Louisiana Budget Project

Changing Policy. Improving Lives.

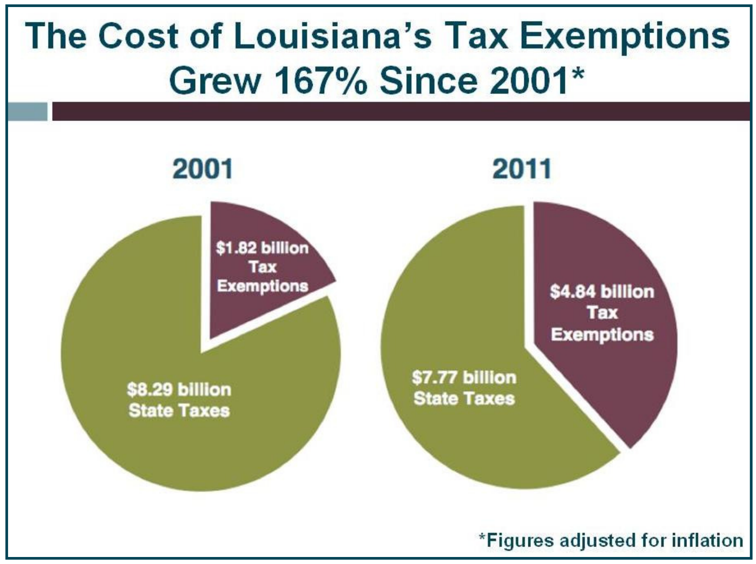
Real Tax Exemption Reform Must Prevent Future Waste and Misuse

By David Gray

Summary

Gov. Bobby Jindal's tax-shift proposal, scheduled to be unveiled in the coming weeks, will almost certainly call for capping or ending some tax breaks for favored industries or groups.

While that is an important step – though other elements of the overhaul the governor has discussed would move Louisiana in the wrong direction – reform of tax exemptions should go further than what the governor is likely to propose. The Legislature also should add new safeguards to ensure that tax exemptions aren't abused in the future and that they fulfill the promise of strengthening Louisiana's economy. This includes requiring periodic reviews of all tax exemptions to ensure the state is getting a positive return on its investment and making it easier for policymakers to eliminate those that don't measure up.



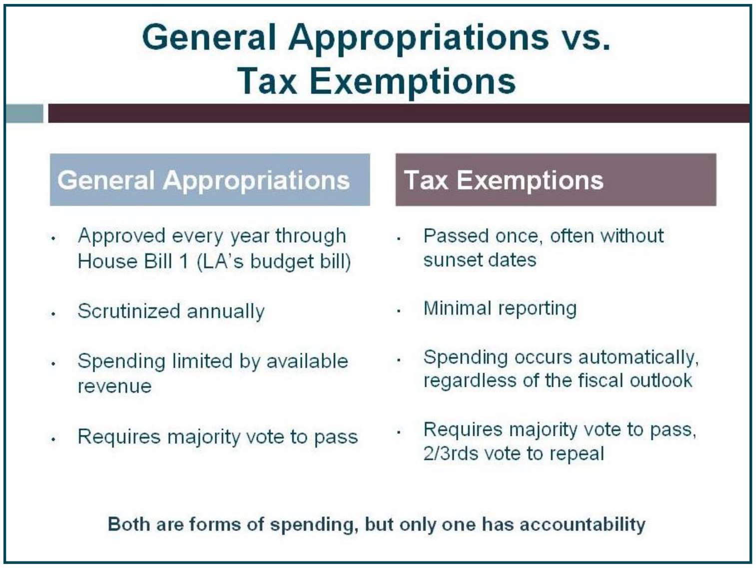
Louisiana's failure to protect taxpayers from tax exemptions that are outdated, costly and ineffective has allowed their cost to skyrocket over the past decade. That cost ballooned to more than $4.8 billion in 2011 from just over $1.8 billion in 2001 – a 167 percent increase when adjusted for inflation. Meanwhile, the amount of revenue raised through taxes fell by 6 percent over the same period. This hemorrhaging of resources has helped cripple Louisiana's ability to pay for vital public services like education, health-care, transportation and public safety that are more reliable assets to Louisiana's economy.

Failure to add new safeguards would mean that future legislatures could reverse any progress made on ridding the tax code of costly, unproductive tax breaks, as interest groups work to reinstate special favors that sap the state of revenue for critical priorities.

Government Spending by Another Name

The term "tax exemption" is used to describe the 468 exclusions, deductions, credits, deferrals and preferential tax treatments permitted by Louisiana's tax code that reduce the amount of money the state has available for higher education, health care, public safety and other vital services.

Tax exemptions have the same effect "as a direct fund expenditure" from the state budget, according to the Louisiana Department of Revenue.[i] For example, Louisiana could spend money to subsidize a new shipbuilding facility, or offer the shipbuilder a tax credit for the same amount. The impact on the state budget would be the same, but the way such spending is treated by the governor and Legislature is very different. A tax exemption would get much less scrutiny from lawmakers than a cash subsidy, which is significant because every dollar lost to tax exemptions is a dollar that cannot be used to finance education, health care, public safety and other services.



Missing Safeguards

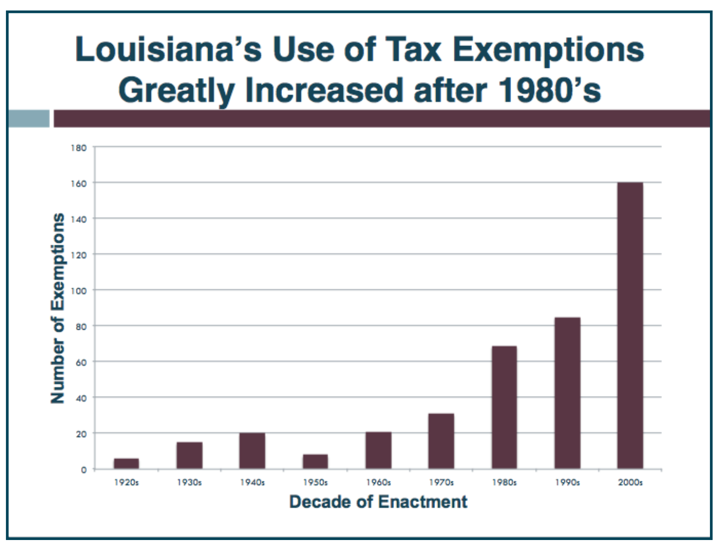
The Legislature carefully reviews direct expenditures each year through the state budget appropriations process, with dozens of hours of public hearings in House and Senate committees. Tax exemptions, on the other hand, go through no formal review process after they are initially approved. Once on the books, they usually remain there for good. Most tax exemptions aren't reviewed by the legislature, and the majority is missing safeguards like "sunset" dates that would require them to expire on a certain date unless action is taken to renew them. Thus, the state pays these costs year after year without knowing whether taxpayers get a positive return on their investment.

While most spending, especially in the state budget, is limited by available revenue, tax exemptions do not face this constraint. Many tax exemptions function as open-ended entitlement programs; the state is required to finance them, regardless of their impact on the budget.

Tax exemptions also are more difficult to modify or eliminate than other forms of spending. Reducing spending on schools, transportation and other services can be done by a simple majority vote of the Legislature, or, in some circumstances, by the governor's executive order. Tax exemptions, on the other hand, require a two-thirds majority vote to be modified or eliminated. This can allow a minority of lawmakers to protect tax exemptions that benefit their favored industries or other special interests – even if these exemptions are not supported by a majority of their colleagues.

The High Cost of Low Standards

A close inspection of the Tax Exemption Budget – an analysis performed each year by the state Revenue Department – shows that the cost of tax exemptions ballooned to more than $4.8 billion in 2011 from just over $1.8 billion in 2001 – a 167 percent increase when adjusted for inflation. Moreover, tax exemptions were responsible for a growing portion of Louisiana's revenue loss between 2001 and 2011. Louisiana gave away 88 percent of potential corporate income tax collections through tax exemptions in 2011, up from 63 percent in 2001. The state lost 34 percent of potential sales tax collections in 2011, up from 13 percent in 2001. The same trend also occurred in foregone individual income taxes (34 percent lost in 2011, compared to 21 percent in 2011) and severance taxes (36 percent lost in 2011, from 15 percent in 2001).



How to Make Things Better

The governor's plan to eliminate state income and corporate franchise taxes would leave Louisiana $3 billion short of what it now spends to provide education, public safety, health care and other basic services. The administration will propose filling the gap in a variety of ways, including by capping or eliminating certain tax exemptions. Eliminating Louisiana's state income tax is a dangerous policy that threatens the state's ability to create jobs and offer the level of services to businesses and families needed to compete in today's economy. But a review of state tax exemptions is nonetheless a welcome development. It provides a rare opportunity to improve the tax system, better protect taxpayers from losing millions of dollars through inefficient and outdated tax breaks and redirect resources toward more effective ways to strengthen the state economy. Lawmakers should go beyond eliminating wasteful tax exemptions and create safeguards that prevent the tax code from becoming a vehicle for out-of-control spending in the future. Methods to accomplish this goal include:

- **Regular reviews of tax exemptions.** Tax exemptions should be subjected to the same scrutiny, deliberation, and accountability as other spending. This would enable policymakers and the public to ask questions and gain more insight on exemptions than what is normally provided in publications like the Tax Exemption Budget. Regular review should be aimed at ensuring that all tax exemptions are easy to understand and have a high return on investment (measured by either net job increases or net economic activity increases). One model for Louisiana is Oregon's Joint Committee on Tax Credits, which regularly reviews all the state's tax credits and considers them as part of the larger budget process. Washington's Joint Legislative Audit and Review Committee, which reviews tax exemptions according to a schedule established by law, is another good alternative.[ii]

- **Mandatory sunset dates.** Legislation creating any tax exemption should have an expiration date, either five or 10 years after enactment. Once the expiration date arrives, the exemption should go through a legislative review to determine its return on investment before the Legislature can vote to keep the exemption on the books. The state should retroactively apply sunset dates to all existing tax exemptions and require sunset dates for any newly created exemption. A good model for Louisiana to follow is Nevada, which requires all exemptions to include specific expiration dates before being sent to the Legislature for a vote. Similarly, Oregon requires all exemptions to expire after six years, and Virginia has a five-year sunset.[iii]

- **Limiting the cost of individual tax exemptions.** Putting a limit on how much money can be given out in a tax exemption is the easiest way to control year-to-year costs, make them more predictable and forecast future revenue losses. This, in turn, would help the state make better budget estimates before each legislative session, reduce the likelihood of mid-year budget cuts and protect basic services from large cuts during low-revenue years. Limitations can be designed so beneficiaries can carry unused credits forward into future years, or the total number of available credits for each year can be distributed on a first-come, first-serve basis. As an alternative, lawmakers can consider requiring legislative review if tax exemptions exceed their estimated cost by a certain percentage.

- **Requiring a simple majority vote to repeal or modify tax exemptions.** The "supermajority" requirement of a two-thirds vote makes it difficult, if not impossible, for the Legislature to eliminate or modify outdated, costly and ineffective exemptions. Requiring a simple majority vote makes it easier to scale back bad exemptions, and it reduces the risk that a small minority will stifle the will of the majority. Moreover, this change would hold tax exemptions to the same degree of accountability as general spending.

About the Louisiana Budget Project

The Louisiana Budget Project (LBP) provides independent, nonpartisan research and analysis of Louisiana fiscal issues and their impact on Louisiana families and businesses. We seek to bring wider prosperity to Louisiana through a deeper understanding of the state budget, broadening fiscal policy debates and increasing public participation in decision-making.

David Gray, Policy Analyst with the Louisiana Budget Project, may be contacted via email at davidgray@lano.org.

[i] Tax Exemption Budget 2011-2012, page 3.

[ii] Washington's exemption schedule can be found at RCW 43.136.065. Also, five additional states that mandate sunset exemptions are Arizona (Revised Statutes, Title 43, Chapter 2, Article 2), Iowa (SF 2380), Maryland (SB 739), Vermont (32 V.S.A. § 306) and Virginia (§ 30-51, sections 330 through 332). Oregon's committee is called the "Joint Committee on Tax Credits."

[iii] Nevada's constitutionally-mandated sunset provisions are in Article 10, Section 6. More information on Oregon is available in HB 2067, and Virginia's information is available in § 30-19.1:11.