CONSIDERING TAX EXPENDITURES IN STATE BUDGET DELIBERATIONS

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I. Introduction

I am going to speak generally about three components of state public finance:

COMPONENTS OF STATE PUBLIC FINANCE
1. Tax Revenue
2. Government Expenditures
3. Allocation of the Tax Burden

first, tax revenue; second, government expenditures; and third, the allocation of the tax burden. I will illustrate how tax expenditures, such as sales-tax exemptions and other preferential laws, affect each component of public finance.

In all of this, we must remember that budget deliberations should focus on keeping the three components of public finance in appropriate balance. For instance, expenditures should not exceed revenue, because deficit spending forces the state to borrow, which creates burdensome finance costs. On the other hand, the state should not collect more revenue than it needs to provide the appropriate level of services. Excess revenue takes resources out of the hands of the populace unnecessarily, and may lead to undesirable government expansion. Fiscal discipline keeps tax revenue and government expenditure in appropriate balance.

Finally, taxation and government expenditures generally redistribute wealth. Tax breaks for the wealthy take money from the middle and lower classes and redistribute it to the wealthy. State programs that benefit only the lower economic classes require support from the middle and upper classes. The redistributive effects of public finance determine the system's fairness. Thus, all public finance decisions affect the state's tax revenue, expenditures, and the allocation of the burden of taxation.

Let's now consider each component of public finance in turn.

II. Tax Revenue

First, let's consider tax revenue. Two important elements determine the state's tax revenue: the tax base and the tax rate. A simple equation illustrates the computation of tax revenue.

TAX REVENUE DETERMINATION

Tax Base x Tax Rate = Tax Revenue

Tax base times tax rate equals tax revenue.

I will now discuss each part of the tax revenue equation. The tax base is the source from which the state collects tax revenue.

TAX BASES

Type of Tax	**Tax Base**
Income Tax	Taxable Income
Sales Tax	Taxable Sales
Property Tax	Assessed Property Value

The tax base for income tax is taxable income, the tax base for sales tax is taxable sales, and the tax base for property tax is the assessed property value.

Statutes define each of the tax bases.[1] Statutes often have broad definitions of each tax base. Tax exemptions and other mechanisms erode the tax bases. For example, statutory exemptions exclude many sales from the definition of taxable sales.

Tax rates are also a product of legislation.[2] Unfortunately, public-finance discussions often focus solely on tax rates. The focus should, however, include thoughtful analysis of the tax bases. Tax rates and tax bases affect the amount of tax revenue the state raises, who pays the tax, and the amount each person pays.

RELATIONSHIP BETWEEN TAX BASE AND TAX RATE

Tax Base	Tax Rate
↓	↓
Who Pays	How Much

[1] *See, e.g.*, KAN. STAT. ANN. § 79-32,116 (defining Kansas taxable income of an individual); § 79-3603 (imposing a tax on sales); § 79-3606 (exempting certain sales from the sales tax); § 79-101 (imposing a tax on property).

[2] *See, e.g.*, KAN. STAT. ANN. § 79-32,110 (establishing the income-tax rates); § 79-3603 (establishing the sales-tax rate at 5.3%).

In fact, the tax base determines who pays a particular tax, and the tax rate determines how much they pay. General concepts apply to every type of tax, but I use state sales tax to illustrate the relationship of tax base, tax rate, and tax revenue.

A simple formula illustrates the computation of the state's 2008 sales-tax revenue.

2008 SALES-TAX REVENUE				
Tax Base	x	Tax Rate	=	Tax Revenue
$57 billion	x	5.3%	=	$3 billion

The state had approximately $57 billion of taxable sales taxed at 5.3%, so it raised approximately $3 billion of sales-tax revenue.[3]

The tax base in 2008, did not, however, include all sales. In fact, in 2008 state law exempted approximately $75 billion of sales from taxation.[4]

EFFECT OF SALES-TAX EXEMPTIONS IN 2008				
Exempt Sales	x	Tax Rate	=	Tax Expenditure
$75 billion	x	5.3%	=	$4 billion

At 5.3%, those exemptions accounted for approximately $4 billion of sales-tax revenue the state did not collect.[5] The $4 billion of uncollected revenue is a tax expenditure. I will say more about that shortly.

[3] *See* STATE OF KANSAS DEPARTMENT OF REVENUE ANNUAL STATISTICAL REPORT 18 (Fiscal Year Ending June 30, 2008), *available at* http://www.ksrevenue.org/pdf/forms/08arcomplete.pdf (providing that sales-tax collections were $3,148,719,105). The $57 billion of taxable sales is the approximate sales-tax revenue divided by the 5.3% tax rate.
[4] The $75 billion of exempt sales is the approximate sales-tax expenditure divided by the 5.3% tax rate.

Changes in the tax base that result from the addition or repeal of exemptions can profoundly affect sales-tax revenue and the tax rate.

2008 Potential Taxable Sales	
Taxable Sales	$57 billion
Plus Exempt Sales	+ $75 billion
Potential Taxable Sales	$132 billion

If the state had no sales-tax exemptions in 2008, it would have had approximately $132 billion of potential taxable sales.

The repeal of tax exemptions could significantly increase sales-tax revenue. To illustrate this point, I show the effect of complete repeal of sales-tax exemptions. Understand, however, that I do not advocate the repeal of all sales-tax exemptions. Some of them, such as certain ingredient and component parts of products manufactured for resale, are appropriate from a state-interest standpoint and others are politically expedient. For the sake of discussion, however, I assume all the exemptions could be repealed.

The relationship of tax base, tax rate, and tax revenue is such that if the tax base gets bigger and the tax rate remains the same, tax revenue will get bigger.

2008 Sales-Tax Revenue with no Exemptions				
Potential Taxable Sales	x	Tax Rate	=	Potential Tax Revenue

[5] *See* Kansas Department of Revenue Tax Expenditure Report 17 (Calendar Year 2007), *available at* http://www.ksrevenue.org/pdf/taxexpreportcy2007.pdf.

$132 billion	x	5.3%	=	$7 billion

Thus, if taxable sales were $132 billion, tax revenue would grow to $7 billion under the current 5.3% rate structure. Notice that the sales-tax revenue increases as the size of the tax base increases. One way to increase the tax base is to modify the definition of taxable sales by repealing sales-tax exemptions. The repeal of sales-tax exemptions could thus help eliminate the state's budget gap.

In pursuit of a fairer tax, the state may consider broader reform that would eliminate exemptions and include more items, such as professional services, in the tax base. The result of such reform would be a broader tax base that would allow the state to reduce the sales-tax rate. Assume, for instance, that the state needed to raise $3 billion of revenue from sales tax in 2008. Assume further that the state could eliminate all of the sales-tax exemptions. With a $132 billion sales-tax base, the state could raise $3 billion of sales-tax revenue using a 2.3% sales-tax rate.

2008 POSSIBLE SALES-TAX RATE WITH NO EXEMPTIONS

Potential Taxable Sales	x	Possible Tax Rate	=	Tax Revenue
$132 billion	x	2.3%	=	$3 billion

This happens because a larger tax base with constant revenue needs allows the tax rate to shrink.

Another way to grow the tax base is to increase the population and business activity in the state. Exemptions that legitimately stimulate economic growth serve a valid state interest, and retaining them may help grow the tax base. We must, however, weigh the cost and benefit of each exemption to determine whether it helps increase the tax base. Undoubtedly, many sales-tax exemptions do not help increase the tax base, and we should repeal them.

III. Government Expenditures

The appropriate size of the tax base, tax rate, and tax revenue depend upon the state's expenditures. Discussions of public finance should consider both direct and indirect government expenditures.

DIRECT EXPENDITURES
Writing Checks or Transferring Funds

Direct expenditures are those expenditures for which the state writes a check or transfers funds. For example, the state writes checks or transfers funds to pay teachers, to operate courts, and to construct state buildings.

Indirect expenditures are those which provide an economic benefit to a particular person or group, even though the state does not actually write a check or transfer funds to such person or group.

INDIRECT EXPENDITURE
Providing an economic benefit without writing checks or transferring funds
-Indirect Expenditure = Tax Expenditure

-Tax Expenditure = Sales-Tax Exemption

A tax expenditure is an example of an indirect expenditure. A sales-tax exemption is an example of a tax expenditure. Sales-tax exemptions and tax expenditures are indirect expenditures because they provide an economic benefit to select taxpayers, even though the state does not write a check or transfer funds.

Consider why tax expenditures in general, and sales-tax exemptions in particular, are indirect expenditures. The state provides services, such as transportation infrastructure, education, police protection, and social services. Those services make sales, property ownership, and earning income possible in the state. For instance, a person could not purchase food and clothing in Kansas, if the final product or materials did not ship over Kansas roads that are protected by Kansas police. Other services, such as education and social services, continue to enhance lifestyle and provide a more competent and healthy workforce. Everyone benefits from state services and should shoulder a portion of the cost of the services.

The state determines each person's share of the tax burden using the tax bases. Any item exempted from the broad tax base allows the beneficiary of the exemption to receive state services at a reduced cost. Exemptions are equivalent to the state providing the services at a discount, or to the state collecting the exempt amount from the beneficiaries and paying it back to them as a subsidy. Thus, the exempt amounts are economically equivalent to state direct expenditures and subsidies, and we should treat them as such.

Tax expenditures are popular to beneficiaries because they do not appear in the state's Budget Report as expenditures.[6]

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[6] The Department of Revenue does, however, publish a Tax Expenditure Report on its website at http://www.ksrevenue.org/pdf/taxexpreportcy2007.pdf.

Popularity of Tax Expenditures
Comparable to Off-Balance-Sheet Financing
Facilitate Secret Manipulation of State Finances

Therefore, tax expenditures are comparable to off-balance-sheet financing that plagues the private sector. In short, tax expenditures allow people to secretly manipulate state finances. I therefore applaud the efforts of Secretary Wagnon and others who are making tax expenditures a part of the current budget talks, and I hope tax expenditures will become a permanent part of budget deliberations.

Considering just a few sales-tax exemptions helps clarify the need for rigorous analysis of these indirect expenditures. Income tax and property tax warrant similar scrutiny. This analysis focuses on three types of sales-tax expenditures:

Types of Sales-Tax Expenditures
1. Organization-Specific Sales-Tax Expenditures
2. Taxpayer-Specific Sales-Tax Expenditures
3. Sales-Tax Expenditures to Out-of-State Beneficiaries

first, organization-specific sales-tax expenditures; second, taxpayer-specific sales-tax expenditures; and, third, sales-tax expenditures to out-of-state beneficiaries. Consider how we might analyze each of these types of sales-tax expenditures in state budget deliberations.

A. Organization-Specific Sales-Tax Expenditures

Let's first consider organization-specific sales-tax expenditures. The state exempts sales to several types of organizations. For example, it exempts sales of property and services to nonprofit hospitals and religious organizations. The justification for such exemptions is that those organizations provide services that the government would otherwise provide.[7] Even though legitimate state interests may justify the sales-tax exemptions for such organizations, in periods of financial difficulty, tax expenditures to such organizations should be subject to the same scrutiny to which direct expenditures are subject. Two examples help illustrate this point.

Recently, the state funding for the Kansas Neurological Institute has drawn public attention. The funding for KNI is a direct expenditure. The services KNI provides are health-related, just as the services provided by nonprofit hospitals are health-related. Those who are scrutinizing the direct expenditures to KNI should similarly scrutinize the indirect expenditures to nonprofit hospitals made in the form of sales-tax exemptions. Because these organizations provide similar services, we should consider cutting the expenditures to both, if we must cut expenditures to one. When considering budget cuts, it is unfair to focus solely on organizations that receive direct funding from the state.

ANALYZING ORGANIZATION-SPECIFIC SALES-TAX EXPENDITURES		
Tax Expenditure Benficiary		**Direct Expenditure Beneficiary**
Nonprofit Hospitals	⟷	Kansas Neurological Institute

[7] *See* H. Rep. No. 1860, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (Part 2) C.B. 728,742. ("The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.").

Religious Organizations	⟷	Education

Similarly, we can compare the important services religious organizations provide to services that state educational institutions provide. A well-educated population is vital to the state's future. Recent studies stress the non-pecuniary educational benefits that are critical to the state's general well-being.[8] More schooling helps people obtain critical-thinking and social skills, which help them be more efficient, make better decisions, and be more civil. Those attributes help improve the state's general welfare. People with more schooling also tend to be healthier and have a lower divorce rate. Thus, education helps relieve the state of many costs it would otherwise incur caring for its residents and is crucial to the state's future.

Religious organizations can positively affect the moral character of the state's population, and some provide valuable state services, such as caring for the poor. Those functions are also critical to the state's future. The state cannot, however, subsidize religious organizations at the detriment of its educational institutions. If the state considers cutting funding for education, it should also consider the indirect expenditures going to religious organizations. Perhaps budget cuts require a partial repeal of some of the organization-specific sales-tax expenditures.

These two comparisons consider organization-specific sales-tax expenditures that serve valid state interests. Unfortunately, many organization-specific sales-tax expenditures go to organizations that do not provide substitutes for valid state services. Fairness dictates that the state should immediately repeal exemptions for such organizations and not grant them in the future to other organizations that do not provide substitutes for valid state services.

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[8] *See* Philip Oreopoulos & Kjell G. Salvanes, *How Large are Returns to Schooling? Hint: Money isn't Everything*, NBER WORKING PAPER SERIES, working paper 15339, *available at* http://www.nber/org./papers/w15339.

B. Taxpayer-Specific Sales-Tax Expenditures

Now I want to talk about a couple of taxpayer-specific sales-tax expenditures. This type of tax expenditure provides tax subsidies to select taxpayers. The sales-tax exemptions for prescription drugs and agricultural machinery are examples of taxpayer-specific sales-tax expenditures. Because of the exemptions, farmers and prescription-drug users do not pay tax on all of their purchases. We must ask whether state interests justify such indirect expenditures when other purchases are not exempt from sales tax.

For instance, consider a young couple who is starting a new family. The couple must pay sales tax on baby formula, diapers, food, and clothing for their children. Compare that to a person who has the wherewithal to afford male-enhancement prescription drugs. The purchase of the male-enhancement product arguably serves a limited state interest, if any. Nonetheless, it is not subject to state sales tax. Meanwhile, the essentials purchased by the couple struggling to raise a family are subject to state sales tax. The broad exemption for prescription drugs appears to be unfair in this and many other comparisons. It deserves close scrutiny.

ANALYZING TAXPAYER-SPECIFIC SALES-TAX EXPENDITURES

Tax Subsidy		**Full Taxation**
Prescription Drugs	↔	Baby Formula and Diapers
Agricultural Machinery	↔	Plumber’s Equipment

Agriculture is a significant part of the state’s economy and way of life, so we often feel comfortable granting tax subsidies to farmers. Nonetheless, farmers are a small part of the state's population. Many other state residents struggle to make ends meet and are a significant part of the state's economy and way of life, but they do not receive state subsidies through sales-tax exemptions. For example, plumbers, carpenters, and electricians must purchase tools and equipment for their trades, but they pay sales tax on those purchases. Thus, the state subsidizes farmers, but it does not subsidize others who are working to make a living.

What's worse is that broad taxpayer-specific sales-tax expenditures do not consider the size or type of taxpayer. An out-of-state corporation that farms in Kansas is able to take more profit out of the state because of the exemption for agricultural machinery. The exemption for prescription drugs may benefit the poor, but it also provides an unwarranted exemption for wealthy users of frivolous products. In fairness, the state probably should not provide tax expenditures to specific classes of taxpayers, especially those who have the wherewithal to pay taxes.

C. Tax Expenditures for Out-of-State Beneficiaries

The third type of tax expenditure benefits out-of-state persons. For instance, the exemptions for prescription drugs and agricultural machinery may benefit out-of-state manufacturers more than they benefit state residents because out-of-state manufacturers may be able to increase prices to account for the sales-tax exemption. To prevent that from happening, we must scrutinize every exemption to see where the benefit goes.

IV. Fair Allocation of the Tax Burden

To conclude, I want to discuss how tax expenditures affect the fairness of our tax system. The appropriate size of the state government and the extent of services that the state provides should always be an important part of our political debates and informed political processes. The state will, however, always provide some level of services, and it must raise revenue to provide those services. Because everyone within the state benefits from state-provided services, every capable person within the state should bear a fair portion of the cost of such services.

Tax expenditures are generally unfair because they benefit a small portion of the population and increase the tax burden of the majority. An example helps illustrate how tax expenditures affect the burden of taxation.

The tax expenditure for prescription drugs was about $68 million in 2008.[9] The $68 million tax expenditure is equivalent to $1.3 billion of exempt sales.[10] The state raised $3 billion from sales tax. Because of the exemption, the tax burden on those left bearing the costs of state services was a 5.3% sales tax, while a fraction of the population derived a benefit from the prescription-drug sales-tax exemption.

UNFAIR ALLOCATION OF THE TAX BURDEN
5.3% with the exemption

If the sale of prescription drugs were included in the tax base and the sales-tax revenue remained constant at $3 billion, the sales-tax burden would decrease to 5.1%.

[9] *See* KANSAS DEPARTMENT OF REVENUE TAX EXPENDITURE REPORT 15.
[10] The exempt sales are the amount of the tax expenditure divided by 5.3%.

Fairer Allocation of the Tax Burden
5.1% without the Prescription Drug Exemption

The repeal of tax expenditures could thus broaden the tax base, reduce the tax burden most of us bear, and more fairly allocate the tax burden.

V. Conclusion

Now imagine what would happen if we repealed all unjustified or unfair sales-tax expenditures. How low would the sales-tax rate go? Could it go as low as 2 to 3%?

What Possibilities Await Us?
2% to 3% with complete repeal

Significant possibilities await us if we get rid of unwarranted tax expenditures in all of our tax bases.

Possibilities
1. Low Competitive Tax Rates
2. Balanced Budget
3. Fair Taxes

If we eliminated unwarranted tax expenditures from our income tax, sales tax, and property tax, we would likely become the over-all most tax-competitive state in the country, we would have a balanced budget, and we would fairly distribute the benefits and burdens of living in a civilized state.

Thank you.