

- Improve transparency for lawmakers and the general public.
- Level the information playing field between direct expenditure and tax subsidization
- Improve understanding of the fiscal impact of tax preferences
- Provide a template for responsible revenue increases involving base expansion rather than higher rates
- Provide a basis for reform of the revenue system to improve its yield, equity, efficiency, and collectability
- Control the expansion of tax expenditures
  - Effectiveness? Federal: from 1995 to 2009, tax expenditure provisions increased from 136 to 179, real annual rate of increase was 2.87%, ratio of tax expenditures to discretionary spending fell from 0.9279 to 0.8561.

What Tax Expenditure Budgeting Requires to Meet Its Potential

- Timely and regular presentation
- Accessible and consistent provision
- Constructed with a clear tax policy standard – an explicit and defensible norm.

Where State Tax Expenditure Budgeting Fails to Meet Its Potential

- Tax expenditure budgets not integrated entirely with expenditure budgets – presentation cycle, linked document presentation
- Treatment of tax expenditure budgets as reports rather than budgets – looking backward instead of forward
- Inadequate attention to a clear concept of the norm. For income tax, tendency to use federal structure as standard; nothing to copy for retail sales taxes.

Conceptions of the Normal: A Retail Sales Tax Illustration

- Reference law baseline: based on legal principles in the existing law with tax expenditures limited to special exceptions that serve programmatic functions. Decide what provisions are “normative” and necessary to establish the baseline.
- Ideal structure: based on standard principle for measuring tax base, regardless of legislative history (e.g., Haig – Simons for income; Due – Mikesell for retail sales)

Illustrating Normal for Retail Sales Tax

- Reference law: tax sales of tangible personal property, except purchases of inventory and raw materials and of machinery directly used in the process of producing tangible personal property, and of household necessities.
- Ideal (Due – Mikesell): base is intended to be household consumption, so tax all household consumption purchases and exempt all business input purchases. That is the most justifiable basis for distribution of the cost of government across the private economy.

What difference does it make?
Two Retail Sales Tax Provisions

- Provision 1: Law exempting input purchases made by a motion picture company from the state retail sales tax -- tax expenditure under reference law, part of normal structure under ideal base.
- Provision 2: Absence of household purchases of services from the state retail sales tax – tax expenditure under ideal base, part of normal structure under reference law.
- Provision 3: Food for at home consumption – tax expenditure under ideal base, part of normal structure under reference law.
- Therefore, tax expenditure measures not necessarily comparable across states – and tax expenditure estimates made by those outside the state's lawmaking process are suspect.

Tax Expenditure Budgets Require

- Clear standard of basic tax policy – definition of the normal determines what tax expenditures will be. Tax policy comes first.
- Preparation of tax expenditure budget on same cycle as the direct expenditure budget
- Organization of tax expenditure budget on the same classification as the direct expenditure budget.
- Presentation of tax expenditure budget in same media as direct expenditure budget

Concluding Issues: How States Can Get a Better Return from Tax Expenditure Budgeting

- Tax reform and base broadening? Requires more attention to clear tax policy principles and to defining the norm
- Part of budget process for deficit control: TEBs looking forward and not backward, integrated exactly with expenditure side of the budget.
- Consider negative tax expenditures – revenues from items in the base that would not be taxable under the normal system