



The Policy Institute

“Tax Expenditures: Their Relevance to Montana’s Budget and their Significance in the 2009 Legislative Session”

A Report by
The Policy Institute

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Prepared by Bob Decker and Molly Severtson

The Policy Institute blends authoritative research and hands-on political engagement to create public policy based on economic justice, fair taxation, corporate accountability and environmental responsibility.

406.442.5506 | P.O. Box 1362 | Helena, MT 59624 | mail@thepolicyinstitute.us | www.thepolicyinstitute.us

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I. EXECUTIVE SUMMARY

Tax expenditures have profound and lasting effects on the structure and quality of state government in Montana, but are little understood by the public and given insufficient attention by lawmakers. With this in mind, the purpose of this report is twofold: 1) to provide an overview of the concept of tax expenditure analysis and 2) to analyze the 57 tax expenditure bills introduced in Montana’s 2009 legislative session.

Since a tax reduction for one group always results in either an increased proportional share of tax responsibility for another group or decreased funding for a public service or program, it is imperative for citizens to examine the stated policy goals of tax expenditures – both existing and proposed – and to require that legislators provide reasoned analysis and objective evidence that the tax expenditures are accomplishing – or can be expected to accomplish – their purported goals.

Until public scrutiny of tax expenditures comes to hold equal importance with the attention given to the appropriations process in state budgeting, Montanans will not have a complete picture of the supporting financial framework of the state budget, how public programs are affected by taxation policies, and how Montanans are sharing – or not – the responsibility of paying for public services. Similarly, Montanans will become more informed and effective citizens if they understand how their legislators reconcile their positions and votes on tax expenditure proposals with their stated values on government budgets and public programs.

II. INTRODUCTION

Tax expenditures policies give a tax break, credit, deduction, abatement or exemption to a selected tax entity. The “expenditure” part of the term refers to the fact that the statute costs the state something in terms of revenue. In addition, if revenue is to remain constant, tax expenditures affect other taxpayers as well, in that the burden lifted by a tax break will inevitably be shifted elsewhere.

Most tax expenditures are found in the income tax systems at both the federal and state levels, although tax expenditure policies, especially at the state level, can also be found in property, sales, and natural resource tax systems. Examples of existing tax expenditures in Montana’s income tax system include health savings account, individual retirement account, student loan interest, and other deductions; itemized deductions, such as for medical expenses, property taxes, charitable contributions,

and home mortgage interest; and credits, such as for energy conservation, elderly care, alternative energy and fuels, mineral exploration, and film production, among others.

Tax expenditure policies are neither inherently good nor bad. Tax expenditure legislation is brought by both Republican and Democratic lawmakers, originates in both legislative houses, and can be designed to benefit different taxpayers in different ways.

III. WHAT IS A “TAX EXPENDITURE?”

Definition 1: “(Tax Expenditures are) revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”¹

Definition 2: “(A tax expenditure is) revenue a government foregoes through the provisions of tax laws that allow 1) deductions, exclusions, or exemptions from the taxpayers' taxable expenditure, income, or investment, 2) deferral of tax liability, or 3) preferential tax rates.”²

Definition 3: “Tax expenditures are provisions in the tax code, such as exclusions, deductions, credits, and deferrals, which are designed to encourage certain kinds of activities or to aid taxpayers in special circumstances. When such provisions are enacted into the tax code, they reduce the amount of tax revenues that may be collected. In this sense, the fiscal effects of a tax expenditure are just like those of a direct government expenditure. Some tax expenditures involve a permanent loss of revenue, and thus are comparable to a payment by the government; others cause a deferral of revenue to the future, and thus are comparable to an interest-free loan to the taxpayer. Since tax expenditures are designed to accomplish certain public goals that otherwise might be met through direct expenditures, it seems reasonable to apply to tax expenditures the same kind of analysis and review that the appropriations budget receives.

“It is essential to distinguish between those provisions of the tax code that represent tax expenditures and those that are part of the ‘basic structure’ of a given tax. The basic structure is the set of rules that defines the tax; a tax expenditure is an exception to those rules. In general, most taxes have a series of features that define their basic structure. These features are: 1) a base, on

¹ Congressional Budget and Impoundment Control Act of 1974 (PL 93-344), sec. 3(3).

² BusinessDictionary.com, <http://www.businessdictionary.com/definition/tax-expenditure.html>.

which the tax is levied, such as net income, or a particular class of transactions; 2) a taxable unit, such as a person or a corporation; 3) a rate, to be applied to the base; 4) a definition of the geographic limits of the state's exercise of its tax jurisdiction; and 5) provisions for the administration of the tax.”³

These three definitions of tax expenditures are provided above in order to: 1) provide the meaning as it was originally conceptualized by Stanley Surrey, an Assistant Secretary of Treasury for Presidents Kennedy and Johnson; 2) provide a brief, general interpretation as it may be understood by contemporary observers; and 3) provide an expanded version that places the concept in a broad fiscal context and indicates why it is important.

IV. BACKGROUND OF TAX EXPENDITURE ANALYSIS

For more than four decades, tax expenditure analysis has been used to evaluate the relative fairness and fiscal impacts of proposed and enacted tax policies. Stanley Surrey, who is generally credited with conceptualizing the idea of tax expenditures in the late 1960s, believed that policy changes resulting in decreased government revenue were the equivalent of direct expenditures and that those policy changes should be identified and quantified for their full consideration and exposure in a budgetary context.

An advocate of tax reform, Surrey thought that tax expenditures were unwise departures from what he perceived as the “normal” tax structure. He saw tax expenditures as “a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies,” and hoped that looking at proposed policies as “expenditures” rather than “incentives” would help lawmakers to see where policies were inefficient, unfair or too complex; in short, not necessarily accomplishing their intended goals.⁴

Surrey’s thinking eventually took root in Congress, which passed the Congressional Budget and Impoundment Control Act (PL 93-344) in 1974. That law required that a list of tax expenditures be included in the annual federal budget in order to control spending and make tax provisions more transparent.

Over time, the practice of quantifying and analyzing tax expenditures spread to other countries, e.g., England, Canada, and Germany, and to state governments. Montana began publishing a tax expenditure report in 1989, as required by passage of a law (House Bill 387) in the 1987 Legislature. Montana’s report is published biennially by the Montana Department of Revenue.

³ Mass.gov, <http://www.mass.gov/bb/h1/fy10h1/tax10/hdefault.htm>.

⁴ “A Reconsideration of Tax Expenditure Analysis,” prepared by the Staff of the Joint Committee on Taxation. May 12, 2008.

It is important here to distinguish between a “tax expenditure report,” which is produced in Montana each biennium, and a “tax expenditure budget,” like that produced by the state of Michigan⁵. While a tax expenditure report lists the tax expenditures in place and the forgone revenue in which they result, a tax expenditure budget takes the concept further by identifying the category of spending in which the tax expenditure would fall if it were a direct spending program. This allows taxpayers and legislators to see the effects of tax expenditures on the different categories of spending, providing more transparency in state spending.

V. WHY TAX EXPENDITURE ANALYSIS IS IMPORTANT

As stated above, tax expenditure policies are, *per se*, neither good nor bad. At times there are justifiable reasons to make exceptions in public policy, and it’s no different in the arena of taxation. Tax expenditures have been used, often with measurable public support, to pursue objectives as diverse as promoting home ownership, incentivizing development of alternative energy sources, and encouraging work in low-income families.

Most tax expenditures, whether existing or proposed, produce opposition, and the decisions associated with the tax expenditures may be distilled into contests of values. Some tax expenditure proposals are advocated on the principal of “improving the business climate,” others on the principal of “obtaining energy independence,” and yet others on the principal of “giving low-income earners more incentive to work.” None of these principals are universally held, and all are the stuff of political push and pull. It is difficult to find someone with a fundamentalist, or pure, view of tax expenditures who categorically opposes or supports all forms of tax expenditures.

However, even when one recognizes the value-based, or subjective, nature of tax expenditures, important questions remain, and it is the purpose of this analysis to identify those questions and encourage Montanans to ask them:

- If a particular philosophical or political value is used to justify a tax expenditure proposal, what is the objective evidence that the stated value is, in fact, served by the tax expenditure? Similarly, if a tax expenditure is long established, what evidence exists to show how the tax expenditure has served – and continues to serve – its stated purpose?
- If a tax expenditure involves a transfer of tax-paying responsibility to another constituency, who makes up that constituency and what is the amount of the transfer? Is the tax-assuming constituency aware of the transfer? Is the constituency supportive of the underlying value(s) of the tax expenditure?

⁵ “Executive Budget Appendix on Tax Credits, Deductions and Exemptions, State of Michigan,
http://www.michigan.gov/documents/treasury/Budget_Report_09_257559_7.pdf.

It is of critical importance to understand that, even if a tax expenditure does not cause a tangible, direct, or immediate tax increase for someone else, it invariably increases the proportional share of tax responsibility borne by all taxpayers who do not benefit from the tax expenditure.

For example, if legislators enact a law to decrease income tax rates for a particular constituency, income tax rates for other constituencies do not increase (unless specified in the enacting legislation, which is rare). However, the proportional tax burden of other constituencies increases as a result of the tax expenditure, and as future increases in general income tax rates may be enacted to address revenue shortages (precipitated by, among other factors, perhaps, the tax expenditure itself), the non-benefitting constituencies will bear a larger portion of the burden.

- What public programs will lose financial support – and in what amount – due to decreased tax revenue from a tax expenditure?

Here it is instructive to contrast the usually limited importance given to the budgetary impacts of tax expenditures with the concentrated emphasis on tax implications that usually accompanies a proposal for a new program on the expenditure side of the state budget. Proposals for new direct spending invariably generate public attention and political heat about related tax and revenue requirements, whereas proposals for new tax expenditures are often discussed with minimal attention to associated program cuts and other expenditure effects. (On the appropriations side, always the question, “How will the new program be paid for?”; on the tax side, rarely the question, “What public programs will the new tax cut affect?”)

- How long will the tax expenditure last? Contrast the fact that direct-expenditure decisions in Montana usually undergo intense scrutiny and must be reconfirmed every two years, with tax expenditure decisions that often fly under the radar and have no fixed ending date. Most appropriations require regular justification, while most tax expenditures last indefinitely.
- Which legislators propose tax expenditures, and how do the proposals square with the legislators’ self-described political and fiscal beliefs? Similarly, do tax expenditure proposals come predominantly from a particular political party? Is there a pattern of what interests are served by tax expenditure proposals that come from particular legislators or political parties?

While lawmakers may purport certain goals for their proposed legislation, there is a low standard for substantiating or quantifying alleged benefits, and such evidence is frequently not provided. For example, five tax expenditure bills in the 2009 legislative session that would have reduced or eliminated the business equipment tax were promoted with the assertion that doing so would stimulate business

activity, translate into increased employee benefits, create jobs, and, as a further result, increase state tax revenue in the future⁶. However, little was provided by the proposals' proponents to support the assertions, and little evidence was provided to demonstrate that previous decreases in business equipment tax rates yielded measurable benefits.

Justifiable as some tax expenditures may be, it is imperative that they be considered and judged in a full budgetary context. We urge Montanans to contemplate the meaning of tax expenditures, measure the number and content of tax expenditure bills during the recent legislative session, and develop a critical sense of inquiry about this important, financially significant aspect of public policy.

VI. HOW THE DATA IS ORGANIZED

Appendix 1 of this report lists the 57 bills introduced in the 2009 session that The Policy Institute identified as tax expenditure bills. The chart includes details related to each bill, including the sponsor of the bill, what the bill proposed to do, the type of tax affected by the bill and the fiscal impact of the bill.

Please note that the term "fiscal note" is used in this report to describe the fiscal estimating statement that accompanies bills judged by legislative and executive branch staff to have fiscal impacts. The figures reported in fiscal notes are estimates and include assumptions about future factors.

Appendix 2 contains 11 tables in which the information gathered from the bills is organized in various ways. Table 1 contains general information about the tax expenditure bills proposed during the 2009 session, including the number of bills introduced by each party and in each legislative house. Tables 2 and 3 outline the legislators who proposed tax expenditure bills. Table 4 shows the tax expenditure bills that became law during the session and their fiscal impacts. Table 5 outlines the different types of taxes affected by the bills. Tables 6-8 divide the bills into different categories based on their policy goals. Table 9 shows the fate of the bills introduced. Table 10 lists large transfer bills introduced in the session that are not technically tax expenditure bills, but that have the potential of shifting a large tax burden from one group to another. Table 11 lists the legislators who voted yes on all of the tax expenditure bills that passed both houses.

Appendix 3 includes the voting record on the ten tax expenditure bills that became law and the one that was vetoed by Governor Brian Schweitzer. This appendix also includes counts of how Democrats and Republicans voted on the bills and how the votes were split in the two legislative houses.

⁶ Other arguments, based more on core beliefs about taxation, were also offered, such as the assertion that taxes should not be assessed on the tools of labor or production.

Appendix 4 is a list of web resources that can be accessed for more information on the topic of tax expenditure analysis.

VII. FINDINGS

- Of the 1,316 bills introduced in the 2009 Legislature, 57 (about 4%) were identified as tax expenditure bills. (See Appendix 2, Table 1)
- Thirty of the tax expenditure bills were sponsored by Republican lawmakers and 27 were sponsored by Democrats. (See Appendix 2, Table 1)
- Thirty-two tax expenditure bills were introduced in the House and 25 were introduced in the Senate. (See Appendix 2, Table 1)
- The 57 tax expenditure bills in the 2009 Montana Legislature were introduced to accomplish a variety of policy goals.
 - Some bills sought to encourage taxpayers to behave in specific ways, e.g., tax breaks for energy conservation or for historic building preservation.
 - Others were designed to help certain taxpayers obtain something they presumably couldn't have obtained otherwise, e.g., tax credits for hearing aids or for contributions to educational accounts.
 - Some tax expenditure bills were meant to provide a tax reduction for the financially vulnerable, e.g., property tax relief for elderly homeowners and the earned income tax credit.
 - Others were intended to stimulate the growth of business, e.g., reduction of business equipment tax.
- Fourteen tax expenditure bills were designed to stimulate business activity. Nine of these bills were sponsored by Republicans and five were sponsored by Democrats. Seven of the bills would have benefitted businesses in general, by reducing property taxes or capital gains taxes for businesses. Seven others would have benefitted a specific type of business, including the coal industry, the film industry, small liquor producers and salvage vehicle businesses. (See Appendix 2, Table 6)

- Sixteen tax expenditure bills proposed to reduce taxes for a specific group of taxpayers. Nine of these bills were introduced by Democrats and seven were introduced by Republicans. Six of the bills would have reduced taxes for seniors, two for low-income families, two for tribes and tribal workers, three for members of the military and their employers and one each for school districts, certain elected officials and taxpayers who itemize their deductions. (See Appendix 2, Table 7)
- Preserving the environment, improving access to technology, energy conservation and property tax reappraisal mitigation were among the policy goals of the remainder of the tax expenditure bills. (See Appendix 2, Table 8)
- Sen. Rick Laible (R-Darby) sponsored five tax expenditure bills (SB 63, SB 64, SB 105, SB 106 and SB 146), the most of any legislator. Four of those bills were designed to benefit volunteer emergency workers and/or businesses that employ such volunteers. The other sought a tax credit for the sale of biomass to a Montana biofuel producer. The estimated average fiscal impact of Sen. Laible’s sponsored bills was \$621,680/year, plus \$5 million in FY 2011 (SB 105). None of Sen. Laible’s bills became law. (See Appendix 2, Table 2)
- Sixteen tax expenditure bills died in the Senate Taxation Committee, 20 died in the House Taxation Committee, and one bill passed both houses, but was vetoed by the governor (SB 503). SB 503 was sponsored by Sen. Jeff Essman (R-Billings). Its estimated average fiscal impact would have been \$364,000/year. (See Appendix 2, Table 9)
- HB 360 and SB 259, each introduced in their respective houses, shared the same policy goal – to enact a refundable earned income tax credit – and can be considered companion bills.
- Of the unsuccessful tax expenditure bills, the one with the largest fiscal impact was HB 381, sponsored by Rep. Mike Miller (R-Helmville). HB 381, which died in the House Taxation Committee, would have provided a tax credit and deduction for unreimbursed health care expenses. Its estimated average fiscal impact was \$72.5 million/year.
- Two tax expenditure bills (HB 412 and SB 499) had no associated fiscal impact statements because no taxpayer currently exists who would benefit from the tax reduction.
 - HB 412, sponsored by Rep. Brady Wiseman (D-Bozeman), will provide a lower liquor excise tax rate for small liquor producers. Since there are no qualifying producers in Montana at this time, the fiscal impact was not estimated. HB 412 passed both legislative houses and became law.

- SB 499, sponsored by Sen. Jeff Essman (R-Billings), would have reduced the coal severance tax rate for new “green” production facilities. Since no such facilities exist, the fiscal impact of this bill was not estimated. SB 499 died in the House Taxation Committee.
- Several bills introduced in the 2009 session had large estimated fiscal impacts, the potential of large shifts in the tax burden and/or large effects on how revenue is spent, but did not meet the definition of tax expenditure bills. HB 20, for example, sought to move more than \$24 million, 5% of the state portion of oil and gas production tax, from the state general fund to a new weatherization fund within the Department of Public Health and Human Services, to be used to weatherize homes. This bill would not have created or changed a special provision of a general tax law, but it would have produced a large shift in how tax revenue was spent. Other bills in this category include HB 388, HB 586, HB 670, SB 12 and SB 504. (See Appendix 2, Table 10)
- Five bills designed to lower the business equipment tax in some form were introduced in the 2009 session, four by Republicans (HB 240, HB 487, SB 315 and SB 490) and one by a Democrat (HB 649). HB 487, sponsored by Rep. Walter McNutt (R-Sidney), became law with an estimated average fiscal impact of \$66,000/year.
- Most of the bills that passed both legislative houses did so by large margins. The bill that passed with the smallest margin was SB 503 (capital gains tax reduction), which passed 54-45 in the House of Representatives and 31-19 in the Senate, and was later vetoed by Gov. Brian Schweitzer. (See Appendix 3)
- Of the 57 tax expenditures introduced in the 2009 session, 10 became law. Eight of these bills were sponsored by Democrats and two were sponsored by Republicans. (See Appendix 2, Table 4)
 - The bill with the largest estimated average fiscal impact that became law was HB 658, sponsored by Rep. Mike Jopek (D-Whitefish), with an estimated average fiscal impact of \$28 million/year⁷. HB 658 was a property tax reappraisal mitigation bill.
 - The bill with the smallest estimated fiscal impact was HB 636, sponsored by Rep. Sue Dickenson (D-Great Falls), with an estimated average fiscal impact of \$8,590/year. HB 636 provides a tax incentive to sell a mobile home park to a residents’ group.

⁷ Reappraisal mitigation bills are complex and address, in addition to changes in basic property tax structure, proposed changes to various existing tax expenditure elements of the existing property tax system. For purposes of relative simplicity, we have entered as the tax expenditure cost of these bills the total net costs of the bills as estimated in the bill’s fiscal notes. It may plausibly be argued that certain elements of the net totals in the fiscal notes for these bills do not reflect true tax expenditures, but that contention may be countered with the argument that many changes in the property tax structure, even if presented as systemic changes, have the effect of transferring tax responsibility to taxpayers in other property tax classes and, occasionally, even to taxpayers in the income tax part of the state’s entire tax structure.

- The estimated average fiscal impact of the other tax expenditure bills that became law range from \$25,000/year to \$1.6 million/year.
- Inspection of the votes cast on the 11 tax expenditure bills that passed both houses of the Legislature reveal patterns of partisan voting, but the patterns are not necessarily the same in both houses.
 - In the House, Democrats broadly supported nine of the 11 measures and generally opposed two of them – the reappraisal mitigation bill (HB 658) and the capital gains reduction bill (SB 503).
 - In the House, Republicans broadly opposed the nine measures supported by most Democrats, but strongly supported the reappraisal mitigation bill and the capital gains reduction bill.
 - In the Senate, there was less difference in the overall support given by parties to tax expenditure bills, with each party voting strongly against three of the 11 measures.
 - The tax expenditure bill that yielded the most similar partisan votes across both houses was SB 503, which proposed to reduce capital gains taxes on the sale of certain Montana businesses (Republicans broadly supported it, while Democrats broadly opposed it). Interestingly, this was also the only one of the 11 tax expenditure bills passed by the Legislature that was vetoed by Gov. Brian Schweitzer, a Democrat.
- HB 262 (revision of list of wood-burning devices that qualify for tax credit) passed with the support of Republicans in the House (44-6), but not in the Senate (6-21). HB 412 (reduction of liquor excise tax rate for small producers) passed with the support of the Republicans in the Senate (23-0), but Republicans in the House were split on the bill (21-19). (See Appendix 3)
- Twelve legislators, seven Democrats and five Republicans, voted yes on all of the tax expenditure bills that passed both houses. (See Appendix 2, Table 11)

[Appendix 1](#)

[Appendix 2](#)

[Appendix 3](#)

[Appendix 4](#)