A Critique of Selective Tax Benefits

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This document is the somewhat reworked text of a talk I gave to the Missoula Cosmos Club in September 2017. The tone of the talk was deliberately informal, which explains why there are no citations verifying the assertions I make in it. If you want me to "prove it," however, I'll be happy to give it a try. You have only to ask.

One of the regular and principal duties of the Senate Taxation Committee, on which I sit, is to consider the many, many legislative proposals, coming from both sides of the political aisle, that would create special provisions in the tax code intended to promote a variety of political, social, economic and private interests. We can call these provisions "selective tax benefits;" "selective" because typically they apply to a relatively small number of taxpayers, and "benefits" because in some way or another they reduce those taxpayers tax bills.

In some cases, the reduction is explicit; in 2017, for example, Governor Steve Bullock proposed a bill that would have allowed local governments to reduce the taxes of businesses that promised to start up or expand in a local area. But benefits can take many forms, and in Montana they do. For example, we provide *tax credits* for a bunch of things, such as investments in renewable energy; *deductions* from taxable income for a different bunch of things; differentially *lower property tax rates* for certain properties such agricultural land; *accounting methods* that allow for substantial portions of *actual* corporate income or property value to be excluded from *taxable* income and property value, and so forth.

Politically, tax codes tend to attract these selective benefit provisions like a magnet attracts iron filings. They just keep building up, and there's a political asymmetry that makes that happen. Interests that stand to benefit from enacting a particular provision have an obvious incentive to lobby hard for it, contribute to the campaigns of legislators who will support it, sway public opinion in its favor, and so forth. They have a lot to gain. On the other hand, the folks who stand to lose - the great bulk of taxpayers who will pay a little bit more because a small group will pay a lot less - don't have much incentive to act in opposition. For example, if a change in accounting rules would reduce the taxes of a handful of companies by a total of, say, $5 million dollars, it's going to be worth a full court political press to get the legislature to approve the change. But if a million Montanans have to pick up the $5 million tax bill, that's $5 a person, hardly enough to get excited about, even if they know it's happening, which is doubtful. This example is only partially hypothetical.

The same asymmetry works in reverse to make tax reform extremely difficult to bring about, if by tax reform we mean getting rid of all the bells and whistles benefits and using the money

saved to reduce rates somewhat for everyone. The losers in this process stand to lose big time, while the winners' gains are modest, and if at all possible, the losers will throw a monkey wrench into the tax reform works.

Before I go too much further, I need to make you aware of a reality that's important to understand whenever we talk about the effects of tax policy, and that's tax shifting. I'll state it this way: there's no guarantee, and in fact it is often unlikely, that the real burden of a tax, or the real gain from a selective tax benefit, will be borne by the entity legally responsible for paying the tax, that is, the guys or gals actually writing the check and shipping it off to the Department of Revenue or the county treasurer. Take, for example, the coal severance tax paid by, say, a surface mining company. It's the company that actually writes the check - which amounts to about 15% of the value of the coal at the mine mouth, before it's loaded on a train and shipped to, say, Minnesota. At that point, the coal is worth about $10 a ton. It's loaded, rumbles halfway across the country at a cost of $20 a ton, sold to a Minnesota power company for $35 (the broker has to get a piece of the action) and burned up to make electricity that sells for 10 cents a kilowatt hour. So who really pays?

It is the shareholders of the mining company? Well maybe. But they might be able to put the squeeze on the employees for some of it. Or better yet, the railroad; it's easy to squeeze because there's not much it can do with its coal cars except haul coal. Or the power company: if it has to pay more for coal, it will turn around and with the blessing of Minnesota utility regulators, raise its electricity rates. If you live in Minneapolis and your electricity rates go up, what are you going to do, read by candlelight? Or going back to the mining company, why not just pay lower rents or royalties to the owners of the coal? Suppose that's the Northern Cheyenne. What are they going to do? Dig up all their coal and rebury it in Wyoming where there's no severance tax? There're two points here. One, the tax tends to get paid by whoever has the least opportunity to avoid paying it and two, it's not always obvious who that is. And I'll add point three: most Montana legislators, and I'm one of them, when we vote for a tax, or for tax relief, have a limited idea of how the burden, or the benefit, is going to be distributed.

In thinking about selective tax benefits, I think it's useful to distinguish between those that are simply intended to provide tax relief to a particular group of individuals or families and those that are intended to incentivize some behavior that somebody, somehow regards as desirable. In Montana, a good example of the former would be our Elderly Home Owner and Renter Credit, which provides for elderly taxpayers with incomes below $45,000 to claim a fully refundable income tax credit for property taxes paid, either explicitly, or implicitly in rent. "Fully refundable" means that if the credit exceeds the taxpayer's tax liability, the taxpayer pays no tax and gets a check for the excess of the credit over the liability. The purpose of this credit is to address the problem of elderly taxpayers on a fixed, low income who can't afford to pay their property taxes. The total dollar value of these credits claimed is pretty high; claims totaled $6.95 million in 2017, making it the second most important after the capital gains credit (I'm not counting here the credit for income taxes paid in another state, which is a different matter.) And the claims for this

credit play a significant role to reducing the effective income tax rate at the lower end of the income distribution.

Most credits intended to provide tax relief are means tested, meaning they are aimed at lower income taxpayers, and have the effect of increasing the progressivity of the tax system, that is, reinforcing a rate structure in which the tax rate rises as income rises. But not always. In the 2017 session, Sen. Keith Regier introduced a bill that created a limit on the taxable value of properties in which the value of the land substantially exceeded the value of the improvements, I.e. the house, outbuildings and so forth. This scheme was intended to provide tax relief to Sen. Regier's constituents who live in modest homes on Whitefish Lake and who have seen the value of their lots increase astronomically. The relief was available regardless of the income of these families, and despite the fact that by virtue of owning these properties, they are arguably quite wealthy.

The idea that selective tax benefits are used to incentivize particular behaviors or activities is pretty obvious, I guess, but just in case it's not, here are some examples. In Montana we have, or have had, tax benefits intended to incentivize investments in energy conservation, movie production, saving for college, retention of high income taxpayers, charitable contributions, provision of small workplace health insurance, agricultural production, recycling, oilseed crushing, biodiesel blending, production of alternative energy, historic preservation, and…well you get the idea.

It's also obvious, I think, that selective tax benefits intended to provide tax relief can often unintentionally incentivize some sort of behavior which may be undesirable. And benefits intended to incentivize some form of behavior can have a significant impact on the progressively of the tax system. An example of the former is the way Montana's various property tax assistance programs operate. All these programs contain "notches," that is, critical income thresholds, which, when the taxpayer earns more and passes through them, trigger a large decline in the assistance received. Indeed, the decline in assistance can easily exceed the increase in earnings that allowed the taxpayer to pass through the notch, leaving him or her or the family worse off, or more likely, discouraging them from trying to increase their income in the first place. So we have a program that is intended to increase the *after*-tax income of low income taxpayers that perversely discourages earning a higher *pre*-tax income because doing so is unaffordable.

An example of a selective tax benefit that is intended to incentivize some behavior but also has a significant effect on the progressivity of the tax system is the capital gains credit, which is nominally intended to incentivize saving and investment. But since the credit is largely claimed by relatively high income taxpayers (low income tax payers just don't have much in the way of capital gains to realize), it appreciably reduces effective tax rates at the upper end of the income scale and the progressivity of the income tax system in general.

I say that the capital gains credit is "nominally" intended to incentivize saving and investment because let's face it, when any interest group or political party comes up with a scheme to

selectively reduce its constituents' taxes, it's not very respectable, even in the sometimes tawdry environs of the legislature, to say 'Please pass this law so we can get rich." No, the incentivization of some noble or at least socially productive activity has to be alleged, and I must say, I've seen some pretty imaginative alleging go on in my time in Helena.

I want to talk more about that in a minute, but before I do, I want to make a few observations about the impact of the tax system and tax benefits on the distribution of income that I hope you will find interesting.

As I am sure almost all of you are aware, since the late 1970s, the distribution of income in the United States has become substantially more unequal. This growth in inequality has a number of features, but probably the most notable are the stagnation of wages for low and moderate income earners and the intense concentration of income at the highest level of the distribution. For example, according to the Economic Policy Institute, as the economy recovered from the recession between 2009 and 2013, the income of the top 1% of households rose by 17.4%, while the income of the bottom 99% grew by 7/10ths. of 1%. For the period between 1979 and 2007, the income of the top 1% doubled while the income of the bottom 99% grew by one fifth, that is, about 6/10ths. of a percent per year. As you are also aware, stagnation of wages and extreme concentration of income growth has had profound social and political impacts. It appears to explain, for example, the Occupy movement and the political emergence of both Donald Trump and Bernie Sanders. Hilary Clinton is said to have lost the election because she failed to recognize the urgency of the problem. Most disturbingly, Angus Deaton, a Nobel laureate in economics, has argued that these profound changes in the distribution of income and the functioning of the labor market may explain the sharp increase in the number of white men who are dying from suicide and drug and alcohol overdoses, such that, for the first time in more than one hundred years and alone in the United States, their life expectancy is falling.

It seems to me that in the context of these developments, the impact of the tax system on the distribution of income should become a salient issue. That is particularly true since we don't seem to have a very good idea about how to fix the labor market, and it's not at all clear that the traditional fixes, such as more specialized education, or the nativist fixes of Donald Trump, such as shutting down immigration and limiting international trade, are going to work. In that case, one of the few handles we have on income distribution is tax policy.

In this regard, Montana stands out in a way that many may be unaware of. First of all, income is significantly more equally distributed in Montana than in the nation as a whole. In 2013, the average American family in the top 1% had an income 25 times higher than that of the average family in the bottom 99%; in Montana the comparable multiple was 17.4. Then there's this: between 1979 and 2007, income inequality grew in Montana at about the same pace as in the rest of the country, but the growth of income of the top 1% was a lot more modest than in the nation as a whole. Indeed, the reason income is more equally distributed in Montana than in the country at large is that high incomes here are quite a bit lower than high incomes elsewhere, whereas lower incomes here really aren't an awful lot lower than lower incomes out beyond our

borders. Most remarkably, during the recovery from the recession, when the top 1% of American families were capturing virtually all of the income growth going on, in Montana, average income of families in the top 1% actually declined. Now add to that the fact that Montana has one of the least regressive tax systems in the country - largely because we have no sales tax - and we are in a relatively enviable position with respect to the income distribution dilemma. It's not all wine and roses, but we're in better shape than most states. I guess that should leave us wondering why Sanders and Trump did so well here, and Hilary did so badly.

I'll turn now to my skepticism regarding tax benefits intended to incentivize desirable behaviors. When we talk about such behaviors, what do we mean? Well, I take it we mean the undertaking of activities of one sort or another that confer benefits that are freely available to society at large, and not just privately to the individuals who undertake them (we don't need to incentivize people to act in what is already their own self-interest). So, for example, what is the rationale for granting tax credits to families who install solar panels on their roofs, or replace their windows with more energy efficient ones? I assume it's that doing those things creates valuable benefits for all of us - in the form of reduced pollution from fossil fuel fired power plants. We all can enjoy those benefits without having to acquire them in a market, unlike the benefit we drive from food, say, or health care. And those nice, conscientious families who are providing us with those benefits have no way of being compensated for doing so. Under these circumstances, it's likely that too few solar panels will get installed on the top of houses, so what do we do? Give a tax credit that sweetens the pot for anyone thinking about putting those panels on the roof.

Suppose there were no social benefits created by solar panels, and that the only benefit would accrue to their owners, in the form of lower power bills or a satisfying sense of independence. Should we grant a tax credit in that case? Well, no. Doing that would make about as much sense as granting a tax credit for going to the movies or drinking a beer in a bar.

In the case of solar panels, the nature, if not the magnitude, of the social returns that accrue is pretty obvious. But for lots of other activities looking for a tax benefit (or seeking to be incentivized, if you will) it's far less so. If the city of Missoula abates the taxes of an expanding business, for example, how does the community benefit? The usual answer to that question is "jobs," and while that might seem like a no brainer, I believe we need to think a little more carefully about the claim that selective tax benefits can be justified by the supposition that they will result in the creation of jobs and related economic activity.

There is no doubt that wage, income and job growth benefit communities, and I am not just talking about the people in the community that get the jobs or higher wages and incomes. I'm talking about everybody. I assume we all want to live in communities where our neighbors have work and earn a decent wage. I assume we all benefit from living in larger communities that can support civic institutions and a wide a variety of commercial opportunities. So to the extent that job and economic growth makes those kinds of things possible, it confers benefits on the community at large. You should be aware that job growth doesn't always have these desirable consequences, but I am not going to dwell on that point. I am also not going to dwell on the fact

that in addition to benefits, growth brings costs, and there is always a tension between policies intended to promote growth and policies intended to mitigate its consequences. So let's take it as a given that job creation benefits the community at large.

The problem, when it comes to selective tax benefits - those affecting a particular industry, say - is that beneficiaries really should be able to make the case that the jobs they are creating and the activity they are engaging in is somehow much more beneficial than the jobs and activity created by everybody else who's not getting the tax break. And so far as I know, that case is never made, if it even can be. Let me give you an example. During the 2017 session, Rep. Jim Hamilton, a Democrat from Bozeman, introduced a bill that would have provided a tax credit to "angel investors," that is, individuals who invested, essentially, in high tech startups. The credit was equal to 30% of the amount invested, which had to be at least $50,000. The credit could not exceed $75,000 a year or $750,000 over all years. Sorting all that out, it means that the state would potentially provide to these angel investors 30% of a total investment of $2,500,000. Now I have some friends, a married couple, both of whom came to Missoula from New York City and established businesses: a mailing service and an office equipment dealership. They invested in these businesses, hired employees, worked hard and supported the community in a variety of ways, including paying their taxes. And nobody ever offered to reimburse them for 30% of the money they plowed into these enterprises. Now Rep. Hamilton may think there's evidence that the benefits conferred on the community by high tech start-ups are that much greater that the benefits conferred by my friends' businesses. But he didn't provide any such evidence and until he does, I remain skeptical, not to say suspicious. The bill died, by the way, in the Senate Finance and Claims Committee.

Would there have been any harm done if this bill had become law? I think there would have been.

It's obvious that the angel investors who could claim the tax credit would have to be pretty well off - not many people in that bottom 99% have $50,000 to invest in a high tech start-up - so the progressivity of the income tax would be reduced. Moreover, the differential treatment of my friends and the angel investors seems to me to be patently inequitable. And by tilting the playing field, the credit would attract investment resources into particular lines of economic activity that may or may not represent their highest and best use. In short, this selective tax benefit arguably has the effect of making the tax system less progressive, less fair, and less efficient. And I think there is another danger: if the legislature hands out tax benefits like lollypops, it has a debasing effect on our politics, because lobbyists, special interests and the prospect of campaign contributions replace the public interest in our deliberations and decisions.

Another reason I find myself at odds with many of my colleagues on both sides of the aisle on the value and propriety of selective tax benefits is that I don't believe they always work and I worry about their impact on revenue. The two concerns are related. It may seem obvious that when the legislature creates a tax benefit, revenue has to go down. Indeed every bill to create a benefit is accompanied by a fiscal note that shows just that. But there's a counter argument that says that because the tax benefit incentivizes more of some taxed activity, some or indeed

all of the revenue lost because the activity is taxed at a lower effective rate can be clawed back because more of the activity is going on. So you can see that how effective these incentives are is critical in determining what impact they will have on revenue.

I hope that it goes without saying that almost always the issue of revenue adequacy, or inadequacy, is a very, very big deal and that means that if our enormous grab bag of tax benefits is eating revenue up, they are a big, big deal as well. The Department of Revenue refers to these revenue reductions as tax expenditures, and every year totes them up and publishes them in a Biennial Report, which I highly recommend if you want to know more about Montana taxes.

So, do tax benefits effectively incentivize whatever it is they are supposed to? I think the record and research on that question is pretty mixed.

Back in the 1980s, Art Laffer famously argued that cutting tax rates would lead to an increase in tax revenue – the tax cuts would "pay for themselves" - because the incentivizing effects of the rate cut would be so strong. Reagan bought it and a legion of supply side economists was born, famously leading George H. W. Bush to declare that we were in the grip of "voodoo economics." And President Trump deployed much the same argument in support of his 2017 tax "reform" bill, which cut corporate taxes dramatically, only to face a ballooning of the Federal deficit in 2018.

However skeptical that Federal experience may make you about the ability of tax cuts to pay for themselves, it's important to realize that when it comes to state and local tax incentives, we're dealing with a different kettle of fish. Laffer was banking on the ability of tax cuts to incentivize *new* economic activity. For the state, all we have to incentivize is that activity *locate here*, rather than in Idaho or Florida or Ciudad Juarez or wherever. It's an easier lift, so there's more reason to believe incentives will work.

On the other hand, there's reasons to think they won't, and some evidence to back it up. I won't go into all of them, but there's one that I think is interesting. Attracting businesses to Montana with tax breaks requires that we lower tax burdens with respect to other states like, say, Idaho. Well, they're not stupid down in Boise, and they know that two can play that game. When states compete with each other in cutting taxes, taxes fall everywhere but no state necessarily gains an advantage. During the 2017 session Rep. Bridget Smith, a Democrat, brought a bill to provide tax credits to film production companies that want to shoot movies in Montana. Those companies all trooped into the hearing and as much as said, "Give us this tax break or we will pick up our marbles and go elsewhere." Of course you know that if we had, their next stop would have been before some legislative committee in Boise or Laramie, making the same threat. And the fact is that over the last couple of decades, about 40 states have offered film production tax credits. And over that same 40 years, there has been no significant change in the interstate distribution of film production activity.

I conclude then that selective tax benefits should be intensely scrutinized and should be created only when it can be clearly demonstrated that they will reduce regressivity in the after-tax

distribution of income or secure the production of legitimately public benefits. In both those cases, selective tax benefits should be carefully designed to avoid the creation of perverse incentives or unjustifiable distributional impacts. And selective tax benefits should not be created without understanding their effects on government revenue and budgets (at all levels) and the likelihood that they will in fact achieve the changes in behavior they are intended to incentivize.