Flying Under the Radar:
Time to Evaluate Tax Expenditures

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Special Series: Balanced Solutions for 2011

All Montanans want a state we can be proud of--a state where our children can learn, grow, prosper, and stay to raise their own families. That future depends on our ability to invest in the public structures that educate our children, keep our communities safe, protect our land and water, and provide health care and other services when we struggle to make ends meet.

Like all other states, the Great Recession has temporarily threatened Montana's ability to adequately invest in these public structures. Montana deserves a balanced approach to our revenue challenges that looks not just at dramatic and harmful cuts to public services, but also targeted efforts to increase revenue. This brief is one in a series of MBPC reports that explores policies to responsibly raise revenue in the state.

Our state is facing a critical moment. As a fragile economic recovery just starts to take hold, jobs and public services hang in the balance. The choices the legislature makes now will have a serious impact on the quality of our economy and education and health systems well into the future.

The legislature is considering ways to balance the state budget. Despite some rhetoric to the contrary, there are plenty of mechanisms available for maintaining our investments in education, health care, and other public services. One option is to scrutinize tax expenditures to determine if any are obsolete or ineffective. Tax expenditures quietly drain the state of million of dollars in revenue every year. In fiscal year 2009 alone, we lost $375 million, which amounted to 20% of the state's general fund budget that year.

What are Tax Expenditures?

Tax expenditures are often described as "silent spending." They come in the form of preferences such as tax deductions, exemptions, deferrals, exclusions, credits or lower tax rates given to individuals or businesses. Tax expenditures are considered a form of spending because they allocate funds for specific public purposes, but not through direct appropriations.

They have a significant impact on state revenue as they reduce or eliminate revenue that would have otherwise been collected. These expenditures are commonly referred to as tax loopholes or incentives. Tax expenditures are not inherently good or bad policy. However, just like other state spending, they deserve to be reviewed and evaluated on a regular basis.

Tax Expenditures in Montana

In Montana, all the major taxes have tax expenditures. Table 1 (on Page 2) details the amount of tax expenditures by the type of tax. Personal income taxes have the largest tax expenditures, accounting for almost 85% of the state's tax expenditures.

Individual income tax expenditures disproportionately benefit the highest income taxpayers of the state (Figure 1 on Page 2). Those at the highest end of the income scale get far more benefit from tax expenditures.

For example, taxpayers with income over $70, 332 are approximately 20% of all Montana taxpayers but receive 66% of the benefit from tax expenditures.

Table 1: Tax Expenditures in Montana, 2009	
Individual Income Tax Expenditures	$317,386,568
Corporate Income Tax Expenditures	$11,325,865
Property Tax Expenditures*	$17,213,009
Natural Resources Tax Expenditures	$28,659,502
Total	**$374,586,070**

* Property tax expenditures are not as straightforward as the tax expenditures for other types of taxes. Local governments are allowed to raise mills to offset a reduction in tax base. Thus the property tax expenditures often result in tax shifts to other property tax payers.

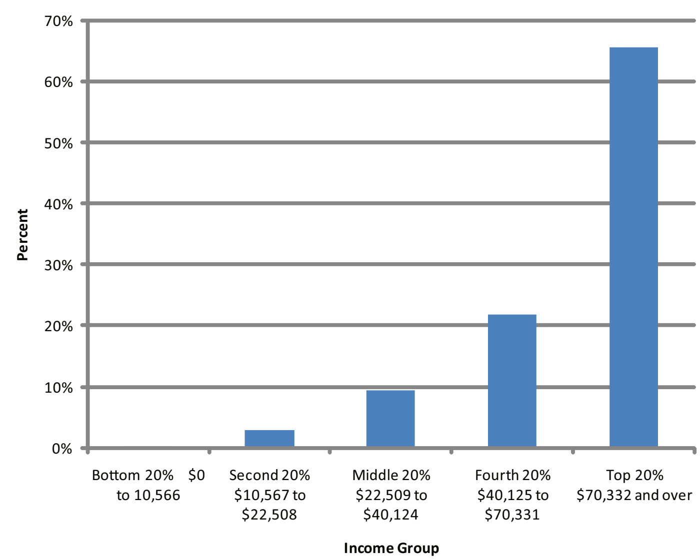
A Model for Tax Expenditure Reporting

The first step in evaluating tax expenditures is the creation of a report that allows policymakers to analyze how much tax expenditures are costing the state, who is benefiting, and which expenditures are serving their purpose.

The Center on Budget and Policy Priorities has issued a report detailing the characteristics of a high quality tax expenditure report. According to their recommendations, a state report should be:

- **Accessible** - Not only should the report be easy to access and use, it should actually be used to determine tax expenditure effectiveness. The report should be published regularly, incorporated into the budget process, and accessible online.
- **Comprehensive** - Most or all tax expenditures should be included in such a report, including implicit expenditures.
- **Detailed** - The report should include detailed information about the structure and cost of each expenditure, and about who benefits. It should include the precise cost to the state, a description of the expenditure (including the legal citation and the year enacted), the number and description of taxpayers benefiting, cost projections for comparison with other expenditures, and separate reporting for any expenditure that impacts both state and local revenues.

Figure 1: Share of Total Tax Expenditures by Income Group



Source: DOR 2008-2010 Biennial Report

- **Analytical** - The report should detail whether the expenditure is meeting its goals and should be classified by function, state the purpose of the expenditure and include an analysis of who benefits.[1]

Our state is one of 42 (including the District of Columbia) that produce a tax expenditure report.[2] Montana's report includes most of the elements mentioned above. Improvements could be made by listing the rationale for each expenditure and projecting future costs of expenditures.

Currently, the Montana Department of Revenue's report is one of the most thorough in the nation, but many of the components of the report are voluntarily included by the Department.[3] Policymakers could ensure the ongoing production of this useful information by requiring that the report and its current components be created each biennium.

Recommendations for Informed Decisions on Tax Expenditure

In order to make decisions about the state budget more accountable and transparent, tax expenditures must face the same scrutiny that other state spending faces. In addition to the tax expenditure report, policymakers could improve accountability in this area by:

1. Automatically sunsetting all tax expenditures on a rolling basis (with a set percentage sunsetting each biennium).

2. Providing funding and a framework for conducting tax expenditure performance reviews. These reviews should be carefully timed so their results are released prior to the legislature's debates over whether or not to extend the sunsetting tax expenditures. Similar tax expenditures should be sunsetted and/or reviewed simultaneously, since these can often have overlapping purposes and/or results.

3. Requiring that the governor make explicit recommendations on every reviewed tax expenditure in his/her budget proposal.

4. Requiring that any piece of legislation enacting or expanding a tax expenditure include a statement of: its purpose, a discussion of data/performance indicators that should be used to evaluate its success, and an explanation of why this purpose is being pursued via the tax code (i.e. why use a tax expenditure rather than a direct spending program?).

Conclusion

State spending in virtually every other area is held under a microscope every legislative session. Having these public discussions about state spending adds to the transparency and accountability of our democratic system. For the same reason, it's time to extend scrutiny of state spending to tax expenditures as well.

End Notes

1. Jason Levitis et al., "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center on Budget and Policy Priorities, April 2009, http://www.cbpp.org/files/4-9-09sfp.pdf. See also, "Tax Expenditures," 2008-2010 Biennial Report, Montana Department of Revenue, at http://revenue.mt.gov/content/publications/biennial_reports/2008-2010/BiennialReport-TaxExp.pdf.

2. Jason Levitis et al., "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center on Budget and Policy Priorities, April 2009, http://www.cbpp.org/files/4-9-09sfp.pdf.

3. Montana Code Annotated 15-1-205 (3).

Appendix A

Personal Income Tax Expenditures

Personal income tax is calculated by:

- Starting with adjusted gross income, which includes cash and non-monetary compensation and subtracts the costs of earning income.
- Subtracting an exemption for each taxpayer and dependant and a standard deduction or itemized deductions to arrive at taxable income.
- Multiplying by a tax rate, which, in Montana, varies by the level of taxable income, to arrive at tax liability.
- Subtracting any credits from tax liabilities to arrive at taxes due.

Table 2: Montana Tax Rates 2010			
If your taxable income is			
More than	**But not more than**	**Then Your Tax is**	**Less**
$0	$2,600	1% of taxable income	
$2,600	$4,600	2% of taxable income	$26
$4,600	$6,900	3% of taxable income	$72
$6,900	$9,400	4% of taxable income	$141
$9,400	$12,100	5% of taxable income	$235
$12,100	$15,600	6% of taxable income	$356
More than $15,600		6.90% of taxable income	$496
Source: Department of Revenue			

Tax expenditures in the personal income tax fall into 4 categories: federal adjustments to income, Montana adjustments to income, deductions, and credits.

Table 3: Personal Income Expenditures		
	Income Reduction	**Tax Expenditure from General Fund**
Federal Adjustments to Income	$590,534,125	$20,873,082
Montana Adjustments to Income	$1,004,454,290	$32,871,334
Itemized Deductions	$5,958,170,395	$199,575,296
Income Tax Credits	n/a	$64,066,856
TOTAL		**$317,386,568**

Montana adopts the federal definition of adjusted gross income as the starting point for measuring income subject to state income taxes. Thus, Montana passively adopts federal rules for exempting certain income from taxation, special rules for measuring income, and extra expense deductions.

In addition, Montana has 40 adjustments to adjusted gross income. Some exist because of federal law or the need to allocate income between spouses filing separately. Many exist because the Montana legislature has decided to partially or total exempt certain income from taxation.

Table 4: Federal Adjustments to Income 2009			
	Number of Taxpayers	**Income Reduction**	**Loss to General Fund**
Health Savings Account Deduction	6,970	$22,475,743	$1,169,701
One-Half of Self Employment Tax	65,693	$98,237,656	$12,133,668
Contributions to Qualified Self-Employed Retirement Plans	3,787	$70,075,437	Included in One-half Self Employment Tax
Self-Employed Health Insurance Premiums Deduction	22,935	$128,080,187	Included in One-half Self Employment Tax
Individual Retirement Account Deduction	13,756	$59,200,325	$3,314,266
Student Loan Interest Deduction	47,184	$37,416,097	$1,996,907
Tuition and Fees Deduction	7,858	$18,306,042	$572,047
Domestic Production Activities Deduction	5,874	$156,742,638	$1,686,493
Total Federal Adjustments to Income	**174,057**	**$590,534,125**	**$20,873,082**

Table 5: Montana Reductions from Federal Adjusted Gross Income 2009

	Number of Taxpayers	Income Reduction	Loss to General Fund
Interest on Federal Government Bonds	23,957	$121,142,934	$2,155,884
Exempt Tribal Income	7,765	$202,838,475	$6,794,935
Unemployment Compensation	36,833	$200,520,703	$7,537,268
Exempt Workers Compensation	220	$1,087,551	$33,366
Capital Gains from Small Business Investment Companies	43	$73,219	$4,029
Active Duty and Non-Resident Military Salary	5,334	$180,143,948	$6,825,170
National Guard Life Insurance Premium Reimbursement	42	$442,752	$2,470
Partial Pension Exemption	41,192	$137,590,517	$3,754,974
Elderly Interest Exclusion	70,657	$50,905,606	$1,523,999
Exempt Disability Retirement Income	160	$686,400	$8,349
Exempt Tips	14,965	$43,163,891	$1,586,494
Health Insurance Premiums Included in Federal Adjusted Gross Income	156	$753,766	$36,769
Health Care Professional Student Loan Repayment Included in Federal Adjusted Gross Income	145	$402,050	$24,845
Medical Savings Account Deposits	5,990	$17,656,099	$992,069
First Time Homebuyers Account Deposits	216	$770,188	$44,023
Family Education Savings Account Deposits	2,104	$6,770,702	$430,250
Farm and Ranch Risk Management Account Deposits	*	$3,730	n/a
Tier II Railroad Retirement	2,919	$37,656,983	$1,025,548
40% Exclusion of Pre-1985 Capital Gains	253	$1,671,203	$84,984
Business Expense for Recycled Materials	103	$136,788	$4,712
Sale of Land to Beginning Farmers	*	$36,785	$1,196
Total Montana Reductions to Federal AGI		**$1,004,454,290**	**$32,871,334**

* Less than 5 taxpayers

Source: Montana Department of Revenue, 2008-2010 Biennial Report

Table 6: Montana Itemized Deductions, 2009			
	Number of Taxpayers	Amount of Deductions from Income	Total Loss to General Fund
Medical Expenses over 7.5% of Adjusted Gross Income	75,768	$335,364,641	$10,686,704
Medical Insurance Premiums Not Deducted Elsewhere	100,118	$378,952,949	$14,140,961
Long Term Care Insurance Premiums	12,444	$29,681,502	$1,144,834
Federal Income Tax	240,490	$1,197,262,151	$50,155,382
Sales or Local Income Taxes	1,446	$19,261,272	$24,472
Real Estate Taxes	211,251	$517,735,367	$21,621,646
Personal Property Taxes	157,505	$60,363,065	$3,103,096
Other Deductible Taxes	25,719	$12,006,090	$477,161
Home Mortgage Interest	158,028	$1,310,011,355	$66,962,389
Unreported Home Mortgage Interest	6,208	$21,367,098	Included in Home Mortgage Interest
Unreported Points	21,465	$9,254,580	Included in Home Mortgage Interest
Qualified Mortgage Insurance Premiums	17,098	$23,579,910	Included in Home Mortgage Interest
Charitable Contributions	167,292	$1,656,798,581	$30,984,127
Non-Cash Contributions	70,802	$291,965,362	Included in Charitable Contributions
Carryover of Contributions from Previous Years	2,979	$71,665,037	Included in Charitable Contributions
Child and Dependent Care Expenses	930	$1,787,400	$8,292
Casualty and Theft Losses	363	$20,439,647	$228,587
Political Contributions	5,737	$674,388	$37,645
Total Itemized Deductions	**1,275,643**	**$5,958,170,395**	**$199,575,296**
Source: Montana Department of Revenue, 2008-2010 Biennial Report			

Table 7: Individual Income Tax Credits, 2009		
	Number of Taxpayers	**Total Loss to General Fund**
Capital Gains Credit	31,073	$20,067,588
Other States' Tax Credit	9,489	$17,195,602
College Contribution Credit	2,564	$245,865
Qualified Endowment Contribution Credit	533	$1,808,443
Energy Conservation Credit	21,457	$10,103,356
Alternative Fuel Credit	*	$40,485
Rural Physician's Credit	20	$90,312
Health Insurance for Uninsured Montanans	*	$302,100
Elderly Care Credit	41	$45,059
Recycling Credit	*	$463,381
Biodiesel Blending and Storage Tank Credit	*	$2,630
Geothermal Energy System Credit	*	$534,153
Alternative Energy System Credit	1,727	$1,322,296
Alternative Energy Production Credit	14	$33,086
Dependent Care Assistance Credit	*	$7,769
Historic Property Preservation Credit	*	$188,227
Infrastructure User Fee Credit	12	$27,699
Research Activities Credit	*	$347,934
Mineral Exploration Credit	*	$7,749
Elderly Homeowner/Renter Credit	17,016	$8,480,797
Film Expenditures Credit	*	$25,235
Insure Montana Small Business Health Insurance Credit	*	$2,541,034
Adoption Credit	*	$186,056
Total Income Tax Credits		**$64,066,856**
* Less than 10 taxpayers		
Source: Montana Department of Revenue, 2008-2010 Biennial Report		

Appendix B

Corporate Tax Expenditures

Table 8: Estimated Cost of Passive (Federal) Corporate Tax Expenditures on Montana Tax Revenue, 2009	
Exemptions	**Loss of General Fund Revenue**
Deferral of income from controlled foreign corporations (normal tax method)	$1,552,207
Deferred taxes for financial firms on certain income earned overseas	$119,401
Excess bad debt reserves of financial institutions	$1,126
Excess of percentage over cost depletion, fuels, and nonfuel minerals	$43,930
Exemption of certain mutuals' and cooperatives' income	$7,885
Exemption of credit union income	$163,331
Inventory property sales source rules exception	$271,467
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	$(6,759)
Deferral of gain on sale of farm refiners	$2,253
Deferral of tax on shipping companies	$2,253
Deductions	
Accelerated depreciation of machinery and equipment (normal tax method)	$3,221,561
Accelerated depreciation on rental housing (normal tax method)	$78,849
Deductibility of charitable contributions (education)	$75,470
Deduction for U.S. production activities	$1,316,785
Empowerment zones, enterprise communities, and renewal communities	$47,310
Expensing of certain capital outlays for farmers	$1,126
Expensing of certain multiperiod production costs for farmers	$1,126
Expensing of certain small investments (normal tax method)	$70,964
Expensing of exploration and development costs, fuels, and nonfuel minerals	$1,126
Expensing of multiperiod timber growing costs	$21,402
Expensing of capital costs with respect to complying with EPA sulfur regulations	$5,632
Small life insurance company deduction	$5,632
Special Blue Cross/Blue Shield deduction	$73,217
Other	
Special alternative tax on small property and casualty insurance companies	$4,506
Special ESOP rules	$146,435
Special rules for certain film and TV production	$(3,379)
Tax incentives for preservation of historic structures	$38,298
Total Passive Corporate Tax Expenditures	**$7,263,154**
Source: Montana Department of Revenue, 2008-2010 Biennial Report	

Table 9: Montana Corporate Tax Credits, 2009

	Number of Credits Claimed	Loss of General Fund Revenue
Film Production Credit	*	$16,583
Contractor's Gross Receipts	91	$1,692,954
Charitable Endowment Credit	18	$54,516
Recycling Credits	*	$70,936
Increased Research Activities Credits	22	$588,068
College Contribution Credit	31	$6,714
Montana Capital Company Credit	0	$0
Health Insurance for Uninsured Montanans	86	$65,632
Alternative Fuel Motor Vehicle Conversion Credit	0	$0
Dependent Care Assistance Credit	0	$0
New and Expanded Industry Credit	0	$0
Historic Property Preservation Credit	0	$0
Infrastructure Users Fee Credit	*	$541,522
Biodiesel Storage and Blending Credit	0	$0
Empowerment Zone New Employees Tax Credit	0	$0
Insure Montana Credit	164	$1,009,331
Alternative Energy Production Credit	*	$15,094
Oilseed Crushing & Biodiesel Production Credit	0	$0
Geothermal System Credit	0	$0
Mineral Exploration Credit	*	$1,361
Total		**$4,062,711**

Source: Montana Department of Revenue, 2008-2010 Biennial Report

Appendix C

Residential Property Tax Assessments

Property tax expenditures are not as straightforward as the tax expenditures for other types of taxes. Local governments are allowed to raise mills to offset a reduction in tax base. Thus, the property tax expenditures often result in tax shifts to other property taxpayers.

Table 10: Residential Property Tax Expenditures, 2009		
	Participants	**Total Benefits to Participants**
Property Tax Assistance Program-PTAP	10,716	$5,100,142
Disabled American Veterans	1,643	$1,465,596
Extended Property Tax Assistance Program- EPTAP	3,132	$483,933
Locally Reduced or Abated Taxable Values	127	$10,163,338
Tax Increment Financing Districts	n/a	n/a
Total	**15,618**	**$17,213,009**
Source: Montana Department of Revenue, 2008-2010 Biennial Report		

Appendix D

Natural Resource Tax Expenditures

Table 11: Natural Resource Tax Expenditures, 2009	
	Tax Expenditure Amount
Oil Production	
Horizontally Completed Wells, first 18 months	$18,169,751
Vertically Completed Wells, first 12 months	$1,182,623
Horizontally Recompleted Wells, first 18 months	$136,257
Stripper Wells	$3,505
Natural Gas Production	
Horizontally Completed Wells, first 18 months	$3,459,634
Vertically Completed Wells, first 12 months	$2,633,572
Stripper Wells	$2,759,693
Metalliferous Mines	$69,789
Metal Mines Gross Proceeds	$3,881
Coal Severance	$115,685
Coal Gross Proceeds	$0
Bentonite Production	$125,112
Total Natural Resource Tax Expenditures	**$28,659,502**
Source: Montana Department of Revenue, 2008-2010 Biennial Report	