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COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
No. 2021-SC-518
(Consolidated with Nos. 2021-SC-519, -520, -522)

COMMONWEALTH OF KENTUCKY
ex rel. Attorney General Daniel Cameron, *et. al.* APPELLANTS

v. Court of Appeals, No. 2021-CA-1320
Franklin Circuit Court, No. 21-CI-461

COUNCIL FOR BETTER EDUCATION, INC., *et al.* APPELLEES

AMICUS CURIAE BRIEF ON BEHALF OF THE KENTUCKY CENTER FOR ECONOMIC POLICY, JENNIFER BIRD-POLLAN, PETER ENRICH, AND DARIEN SHANSKE

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STATEMENT OF POINTS AND AUTHORITIES

ARGUMENT

One of the significant questions raised by Appellants' arguments in this case is whether, for purposes of Kentucky constitutional law, the delivery of funds to account-granting organizations ("AGOs") pursuant to the provisions of the Education Opportunity Account ("EOA") program should be regarded as the use of the Commonwealth's tax system to fund grants and tuition payments to private schools. As individuals and organizations with expertise in state tax and fiscal policy, both from within and from outside the Commonwealth, we offer this brief, as friends of the Court, to explain the reasons why the answer to that important question is "Yes."

In short, for many years, tax policy experts have recognized that tax expenditure programs, like the tax credits at the heart of the EOA program, are in many respects the functional equivalent of direct government expenditure programs, while also recognizing that many tax expenditure programs bear some significant differences from budgetary expenditure programs. In the case of the EOA program, however, the design of this particular tax expenditure program removes all of the significant distinctions that functionally distinguish most other tax expenditure programs from direct spending programs. As a consequence, the EOA program is, in all meaningful respects, the functional equivalent of a government expenditure program. The funds raised for the program are, in all practical respects, generated as tax revenues of the Commonwealth. And the expenditures for the EOA program are, in all practical respects, expenditures of state tax revenues. Any distinctions between this program and an analogous program expressly appropriating state tax revenues to the AGOs are entirely nominal.

I. TAX EXPENDITURE PROGRAMS, LIKE THE EOA PROGRAM, ARE WIDELY RECOGNIZED TO BE FUNCTIONALLY SIMILAR IN MANY RESPECTS TO BUDGETARY EXPENDITURE PROGRAMS, ALTHOUGH THERE ARE OFTEN SIGNIFICANT DISTINCTIONS BETWEEN THE TWO.

For more than a half-century, tax policy experts have highlighted the ways in which certain elements of tax laws, what have come to be referred to as "tax expenditures," should be understood and analyzed as functional alternatives to governmental programs that rely on the appropriation and expenditure of governmental revenues. In large measure, this understanding can be traced back to the path-breaking work of eminent Harvard Law School professor Stanley Surrey in the 1960s and 70s, but over the ensuing decades Surrey's insights have been widely incorporated into policy experts' and policy makers' discussions of the numerous tax provisions (at both the federal and state level) that seek to advance policies beyond the fair and simple calculation and collection of tax obligations.

In 1967, Surrey, then serving as Assistant Secretary of the Treasury, introduced the concept of tax expenditures in a widely noted speech. Surrey explained, "[t]hrough deliberate departures from accepted concepts of net income and through various special exemptions, deductions, and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures—in effect to produce an expenditure system described in tax language." *Excerpts from remarks by Assistant Secretary Surrey, Nov. 15, 1967, before The Money Marketeers, on the U.S. income tax system—the need for a full accounting*, in *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968,* at 323 (1969). Surrey defined tax expenditures as "tax rules" that are not "integral to a tax system in order to provide a balanced tax structure and a proper measurement of net income" but instead "represent departures from that net income concept and balanced structure to provide relief, assistance, incentive, or what you will for a particular group or activity." *Id.* at 323–24.

Surrey noted that "a decrease in revenues through a tax expenditure has the same impact on the budget deficit as a direct increase in expenditures." *Id.* at 325. Each such "special tax provision[] reduces Government revenues available for other purposes, much as do increases in direct Government expenditures," he added. *Id.* at 326. "Most [such] special tax provisions are designed expressly to achieve objectives similar in nature to those of direct Government expenditures or loan programs," Surrey pointed out. *Id.* at 327. In other words, "tax expenditures serve ends similar to those which are, or might be, served by direct expenditure programs or loan programs." *Id.* at 329. *See also* Stanley S. Surrey, *Pathways to Tax Reform* 6 (1973) ("a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures . . . provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies"). Surrey's conclusion was that policy makers need to assess such tax expenditures together with their assessment of direct expenditure programs, since both have the same impact on the public fisc and on the policies they are designed to fund.

Professor Surrey's insights have become the accepted wisdom both among fiscal policy experts and among governmental policymakers. For example, the most widely used and highly regarded public-finance textbook—Richard A. Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice* (5th ed. 1989) at 352—explains: "[F]ailure to collect the revenue . . . is in fact the same as collecting the revenue and then making an expenditure to leave the taxpayer in the same position."

In recognition of the fact that tax expenditures are functional alternatives to budgetary expenditures, both the federal government and the vast preponderance of the states regularly publish detailed reports cataloguing their tax expenditures and documenting the annual dollar amounts of those expenditures. Many of these "tax expenditure budgets" or "tax expenditure reports" are statutorily mandated as a part of the government's annual budget process. On the federal side, the Congressional Budget and Impoundment Control Act of 1974 ("the Budget Act") requires the Congressional Budget Office and the U.S. Treasury to annually publish detailed lists of tax expenditures. *See* Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024* at 2 n.4 (2020); Pub. L. No. 93-344; 2 U.S.C. § 602(e)(1); 31 U.S.C. § 1105(a)(16). Federal law also requires the Congressional Budget Office and other federal bodies to provide various studies and analyses of tax expenditures, including in conjunction with proposed budgets and legislation. *See* 2 U.S.C. §§ 602(g)(1); 2 U.S.C. § 632(e)(2)(E); 2 U.S.C. § 639(c); 31 U.S.C. § 1115(a)(2); 31 U.S.C. § 1121(a); 31 U.S.C. § 1122(c). The Budget Act defines "tax expenditures" as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 2 U.S.C. § 622(3).

State governments have likewise incorporated the tax-expenditure concept into their budgetary processes. According to the Institute on Taxation and Economic Policy, 49 states and the District of Columbia produce reports on tax expenditures in their states. *See* Institute on Taxation and Economic Policy, *State-by-State Tax Expenditure Reports* (Jan. 31, 2017), https://itep.org/state-by-state-tax-expenditure-reports/; *see also* Michael

Leachman, Dylan Grundman, & Nicholas Johnson, Center on Budget and Policy Priorities, *Promoting State Budget Accountability Through Tax Expenditure Reporting* 1 (2011) https://www.cbpp.org/research/state-budget-and-tax/promoting-state-budget-accountability-through-tax-expenditure (reporting that, as of 2011, 43 states and the District of Columbia were regularly producing tax-expenditure reports). In many states, such reports are produced pursuant to statutory requirements. *See, e.g.*, Mass. Gen. Laws ch. 29, § 5B; Colo. Rev. Stat. § 39-21-303.

Like many of its peer states, Kentucky's Office of the State Budget Director produces a Tax Expenditure Report, pursuant to legislative directive. *See* Office of the State Budget Director, *Tax Expenditure Analysis – Fiscal Years 2022-2024* (2021) ("Kentucky Tax Expenditure Report") (issued pursuant to House Bill 192 (RS 2021)). Comparably to other jurisdictions, House Bill 192 defines a "tax expenditure" as "an exemption, exclusion, or deduction from the base of a tax, a credit against the tax, a deferral of a tax, or a preferential tax rate." 2021 Ky. Acts 1151.

In line with the accepted understanding, the Kentucky Tax Expenditure Report expressly recognizes the functional similarity between budgetary expenditures and tax expenditures. The Report explains that "governments have a responsibility to be accountable to the public for the use of each and every tax dollar," Kentucky Tax Expenditure Report (cover letter), and that "[a] tax expenditure analysis can be used to evaluate the cost to state government of the many programs funded through tax expenditures," *id.* at 10. In light of this recognized parallelism between tax expenditure programs and direct expenditures of tax revenues, the Tax Expenditure Report is intended to "permit the review and evaluation of the numerous tax expenditures in much the same manner as that used for the review of direct outlays of government funds". *Id.* at 7.

Given the well-established understanding of tax expenditures and Kentucky's definition quoted above, there is no question that the funding mechanism for the Education Opportunity Account program is a clear example of a tax expenditure, and the Kentucky Tax Expenditure Report recognizes and describes it as such. *Id.* at 106. Funding for the program is generated by the grant of a tax credit, against any of several Kentucky taxes on individual and business income, based on the amount of a taxpayer's payments to an AGO approved by the Department of Revenue. Thus, as with other tax expenditures, the program reduces state tax revenue in order to subsidize payments to the AGOs, in practical effect diverting tax revenues to those organizations for expenditure by them on their statutorily defined purposes, including in particular, grants to and tuition payments for private schools.

Notwithstanding these close functional analogies between tax expenditure programs and parallel programs relying on the appropriation of budgetary funds, policy experts and the courts have recognized significant operational differences between the two types of funding systems, differences which may, in some circumstances, call for different analyses of the two. *See, e.g.*, *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 590-91 (1997) (a distinction between tax expenditures and direct subsidies "is supported by scholarly commentary and precedent, and we see no reason to depart from it"); *Walz v. Tax Commission*, 397 U.S. 664 (1970). Before concluding that a particular tax expenditure is truly the functional equivalent of direct budgetary spending, it is important to take account of these potential differences.

Perhaps the most important distinction is that typical tax expenditure programs, instead of directly allocating funds to a favored activity, instead operate by providing an incentive or reward to private actors that encourages and to some degree regulates their decisions about how to deploy their own resources. For example, the deduction for charitable donations, *see* Kentucky Tax Expenditure Report, *supra,* at 39, rewards and incentivizes taxpayers' decisions to contribute to charities of their own choosing, by underwriting a small portion of the cost of their contributions; the Commonwealth gives up five percent of the amount a taxpayer chooses to donate, and thus, in effect, pays five percent of the cost of the donation through a reduction in the taxpayer's tax bill. But the taxpayer bears the predominant share of the cost, with the tax benefit merely providing some reward and encouragement for the taxpayer's socially valued uses of the taxpayer's own resources. The vast preponderance of tax expenditures, whether taking the form of deductions, exclusions, deferrals, preferential tax rates, or credits, operate similarly, in underwriting the taxpayers' decisions about how to deploy their own private resources, by picking up some portion (in the case of state tax expenditures, typically a relatively small portion) of the cost through a tax reduction.

A second, related characteristic that distinguishes many tax expenditures from budgetary expenditures is the degree to which tax expenditure programs tend to leave broad discretion about specific choices or expenditures to the taxpayer. Budgetary programs are managed by government officials and reflect specific governmental policy decisions about how the public funds are to be spent. By contrast, many tax expenditure programs cover a wide range of private choices and allow the private beneficiaries of the program considerable leeway about the range of actions that will trigger the tax benefit. For example, the wide breadth of types of charitable organizations that were eligible for property tax exemptions was one of the factors that led the Supreme Court to distinguish such exemptions from direct public subsidization of religious organizations. *See Walz*, 397 U.S. at 672-73. Similarly, deductions or exclusions for retirement contributions, *see, e.g.*, Kentucky Tax Expenditure Report, *supra* at 26, or the sales tax exemption for purchases of machinery for new or expanded businesses, *id.* at 53, cover a range of choices that are left to the taxpayer. These tax expenditure programs define limits on what taxpayer activities and expenses will qualify for the tax benefit, and in that way the programs influence and regulate taxpayer behavior, but it is ultimately the taxpayer, not the government, that determines the allocation and use of the diverted tax revenue.

Finally, tax expenditure programs typically also differ from budgetary expenditure programs in the specificity with which the government manages and controls the levels of expenditure in the programs. As the Kentucky Tax Expenditure Report explains, *id.* at 8,

> Tax expenditures differ from normal budget expenditures in that normal budget expenditures are explicitly appropriated on an annual or biennial basis as part of the budgetary process. Tax expenditures are approved by the legislature and then become a permanent part of a state's tax laws until modified by future sessions of the General Assembly.

While tax expenditure reports serve to provide policymakers with estimates of the costs of tax expenditure programs, they do not provide policymakers with any control over the costs of these programs, nor with an ability to make decisions, as part of the budget process, about the trade-offs between tax expenditure programs and other potential uses of governmental resources.

In sum, tax policy experts have identified a wide range of ways that tax expenditure programs are functionally equivalent to budgetary expenditure programs, as ways of directing governmental resources in furtherance of specific policy purposes. At the same time, they have recognized several significant respects in which many tax expenditure programs operate differently from typical budgetary expenditure programs, in ways that leave such tax expenditure programs somewhat less closely tethered to governmental programmatic management. As a result, there is no single clear answer to the question of whether a tax expenditure program should be regarded as the functional equivalent of an analogous budgetary program. Specific answers will depend on specific circumstances.

II. THE SPECIFIC DESIGN OF THE EOA PROGRAM ELIMINATES ANY SIGNIFICANT FUNCTIONAL DIFFERENCES BETWEEN THAT PROGRAM AND AN ANALOGOUS BUDGETARY EXPENDITURE PROGRAM.

While there is no room for question that the Education Opportunity Account program is a tax expenditure program, there is also no question that it is not an ordinary tax expenditure program. In fact, on each of the dimensions discussed above as distinguishing typical tax expenditure programs from analogous budgetary programs, the EOA program demonstrates the features that usually characterize a budgetary program, rather than typical tax expenditure programs.

First, and perhaps foremost, whereas typical tax expenditure programs provide only a modest subsidy for taxpayer activities or expenses, the EOA program, uniquely among Kentucky tax expenditure programs, offers tax benefits that cover virtually the entire cost of the taxpayers' expenditures on the program. Even the de minimis share of the taxpayers' expenditures that isn't directly reimbursed by the program's tax credits will, in many cases be covered by other tax benefits allowed by the program. As a result, in the unique case of the EOA program, the entire (or virtually the entire) cost of the program is covered through the tax system, leaving virtually no element of taxpayer commitment or investment to the program. A taxpayer's payment to the program is nothing more nor less than a choice to direct a portion of their tax obligations to a specific statutory program created and defined by the legislature.

The EOA program provides taxpayers with a credit against their ordinary tax obligations equal to 95 percent of their payments to a qualifying AGO. KRS 141.522. Thus, a taxpayer who contributes $1000 to an AGO will obtain a tax credit of at least $950; the Commonwealth pays $950 of the taxpayer's "contribution," with the taxpayer only contributing, at most, the remaining $50. To allow this de minimis taxpayer commitment to meaningfully distinguish this program from a direct expenditure of governmental resources threatens to elevate form over substance, and to open a path for future lawmakers to circumvent constitutional restrictions on governmental spending by use of similar sleight of hand.

But, in fact, even this five percent taxpayer contribution will often be illusory. If a taxpayer commits to payments to the program in multiple years, the credit percentage automatically increases to 97 percent, KRS 141.522(4), so that each $1,000 payment only costs the taxpayer $30. And, of course, the portion of the payment which isn't offset by the credit will constitute a deductible charitable contribution for both federal and state tax purposes, thus reducing the taxpayer's taxes by as much as 42 percent of the remaining taxpayer cost (37 percent for the federal top rate plus 5 percent for the Kentucky tax rate), potentially shrinking the taxpayer's cost for a $1,000 payment to an AGO to less than $18.

But there's more: The EOA program allows taxpayers to use, not only cash, but also marketable securities for contributions to an AGO, with the credit amount measured by the market value of the securities at the time of contribution. Under federal law (to which Kentucky tax law is coupled), such contributions of securities avoid the capital gains taxes that would otherwise be owed upon disposition of securities that had gained in value.

This provides an additional and substantial tax benefit, which would allow many taxpayers to gain significantly more in tax reductions than the entire amount of their contribution to the AGO. For example, if a taxpayer, instead of contributing $1,000 in cash, contributed $1,000 of Microsoft stock which the taxpayer had originally purchased for $200, then, in addition to the $970 tax credit and the roughly $12 tax reduction due to the charitable deduction, the taxpayer would also avoid as much as $230 in federal (top rate of 23.8%) and state (rate of 5%) capital gains taxes on the increased value of the Microsoft shares. In total, the taxpayer would be enjoying as much as $1,212 in tax savings, in exchange for a $1,000 payment to an AGO. In such a case, not only is the state, with a little help from the federal government, paying the full cost of the contribution to the AGO, but it is also paying a substantial bounty to the taxpayer for serving as a conduit for funding the AGO.[1]

Indeed, it seems likely that many of the first taxpayers in line to benefit from the program's "first come, first served" limited pool of tax credits will be taxpayers for whom the program will yield a net gain. Tax advisers for a taxpayer who has both substantial tax liabilities and also significantly appreciated assets they wish to cash out will encourage such a taxpayer to apply for EOA credits at the earliest opportunity, since, for such a taxpayer, participation in the program will result in a significant positive cash flow. It would not be at all surprising if the program in toto provided greater tax savings to participants than the total amount of money contributed to the AGOs.

The fact that the EOA program is designed to compensate the taxpayer for virtually the entire cost, if not considerably more than the entire cost, of the taxpayer's payment is

[1] Even if attention is limited only to the state tax benefits resulting from the EOA program, contributions of appreciated property could frequently result in Kentucky tax savings in excess of the total amount contributed to an AGO. In the example here, the state tax savings alone would amount to $1,011.50 for a $1,000 contribution.

authorized to raise and spend no more than a specific dollar amount ($25 million annually) for a limited period of time (five years). The program's tax credits are not generally available to all taxpayers who wish to participate in the program; instead, they are allocated by the Department of Revenue to the first taxpayers to apply, until the annual $25 million cap has been reached. As with ordinary expenditure programs, the state legislature has decided on the specific amount of tax resources to be allocated to this program on an annual basis, allowing for recognition of the trade-offs between allocating these sums to this purpose rather than for other competing budgetary priorities. So, in this important respect as well, the EOA program is functionally indistinguishable from a budgetary allocation of tax revenues to a governmental program. The only difference is the mechanical difference between taking in the tax revenues and then directing them to the program and, instead, having taxpayers contribute amounts that they owe in taxes directly to the program while reducing their tax payments accordingly. In each case, the government is defining the parameters of the program, including the amounts to be expended on it, and then using the state's tax laws to raise the authorized funds.

Thus, on each of the dimensions that often distinguish tax expenditure programs from comparable budgetary expenditure programs, the EOA program exemplifies the characteristics of a budgetary expenditure program, not those that commonly distinguish tax expenditure programs. Functionally, the EOA program, in every significant respect, operates just like a budgetary program expending state tax revenues. A review of the Kentucky Tax Expenditure Report reveals no other tax expenditure programs that are similarly indistinguishable from a direct spending program. Nor are amici aware of such tax expenditure programs elsewhere, with the exception of several other states' comparable private-school tuition voucher programs.

In addressing the constitutional questions relating to the program, the Court should take account both of the functional equivalence between the EOA program and an analogous budgetary expenditure program and also of the sharp differences between this program and more typical tax expenditure programs. In both the manner in which program funding is raised and in the manner in which it is expended, the EOA program is functionally indistinguishable from a budgetary expenditure program, in which $25 million dollars of tax revenues yearly for five years are paid out to governmentally approved, private grant-making organizations that are required to expend the money on grants for a legislatively defined range of supports for certain public and private education programs.

CONCLUSION

For all practical purposes, the EOA tax-credit funded expenditure program is the functional equivalent of a direct budgetary expenditure program advancing the same legislatively defined purposes through appropriated expenditures using the same mechanisms. This functional equivalence sharply distinguishes the EOA program from most other tax expenditure programs.

Amici tax and fiscal policy experts urge the Court to recognize this functional equivalence in its analysis of the constitutional challenges being brought against the program. Granting significance to the technical differences in the mechanics between the EOA program and a functionally identical budgetary expenditure program will only invite future legislatures to use identical devices to nullify important constitutional restrictions on state governmental spending.

Respectfully Submitted,

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