Reviewing Tax Expenditures: Improving Transparency and Accountability in Over $7 Billion of Off-the-Books Public Spending

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Unlike spending on schools, hospitals, and transportation, there will be no public debate on the $7.2 billion of revenue lost through tax expenditures in the coming fiscal year during this year's budget negotiations.[1] In Fiscal Year (FY) 2017, revenue lost to tax expenditures is equal to 40 percent of total General Fund revenue, estimated at $18.1 billion — a revenue loss that has grown by more than 70 percent since 2000, when tax expenditures were equal to $4.2 billion.[2]

Tax expenditures reduce the amount of taxes that individuals and businesses owe in order to advance certain public policy goals, including making our tax code fairer and incentivizing behavior from individuals and businesses. But once tax expenditures are enacted, they are rarely reviewed, and typically become a permanent cost to the state – even when changing economic conditions or policy priorities would suggest they should be modified or repealed.

In its biennial report, the Office of Fiscal Analysis defines tax expenditures as a provision that (1) impacts a statewide tax; (2) results in reduced tax revenue; (3) is not an appropriation; (4) is included in the definition of the tax base; (5) is not subject to an alternative tax; and (6) can be amended or repealed by a change in state law alone.[3]

Tax expenditures come in the form of tax credits, exemptions, deductions, or reductions. Examples include:

- Film production tax credits for corporations, worth more than $30 million;
- Sales tax exemptions for noncommercial winter boat storage, worth $2.5 million;
- Tax deductions for social security benefits, worth an estimated $130.3 million; and
- A tax rate reduction on residential utilities, worth $28.4 million.

Tax expenditures do not fall proportionately across all tax types. While the personal income tax makes up over half of General Fund revenue, personal income tax expenditures comprise less than a tenth of total tax expenditures. Nearly two-thirds of total tax expenditures are from foregone sales and use tax revenue; although the sales and use tax brings in $4.092 billion, nearly the exact same amount, $4.065 billion, is estimated to be lost to tax expenditures. Figure 1 compares the estimated revenue in FY 17 to the estimated revenue lost to tax expenditures for each tax type.

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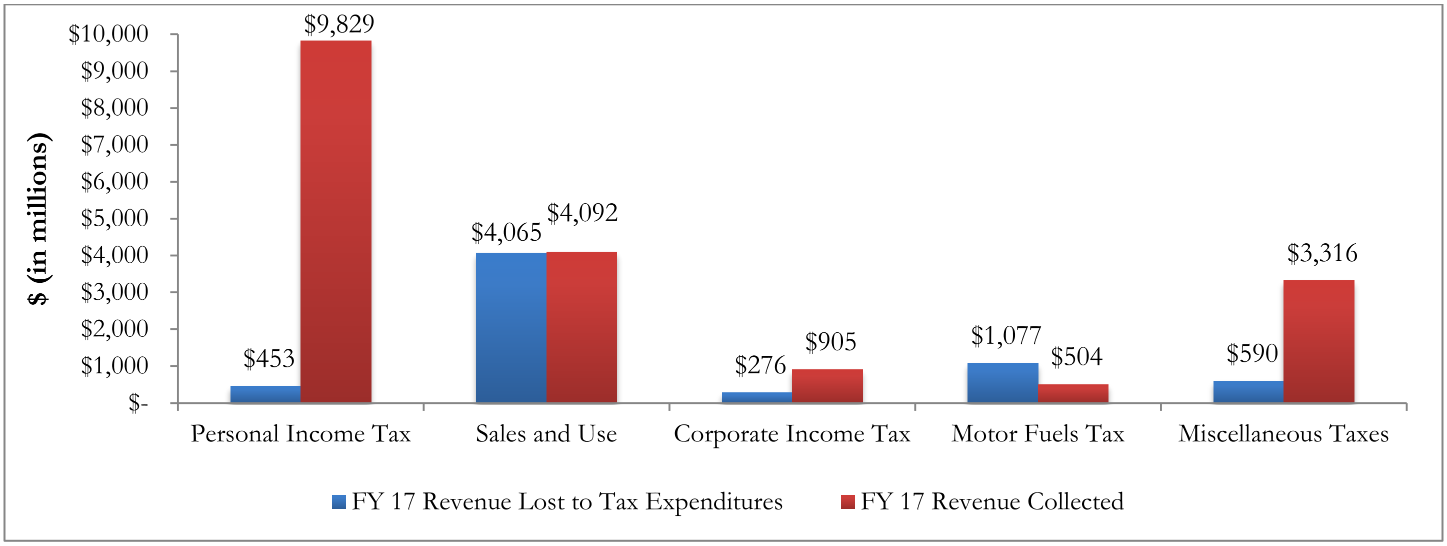
[1] Note that this total amount is *less* than the amount reported by OFA in the Connecticut Tax Expenditure Report because of the mistaken exclusion of "Farmers and Other Exempt Purchasers, Aviation Fuel" which total $772 million.
[2] The total amount lost to tax expenditures includes those in the Motor Vehicles Fuels Tax, which is part of the Special Transportation Fund.
[3] See: Office of Fiscal Analysis, "Connecticut Tax Expenditure Report," February 2016. Available at: https://www.cga.ct.gov/ofa/Documents/year/TER/2016TER-20160201_Tax%20Expenditure%20Report%20FY%2016.pdf

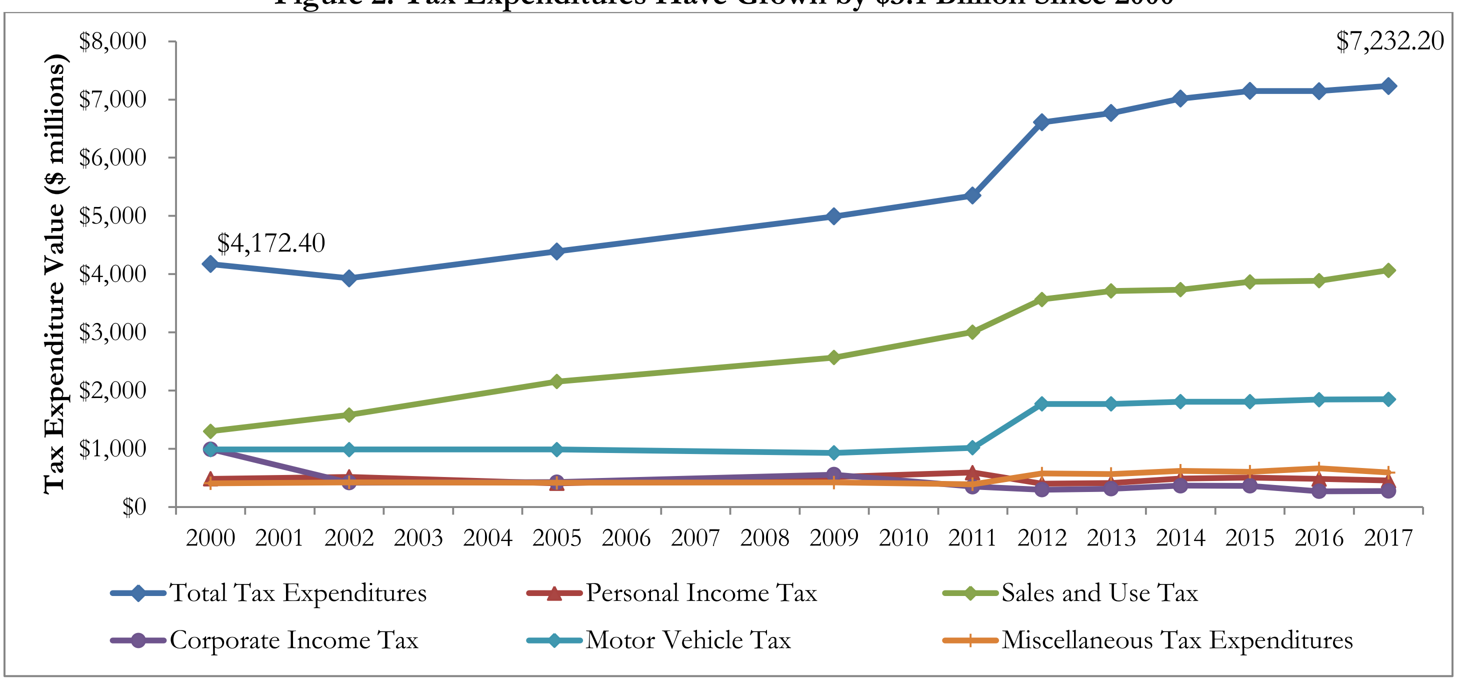
Figure 1: FY 17 Estimated Revenue Collection vs. Revenue Lost to Tax Expenditures (in $ millions)



Sources: Voices analysis of Office of Fiscal Analysis 2016 Tax Expenditure Report, Governor's FY 17 Midterm Budget Proposal. "Other Revenue" includes the Cigarette Tax, Health Provider Tax, and all other General Fund revenue sources.

Since FY 2000, the amount of revenue foregone to tax expenditures has grown from $4.2 billion to $7.2 billion, an increase of 71 percent. Much of this change was driven by an increase in sales and use tax expenditures, from $1.3 billion in FY 2000 to an estimated $4.1 billion in FY 2017. Corporate income tax expenditures, meanwhile, dropped significantly over that time, from $993 million to $276 million.

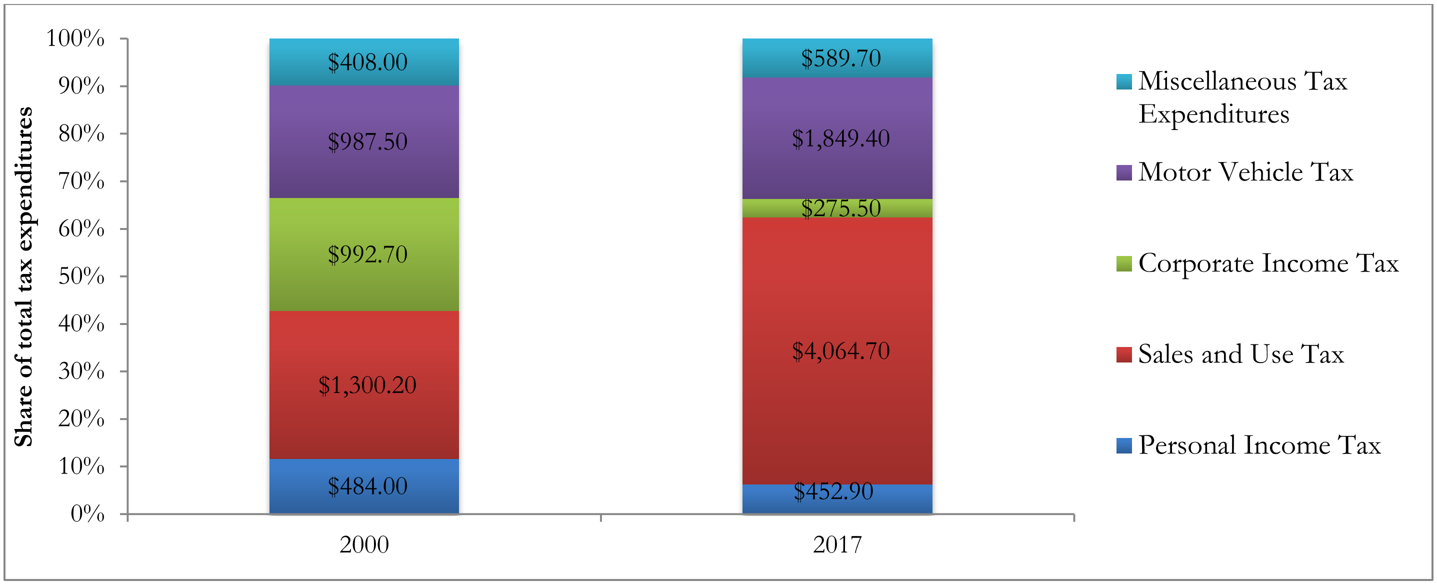
Figure 2: Tax Expenditures Have Grown by $3.1 Billion Since 2000



Sources: Voices analysis of Historical Office of Fiscal Analysis Tax Expenditure Reports. "Miscellaneous Tax Expenditures" includes the Cigarette Tax, Health Provider Tax, and all other revenue sources. Points represent years for which data is reported. The 2016 and 2017 totals differ from the OFA report due to the inclusion of fuels tax expenditures under the Motor Vehicle tax.

This shift is demonstrated again in Figure 3, which displays how the total makeup of tax expenditures has shifted from 2000 to 2017, most notably the relative increase of sales and use tax expenditures and the relative decrease of Corporate Income and Personal Income tax expenditures.

Figure 3: Tax Expenditure Makeup Shifted Since 2000 (in $ millions)



Sources: Voices analysis of historical Office of Fiscal Analysis Tax Expenditure Reports. "Miscellaneous Tax Expenditures" includes the Cigarette Tax, Health Provider Tax, and all other revenue sources. The 2017 total differ from the OFA report due to the inclusion of certain fuels tax expenditures under the Motor Vehicle tax.

Recommendations[4]

To account for growing deficits, lawmakers have committed to making the tough choices to balance the budget. This should mean looking at *all* expenditures — including those through our tax code — to ensure they are addressing pressing public needs in a cost-effective manner. In addition, transparency in state spending mandates all areas of Connecticut's budget should be evaluated and subject to routine public scrutiny.

In order to meet these objectives by making our public budgeting more fair, accountable, and transparent, Connecticut Voices for Children recommends the following:

Expand the Tax Expenditure Report.

At present, tax expenditures are only assessed in a biennial report by the Office of Fiscal Analysis. In the "Connecticut Tax Expenditure Report," OFA describes each tax expenditure, the year it was enacted, its purpose, an estimated amount of revenue gained if the expenditure were to be repealed, and the number of taxpayers benefitting. While the report provides useful detail, it does not offer any *evaluation* – that is, an appraisal of how well the tax expenditures are functioning, the extent to which they are meeting their policy goals, and ultimately, whether each tax expenditure should be continued, modified, or repealed.

If tax expenditures are evaluated and found to be operating efficiently, they should be continued or expanded; if they are found to be an ineffective use of scarce taxpayer resources, they should be modified or repealed.

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[4] For more, see: Testimony Supporting S.B. 465: An Act Concerning Finance Nick Defiesta Finance, Revenue and Bonding Committee March 28, 2016: http://www.ctvoices.org/sites/default/files/032816_fin_sb465_finance.pdf

The report should be strengthened with the following reforms:

- **Evaluate the extent to which each tax expenditure is meeting its policy goal**, including considerations of each tax expenditure's administrative cost, distributional impact, evolving fiscal climate, and expected change over time.
- **Submit a recommendation to continue, modify, or repeal each tax expenditure**, based on how well each tax expenditure is meeting the state's current policy goal(s).

Bolster the Legislative Review Process.

Currently, the General Assembly is not obligated to act on the findings of the tax expenditure report. By statute, the Finance, Revenue and Bonding Committee "…shall meet to receive and analyze the report"[5] – with no further action required. While normal appropriations are subject annually to the rigor of public hearings, expert testimony, and legislative deliberation, the $7.2 billion in tax expenditures go nearly entirely disregarded by the General Assembly. Not only does this process fail to hold tax expenditures accountable for the policy goals they were intended to achieve, but it harms transparency in our public budgeting process by effectively keeping this spending "off the books."

For example, in 1997 the General Assembly exempted from the sales tax "services rendered in connection with the creation, development hosting or maintenance of all or part of a web site…"[6] with the intention of incentivizing the then-new industry of web development. Nearly 20 years later, policymakers may find that the $57.8 million foregone to the World Wide Web tax expenditure is better utilized elsewhere – but there is no clear mechanism for them to be forced to review the tax expenditure and make that decision.

The Legislative review process should be strengthened:

- **Hold public hearings on the results of the Tax Expenditure Report,** so that taxpayers can weigh in on how public funds are used as they can during the regular appropriations process.
- **Require the Finance Committee and the General Assembly to vote on the recommendations of the tax expenditure report,** taking into account public testimony.

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[5] Public Act 97-316
[6] *ibid.*