Budget CONNECTion$

A Connecticut Voices for Children
Issue Brief

January 2002

An Overlooked Form of Spending:
Tax Expenditures & The Need For Review

Douglas Hall, Ph.D., Ellen Scalettar, JD, Shelley Geballe, JD, MPH

> *[W]ith a tax expenditure, the money does not come in and go out again: it does not come in at all. The reason it does not come in is that the law has provided for an exemption, deduction, credit, reduced rate, or other mechanism that lowers the amount of tax revenue that would otherwise be collected.*
>
> * * *
>
> *A tax expenditure is different from a direct expenditure in that it does not need to be re-enacted. Unless a sunset date is placed on a tax expenditure provision, it continues indefinitely (or until amended or repealed), whereas direct expenditures must be appropriated for each budget period.*
>
> Connecticut Office of Fiscal Analysis ("OFA"), *Connecticut Tax Expenditure Report*, 2001

In June of this year, the State of Connecticut adopted its Fiscal Year 2002 budget in the amount of $13 billion to fund programs and services in areas including education, corrections, transportation, human services, and health and hospitals.[1] Approximately three-quarters of the money needed to support the spending in that budget will be raised through a variety of taxes:[2] the personal income tax, sales and use tax, business tax, and others.

The appropriations in the budget were agreed upon only after detailed review, public hearings, and lengthy, intense debate and negotiations. In stark contrast, there was no attention paid to the nearly $4 billion of foregone revenues from a variety of businesses and individuals who enjoy the benefit of exemptions, reductions or credits from what would otherwise be their tax liability.

[1] The slowing economy has caused changes in projected revenues for the current fiscal year and, as a consequence, at the Special Session of the General Assembly in November, certain cuts to the budget were made. This paper relies on budget and tax numbers in effect at the time the budget was passed in June 2001.
[2] Other than taxes, the primary source of funds for Connecticut's budget is the federal government.

This report is funded through the Charles Stewart Mott Foundation, the Annie E. Casey Foundation and the Melville Charitable Trust. The contents of this report are the sole responsibility of Connecticut Voices for Children

This paper examines those foregone revenues, that are in fact a form of State expenditure, and argues for greater transparency and accountability in their enactment and continuation.

Tax Expenditures

Tax expenditures are a form of preferential government spending. Unlike appropriated expenditures that are made through the budget appropriations process, tax expenditures are enacted through the tax code. Tax expenditures are usually in the form of tax credits, tax exemptions, tax exclusions, tax deductions or rate reductions.

> [W]ith a tax expenditure, the money does not come in and go out again: it does not come in at all. The reason it does not come in is that the law has provided for an exemption, deduction, credit, reduced rate, or other mechanism that lowers the amount of tax revenue that would otherwise be collected.[3]

To be classified as tax expenditure by OFA, a provision must, in part:

- have an impact on a tax that is applied statewide;
- confer preferential treatment;
- result in reduced tax revenue in the applicable fiscal years; and
- not be an appropriation.[4]

The table below provides examples of different types of tax expenditures:

Tax Expenditure Type	Description	Examples
Tax Credit	Applied after initial calculation of tax owing; reduces tax by amount of credit.	Credit against income tax for property taxes paid on primary residence
Tax Exemption	Exempts category of good or service from tax	Sales of magazines (by subscription) and newspapers, advertising agency services, and direct mail advertising are exempt from the sales tax
Tax Deduction	Expenses deducted from gross income in determining taxable income	Income from foreign corporations received as dividends is deducted from corporate gross income
Rate Reduction	Reduces the rate of taxation applied	Reduction of corporate income tax rate from 11.5% (1995) to 7.5% (2000)

Source: OFA, *Connecticut Tax Expenditure Report*, 2001.

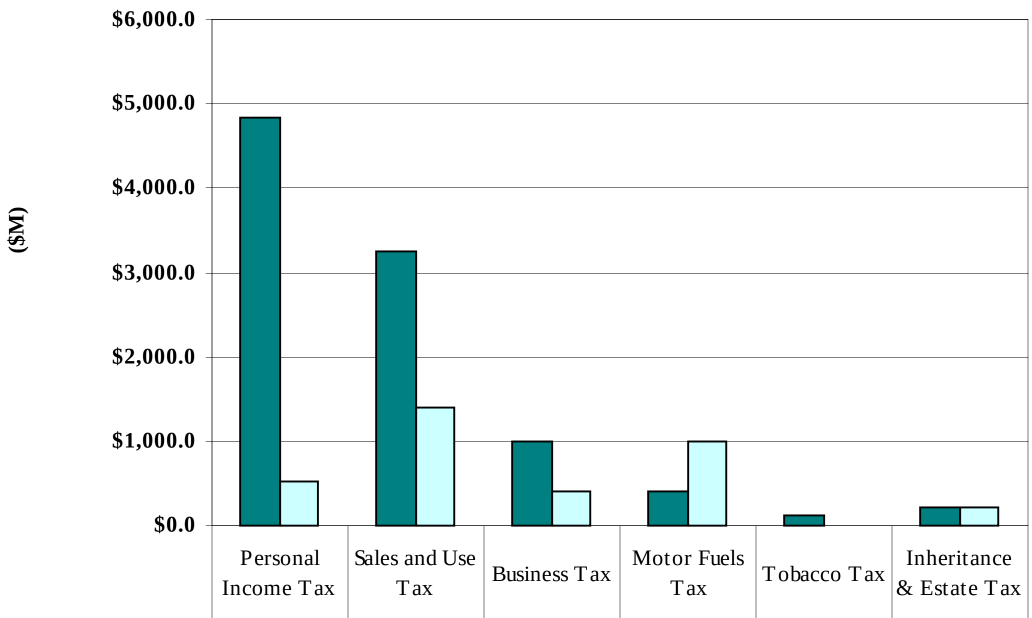
[3] OFA, *Connecticut Tax Expenditure Report*, 2001. Although OFA includes rate reductions in this definition of tax expenditures, rate reductions are not included in OFA's Tax Expenditure Reports. In this issue brief, use of the term tax expenditure includes rate reductions unless otherwise noted.
[4] OFA, *Connecticut Tax Expenditure Report*, 2001. The complete list of requirements is discussed in the "Tax Expenditure Report" section of this issues brief, below.

The fact that a tax credit is indeed a form of expenditure is illustrated by a recent targeted tax expenditure that occurred when three managed care organizations (MCOs) sought higher fees in order to stay in the Medicaid program. Connecticut could not pay those higher fees directly because of the spending cap and certain federal requirements. Instead, the Governor and the General Assembly agreed to give tax credits against unrelated taxable corporate income to those MCOs; the amount of the tax credit was in lieu of the additional fees that the MCOs had sought.

The Fiscal Impact of Tax Expenditures

Figure 1 shows how the value of tax expenditures in several tax categories compares to the revenue projected to be collected from those sources in FY ’02:

FY'02 Revenues Projected to be Collected vs. Revenues Projected to be Lost to Tax Expenditures



	Personal Income Tax	Sales and Use Tax	Business Tax	Motor Fuels Tax	Tobacco Tax	Inheritance & Estate Tax
Revenue Projected to be Collected*	$4,841.4	$3,253.7	$990.3	$413.9	$120.0	$210
Revenue Lost to Tax Expenditures	$517.0	$1,404.4	$406.2	$987.5	$5.0	$216.6

Major Tax Categories

* Revenue projections reflect gross revenue, totaling $13.8 billion, including $783.3 million in revenue adjustments due to be netted out. This amount to be netted out is comprised mainly of refunds of taxes.

Figure 1 Sources: OFA, *Highlights of the 2001-2003 Biennial Budget*, and OFA, *Connecticut Tax Expenditure Report, 2001.* Note that this chart documents only *revenue loss from tax credits, deductions and exemptions, but not from base or rate changes.* Therefore, tax reductions achieved through other means – notably through base and rate changes, are not reflected here. Figure 2 documents all tax reductions affecting businesses, from 1991-2000, including base and rate changes.

Tax expenditures erode Connecticut's revenue base. The projected loss in revenue in FY '02 from tax expenditures (excluding rate reductions) is $3.73 billion, almost 29% of projected revenues of $12.99 billion.[5]

We do not have a figure for total revenues lost to all types of tax expenditures because the Tax Expenditure Report does not include the impact of base and rate changes. We do know, however, that from the 1991 through 2000 legislative sessions, $1.3 billion in tax reductions benefiting businesses were enacted, of which 39% ($506 million) came from rate reductions and 61% ($783 million) came from other tax expenditures (See Figure 2).[6]

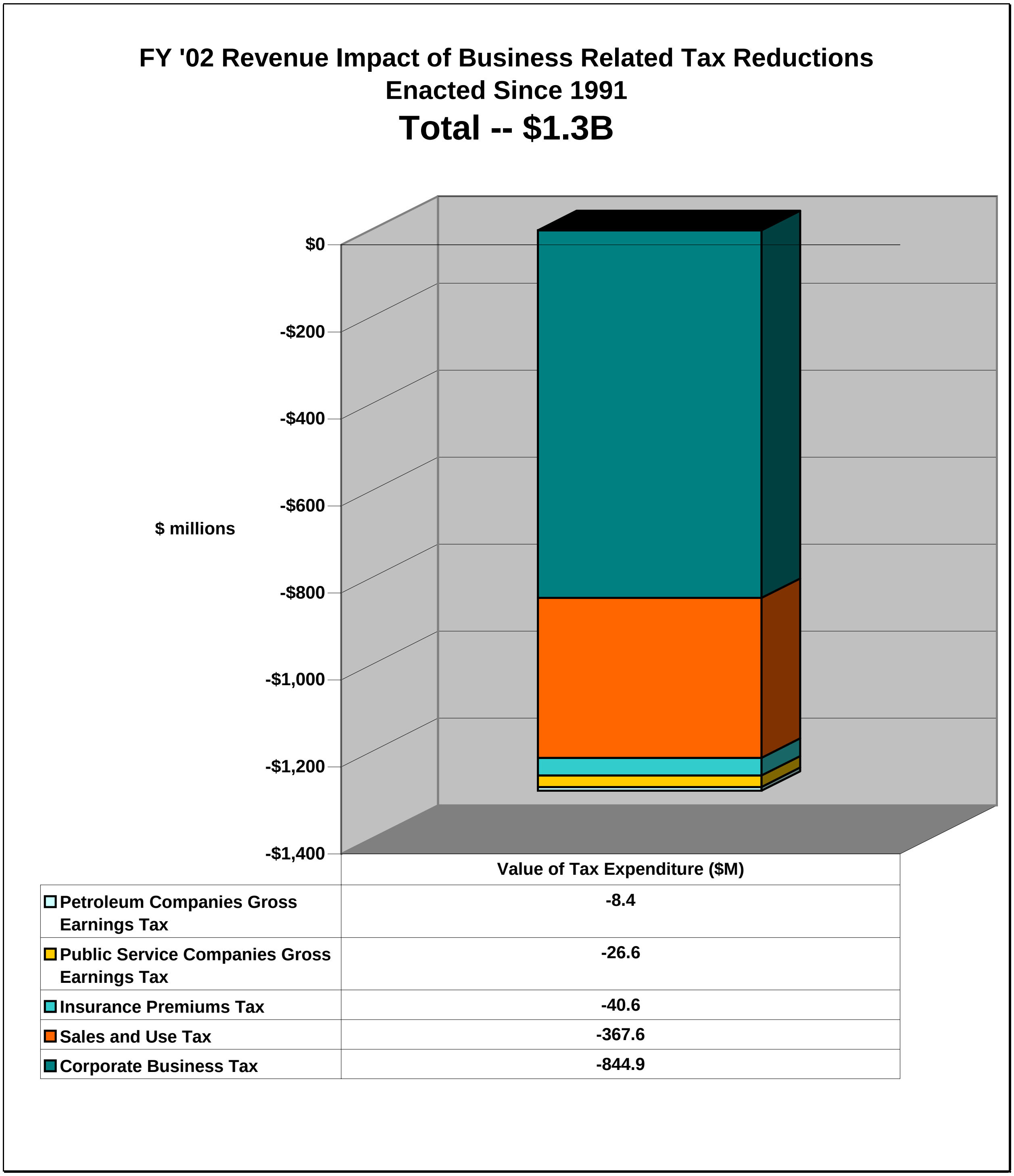
Phased in tax exemptions present another impediment to calculating the full impact of tax expenditures. Ironically, a phased in tax exemption will show up as a tax expenditure during the phase in period, but when it reaches its maximum impact – total phase out of the tax -- it no longer appears as an expenditure at all. For example, assume a tax category yielding $100 million annually that is to be phased out equally over four years. The result is decreasing tax yields of $75 million in year 1- a tax expenditure of $25 million; $50 million in year 2 - a tax expenditure of $50 million; and $25 million in year 3 - a tax expenditure of $75 million. In year 4, when the tax is completely phased out, the revenue loss (tax expenditure) is $100 million, but it would appear as $0 because the tax would be gone from the books altogether.[7]

---

[5] OFA, *Connecticut Tax Expenditure Report*, 2001; OFA, *Highlights of the 2001-2003 Biennial Budget*, 2001. It is noteworthy that Connecticut's *tax expenditures* for FY '02 approximate the amount of *total general revenues* collected in FY '99 by other New England states: New Hampshire ($3.1B) and Vermont ($2.8B) each collected less than our foregone taxes; Maine ($4.9B) and Rhode Island ($4.0B) collected slightly more. U.S. Census Bureau, *Government Finances, 1998-99*, 2001.

[6] OFA, *Synopsis of Tax Reductions for Business and Workers Compensation Reductions*, 2001.

[7] As difficult as it is to quantify fully the impact of all tax expenditures within the state, it is virtually impossible to compare tax expenditures among states. Some states, for example, *include* services in the tax base unless they are specifically excluded. Connecticut, on the other hand, *excludes* services unless they are specifically included. Thus, a decision not to tax professional services (such as lawyers' fees) would show up as a significant tax expenditure in states that generally tax professional services, but not at all in Connecticut.



	Value of Tax Expenditure ($M)
Petroleum Companies Gross Earnings Tax	-8.4
Public Service Companies Gross Earnings Tax	-26.6
Insurance Premiums Tax	-40.6
Sales and Use Tax	-367.6
Corporate Business Tax	-844.9

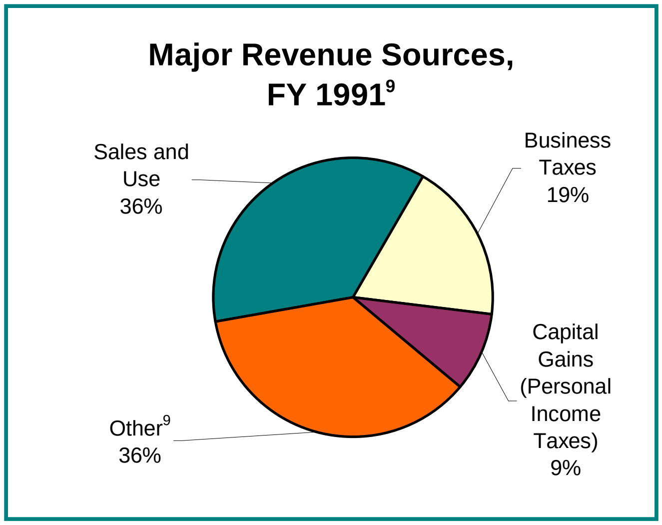
Figure 2 Source: Office of Fiscal Analysis, *Synopsis of Tax Reductions for Business and Workers's Compensation Reductions*, 2001. Note that these tax reductions include base and rate changes that account for much of the discrepancy between data in Figures 1 and 2.

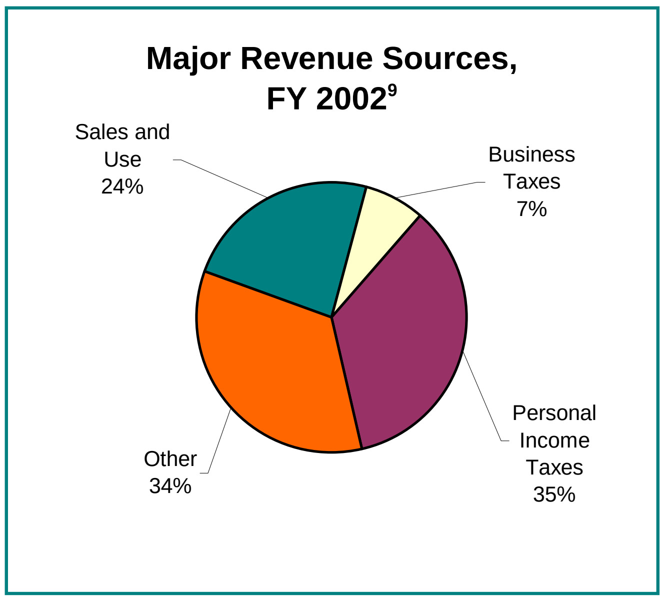
The Impact of Tax Expenditures on the Relative Burdens (*Incidence*) of Taxation

Tax expenditures can also affect the distributional impact or *incidence of taxation*. Two significant measures of tax incidence are the relative burdens of businesses versus those of individuals, and the distribution of taxes among individuals of differing incomes. Both of these have been significantly affected by structural changes in Connecticut's tax code over the last decade.

During the 1990s, Connecticut's tax structure was significantly altered by adding a personal income tax and reducing the corporate tax. Figures 3a and 3b show that the most dramatic revenue shift resulting from this restructuring was to increase the share of the revenue burden borne by personal income taxes, while the revenue burdens borne by business taxes and sales and use taxes were significantly reduced. Between 1991 and 2002, the proportion of state revenue derived from personal income taxes increased from 9% to 35% of appropriated revenues[8], while the proportion of appropriated revenues derived from sales and use taxes declined from 36% to 24%., and the reliance on business taxes declined from 19% of appropriated revenues to 7%.[9]

Figure 4 shows that the *income tax* in Connecticut is quite progressive at the very low income levels - those with low incomes pay a much smaller proportion of their family income on income tax than do middle or upper income earners. The sales tax,[10] on the other hand, is regressive throughout the income spectrum.[11] The lowest income earners in Connecticut pay the highest proportion of their family income on sales taxes (4.9%), while the top income earners in Connecticut pay the smallest





Figures 3a,b: Sources: Office of Fiscal Analysis, *The State Budget for the 1990-91 Fiscal Year*, 1990 and Office of Fiscal Analysis, *Connecticut State Budget, 2001-2003*, 2001.

[8] The capital gains tax in Figure 3a was a tax on individuals that was rolled into the personal income tax.

[9] State Office of Fiscal Analysis, *The State Budget for the 1990-91 Fiscal Year*, 1990 and Office of Fiscal Analysis, *Connecticut State Budget, 2001-2003*, 2001. Note that "Other" includes federal funds, gambling revenues, motor fuels taxes, "other revenue", and "other taxes", and "Business Taxes" include taxes assessed on Corporations, Public Service Corporations, Insurance Companies, and Oil Companies.

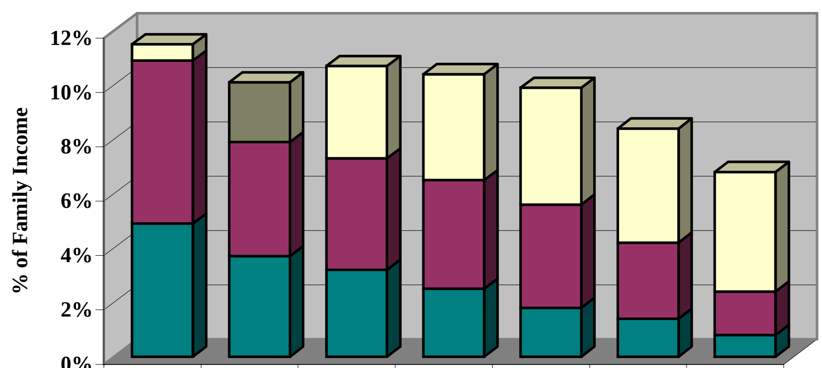
[10] In this discussion and in Figure 4, the term "sales tax" includes sales, use, and excise taxes.

[11] A progressive tax is one which places a proportionately higher burden on those whose incomes are higher; a regressive tax is one which places a proportionately higher burden on those whose incomes are lower.

proportion of their income in sales taxes (0.8%).[12] By shifting the emphasis in revenue collection from the sales tax to the personal income tax in 1991, Connecticut's tax structure became more progressive, although it remains, on average, regressive.

At the same time this shift to the personal income tax was occurring, the proportion of state revenues derived from business taxes declined. This decline, that in part is a reflection of the $1.3 billion in tax expenditures benefiting business between 1991 and 2000, shifted more of the burden to individual tax payers.

Connecticut State and Local Taxes, 1995



	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Taxes	0.6%	2.2%	3.4%	3.9%	4.3%	4.2%	4.4%
Property Taxes	6.0%	4.2%	4.1%	4.0%	3.8%	2.8%	1.6%
Sales and Excise Taxes	4.9%	3.7%	3.2%	2.5%	1.8%	1.4%	0.8%

Income Categories

Figure 4: Source: Michael P. Ettlinger, et al, *Who Pays: A Distributional Analysis of the Tax Systems in All 50 States*, Citizens for Tax Justice, 1996. An updated release of this publication is due early in 2002. Note that Figure 4 does not include the property tax credit or other changes since 1996 that have made the income tax even more progressive than it appears here.

Once Enacted, Tax Expenditures are Rarely Revisited

Tax expenditures can be used to advance a range of fiscal and other public policy goals efficiently, without expanding government bureaucracy or imposing regulatory burdens. They may provide incentives for businesses or individuals to engage in certain conduct deemed to be in the public interest, they may make the tax code fairer, by applying the same standards to those similarly situated, or they may confer a special benefit on a small number of taxpayers.

But whatever the rationale for enactment, once a tax expenditure is on the books, it is rarely revisited. It generally becomes a permanent cost to the state, without re-evaluation in light of new

[12] The combined impact of state and local taxes in Connecticut is regressive, placing a tax burden on low income tax payers that is higher than that placed on high income taxpayers. This can be seen in Figure 4.

facts or circumstances, changing economic conditions, or evolving public policy. In PA 97-316, for example, the legislature exempted from the sales tax "services rendered in connection with the creation, development hosting or maintenance of all or part of a web site…." This tax expenditure is categorized by OFA as an "incentive": no doubt, as an incentive for companies to build web sites and promote internet communications.

Today, the need for a government incentive for website creation may or may not be as clear as it was even a few years ago. And the economic downturn is creating new pressures on spending for programs and services, both essential and otherwise. Thus it is important to ask: is the tax credit to encourage the creation of web sites still a good idea? Is the loss of revenue worth the programs or projects that could be paid for in lieu of this tax expenditure? And how is that determination made?

The answer is that the re-evaluation of existing tax expenditures in light of new facts or circumstances certainly will not be automatic and indeed may never take place at all. In fact, tax expenditures need not be reenacted and, absent legislative action, they *continue to exist* in perpetuity. By contrast, appropriated expenditures must be reenacted (appropriated) at least biennially and, absent legislative action, they *cease to e*xist within two years of enactment.

The affirmative legislative action necessary to end a tax expenditure can be a subsequent repeal or amendment of the law. It also can be in the form of a sunset provision in the law that created the tax expenditure itself. Tax expenditures with sunset provisions, like appropriated expenditures, come to an end at a date certain unless the legislature takes affirmative action to continue them.[13]

Sunset provisions are not generally included in tax expenditure laws. Thus, tax expenditures often operate as hidden entitlements, and they are far more likely to escape regular review and re-evaluation than appropriated expenditures:

> A tax expenditure is different from a direct expenditure in that it does not need to be re-enacted. Unless a sunset date is placed on a tax expenditure provision, it continues indefinitely (or until amended or repealed), whereas direct expenditures must be appropriated for each budget period.
>
> OFA, *Connecticut Tax Expenditure Report*, 2001.

Yet regular review is equally important on the tax expenditure side. Without it, a review of the state's budgetary priorities considers only half the picture, and the "forgotten" half may violate fiscal or policy imperatives of the day. Connecticut at one time had a sales tax exemption for cigarettes, a provision that no doubt encouraged the practice of smoking. When that exemption was repealed it represented a tax expenditure valued at $17.6 million ($34 million in current dollars), money that was returned to state coffers for other uses.

Connecticut's Tax Expenditure Report

Although tax expenditures are rarely revisited once they are on the books, Connecticut has gone farther than most states in recognizing the significance of this form of spending and making it publicly visible and available. In 1993 the General Assembly passed a law (CGS sec. 12-7b[e]),

[13] See for example, the alternative fuels tax credit, first enacted in 1991 (PA 91-179), with a sunset provision. That law has been renewed repeatedly since enactment.

requiring OFA to prepare the biennial tax expenditure report that has been cited throughout this issue brief.

The Tax Expenditure Report includes a description of each tax expenditure, the year it was enacted, its purpose, an estimate of revenue loss and the number of taxpayers benefiting. To be classified as a tax expenditure by OFA and included in the report, a provision must:

- have an impact on a tax that is applied statewide;
- confer preferential treatment;
- result in reduced tax revenue in the applicable fiscal years;
- not be an appropriation;
- be included in the definition of the tax base;
- not be subject to an alternative tax; and
- be able to be amended or repealed only by a change in state law.[14]

To meet the requirement of CGS sec.12-7b(e) that OFA indicate the purpose for the enactment of each tax expenditure, OFA uses seven categories to characterize the rationale that justifies the tax expenditure:[15]

- **Perceived Equity** – "The tax expenditure was created to remedy a perceived inequity in tax burden." *Example: the sale of food products for human consumption is exempt from the sales tax.*
- **Efficiency** – "The cost of adequately collecting and administering the tax is high in comparison to the potential revenue that could be gained from taxation." *Example: the transfer of property located outside the state of Connecticut is excluded from the gift tax for reasons of administrative efficiency.*
- **Incentive** – "The expenditure is intended to encourage the performance of certain desirable activities such as economic growth and development, charitable or nonprofit work, or conservation of resources." *Example: the tax credit for certain expenses relating to the rehabilitation of historic homes.*
- **Redundancy and Cascading** – "The entry is included in the base of one tax and excluded from the base of another to avoid over taxation." *Example: the purchase of gasoline is subject to the motor fuels excise tax in lieu of the general sales tax.*
- **Clarification** – "The entry clarifies the definition of what is taxable." *Example: strawman deeds and deeds to correct previously recorded deeds are not subject to the Real Estate Conveyance Tax surcharge on property that is sold while in the Farm, Forest and Open Space Program because such deeds do not convey title to a new owner.*
- **Conformity** – The entry conforms the state statute with applicable constitutional and other federal requirements. *Example: property purchased from the United States is exempt from the sales and use tax because the United States Constitution prohibits state taxation of the federal government.*

[14] Although this last requirement suggests that a tax expenditure statute with a sunset provision would not be a tax expenditure for purposes of the Tax Expenditure Report, it has not been interpreted that way, nor should it be.
[15] The quoted explanations of each rationale are from OFA, *Tax Expenditure Report*, 2001.

- **Expediency** – "Expenditures of this type violate one or more of the principles of a high-quality revenue system without any apparent counterbalancing or compensating precept." *Example: Car washes are exempt from the sales and use tax*.

Connecticut's Tax Expenditure Report is an invaluable tool for those who seek to know and understand Connecticut's fiscal policy and spending.

Making Tax Expenditures More Visible

Tax expenditures, like budget expenditures, represent a significant form of government spending. As such, they should be reviewed regularly by the legislature in light of changing fiscal and public policy realities and they should be reported in a manner that makes them readily available and comprehensible to the public.

Mandatory Periodic Review Of All Tax Expenditures

To assure periodic review by the legislature to determine whether or not tax expenditures should be continued, it would be appropriate to require that:

- Every new tax expenditure sunset within 5 years or some other period of time, ranging from 2 to 10 years, that the General Assembly deems appropriate in light of the rapidity of changing economic conditions, the purpose of the tax expenditure, and the like; and
- A procedure be adopted to review all existing tax expenditures and to amend each of them to include a sunset provision.

Expanding the Tax Expenditure Report

The Tax Expenditure Report is essential in promoting fiscal transparency: the ability of the public to know and understand government spending and taxation functions. In addition to what is already in the report, some additional areas would enhance its value:

- Report rate reductions as tax expenditures. Although rate reductions are in the definition of a tax expenditure, they are not now a required category of reporting;
- Calculate tax expenditures as a proportion of total tax revenues collected by type of tax. That is, for each category of reported tax (i.e. "Personal Income Tax"), report the total tax expenditures in that category as a proportion of the total revenue generated by that tax;
- Calculate the impact of the tax expenditure over time. This is already done in the State Budget Summary under "General Fund Revenue Changes"[16] and would be appropriate to include in the Tax Expenditure Report as well.[17] An explanation of the factors going into the analysis would also be helpful, and should explicitly include the projected growth (positive or negative) of the particular revenue source over time;[18]

---

[16] OFA, *General Fund Revenue Changes From FY 2001-02 to FY 2002-06 Using FY 00-01 As The Base Year*, CT State Budget, 2001-03.

[17] A related change would also be helpful in OFA's report, *Revenue and Budget Data,* which details specific changes that increase or decrease revenues. The dollar amounts are reported in nominal dollars for the fiscal year in which the changes took effect, but would be even more useful if they were also calculated to reflect current dollars.

[18] This can provide significant information especially in areas of rapid growth (such as technology) where revenue losses from tax expenditures will be of a magnitude that exceeds (proportionally) the average increase in the cost of the tax expenditure over time.

- Include the incidence of tax expenditures among income groups for those tax expenditures that affect individuals, and between large and small businesses for those tax expenditures that affect businesses;[19]
- Include the anticipated cost of administering the tax expenditure; and
- For tax expenditures known to benefit 10 or fewer taxpayers, identify by name those who benefit.

Conclusion

Tax expenditures are an integral part of Connecticut's budget and budget process. They represent considerable state spending; effectuate a broad range of public policy goals; confer significant benefits on select Connecticut taxpayers; and affect the relative tax burdens between businesses and individuals, between large businesses and small businesses, and among individuals of different incomes.

As significant as tax expenditures are in the life of Connecticut's people, it is problematic that they escape the regular review given to appropriated expenditures. Greater transparency and accountability should and can be achieved by requiring that all tax expenditures sunset at a date certain, thus necessitating a public hearing and affirmative legislative action if re-enactment is sought, and by expanding the scope of OFA's Tax Expenditure Report.

Connecticut established itself as a leader in sound fiscal policy by requiring the publication of the Tax Expenditure Report. As that leader, now is the time to take the next steps in exposing tax expenditures to the same sunlight and review that are applied to appropriated expenditures.

* * * * *

For Additional Information:
Connecticut Voices for Children
33 Whitney Avenue
New Haven, CT 06510
203-498-4240
www.ctkidslink.org

[19] This would be similar to the Connecticut Department of Revenue Services' annual report examining the distributional impact of the personal income tax.