

2 Revenue Politics

But if you really want to raise taxes, I do want to have an argument.

—Grover Norquist

And I don't think you can have a rule that you're never going to raise taxes or that you're never going to lower taxes. I don't want to rule anything out.

—Rep. Peter K. King

In public budgeting, the tax payers and the decision makers who determine tax and spending levels are separated. This separation sets up the possibility of some radical disagreements. Citizens would undoubtedly be happier about paying taxes if they could choose the services they wanted and pay only what they felt those services were worth. They might be even happier if they could get others to pay the taxes while they received the services. Individual taxpayers usually do not control the mix of services and may have to pay for some programs they do not want. Moreover, many citizens are convinced that they are paying for waste and mismanagement and that others are getting away with paying less than they pay. They resent being forced to pay what they consider to be more than their share.

Elected officials often have legal power to raise taxes, but they cannot do so willy-nilly. The ability to raise taxes is highly constrained, by legislative or constitutional tax limits, by politicians' campaign promises and written pledges not to increase taxes, and by the often justified belief that the public will throw out of office any elected officials who raise taxes. Active lobby groups continually push for reductions in taxes and oppose increases. Further, many elected officials express the need to avoid putting an undue burden on businesses that would

make it difficult for them to compete. Given all these constraints on raising taxes, the puzzle is not why—as some have asked—government grows in a democracy, but rather how government can ever raise taxes to pay the bills.¹

This chapter describes the difficulty of raising taxes and the variety of strategies employed. It then discusses the various tax breaks granted to offset inequitable tax burdens and to respond to interest group demands and the resulting complexity of tax codes at all levels of government. Finally, the chapter addresses efforts to reform the tax system, to make it simpler, more productive, and more equitable.

Raising Taxes

Raising taxes is problematic, not only because citizens get angry when their taxes are raised, but also because some states have passed laws making it intentionally difficult to raise taxes. States sometimes limit the permissible rate of growth of tax revenue (see the minicase of TABOR in Colorado for one example, in Chapter 1) or require public referendums for tax increases. Some states require difficult-to-obtain supermajorities in the legislature to pass tax increases. These constraints on revenues can be more or less restrictive and easier or harder to change. Some are written into state constitutions, a particularly inflexible constraint.

In our federal system, the states have power over the local governments. States have found it tempting to impose limits on taxes at the local level. By limiting local taxes, state elected officials get the credit for tax relief without unbalancing the state budget. As a result, local officials may find it difficult to raise sufficient revenue to pay for basic services. Sometimes the states replace the lost revenue for the local governments, but when times get tough, as during recessions, this assistance may be reduced or disappear.

Raising taxes is not only unpopular; it can be embarrassing. In order to force elected officials to keep their campaign promises not to raise taxes, Grover Norquist of the Americans for Tax Reform has asked those running for office to sign a written pledge that they will not raise taxes. If they fail to keep their word at any time after they sign and while they are still in office, Norquist publicizes and criticizes their defection, threatening them with electoral defeat. The written agreement, called a *taxpayer protection pledge*, is a promise to oppose *any* tax increase. Norquist makes no exceptions for emergencies. Elimination of tax breaks is treated as a tax increase and hence prohibited. Some of Norquist's Republican supporters complained that they did not think when they signed his document that it would be binding perpetually, regardless of the circumstances or the amount of time passing. One, Representative Frank Wolf, R-VA, charged that the pledge made it more difficult to tackle the deficit problem at the federal level.²

Despite the occasional complaint, signing the pledge is almost a prerequisite for running for statewide or national office among Republicans and among Democrats running in Republican districts. Though there has been a noticeable drop in the past few years, the numbers of those bound by the no-tax-increase pledge are still impressive. According to the Americans for Tax Reform database, the 2015 numbers are 221 House members and 49 Senators.³ At least eleven of those listed as incumbent pledgers on the Americans for Tax Reform website had repudiated part or all of the pledge (Coburn, McCain, Graham, Corker, Alexander, and Crapo in the Senate, and Rigell, Fortenberry, Cole, Desjarlais, and King in the House). One of the retired senators who repudiated the pledge, Saxby Chambliss, was still listed as an incumbent; one of the defeated representatives, Cantor, was also still listed as a pledger, though no longer as an incumbent. A corrected total for 2015 is 216 in the House and 42 in the Senate.

There were thirteen Republican governors in office in 2015 who had taken the pledge, with few surprises: Alabama, Florida, Georgia, Louisiana, Maine, Mississippi, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, and Wisconsin. In addition to the governors, over a thousand state legislators had taken the pledge. However, some of the newer congresspersons and two of the seventeen Republican presidential candidates expressed reluctance to sign the pledge: Jeb Bush and Donald Trump. Even if the pledge has lost some of its obligatory nature, the large number of signers has made it more difficult to raise taxes, especially where Republicans are in the majority or where supermajorities are required to raise taxes.

Never raising taxes is a difficult promise to keep. During recessions, revenue levels fall and need increases simultaneously, creating budget gaps. States that have sharply reduced tax rates have often created budget gaps for themselves as well. Continual deep spending cuts have put pressure on these states to raise revenues in some manner. Even without recessions or tax cuts, without service expansion or new programs, the costs for state and local governments may grow more quickly than revenues, opening budget gaps that need to be closed.

Minicase: Louisiana—Getting Around the No Tax Increase Pledge

Never raising taxes is indeed a difficult promise to keep. Louisiana's governor, Bobby Jindal, was one of the governors who took the no-tax-increase pledge. He threatened to veto any legislatively approved tax increases.

(Continued)

(Continued)

Louisiana had a budget surplus of \$1.1 billion when Jindal took office in 2007. In the ensuing years, the surplus was spent and there were major tax reductions, amounting to half of the 2002 voter-approved income tax increase and half the corporate income taxes. In an effort to balance the budget, the state made spending cuts, but not enough to offset the tax reductions. For 2016, the budget shortfall was predicted to be \$1.6 billion. Facing the largest budget gap in decades and after severe spending cuts in prior years, the state needed more revenue.

Jindal, caught between the need for additional revenue and fear of violating his oath to never raise taxes, devised an odd scheme that would allow him to raise taxes while appearing to be keeping the pledge. Part of his proposal was to change reimbursable to non-reimbursable tax credits, meaning that taxpayers could no longer collect more in tax breaks than they owed in taxes. That would save the state money, and Norquist agreed to treat that change as a cut in spending rather than an increase in taxation. But there were also increases in fees and in cigarette taxes, which Jindal needed to offset with tax reductions elsewhere or at least create the appearance of tax reductions elsewhere. So Jindal proposed and the legislature reluctantly approved a fee on public college students in the state, while giving them a tax credit to compensate them, and then the students were to give the tax credit to the state board of regents, which in turn would collect the money from the state. Though there is no way that this scheme could actually offset anything, Jindal claimed that he had not raised taxes and obtained Norquist's consent to the plan. Presumably, Jindal did not count the assessment on the students (which they did not pay) as a tax but counted the tax credit as a tax reduction, helping to offset the new revenue from the cigarette tax increase.

In 2016, facing huge deficits and with Jindal out of office, the legislature repealed Jindal's SAVE tax credit and raised taxes. One legislator called the SAVE program no more than an accounting gimmick. Conclusion: Constraints that are too tight encourage evasions, unfathomable complexity, and sometimes, downright silliness.

Sources: Campbell Robertson and Jeremy Alford, "Louisiana Lawmakers Hold Their Noses as They Balance the Budget," *The New York Times*, June 11, 2015, <http://www.nytimes.com/2015/06/12/us/louisiana-lawmakers-arrive-at-11th-hour-compromise-on-funding.html?ref=us&r=1>; Stephen Winham, "Louisiana Budget Practices: A Brief 30-Year History and One Scenario for Closing the \$1.6 Billion Gap for Fiscal Year 2016," *Louisiana Voice*, March 31, 2015, <http://louisianavoice.com/?s=budget+practices>. "House Votes to Repeal Much-Maligned Jindal Tax Credit," *Biz New Orleans*, February 19, 2016, <http://www.bizneworleans.com/2016/02/19/house-votes-to-repeal-much-maligned-jindal-tax-credit/>.

Given the seriousness of these constraints, when politicians feel taxes must be raised, they try to do so very carefully. The fear of being thrown out of office by angry taxpayers is based on cases where this has occurred, but taxpayers do not uniformly reject tax increases or the politicians who propose them. One study pointed out, for example, that even among Republican voters, there was considerable sentiment for combining spending cuts and tax increases in order to reduce the federal deficit.⁴ In surveys, two-thirds of the U.S. public and half of Republicans agreed to support higher taxes as part of deficit reduction.

Research has generally supported the position that those who advocate tax increases are more likely to face defeat, but the relationship is not airtight, and many other factors besides tax increases influence reelection chances, including the public dislike of deficit spending and the impacts of deep service cuts absent a tax increase. In fact, raising taxes is not impossible, just difficult.

Looking at tax increases that have failed and those that have succeeded suggests a number of principles for a successful tax increase that doesn't result in (metaphorical) slaughter of incumbents at the next election:

1. Make the extent of the revenue problem clear and credible.
2. Spell out clearly and realistically the consequences of cuts in spending if taxes are not increased.
3. If need be, make the tax increase temporary to make it more palatable.
4. If necessary, go to the public for a referendum; if it passes, there can be little blame for the politicians.
5. Make it as clear as possible that the money will not be wasted. Describe how the revenue will be spent. Show a collective benefit from the tax increase or tie it to specific benefits for several groups. A tax increase to prevent a further reduction in spending for education may be more acceptable than a vague proposal to balance the budget.
6. Demonstrate that prior inefficiencies have already been wrung out of the budget.
7. Design the increase so that it is fair and not overly burdensome to any particular group. One approach is to raise a variety of revenue sources that affect different groups just a little bit each; another is to raise taxes for groups that have not been paying taxes proportional to their incomes.
8. Explain all of the above to the public.

Any given campaign may emphasize some of these over others, depending on the problems being confronted. The minicase of Philadelphia, Pennsylvania, illustrates that taxes can be increased if these principles are followed (see p. 42).

Jindal took office in 2003, and there were major tax increases. To balance the budget, the governor sought spending reductions. For the first time in 15 years, the state

and fear of violating the constitution that would allow him to raise taxes. Part of his proposal was to increase the state's income tax credits, meaning that taxpayers would owe less in taxes. He wanted to treat that change as a tax cut. But there were also other changes. He wanted to offset with tax cuts the tax reductions elsewhere. He had already approved a fee on the state's tax credit to compensate for the loss of revenue to the state board of education. Though he had the support of the state, Jindal claimed that he needed the legislature's consent to the plan. He also wanted to reduce the state's debt (which they had increased) and to reduce the state's debt, helping to

the legislature. The legislature called the governor's plan a "tax cut." Conclusion: the governor's plan was a complex one.

Lawmakers Hold Their Ground. 11, 2013, <http://www.philly.com/philly/news/politics/2013/01/11/hold-their-ground-compromise-budget-practices-a-look-at-the-gap-for-fiscal-year-2014-budget-practices.html>. New Orleans, February 2013. <http://www.foxnewsonline.com/2013/02/20/jindal-tax-2013-02-20.html>.

Many states have tried the referendum option, testing the public level of willingness to accept a tax increase. Sometimes, the public is convinced there is nothing left to cut and that more deep cuts are on the way if they don't pass a tax increase. However, Oregon did not intentionally put a tax increase before the public for approval. Rather, Oregon legislators took a chance on public reaction by passing tax increases in 2009. The decision was challenged in a public veto referendum, a direct democracy device that allows citizens to vote on legislation of which they disapprove. (Twenty-three states have such a procedure.) Several citizen and business groups organized a petition drive to get the tax increase on the ballot, with the hope that the public would vote it down. These opponents of the tax increase were probably surprised by the result: In January of 2010, voters supported the legislatively approved tax increases, including a historic increase in corporate minimum taxes, which had been set at \$10 since 1931, an increase in business taxes, and an increase in the income tax for top earners.

Proposed cuts if the taxes were not approved included those to education, public safety, and services to the elderly. The public was informed that these cuts would be necessary without a tax increase. Campaigns organized by unions to approve the taxes tapped resentment against the highest earners.⁵ In addition, the state had already cut \$2 billion from the budget before the legislature passed the tax increases. Under Oregon law, any surpluses have to be returned to the taxpayers, making it impossible to create a rainy-day fund to see the state through recessions, deepening the level of necessary cuts. The state had no buffer, so the choice was between deep additional cuts or a tax increase.

Minicase: A Recent Tax Increase in Philadelphia

Property taxes are highly unpopular, but Philadelphia successfully raised its property taxes in 2011, for the second year in a row. How did the city do it?

The answer involves all three levels of government—national, state, and local. During the recession that began at the end of 2007, the national government passed an antirecession package including aid to school districts to prevent teacher layoffs. The federal assistance ended in 2011. The governor then proposed and the legislature accepted drastic reductions in aid to education for 2012. The school district for Philadelphia was in a deep hole and pleaded with the city of Philadelphia for help.

The city had just increased the property tax the previous year, and doing it again seemed impossible, so the sympathetic mayor proposed a tax on sweet bottled drinks instead. The soft drink manufacturers engaged in a full court press of lobbying to block the mayor's proposal. The soft drink industry

the public level of will-
 convinced there is noth-
 they don't pass a tax
 increase before the
 on public reaction
 in a public veto
 on legislation
 a procedure.) Several
 the tax increase on
 These opponents of
 January of 2010, voters
 a historic increase
 since 1931, an increase
 earners.

those to education,
 informed that these cuts
 organized by unions to
 earners.⁵ In addition, the
 legislature passed the
 returned to the taxpay-
 the state through
 had no buffer, so the

successfully raised its
 how did the city do it?
 national, state, and
 2007, the national gov-
 school districts to
 2011. The governor
 in aid to educa-
 was in a deep hole and
 previous year, and doing
 proposed a tax on
 engaged in a full
 the soft drink industry

had contributed heavily to the campaigns of the council members, which made them vulnerable to such pressure.¹ As a result, the mayor was unable to maintain a majority of the council to vote for the soft drink tax. In addition, some council members voiced concern that the school district would mispend the money. They argued that the school district knew about the future loss of funding and had not done enough to prepare for it.

Mayor Nutter had no alternative but to advocate a second property tax increase. To gain council members' support, he negotiated a deal that required the school district to outline in detail how the money would be spent and what the consequences of failure to pass the tax would be. Another requirement was that the school district had to submit to the city a five-year financial plan, forcing it to plan ahead. A third feature of the tax increase was that it was temporary. While there was some grumbling that the deal had no enforcement mechanism to see that the school district was following through on the agreement and that standards of financial soundness were met, it was clear to all that there was a need and that the consequences of failure to bail out the school district would be severe. A narrow majority of council members reluctantly voted to increase the property tax, because, as they said, sometimes you have to do what you have to do.²

1. Jeff Shields, "Soft-Drink Industry Has Given Heavily in Council Races," *Philly.com*, June 5, 2011, http://articles.philly.com/2011-06-05/news/29623332_1_danny-grace-council-races-soda-tax.
2. Marcia Gelbart and Jeff Shields, "How Philadelphia's City Council Decided on a Property-Tax Boost," *Philly.com*, June 19, 2011, http://articles.philly.com/2011-06-19/news/29676981_1_property-tax-hike-soda-tax-tax-on-sugary-drinks.

The referendum on taxes split labor and business, creating a kind of budgetary class warfare. A major campaign supported by broad coalitions on each side educated and, sometimes, miseducated the public. Supporters claimed that families earning less than \$250,000 a year would not be affected. Further, the supporters argued that business and the wealthy should pay their fair share. Most business groups opposed the increases. Opponents of the tax increases called them job killing and a threat to small businesses. A key to the success of this tax increase in a low-tax, low-service state is that ordinary voters understood that these increases would not affect them directly and would stave off deep cuts in necessary services.

While tax increases can be successful, they sometimes fail because they are either poorly timed or ignore some of the principles of a successful tax increase. The failure of the governor in Minnesota to raise taxes in 2011 suggests the importance of educating the public and the difficulty of raising taxes when there

is a Republican majority in the legislature. Governor Dayton, a Democrat, faced Republican majorities in both houses. The state faced a gap of \$5–6 billion over the biennium. The governor proposed a tax increase on the top 1 percent of earners, which the legislature refused to pass. The governor's main strategy seemed to be to allow a long government shutdown to pressure the Republicans to compromise—to force some cuts but allow some tax increase. The Republicans did not yield. Twelve of Minnesota's thirty-seven Republican state senators and twenty-five of the seventy-two Republican state representatives had signed Norquist's no-tax-increase pledge; even more important, three of the four top leaders of the Republican caucuses had signed the pledge.⁶ Several Democrats had also signed. Many Republican legislators who had not signed the pledge also believed that government should not raise taxes.

During the shutdown, Governor Dayton began to travel the state and make speeches explaining what would be cut and with what consequences under the Republican plan, but his effort was too late and too little. The governor gave in but did not give up.

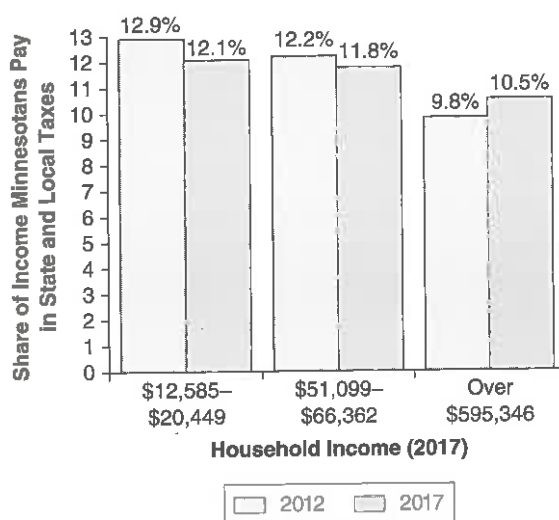
The next session of the Minnesota legislature was dominated by the governor's own party, and in 2013, the governor just managed to get his tax increase through. The vote was nearly completely along party lines in the senate. One argument Governor Dayton used was the unfairness of the state income tax, in which higher earners paid a smaller share of their income than middle class and lower income people. Although initially opposed to a cigarette tax because the burden would fall on poorer people, the governor included an increase in cigarette taxes when a coalition of health advocates convinced him that higher taxes on cigarettes would reduce use and improve public health. His tax package also included several business-to-business sales taxes. He used the new money to plug a \$1.1 billion budget gap, boost school funding, and provide property tax relief. Less than a year later, Governor Dayton signed off on more than \$400 million of tax cuts.

Defying traditional political wisdom, despite the tax increases, Dayton got reelected by a wide margin in 2014. He had taken time to educate the public, there was clearly a need, and there were many beneficiaries and few losers. The income tax increase affected only the top 2 percent of earners. After the tax increase and tax cuts, people with higher incomes still paid a smaller proportion of their income for state and local taxes than poorer people did, but the gap was not so great. (See Figure 2.1 on p. 45.)

The Politics of Protection

The politics of raising revenues has a mirror image, that of protecting the specific groups or the population in general from taxation or lowering tax levels for individuals or groups. Just as raising taxes necessarily brings a certain

FIGURE 2.1 Minnesota's Tax System Fairer



Source: Nan Madden, "Minnesota's Tax System Fairer; Proposed Legislation Would Take Us Backward," *Minnesota Budget Bites*, March 18, 2015, <http://minnesotabudgetbites.org/2015/03/18/minnesotas-tax-system-fairer-proposed-legislation-would-take-us-backward/#.VYMtgflViko>. Reprinted with the permission of the Minnesota Budget Project.

amount of blame, the lowering of taxes brings, if not praise, at least a measure of gratitude. Interest groups may hire lobbyists to help deflect taxation onto others, or they may contribute to election campaigns to promote candidates who will protect them from tax increases. Groups seeking protection from taxation try to influence the choice of which taxes to use and the definition of taxable wealth; they also try to secure exceptions for themselves from broad-based taxes.

The acceptability of taxation is at least in part a function of where the burden falls. The choices revolve around which taxes to rely on more heavily and what exceptions to broad-based taxes are granted.

Different Revenue Sources Hit Different Groups Differently

Part of revenue politics involves pressure to adopt or increase reliance on tax sources that burden others more than oneself. The major sources of revenue currently in use are income and wage taxes, sales taxes of various sorts, tariffs, property taxes, and user fees. Each works differently and affects the population differently.

Income and Wage Taxes. Income taxes are taxes paid on different forms of income, including wages and income from investments. They are paid by almost everyone who lives in a jurisdiction regardless of where they work or how they derive their income. Income taxes may burden the rich more heavily than the poor, or they can tax everyone the same percentage regardless of income. Sometimes they actually tax the rich at lower rates than the poor. Wage taxes are taxes only on *earned* income from work, not on all income regardless of source, and they tax those who earn their income in a jurisdiction, whether they live there or not. Wage taxes are one way of taxing outsiders: commuters to a city who work there but live and vote elsewhere.

Sales Taxes. Sales taxes are taxes paid when people or businesses buy something, usually (but not always) a finished product. Retailers who collect the tax have extra work to do, and because the price with tax is higher than without tax or with lower taxes, they may lose some customers. Consumers are the most directly affected, but they pay sales taxes in small, almost invisible amounts during the year, so they tend not to mind them too much. Sales taxes are not closely linked to ability to pay; they often fall more heavily on the poor than the wealthy because the poor spend a larger proportion of their incomes on taxable items.

Tariffs. Tariffs are fees that foreign producers pay to be allowed to market their goods in this country. Tariffs protect domestic industries from foreign competition by raising the price of imported products, but they also raise prices for consumers. Tariffs are ultimately paid by the consumer, without regard to ability to pay. Tariffs are levied only by the national government.

Property Taxes. Property taxes are levied on a proportion of the worth or sales value of property people own. This may be personal property (for example, cars or horses) or real estate (land and buildings). Property taxes on real estate are loosely related to ability to pay, because wealthier persons are likely to own more expensive homes, but the relationship is not tight. Older people on fixed incomes may find property taxes rising because the value of their homes is increasing over time. A business may own expensive property and equipment but not be making much income on it proportional to the value of the property. Owners of rental property typically pass the tax on to their tenants, who usually have less income than the owners.

User Fees. User fees produce revenue when citizens pay in proportion to how much they use a service. For example, you may pay a fee each time you use a public golf

course or swimming pool, and you typically pay per gallon for water you use. User fees have the advantage of allowing those who pay to select only the services they want and not to use them and not pay if the cost is too high. But they have several disadvantages as well. First, they often have little to do with ability to pay. And second, others who are not currently using the services directly, and hence not paying for them, may benefit indirectly. Because indirect users are not sharing the cost with the direct users, the direct users have to pay the entire price. As a result, the price may be too high to be affordable by many would-be service users.

Business groups often prefer sales taxes on consumers and oppose income taxes, especially those levied on corporate income. Labor groups usually favor income taxes, but as wages have risen, labor rank and file have become more reluctant to support high individual income taxes and are more supportive of higher corporate income taxes. Many groups support user fees, because they seem to be both fair and voluntaristic. Those who favor smaller government tend to favor user fees.

Because different forms of taxation affect different kinds of wealth, and the regions of the United States depend on different kinds of wealth, the politics of taxation has historically had a strong regional cast. Until the late 1930s, "the Northeast favored first tariffs (which protected their industrial goods) and excise, license and land taxes if needed; the South and West resisted all these taxes, whose impact fell disproportionately on them, and favored taxes on income and wealth, of which they had little."⁷

When they have power and face budget gaps, many Democrats favor increasing taxes rather than cutting services; when they raise taxes, they prefer to increase the burden on the rich and businesses. When Republicans are in power, many prefer to reduce taxes, especially for high earners and businesses, and close budget gaps primarily by cutting services and programs.

As a result of these partisan preferences, sometimes elected officials shift the burden of taxation up or down by raising or lowering income taxes, which typically fall more on the wealthy, and by raising and lowering sales taxes, which fall more on the poor. As described above, Governor Dayton in Minnesota, a Democrat, raised the income tax on top earners when he had Democratic majorities in both houses; Bobby Jindal, a Republican governor in Louisiana, cut the income tax, benefiting the wealthy, and raised the sales tax on cigarettes, which burdens the poor disproportionately. In the past few years, other states have also experienced major shifts in the burden of taxation. Ohio, North Carolina, and Kansas fall into the camp of reducing burdens on richer people and businesses; Delaware and California fall in the opposite camp, increasing the tax burden on the wealthy.

Ohio reduced personal income taxes while increasing the sales tax. North Carolina changed from a graduated income tax, which asks richer people to pay a larger proportion of their income than the poor, to a proportional income tax that asks everyone, rich or poor, to pay the same percentage of their income; the state also increased the sales tax on electricity and is phasing in a dramatic reduction in corporate income tax rates. Until forced to raise taxes by persistent failure of revenue to meet expectations and pressed by a long running dispute with the courts over school funding, Kansas continued to reduce its income tax rate. When the state had to raise revenue, the governor and legislators raised the sales tax rate. On the other side of the ledger, Delaware increased the top rate of its personal income tax. California in 2012 raised its income tax substantially for upper income earners. Proposition 30 was a citizen initiative passed by the voters, to amend the constitution. The purpose was to fund education and local public safety. It was also a temporary tax, to last seven years. At the same time, the voters passed an increase in the sales tax .25 percent, for four years.

Tax Breaks

Tax breaks are exceptions from the structure of a tax. If a sales tax applies to all goods purchased (the structure), but a law is passed that exempts bull semen (the example is real), that omission is an example of a tax break. In addition to exemptions, some tax breaks are phrased as tax credits, amounts deducted from taxes otherwise owed. Preferential rates for some purposes may also be classified as a tax break, though some consider such preferences part of the tax structure rather than an exception to it. What counts as a tax break is controversial; estimates of losses because of tax breaks vary widely.

At the federal level, the Department of Treasury and the Office of Management and Budget keep track of tax breaks for the executive branch; the Joint Committee on Taxation does the same for Congress. Different states use different definitions of tax breaks, though most now have some kind of reporting. By contrast, until recently, local governments seldom reported their tax breaks. New accounting standards may make local tax breaks more visible going forward. Although estimates of revenue losses due to tax breaks are rough, the amounts are substantial. For the federal level, estimates for 2015 range from \$1.3 to 1.5 trillion annually.⁸ Studies using data from 2004 estimated the cost of state and local tax incentives to stimulate business growth at fifty billion a year, with another twenty billion in tax breaks not related to economic development.⁹ A more recent estimate put the figure for business subsidies alone from state and local governments at more than \$80 billion, and that was considered a low estimate.¹⁰

increasing the sales tax. North
which asks richer people to pay
to a proportional income tax
percentage of their income; the
is phasing in a dramatic
to raise taxes by persistent
by a long running dispute
to reduce its income tax
and legislators raised the
increased the top rate of
income tax substantially for
initiative passed by the vot-
to fund education and local
years. At the same time,
for four years.

tax. If a sales tax applies to
that exempts bull semen
of a tax break. In addition to
amounts deducted from
may also be classified
part of the tax structure
break is controversial; esti-

as the Office of Management
mach; the Joint Committee
use different definitions
reporting. By contrast, until
breaks. New accounting
forward. Although esti-
amounts are substantial.
to 1.5 trillion annually.⁸
and local tax incentives
another twenty billion in
recent estimate put the
governments at more than

Tax breaks may be granted for policy purposes, to gain some public benefit—in the same way that direct expenditures are aimed at achieving some policy goal—or they may be granted because groups or individuals ask for them and elected officials want their support at election time. In the extreme case, an elected official may grant a tax break and expect (and receive) a campaign contribution in return. Such transactions are a form of corruption.

Tax breaks, sometimes called *tax expenditures* to emphasize the parallels to direct expenditures, often work like entitlement spending, that is, anyone who qualifies and applies for the tax break can get it. The cost to government is indeterminate, difficult to budget for, and may grow over time. Other tax breaks are either capped at a certain budgetary total or may be project specific. Project-specific tax breaks more often occur at the state and local level, though states and cities may also offer entitlement type tax breaks. The budgetary costs and implications vary depending on the mix—from all entitlement on one end to all project based on the other.

Narrow tax breaks, for a specific industry or even a single company, tend to broaden over time, as others use the same justification to make their claim to a tax break. A generous tax break for the oil industry was gradually extended to include other raw materials that, like oil, can be used up (this break is called a *depletion allowance*). Because of the way the tax break was worded, it came to include gravel, which is not in short supply and not a pillar of the economy, but the gravel in any individual quarry might be used up, and so gravel qualifies for a generous tax break. The process of expanding a tax break over time from the original purpose, which may have made sense, to others that seem to serve no public purpose, is also illustrated in a tax deferral called *like-kind exchange*. There is a special federal tax break that allows art collectors to defer some of their tax payments. This break was initially aimed at farmers in the 1920s who wanted to swap property and then was expanded to real estate investors selling one property and buying another. Now it is used by high-end art collectors who want to sell one expensive work of art and buy a different one.

Tax breaks have some positive characteristics. First, they gain credit for elected officials, without the political risk of raising taxes. They function like direct expenditures for specific constituencies or supporters and hence are extremely tempting.

Second, tax breaks may be more efficient than lowering overall business taxes (to improve business climate), because they can be targeted to specific industries, businesses, or projects that may have higher payoff and can be designed to ensure the creation of public benefits. For example, a tax break may be given over a period of years, as new jobs are created. If the jobs are not forthcoming, the government may withdraw the tax break. Or tax breaks may be given to companies that pay

employees a living wage and provide health insurance, which lowers the costs to the public of provision of Medicaid to the poor. By contrast, a broadly lower business tax benefits those who create jobs as well as those who do not, those who pay a living wage and those who do not. Its ability to serve as an incentive for providing a public benefit is therefore close to zero.

Third, tax expenditures of various sorts can be used to offset inequitable burdens imposed by the tax structure. *Regressive* taxes, like sales taxes, which fall more heavily on the poor, are often easier to pass than taxes that are more *progressive*, that fall disproportionately on the rich. Sales taxes can be made less burdensome on the poor by exempting food and medicine. Property taxes, also somewhat regressive, can be modified by adopting so-called circuit breakers, which grant people with low incomes a break on their property tax bills.

Tax breaks also have some less desirable characteristics. Money that is not collected is less visible than money that is collected, counted, reported, and budgeted. The names of recipients of tax breaks are sometimes withheld from public scrutiny, allowing breaks for political supporters or campaign donors and making it impossible to see if the public has received promised benefits. Tax breaks typically do not get the same level of scrutiny as direct expenditures (see the minicases on Wisconsin and Illinois for examples of wasteful tax breaks) and, equally serious, normally are not compared with direct expenditures in budget deliberations. Budget deliberations on direct expenditures take place after tax breaks have been subtracted from the available revenue totals. They thus weaken one of the major functions of good budgeting, prioritization according to need or urgency and public purpose. They take some spending out of competition and protect it. Sometimes tax breaks are not only given priority in the budget but are not offset by any revenue source, forcing cuts in other programs or increases in borrowing.

Minicase: Wisconsin and Unexamined Tax Breaks

Wisconsin subsidized Kohl's department stores, a local company, with the goal of retaining existing jobs, creating new ones, and encouraging investment. In 2012, tax credits were granted for up to \$62.5 million, in exchange for Kohl's promise that it would create three thousand new jobs and invest \$250 million to construct a new headquarters building. The deal included financial incentives for retaining existing jobs as well as tax reductions for the creation of new jobs. Only a small proportion of the promised jobs had been created by 2015, and instead of building a new headquarters, the company refurbished a purchased building.

which lowers the costs to
 contrast, a broadly lower busi-
 ness who do not, those who pay
 as an incentive for provid-

to offset inequitable bur-
 den sales taxes, which fall
 on businesses that are more *progres-*
 sive can be made less burden-
 some property taxes, also somewhat
 regressive breakers, which grant

Money that is not
 reported, and bud-
 get withheld from public
 donors and mak-
 ing benefits. Tax breaks
 expenditures (see the
 tax breaks) and,
 expenditures in budget
 take place after tax
 cuts. They thus weaken
 according to need
 out of competition
 priority in the budget
 in other programs or

company, with the
 encouraging invest-
 ment, in exchange
 new jobs and invest
 ment. The deal included
 reductions for the
 jobs had been
 the company

The incentives were worded in such a way that even if the company did not comply with expectations, it would still receive tax breaks. Thus the company was required to retain at least 3,783 jobs, while its current level of employment was reported at 4,500. The company could thus fire employees or outsource jobs and still get a tax reduction for retention of jobs. Also, the company got tax credits for creating new jobs, even if those jobs disappeared after a year. While theoretically the state could "claw back" tax credits that had not been earned, there was no procedure for doing so. The agency giving out these tax credits, created by governor Scott Walker in 2011, awarded such breaks to Kohl's and twenty-three other companies without formal scrutiny. The requirements for tax credits have been tightened up since these original benefits were awarded.

Source: Dee J. Hall and Tara Golshan, "Scott Walker's Untold Story: Jobs Lacking After Big State Subsidy of Kohl's Stores," *Wisconsin Watch.Org*, September 20, 2015, <http://wisconsinwatch.org/2015/09/scott-walkers-untold-story-jobs-lacking-after-big-state-subsidy-of-kohls-stores/>.

Minicase: Illinois and the Role of the Press

Like Wisconsin, Illinois had a large tax break program for businesses. The depth of Illinois's fiscal problems and long-running budget stalemate focused new attention on this tax incentive program. Designed to ensure that the state retained and added jobs and investment, the program had a number of serious weaknesses, but no action was taken to redesign the program until the *Chicago Tribune* did an investigative report on the recipients of tax breaks and the outcomes of these incentives. The report discovered that not only did the program pay for job retention as well as job creation, but companies that added jobs in one location and cut even more in another location still got tax breaks for the ones they added. To make matters worse, the program was not transparent, providing public information on job creation only for several years, after which, if the company reduced employment, the public could not find out.

When the extent of the corporate welfare (a term the governor used) was revealed, the governor changed the program to eliminate tax breaks for companies that increased jobs in one place and reduced them elsewhere and to eliminate the breaks for job retention and keep them only for job creation and investment. He had frozen new applications when he first took office, but with these changes he reopened the program to new applications and unfroze existing applications.

(Continued)

(Continued)

The governor planned to restore the film subsidy, one of the most expensive and least effective subsidy programs. Thus he seemed to be responding only to the specifics of the Tribune's investigative report rather than trying to make the tax break program more cost effective for the state. It was only the relative invisibility of the corporate tax breaks that allowed these expensive subsidies to continue; once brought to light, they were curtailed.

The governor then proposed a public private partnership to award tax breaks to businesses. The new organization would not be subject to freedom of information requirements, allowing it to operate more or less in the dark. When the speaker of the house proposed that the arrangement be evaluated after three years to assure that tax dollars were spent wisely, the governor opposed the legislation.

Source: Ray Long and Michael J. Berens, "Gov. Rauner Ends Tax Break for Firms That Add Jobs in One Place, Cut in Another," *Chicago Tribune*, November 11, 2015, <http://www.chicagotribune.com/news/watchdog/ct-rauner-edge-changes-met-20151111-story.html>. Rich Miller, "Madigan Forms New Committee to 'Study' Rauner's New Economic Development Agency," *Capitol Fax*, February 24, 2016, <http://capitolfax.com/2016/02/24/madigan-forms-new-committee-to-study-rauners-new-economic-development-agency/>.

Tax breaks erode the tax base, meaning that rates for everyone have to rise to obtain the same amount of revenue on a narrower base. Another problem is these tax breaks often result in two similar taxpayers paying different amounts of taxes, which not only makes the tax system famously complicated (and has created an industry of accountants to help people minimize their tax bills) but also inequitable, as those with accountants to show them the possibilities pay less than those who do not know about tax breaks. Tax breaks for a new business coming into a city or state may put the existing businesses at a disadvantage.

At the national level, tax breaks for the federal income tax are often skewed toward the wealthy. Because the federal income tax is progressive, with higher rates on higher incomes, tax breaks are worth more to those who have greater incomes. Fifty-one percent of the benefits of the tax expenditures go to the top 20 percent of earners.¹¹

While some tax breaks are aimed at encouraging desired behavior, such as owning a home or carrying health insurance, some have few if any benefits for the public at large. The minicase on hedge fund managers on p. 53 illustrates both the bias toward the rich and the lack of policy thrust of some federal tax breaks.

one of the most expensive seemed to be responding to support rather than trying to fix the state. It was only the that allowed these expensive were curtailed.

partnership to award tax not be subject to freedom more or less in the dark. arrangement be evaluated spent wisely, the governor

State Tax Break for Firms
 November 11, 2015,
 changes-met
 Committee to 'Study'
 February 24, 2016,
 committee-to-study

everyone have to rise to Another problem is these different amounts of taxes, (and has created an tax bills) but also inequities pay less than those new business coming into a advantage.

tax are often skewed progressive, with higher those who have greater expenditures go to the top 20

desired behavior, such as few if any benefits for the p. 53 illustrates both the federal tax breaks.

Minicase: Tax Breaks for Hedge Fund Managers

The carried interest tax break is a federal tax expenditure for hedge fund managers who run particular types of investment funds, often including risky investments and investment strategies for sophisticated and wealthy investors. For 2014, the income of hedge fund managers over \$406,750 was taxed at 20 percent instead of the 39.6 percent they would have had to pay if they earned the same amount in a different job. The top twenty-five hedge fund managers earned \$11.62 billion in 2014. They saved \$2.2 billion on their tax bills because of this break. The social or economic good to be achieved by this break is unclear. Some have argued that the carried interest tax deduction has no economic rationale. "With most other tax breaks there is at least an argument as to how it serves some socially useful purpose. That is not the case with the hedge fund managers' tax break."¹ Commentators speculate that one reason for this tax break is that the hedge fund managers have good lobbyists. Another possibility is that these wealthy investment managers contribute heavily to political campaigns and so win legislators' support for their requests. In 2014 campaigns, the hedge fund industry contributed over \$50 million to congressional candidates.² (See Table 2.1 on p. 54.)

1. Dean Baker, "The Hedge Fund Managers Tax Break: Because Wall Streeters Want Your Money," *Center for Economic Policy and Research*, April 14, 2014, <http://www.cepr.net/publications/op-eds-columns/the-hedge-fund-managers-tax-break-because-wall-streeters-want-your-money>.
2. Scott Klinger, "Meet the 25 Hedge Fund Managers Whose \$2.2 Billion Tax Break Could Pay for 50,000 Highway Construction Jobs," *Center for Effective Government*, May 21, 2015, <http://foreffectivegov.org/blog/meet-25-hedge-fund-managers-whose-22-billion-tax-break-could-pay-50000-highway-construction-job>.

Tax breaks are difficult to eliminate, in part because, like entitlements, they are built into people's lives and businesses and people are unwilling to give them up. The no-tax-increase pledgers define the reduction or elimination of tax breaks as a tax increase, which makes it even more difficult to rescind them. Tax breaks are also hard to remove because many of them were demanded by lobby groups, who continue to defend them. Even when tax breaks are shown to be ineffective and budget gaps threaten, it is difficult to reduce or eliminate them. Efforts to eliminate even the most ineffective of tax breaks may take years, as the minicase on California and its enterprise zones on p. 55 indicates.

TABLE 2.1 Hedge Funds: Long-Term Contribution Trends

Election Cycle	Total Contributions	Contributions From Individuals	Contributions From PACs	Soft/Outside Money	Donations to Democrats	Donations to Republicans	% to Dems	% to Repubs
2016	\$220,500	\$168,500	\$0	\$52,000	\$250	\$168,250	0%	100%
2014	\$50,833,908	\$13,959,307	\$312,500	\$36,562,101	\$4,398,245	\$9,862,162	31%	69%
2012	\$45,432,676	\$17,581,101	\$281,500	\$27,570,075	\$4,220,813	\$13,617,288	24%	76%
2010	\$14,031,544	\$12,425,044	\$407,500	\$1,199,000	\$5,992,462	\$6,784,882	47%	53%
2008	\$20,159,156	\$19,932,156	\$227,000	\$0	\$13,436,062	\$6,675,117	67%	33%
2006	\$6,047,951	\$5,879,851	\$168,100	\$0	\$4,334,656	\$1,461,845	72%	24%
2004	\$5,097,706	\$5,029,406	\$68,300	\$0	\$3,142,255	\$1,953,951	62%	38%
2002	\$4,650,364	\$1,140,604	\$6,500	\$3,503,260	\$3,124,653	\$1,524,711	67%	33%
2000	\$3,160,490	\$1,213,298	\$14,000	\$1,933,192	\$2,182,138	\$976,102	69%	31%
1998	\$1,908,892	\$598,392	\$7,500	\$1,303,000	\$1,101,242	\$765,150	58%	40%
1996	\$2,185,454	\$744,854	\$0	\$1,440,600	\$1,112,974	\$1,072,480	51%	49%
1994	\$811,799	\$329,929	\$0	\$481,870	\$273,600	\$537,199	34%	66%
1992	\$742,390	\$382,900	\$0	\$359,490	\$636,300	\$106,090	86%	14%
1990	\$128,450	\$128,450	\$0	\$0	\$107,950	\$20,500	84%	16%
Total	\$155,411,280	\$79,513,792	\$1,492,900	\$74,404,588	\$44,063,600	\$45,525,727	49%	51%

1992	\$74,411,280	\$128,450	\$3,112,900	\$0	\$0	\$3,519,490	\$636,300	\$106,090	\$20,500	84%	16%
1990	\$155,411,280	\$128,450	\$79,513,792	\$1,492,900	\$74,404,588	\$44,063,600	\$45,525,727			49%	51%
Total											

Source: Center for Responsive Politics, <https://www.opensecrets.org/industries/totals.php?cycle=2014&ind=F2700>.

Minicase: California and Enterprise Zone Tax Breaks

California had an Enterprise Zone (EZ) Tax Credit Program, providing tax breaks for businesses that located in designated places with concentrations of the poor and unemployed. To lure companies to those less-than-desirable locations and encourage them to hire the poor and unemployed, the state granted the companies tax breaks, including state income tax credits, property tax abatements, utility tax exemptions, sales and use tax credits, and interest deductions. The state also offered a tax credit for new jobs created.

Many analysts viewed California's program as badly designed and ineffective. The success of Enterprise Zones varied from zone to zone, but little selectivity was used in awarding areas EZ status, and ineffective zones were allowed to persist. Two major studies years apart concluded that the zones did not have a significant effect on business creation or employment growth rates, shifting jobs around the state rather than creating new ones.¹ Even program advocates acknowledged that only a small proportion of businesses locating in enterprise zones even applied for the tax credit, suggesting that the credit played little role in encouraging businesses to locate in poverty areas.² The program was not only ineffective, it was also expensive, costing hundreds of millions of dollars a year.³

The governor called for the elimination the ineffective tax break program in an effort to save money during a severe budget crunch. In the face of opposition to elimination of the zones, he revised his proposals to retain the zones but required evidence of new job creation rather than rewarding businesses for decisions they had already made. However, the budget passed in June of 2011 without a vote up or down on the Enterprise Zone Program. As a substantive tax change, it would have required a two-thirds majority to pass. The supermajority requirement was intended to make it more difficult for the state to increase taxes, but in this case, made it more difficult to eliminate wasteful spending.

In response to legislative inaction, the governor proposed a study of regulatory changes that could be made to the program in the executive branch and in the interim, stonewalled the granting of EZ status for new applications. Those that had been conditionally approved were frozen at that level.

It took another two years before the legislature terminated the program and then only with the creation of some new tax expenditures.⁴ The case of the California Enterprise Zones provides testimony to the difficulty of eliminating tax breaks.

1. Jed Kolko and David Newmark, "Do California's Zones Create Jobs?" *Public Policy Institute of California*, June 2009, 14-15; Legislative Analyst's Office, *An*

(Continued)

(Continued)

- Overview of California's Enterprise Zone Hiring Credit*, December 2003, www.lao.ca.gov/2003/ent_zones/ezones_1203.pdf.
2. CLC Tax Credits, "CA Enterprise Zone," www.clctaxcredits.com/ca-enterprise-zone.
 3. Alissa Anderson, "California's Enterprise Zone Program: No Bang for the Buck," California Budget Project, February 2011, 3, www.cbp.org/pdfs/2011/110207_Enterprise_%20Zones.pdf.
 4. "Out With California Enterprise Zones, In With the New California Hiring Credit and Sales Tax Exemption," *A&M*, October 23, 2013, <http://www.alvarezandmarsal.com/out-california-enterprise-zones-new-california-hiring-credit-and-sales-tax-exemption>.

State and Local Business Tax Incentives

No one knows exactly how much state and local governments spend on incentives for business location and growth. The Accounting Standards Board for state and local governments recently added a requirement that state and local governments report their tax abatements, but data are not yet available. No one knows whether business tax incentives are effective, because no one can tell you what would have happened in the absence of the tax breaks. Some of the projects subsidized by state and local governments probably would have succeeded without taxpayer help, but no one knows what portion of the positive outcomes to attribute to the break. The fact that no one knows—or can know—how well the incentives work makes the frequent use of business tax incentives puzzling.

Tax incentives to new or existing businesses seldom pay for themselves, forcing deeper cuts in basic services or tax shifting to individuals and homeowners. Moreover, they attract footloose industries that are likely to pick up and move when they get a better offer. Nevertheless, even in hard times, states have continued to grant such incentives. Supporters of these transfers argue that if we don't offer them, the businesses will go to other states that do offer them. Politicians running for office would be vulnerable to attacks from opponents if they failed to win bidding wars. One result has been a proliferation of incentives.

These tax incentives can take a variety of forms, including tax sharing, in which a unit of government lures a commercial site to the state or community, promising to share any new taxes generated by the business with the business itself. This arrangement seems free to the elected officials, because if the business did not locate there, there would be no taxes at all. Of course the business should

have good economic reasons to locate there anyway, in which case the government would be entitled to all the revenue, not just a part of it, but this counterargument is often ineffective.

One of the oddest and least well-known subsidies to business occurs when states allow particular businesses to keep some of the state taxes they withhold from employee paychecks. The employees pay their taxes, records are kept indicating they have paid this total, but the business gets to keep some or all of the taxes—it never goes to the government to pay for roads or education or police or unpaid bills. The employees are generally unaware that part of their paycheck is going to subsidize the company. Sometimes states offer businesses their employees' tax withholding funds against future tax liabilities. The businesses' employees are thus paying the businesses' taxes due to the state.

Illinois is one of the states that passed such legislation (Pub. L. No. 97-0002). Originally intended to help the automotive industry (Ford in 2007, and Chrysler and Mitsubishi in the depths of the recession in 2009), the law was later expanded to other businesses that threatened to leave the state or promised major new capital investment. Such businesses could keep up to half the amount of withheld taxes for retained jobs and up to 100 percent for new jobs created. All these companies had to do to reduce their tax liability was threaten to leave the state and take jobs with them. One of the companies that received the special tax incentive was Motorola, which proceeded to lay off 1,400 employees, but the company was still "eligible to keep \$22.6 million of its employees' taxes."¹²

Seventeen states had such programs as of August 2015. A 2012 estimate of the costs based on sixteen states (Oklahoma was not included in these estimates; its program cost \$11 million in 2014) was \$685 million a year.¹³ The recession and state financial problems seemed to encourage this form of subsidy to businesses, in the desperate hope of retaining or creating new jobs. The state that used this tool the most, New Jersey, as of December 2014, had diverted \$1.5 billion from employee withholding, and the diversion program still had many obligations for the future, though the program was no longer accepting new applications.¹⁴ Many of these programs do not result in new jobs but either subsidize a move from one state to another or pay (bribe?) a company not to move out of state.¹⁵ The minicase of North Carolina (p. 58) explains why the state offered businesses large tax breaks and makes the point that businesses that need to close or leave a state for economic reasons will do so regardless of any subsidy they have received.

Why do public officials offer business tax breaks rather than allowing the market to determine the location of firms? One possibility is that elected officials believe these incentives are effective, even without evidence. Perhaps they accept

the results of studies that exaggerate the benefits. Or perhaps they believe that such tax breaks will pay for themselves, that they are in essence free. Elected officials also seem to respond to threats to leave the state or city if particular businesses do not get the tax break they demand. For some elected officials, such tax breaks may be a way of giving something to a constituent who asks for it, while the actual costs are often obscured or at least kept out of the public eye. Finally, the excitement of deal making and the occasional big wins create experiential learning that is hard to challenge.

Minicase: North Carolina and Business Tax Breaks

North Carolina has good transportation, good schools, universities, and research centers, and an attractive location on the East Coast. The state has no reason to offer tax breaks to overcome locational disadvantages. But then BMW built its plant in South Carolina and Mercedes Benz chose Alabama, largely on the basis of hundreds of millions of dollars of state incentives. North Carolina officials, frustrated, bought into the policy of competing by granting bigger subsidies. They offered tax breaks to FedEx, which decided to locate in the state, cementing the association between tax incentives and success.

State officials offered a huge tax incentive package to Dell Corporation, which subsequently located in North Carolina, but the company closed its facilities within a few years, laying off its staff. While the local governments were able to claw back much of their investment, the governor had given the legislature a non-negotiable package to vote up or down, which omitted major claw-back features. As a result, the state simply lost its investment.

Companies respond to market forces and will open, close, expand, or move in response to those forces, regardless of state tax breaks. Lack of claw-back provisions or reluctance to invoke them exacerbates public losses.

Source: Paul B. Johnson, "NC Becomes Reluctant Player in Incentives Game," *High Point Enterprise*, October 16, 2011, www.hpe.com/view/full_story/16069769/article-NC-becomes-reluctant-player-in-incentives-game?

There is another possible explanation. In the face of stagnating economies because of recession and globalization, some decision makers have become desperate. They are unwilling to give up policies of subsidizing business, because these policies create the *appearance* of doing something to help. As an illustration, cities in North Carolina during the Great Recession began to change the way they

used incentives, adding small business and retail outlets to the list of candidates eligible for public funds. Small businesses have minimal impact on the economy, and retail outlets choose their locations on the basis of market demand. The fact that location decisions for retail outlets seldom depend on government incentives was apparently beside the point. At least they were doing something, even if that something wasn't likely to be effective.¹⁶

Business tax incentives may have some positive impact, but the increase in revenue to government from successful incentives does not typically cover the outlays to pay for business tax incentives. While one can argue that the overall social good to come from them outweighs these losses, one ought not argue that tax breaks to business are a good way to get out of a deficit situation. Because state budgets have to balance, expenditures for business tax breaks have to be offset by additional service reductions or increased taxes somewhere else.

A study of Michigan's MEGA program to subsidize businesses found an overall positive benefit but noted that the subsidy accounted for the success in something like 8 percent of the cases where it was used. Most of the business successes that occurred would have occurred without the tax break. And MEGA did not pay for itself, as the projects tended to pay for only about two-thirds of the cost; the rest had to be picked up by deeper service cuts or increased taxation. Finally, the cost per job created was \$4,000 per job year. That means for a new job that lasted ten years, the cost of the subsidy would be \$40,000.¹⁷

When companies get states or local governments to bid against each other to see who can offer the largest subsidy and lure a business away from another state or city, the costs to the winner can outstrip the benefits. In a recent case, Tesla cost Nevada up to \$200,000 per job created.¹⁸ If the number of jobs created or retained increases, the cost per job goes down to a more reasonable level, and if the quality of the job goes up—that is, if it carries health insurance and provides enough money to live on—the benefits to the society increase. The number and the quality of jobs produced are critical to ensuring that such programs on balance produce more benefit than costs. In fact, many states in recent years have improved their programs to monitor the number of jobs produced or designed their programs so that subsidies are paid only if the promised jobs are actually produced. Some states have added requirements that the jobs produce what is called a *living wage*, that is, good jobs with benefits, jobs that will keep people out of poverty and off welfare and Medicaid rolls. In addition, some have added claw-back provisions, requiring that companies that fail to meet the requirements of the aid give back the benefits they have received.

Against this logical set of requirements is the logic or illogic that says, we have to offer this tax break, because others do, and if we don't, we will lose the business.

Or perhaps they believe that they are in essence free. Elected state or city officials, such tax incentives who asks for it, while of the public eye. Finally, big wins create experiential

schools, universities, and the East Coast. The state has disadvantages. But then Benz chose Alabama, a policy of competing by FedEx, which decided between tax incentives and

to Dell Corporation, the company closed its the local governments the governor had given the down, which omitted lost its investment. open, close, expand, or breaks. Lack of claw-backs public losses.

"Incentives Game," *High*
story/16069769/article

of stagnating economies makers have become des- izing business, because help. As an illustration, to change the way they

When nearly all states offer the same benefits so that no state gets an advantage from them, the logic shifts to offering larger targeted tax breaks and doing so more quickly than rivals. The prime example of this logic in recent years has been subsidies for making movies in a given city or state. In 2002, only five states offered movie tax incentives; by 2010, forty-four states did.¹⁹

The movie industry produces few new jobs, and those that are created last at most a year or two. The cost per job created is often high. According to the Massachusetts Department of Revenue, the cost to the state per film industry job created during 2006 through 2009 was \$133,055. Louisiana reported in 2005 that it would earn back only 16 to 19 percent of its costs through new revenue, while Massachusetts reported that every dollar of tax credit earned back only fourteen cents.²⁰ These figures suggest that the social benefit from this particular industry subsidy does not outweigh the costs to the public sector, and yet these programs have increased and become more expensive from year to year.²¹

Minicase: Michigan—Terminating Its Film Subsidy

In 2010, Michigan faced an anticipated budget gap of over \$1 billion. Hoping to stimulate an industry other than the struggling automobile industry, it appropriated about \$50 million a year in subsidies to film companies like Disney. The city of Pontiac built a state of the art film studio, hoping to lure the companies subsidized by the state. Acting on reports that film subsidies were not cost effective (the state reportedly got back only eleven cents for each dollar of subsidy, and the program did not create a single permanent job in 2013), Governor Rick Snyder cut back the film subsidy. The film business dried up, and the studio was unable to make the payments on its loans. To complicate matters, former governor Jennifer Granholm had required the state pension fund to guarantee the loan to build the studio, so when the studio failed, the severely underfunded pensions were on the hook to make the payments instead. For the 2015 through 2016 fiscal year budget, the state appropriation for the film credit was to be used mainly to pay off the bond obligation and free the pension fund. In July 2015, the state terminated the subsidy.

Predictably, film industry advocates vociferously protested the cuts, but there was also support for terminating this tax subsidy. A spokesperson from the national federation of independent businesses argued that such programs meant that other businesses had to bear the burden of paying for the film subsidy. Also against the subsidy were legislators hearing from constituents that the top priority was roads and transportation. The subsidy was draining funds from badly needed projects.

that no state gets an advantage from targeted tax breaks and doing so in this logic in recent years has been the state. In 2002, only five states did.¹⁹

and those that are created last at are often high. According to the to the state per film industry job Louisiana reported in 2005 that through new revenue, while credit earned back only fourteen from this particular industry sector, and yet these programs year to year.²¹

Film Subsidy

equal over \$1 billion. Hoping the automobile industry, it to film companies like film studio, hoping to lure the that film subsidies were seven cents for each dollar permanent job in 2013), The film business dried up, on its loans. To complicate required the state pension when the studio failed, the to make the payments the state appropriation bond obligation and free the subsidy.

protested the cuts, but A spokesperson from argued that such programs of paying for the film from constituents The subsidy was draining

Industries like the film industry that respond to incentives are "footloose," that is, they do not have sunk costs in any geographic location and will move to seek the highest bidder, playing off one state against another and pushing up the costs of this subsidy from year to year. Someone has to pay for such subsidies, which is especially difficult when states are in fiscal stress and do not have the funds to pay the costs of basic services.

Sources: Kathleen Gray and Julie Hinds, "Senate Panel Votes to Kill Mich. Film Office, Incentives," *Detroit Free Press*, June 10, 2015, <http://www.freep.com/story/news/politics/2015/06/09/bill-end-film-incentives-funding-film-office-oct/28742183/>; Kathleen Gray, "House Panel Votes to End Michigan Film Incentives," *Detroit Free Press*, March 4, 2015, <http://www.freep.com/story/news/politics/2015/03/04/film-incentives-end-oct-bill-house/24360757/>; Joseph Henchman, "Michigan-Subsidized Film Studio Fails; State Pension Fund Had Guaranteed Loan," *The Tax Foundation*, January 27, 2012, <http://taxfoundation.org/blog/michigan-subsidized-film-studio-fails-state-pension-fund-had-guaranteed-loan>; *The Wall Street Journal*, "Film Subsidies: Exit Stage Right," March 17, 2015, <http://www.wsj.com/articles/film-subsidies-exit-stage-right-1426634855>.

During the Great Recession that began in late 2007, many states encountered financial problems. One response was to begin to review their tax expenditures. A number of states singled out their film subsidy for reduction or elimination, because of the subsidy's lack of effectiveness and expense. Arizona, Kansas, Iowa, and New Jersey suspended theirs. Washington state failed to renew its film tax reduction program. Idaho, Arkansas, and Maine appropriated no money for the program for 2011. New Mexico capped its program. Governor Doyle in Wisconsin was able to cut back this break after a negative evaluation of its costs and benefits.

While state and local governments may compete with each other with new or expanded tax breaks, during times of economic hardship, there is also pressure to review existing tax breaks because of the high costs and sometimes dubious public purpose behind them. As of January 2015, seventeen states plus the District of Columbia required some evaluation.²²

It is easier to evaluate tax breaks if you know what they are, how much they cost, and what the purpose is. At the state level, reporting on the number and cost of tax expenditures has become widespread in recent years. By 2014, forty-seven states plus the District of Columbia had some kind of tax expenditure report. Some are published yearly, cover most tax sources, and include realistic estimates of costs, the legislative basis for the tax break, and its purpose and success. Some

even include recommendations for further action. Others are issued only episodically or cover only some tax sources and do not refer to actual tax forms to see how much revenue was lost.

Recent years have witnessed an additional push to adopt and improve regular reporting on tax expenditures, to make them more visible, make their public purposes clearer, and make the effectiveness of the tax breaks clearer. Such reports seem to be a good government reform with few drawbacks, other than the cost of preparation. However, because tax breaks for new businesses may disadvantage existing businesses, they may be controversial within the business community, and because some ineffective tax breaks persist because of interest group support or campaign contributions, they may be embarrassing to elected officials. When expenditures would not be acceptable to the public if known, they are often not clearly presented or easily available. Tax expenditure reporting can become a political hot potato, as illustrated in the case of New Mexico (see the minicase "New Mexico and Tax Expenditure Reporting" below).

Minicase: New Mexico and Tax Expenditure Reporting

In an eye-catching set of events, the New Mexico legislature passed a bill for the third time in 2013 to require the state to prepare a tax expenditure report, only to have the governor veto it. In 2007, Governor Richardson vetoed the measure, arguing that tax expenditure reporting was not an executive responsibility. More recently, governor Susana Martinez vetoed the second attempt to mandate tax expenditure reporting, saying that it was exclusively an executive responsibility. She went on to issue an executive order to list and evaluate tax expenditures in the state on a yearly basis. Some legislators were not content with her mandated report, as it lacked evaluation of the effectiveness of the tax breaks, and so was not a sufficient basis for decision-making. When the legislature passed a requirement for more extensive tax expenditure reporting, Martinez vetoed that too, saying her executive order was sufficient. Legislators in 2014 tried to get some traction for a constitutional amendment, but the proposal died in committee. The governor took complete control of the process, selecting what to reveal and what to deemphasize and was not bound by an evaluation of effectiveness.

Source: Matthew Reichbach, "Gov. Vetoes Tax Expenditure Budget Again," *New Mexico Telegram*, April 5, 2013, <http://www.nmtelegram.com/2013/04/05/gov-vetoes-tax-expenditure-budget-again/>.

eligible for breaks, angering taxpayers and feeding tax limitation movements. The perception that taxes are unfair encourages legal and illegal forms of evasion, pushing up the costs of tax collection and putting added burdens on those who do pay their full taxes.

Mismatch of Economy to Tax System

Sometimes a tax structure is devised during one period of time when the economy has particular characteristics and does not adjust when the economy changes, making it less and less productive. For example, as the economy in the United States has changed from heavy manufacturing to more service industries, some states have found their sales taxes, levied on manufactured goods, capture less and less of the actual economy. Online purchases have also been excluded from taxation, except when the company has a physical presence in a given state or has a relationship with a company in the state. The resulting loss of revenue to state and local governments has been substantial and growing, leading to a variety of reform proposals, including taxation of Internet sales and sales taxes on services.

Tax Unfairness

Many large and profitable corporations pay either no taxes or considerably less than the stated rate for corporate income taxes. A recent study of 265 Fortune 500 companies looked at the amount of state taxes they actually paid compared to what they would have owed if they had paid the full corporate rate. The average rate in the states for corporate income taxes was 6.2 percent in 2008 through 2010, but these companies paid about half that rate. Even more telling, sixty-eight of the companies paid no corporate income taxes at all during that period, despite telling shareholders that they had made \$117 billion in pretax profits during those years.²⁴

The story is similar but even more dramatic at the national level. In 2014, Citizens for Tax Justice looked at Fortune 500 companies that had been consistently profitable between 2008 and 2012. Although the statutory rate was 35 percent, these 288 companies paid an average rate of 19.4 over the five-year period. Twenty-six paid no taxes at all over the five-year period. One hundred eleven of the 288 companies paid zero or less than zero in at least one of the five years, despite earning \$227 billion in the years they paid no taxes. Most startling, twenty-six of the companies paid less than nothing over the five years—they used so many tax credits they more than offset their tax obligations, so that the federal government owed them money.²⁵

Some inequities are built into the tax structure. The basic federal income tax rates are progressive: People with greater incomes are supposed to pay a higher percentage of their income than poorer people. This feature adds an important element of equity to the U.S. tax system, because taxes at the state and local level tend to burden the poor more than the wealthy. However, Social Security taxes are regressive, because Social Security taxes are paid only up to a given dollar limit of income. Dollar limits change from year to year, but in 2015 it was \$118,500. If you earn \$1 million a year, you pay a much smaller percentage of your income for Social Security than someone earning much less.

Moreover, a key feature of the federal income tax has offset the progressivity of the federal income tax for the highest earners, with the result that some wealthy people have paid a lower rate of taxation than people earning much less. The billionaire investor Warren Buffett called attention to this problem by noting that he paid a lower proportion of his income in taxes than his secretary. The reason is that there is a differential rate of taxation depending on the source of people's income: The federal income tax imposes a higher rate of taxation on income from wages than on income from investments. A lower rate applies to both capital gains and dividends, that is, on profits gained from the sale of an investment and on income from shares of the profits of a company. Richer people have a much larger share of their income from investments than poorer people, with the result that the very rich have paid a lower rate of taxation than people with more moderate incomes—such as Warren Buffett's secretary.

The IRS reports on the taxes paid by the country's four hundred top-earning families. In 2012, the top four hundred earners averaged \$336 million income each. Their average tax rate was 16.72%. To put that figure in context, first, the percentage of their income that the superrich paid in taxes dropped from an average of 29.35 percent in 1993 to 16.72 percent in 2012. Second, in 2012, because much of their income comes from investments that were taxed at a lower rate than ordinary income from wages and because many tax breaks applied to them, the top four hundred earners paid a lower rate than ordinary workers. A person earning \$100,000 in 2012 would pay almost 20 percent of his or her income in federal taxes, while the person earning an average of \$336 million would pay less than 17 percent. Generally, the more you earn, the higher percent of your income you pay, but in 2012, that rule did not apply to the very wealthy.

In January of 2013, the income tax rate for those earning more than \$464,850 per year for dividends and long-term capital gains was increased from 15 percent to 20 percent but remained 15 percent for those earning less than \$464,850. In addition, some itemized deductions had less value for higher-income earners. A

surcharge on Medicare for high earners added to the taxes paid by the highest earners. These changes pushed through by the Obama administration resulted in an increase in the percentage of their income that the very, very wealthy paid, to 22.89 percent. That is a substantial increase but still considerably below the rate the very, very wealthy had paid in 1993. Had all the income of the very wealthy been taxed at the rate of ordinary income, they would have paid 39.6 percent of their income in federal income taxes.

The basic structure of the federal income tax remains that income from investments is taxed at lower rates than income from wages, but at present, the very well off are paying more than they had been. How long this will last is unclear, as the very wealthy wield a disproportionate amount of political power, especially after the Supreme Court decision in *Citizens United* in 2010, which has permitted a small number of extremely wealthy individuals to make unlimited contributions to single-candidate super PACs (political action committees). In the future, a Republican majority Congress and a Republican president might well reverse these increases on the very wealthy.

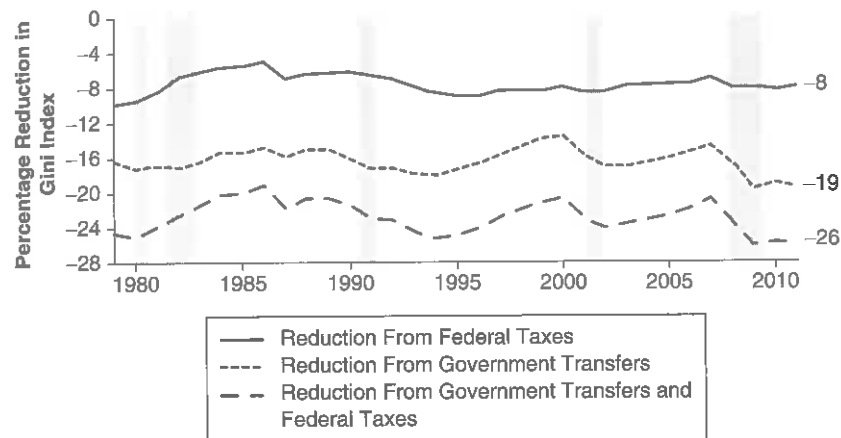
State and local taxes, including excise, sales, income, and property taxes, are regressive; that is, middle income and the poor people pay a higher percent of their income on these taxes than the rich. Data for 2015, from Citizens for Tax Justice, demonstrate the extent to which state and local taxes take a bigger bite from poorer than from richer taxpayers. Those with the lowest incomes paid 12.1 percent of their income on state and local taxes, while those with the highest incomes paid only 8.3 percent of their incomes.²⁶ A second study came up with even more extreme results, concluding that those with the lowest incomes paid on average double what those with the highest incomes paid, 10.9 percent for the lowest income group compared to 5.4 percent for those in the highest income class.²⁷

The Institute on Taxation and Economic Policy updates its study on who pays state and local taxes at regular intervals, so it is possible to see trends. There have been five studies, beginning in 1996. What do these numbers suggest about trends in equity of state and local tax burdens? First, state and local tax burdens remain regressive, burdening the poor more than the well-to-do. Second, the overall burden for *all* taxpayers of state and local governments has been *decreasing*. The rate of decrease has been steeper for the very rich than for the poor or middle income groups. The rich experienced about 31 percent reduction; the poor a bit over 12 percent reduction; the middle about 4 percent. One result is to make an already regressive tax system even more regressive. In 1996, the share of income the bottom 20 percent of earners spent for state and local taxes was 1.63 times larger than the share of income spent by the top 1 percent of earners; in 2015, the poorest paid 1.85 times as much of their income as the top 1 percent.

While state and local taxes are regressive, the federal income tax is generally progressive. Because federal taxes are greater than state and local taxes, when added up, the U.S. tax system is mildly progressive. However, it is not progressive enough to offset the increasing inequality created by the free market. The United States does less to offset market-based inequality than other developed countries.²⁸

The Congressional Budget Office does an annual study on the distribution of income and federal taxes. Based on tax data for the most recent year available, 2011, CBO estimated that federal taxes made income distribution *slightly* more equal. The lowest 20 percent received 5 percent of all income, including transfer payments as income, before taxes and 6 percent after taxes; the 20 percent of the population with the highest incomes received 52 percent of all income before

FIGURE 2.2 Reduction in Income Inequality From Government Transfers and Federal Taxes, 1979 to 2011



Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011," November 2014, <https://www.cbo.gov/publication/49440>, p. 27.

Notes: The Gini index is a measure of income inequality that ranges from zero (the most equal distribution) to one (the least equal distribution). Gini indexes are calculated using income measures adjusted for household size.

Government transfers are cash payments and in-kind benefits from social insurance and other government assistance programs. Those transfers include payments and benefits from federal, state, and local governments.

Federal taxes include individual income taxes, payroll taxes, corporate income taxes, and excise taxes.

taxes and 48 percent after federal taxes. CBO notes that between 1979 and 2011, transfer programs reduced inequality more than taxation did. Transfers accounted for two-thirds of the reduction in inequality observed between market income and after tax income.²⁹

The CBO graphic shows the reduction in inequality due to taxes, due to transfers, and due to both together, over the period of the study. The graph shows clearly that taxes reduced inequality considerably less than transfer payments did but also shows that during the 2008 to 2009 deep recession, transfer payments played an increased role in reducing inequality, while tax policy maintained a constant role. This is what one might expect given the nature of entitlements that increase automatically as need increases.

Tax Complexity

The difficulty of raising taxes and the desire to protect particular groups from increased taxation lead to a multiplicity of revenue sources and a variety of tax breaks, sometimes hundreds of them. Efforts to get support for tax increases often lead to earmarked taxes, which further increase the complexity of the tax system. Richer and more determined individuals and companies hire accountants to get them through the thicket of changing rules. The costs of doing so in time, money, and aggravation create pressure to simplify the tax code, reviewing and eliminating the most wasteful of the tax breaks.

Taxes and the Economy

Ideally, a tax system yields revenue growth when the economy is booming but doesn't fall too far when the economy is shrinking or growing only slowly. To achieve this golden mean requires some more elastic and some less elastic revenue sources—*highly elastic* means grows quickly and drops quickly, *less elastic* is more stable and doesn't change much when the economy changes. States that have highly elastic revenue systems, with income taxes that are dependent on the higher earners, fared poorly during the Great Recession because the stock market fell and these earners suddenly paid much less tax. When tax systems do not respond to cycles of the economy in the optimal fashion, there may be pressure to reform the tax system and increase or decrease the degree of elasticity.

Dynamics of Tax Reform

In general, tax reforms are difficult to achieve. They are relatively easier to accomplish if they are revenue neutral; that is, they do not increase or decrease the overall tax burden. They are also easier to pass if they do not result in a major

shift from one group to another, burdening some at the expense of others. Those who would be negatively affected by the reforms are often organized and represented by dogged lobby groups. Tax reforms do sometimes succeed, but often they do not (see the following minicases of Georgia and Michigan).

Minicase: Georgia Tax Reform Left Hanging

The story of Georgia's failed tax reform effort in 2011 reveals some of the dynamics of tax reforms and how difficult they are to adopt. It is not only that each tax break proposed for elimination has an organized constituency and experienced lobbyists to defend it, but also that the tax overhaul needs to leave the burden of most of the taxpayers as is or reduced in order to gain sufficient public and political support.

In 2011, Georgia was coming off several years of poor growth and deep spending cuts. The state was determined to redesign its tax system to encourage growth and be more reliable during economic downturns. Taxing food for home consumption would provide a more dependable (inelastic) source of revenue during economic downturns, as people need to eat during good times and bad. The state sales tax had many exemptions and included few services. Many of the exemptions in the sales tax were ineffective. No one had shown that the exemptions in the corporate income tax were effective either. A number of state officials, along with the panel of experts assigned to recommend a new tax system, assumed that income taxes were bad for business growth and therefore had to be reduced or eliminated.¹ The major thrust of reform proposals was to shift the burden of taxation away from income taxes onto consumption (sales) taxes. At the same time, any tax reform had to be revenue neutral—the state could not afford further cuts in spending after years of deep cuts, and opposition to any tax increase was intense.

A panel of experts convened to examine the tax system and make recommendations to a joint legislative committee that held public hearings on the proposals. The public, including interest groups, was alerted to the possible elimination of specific tax breaks before legislation was prepared and presented to the legislature.

The panel recommended a broad set of reforms, first flattening the graduated income tax and reducing the rate and then eliminating the tax completely. The reforms would pay for the initial changes by eliminating nearly all exemptions and deductions, including that for food for home consumption, but offsetting the effect with a tax credit for the poor. Both personal and corporate income taxes were to be eliminated. The sales tax was to be extended to many services. Several new tax exemptions were proposed to make the state

(Continued)

(Continued)

more competitive with its neighbors, including the elimination of a tax on energy for manufacturing. The proposals included a shift in the burden of taxation from wealthier to less wealthy people, but also included at least some consideration for equity, including a temporary tax credit for the poor.

The proposals ran into difficulty because the governor opposed taxing food for home consumption, which hit the poor most severely. Difficulty also arose because interest groups actively lobbied to prevent the extension of the sales tax to their services. In the end, only two survived, the private sale of cars outside of dealerships and automobile repair services, neither of which had strong lobbies. But ultimately, the reason that the reform failed was that, although the proposals were almost revenue neutral, some providing a little more or a little less revenue than before, some groups of taxpayers were negatively affected. Studies showed that the very well-to-do would benefit greatly, but that the majority of middle-class taxpayers would pay more under the reforms than before. Republicans who sponsored the tax reforms were unwilling to be seen as responsible for this increase of tax burden before an election.

Many of the same proposals have resurfaced and will be eligible for reconsideration in 2016.

1. It is not clear that this assumption is correct. A recent study comparing high income tax states with no income tax states found that economic growth rates were higher in the high income tax states and that those states generally weathered the recession better than the no income tax states. Institute on Taxation and Economic Policy, "High Rate Income Tax States Are Outperforming No Tax States: Don't Be Fooled by Junk Economics," February 2012, www.itepnet.org/pdf/junkeconomics.pdf.

Source: This case relies heavily on "Revenue and Taxation HB 385 388," *Georgia State University Law Review* 28, no. 1, Article 13, <http://digitalarchive.gsu.edu/gsulr/v0128/iss1/13>. See also, Kelly McCutchen, "Issue Analysis: Analyzing Georgia's Tax Reform Proposal," *Georgia Public Policy Foundation*, March 29, 2011, www.gppf.org/pub/Taxes/LAGATaxreform110328.pdf.

Minicase: Michigan Tax Reform or Class Warfare?

Michigan reduced its taxes on businesses by eliminating tax breaks for the poor and retirees, despite public opposition. Some argued that this was a tax reform, aimed at stimulating the economy of a financially strapped state, but others saw it as class warfare that deepened inequities in the state tax system.

The changes in Michigan were not fully revenue neutral: The reductions in business taxes and the continuation of the credits already granted resulted in over a billion dollars in losses each year, while the increases in income taxes did not cover all the losses. A portion of the Michigan Business Tax revenues that the reforms repealed had been earmarked for education; the education fund losses were not replaced.

The court made the tax reform more regressive. The court ruled taxing pensions legal, but declared the phase-out of tax breaks for the wealthy illegal. The phase-out of the tax break to the wealthy had been necessary to get enough votes to pass the legislation, but that feature was removed after the fact.

Michigan changed its tax structure for the purpose of stimulating business in a state hard hit by recession. However, the specific changes led to charges of class warfare as the government cut funding for public education (K-12 cut by 6 percent, higher education by 15 percent), increased taxes on the elderly and on the poor, reduced welfare payments, cut taxes for businesses, and maintained tax breaks for the wealthy.

Source: Charles Crumm, "Gov. Snyder Signs Tax Changes into Law," *The Oakland Press*, May 25, 2011, www.theoaklandpress.com/articles/2011/05/25/news/doc4ddd35a684a04708490852.txt.

Not all changes to a tax system should be thought of as reforms. Just cutting taxes is not necessarily a reform and may in fact increase fiscal stress as well as encourage excessive borrowing or odd adaptations to balance the budget. Reducing the burden of taxes may be a reform if a government realistically is concerned that its level or type of tax puts it at a competitive disadvantage with respect to neighbors or rivals. Raising or lowering the burden on one class or another may be a reform if the burden was excessive to start with or if there were major disincentives in the tax structure to engage in socially desired behavior. Just claiming the existence of a disincentive should not be sufficient to warrant the term "reform." For example, some have claimed that relatively higher taxes on the well-to-do discourage them from working or encourage them to leave the state or country. The evidence for either of those claims is weak. The idea that lower taxes on income and higher taxes on sales stimulates business has not been demonstrated convincingly either, but such shifts may be considered reforms if high reliance on income taxes has resulted in high volatility of revenue, deepening the impact of recessions. The minicases suggest that what is claimed as tax reform sometimes just means passing the tax burden from one class to another when the party in power can protect its own constituents from taxation.

Real tax reforms are not impossible, just difficult and often take years. California, for example, succeeded in collecting sales taxes on Internet sales, helping to rematch the economy and the tax system. Minnesota, as described earlier in the chapter, made its tax system more equitable. Maine broadened its sales tax base to include more services in 2009. Oregon, Minnesota, and the District of Columbia publish informative and transparent tax expenditure reports. New York State changed its business taxes, not only lowering them, but combining banks and other financial institutions into one category, so that those engaged in the same kind of enterprise are not working with different laws. Some states, like Michigan, have terminated their film subsidies. Utah increased the amount of money it could put into its rainy day funds, helping to manage revenue volatility over the business cycle. Washington, D.C., also broadened its sales tax base, while lowering the overall rate. Several states increased their Earned Income Tax Credit, which is a way of helping the lowest earners through the tax system. Washington state, though it failed in an effort to eliminate some outdated tax breaks, managed to include in budget legislation a ten-year sunset for any new tax exemptions and a requirement for any new exemption that the legislature specify the purpose and include measurements to see whether those purposes were being achieved.³⁰

This list of examples is only meant to demonstrate possibility; it is not a complete list of all recent tax reforms.

Summary and Conclusions

The politics of taxation has a number of special features. One is the tendency of one group or political party, when it is in the majority, to shift taxes to another group and protect itself, either by specifying that taxes will be levied on the income sources of another group or economic class or by changing rates up or down on particular groups, often making exceptions in the taxes for particular industries or groups of people with effective lobbyists. These exceptions make the tax system more complicated, less transparent, and often unfair. They also erode the tax base, either reducing revenue or increasing the rates paid by those who do pay the taxes, increasing resentment against the public sector and energizing tax reduction movements.

Increasing taxes is fraught with danger for politicians and consequently is done carefully. Temporary taxes and earmarked taxes are easier to pass, relatively speaking, with the result that taxes may not be sufficiently flexible to deal with changing priorities or fluctuations in revenue caused by recessions. Sometimes tax changes that need to be made are not, leading to a mismatch between the economy and the revenue system.

Narrow tax bases that do not match a changing economy or deliver sufficient revenues, complicated tax structures that frustrate taxpayers and result in unequal burdens as some taxpayers manage to pay much less than others with similar incomes, ineffective and hard to track tax breaks—all feed into a need for periodic review and revamping of tax structures. Sometimes more popular taxes and less visible taxes fall more heavily on the poor, raising serious questions of equity, which also suggest the need for tax reform.

Tax reforms are even more difficult to achieve than tax increases. Many fail. The ones most likely to succeed are those that are revenue neutral and do not hurt large numbers of taxpayers. Alerting those who might lose by a proposed tax reform is likely to trigger an army of lobbyists to defend their relatively advantaged positions. Symbolic politics becomes the norm, as political candidates support or decry a millionaire's tax or call attention to wealthy corporations that pay no taxes at all or claim that wealthy people are paying too large a share of government costs.

Useful Websites

A site that has useful information on state and local finance is the **Rockefeller Institute of Government** (www.rockinst.org/government_finance/) in Albany, New York. The institute monitors revenue trends such as the impact of recession on property taxes.

The **Pew Charitable Trusts' Subsidyscope** (www.subsidyscope.org) is a good source for information about tax breaks from the Federal Income Tax. This source compares estimates of revenue losses between the Treasury (executive branch) and the Joint Committee on Taxation (legislative branch). Data go back to 2001, allowing some examination of trends. This data archive provides totals by functional areas as well, which is particularly handy. Data can be downloaded and manipulated by the user.

Citizens for Tax Justice (www.ctj.org) on the left and **Americans for Tax Reform** on the right (Grover Norquist's group, www.atr.org) present many of the political arguments for increasing or decreasing taxes or shifting the burden from one economic class to another. Closer to the center is the **Urban-Brookings Institute Joint Center on Taxation** (www.taxpolicycenter.org/). This site presents the results of economic simulations to describe the impact of tax proposals on different groups and income levels; it also presents extensive information about taxes and social policy more generally.

A website that focuses on business incentives is **Good Jobs First** (www.goodjobsfirst.org). This website offers a database called **Subsidy Tracker** (<http://goodjobsfirst.org/subsidy-tracker>), along with some eye-opening studies of who does or does not pay taxes.