

Fiscal Magic: Outsourcing and the Taxing Power

Seth B. Payton*

Assistant Professor, School of Public and Environmental Affairs
Indiana University-Purdue University Indianapolis
801 W. Michigan St., IN 46202
sbpayton@iupui.edu

Sheila S. Kennedy

Professor, School of Public and Environmental Affairs
Indiana University-Purdue University Indianapolis
801 W. Michigan St., IN 46202
shekenne@iupui.edu

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*Corresponding Author

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Some state and local governments in the United States are increasingly outsourcing services through third party surrogates. In some instances, outsourcing is used as a mechanism to raise revenue to cover current deficits or pay for goods that would otherwise require increasing taxes. We argue that certain forms of outsourcing have been used to mask accountability for the levying fees that are substantively indistinguishable from taxes and thus shift tax burdens. We call for additional research to examine the shifting cost burden associated outsourcing deals and the increased challenge of maintaining public fiscal accountability.

Introduction

Government authority to tax is directly related to the provision of public goods and services. The relationship between taxing authority and taxpayer is shaped by demands for goods and services and budget constraints. Principles like transparency, neutrality, equity and fairness have long been held essential to the proper exercise of the taxing power (Stiglitz 2000; Mikesell 2010). The recent legal argument that there is no “reasonable” distinction between a tax, a fee or a penalty, does not render the matter moot.¹ The imposition of a tax by a governmental unit possessing statutory taxing power is subject to certain constraints. The governmental unit that fails to comply with those constraints risks loss of legitimacy.

The purpose of this paper is to examine one of the ways in which local government officials may relinquish taxing power. In this paper, it is argued that outsourcing pays for hidden costs using a powerful “fiscal illusion.” The fiscal illusion associated with outsourcing is so powerful it might be deemed “fiscal magic.” The fiscal magic to which is alluded in this paper evades transparency and therefore legitimacy. This paper first presents a brief explanation of the notion of fiscal illusion- a term that represents multiple hypotheses for how the costs of public goods and services are hidden and difficult to calculate. Then this notion is extended to show how tax arrangements not designed for, but used to, support outsourcing revenue collection can hide real costs from the public. Such hidden costs result in another sort of fiscal illusion. This notion is applied to a case study in Indianapolis, Indiana – a city that has vigorously embraced the outsourcing of goods and services historically provided by government, within a state

that has done likewise. Finally, this paper concludes with some thoughts on the wider implications of these notions.

Fiscal Magic and Fiscal Illusion

Like good magicians, sometimes public officials are able to deflect the attention of their taxpayer audience from what is actually important in understanding how taxes pay for government goods and services. When public officials are able to pull this kind of trick, the public believes that some managerial magic has been performed on the costs and associated tax revenues rather than having them understand that the bargain price is an illusion. Nevertheless, the reality is that a good illusion has passed for magic. This is equivalent to a stage show. The “trick” results in what public finance scholars call a “fiscal illusion.”

Fiscal Illusion

When public officials’ implement shifts in the tax burden which are not transparent to the taxpayers and create the impression that the resulting tax burden is better than it is, they are using a fiscal illusion. Clearly, public officials may have an incentive to do this. Public officials may appear fiscally conservative while covertly addressing constituent demands at a perceived lower cost. Fiscal illusion is a concept based upon the notion that taxpayers do not always understand the real costs at which they receive public goods and services. Oates (1988) specifically presents five potential forms of fiscal illusions used by public officials: (1) tax structure complexity; (2) income elasticity of tax structure; (3) renter illusion; (4) the Flypaper Effect; and (5) debt illusion.

He notes that Puviani (1903) and Buchanan (1967) suggest that political leaders may fragment tax levies through complex tax structures to make it difficult for taxpayers to accurately identify the actual costs associated with public goods and services. In addition, public officials may benefit from the hidden tax burden shift from landlords to renters, creating a renter illusion, which leads to increased spending when a jurisdiction is made up of a larger fraction of renters. Furthermore, public officials may offset taxes collected from highly income elastic sources when economic circumstances are beneficial for the underlying tax base (i.e., income elastic tax structure) or from intergovernmental revenues (i.e., flypaper effect). Finally, when taxpayers are confronted by borrowing strategies that displace the current costs of public services and goods onto future generations they may be denied the transparency necessary to calculate those costs as part of the tax burden and suffer from a particular fiscal illusion, what might be called debt deception and Vickery calls “debt illusion” (1961).

Oates (1988) explains that the empirical evidence has yielded mixed results for various fiscal illusion hypotheses. Those hypotheses are difficult to test. Outcomes sought are whether or not circumstances exist that reduce the perceived costs of public goods and services.

This paper suggests that fiscal illusion may occur through an additional mechanism, the outsourcing of the taxing power- a fiscal mechanism we provocatively refer to as fiscal magic because it encompasses and transcends typical fiscal illusionary strategies. This is an illusionary tactic that is easier to explain. It is a case in which the power to tax for providing public goods and services has been delegated to the nongovernmental sector. A case from Indianapolis, Indiana illustrates the fiscal transfer

associated with our hypothesis of fiscal magic in which public officials relinquish a portion of their taxing power to finance a particular project that is not disclosed as such. Specifically, the case looks at the sale of a public sewer and water utility to generate revenue for the repair of sidewalks and streets.

Outsourcing as a Source of Fiscal Illusion

Outsourcing, privatization and contracting² are terms employed to describe mechanisms intended to provide government services through third-party surrogates. There are literally hundreds of scholarly articles on these and various other aspects of contracting and the New Public Management. These terms have been subject to comprehensive analyses by scholars in public administration, political science, and law among others (e.g. Dannin 2006, Minow 2000, Project on Government Oversight 2011, Milward 1994, 1995, 1996; Milward and Provan 1993, 1998, 2000, Brudney, Ryu, Wright 2003; Hefetz and Warner 2004, Winston, Burwick, McConnell and Roper 2002; Kennedy and Jensen 2004, Kennedy and Bielefeld 2002, Kennedy 2003, Dannin 2008; Fernandez 2007; Marvel and Marvel 2007 Kennedy 2001, Metzger 2003, Gilmour and Jensen 1998).

Yet little of this literature has focused on the relationship between outsourcing and taxation. Specifically, the current literature has not examined how the former affects the levying of the latter when delegating to vendors and other third parties the inherently governmental authority to raise fees or tax. There remains an unanswered question. Has outsourcing been used effectively to mask accountability for the levying of fees that are substantively indistinguishable from taxes and thus shift tax burdens?

Creating Fiscal Illusion through Outsourcing Taxation: The Indianapolis Water Utilities PILOT

The State of Indiana and especially the City of Indianapolis have been among the units of government most enthusiastic about outsourcing, and have entered into transactions that highlight the sort of question to which we allude. Indiana's Toll Road contract to lease the Indiana Toll Road to a private consortium for 75 years drew criticism for a number of reasons, not the least of which was the ceding of authority to raise tolls to a private vendor; that contract was similar to infrastructure outsourcing elsewhere (Gilmour 2012). Had the Governor and legislature opted for a bond issue secured by higher toll revenues instead of leasing arrangement, the State's yield may have been substantially higher. Such a decision would have required the legislature to raise tolls (these tolls fall within the definition of fees, rather than taxes); however, the lease transaction shifted the decision about raising tolls from legislators to the private vendors and made it a business rather than a political decision. This insulated elected legislators from the consequences of a potentially unpopular decision. Rates for use on a public property went up, but "the public" did not pay more and "public officials" did not decide to raise the rates – fiscal magic!

Indianapolis Water and Sewer Utility Sale

The subsequent sale of Indianapolis' water and sewer utilities was a highly sophisticated transaction that raised far more complicated issues. The Indianapolis Water Company had operated as an investor-owned utility for most of its existence. In 2002, during the Peterson Administration, the City of Indianapolis purchased the water

company, citing the need to control costs. A number of experts publicly charged that the City paid too much for the utility; whether or not those criticisms were justified, the City found itself facing significant deferred maintenance costs and a lack of employees with the expertise needed to oversee management of the utility. The Peterson administration also negotiated a settlement with the EPA of a protracted lawsuit over numerous environmental violations caused by an inadequate City-owned sanitary sewer system.

After a new administration was installed, the City's ability to assume the costs of the deferred maintenance of the water company and the legally-required upgrades to the sewer system were further challenged by newly-enacted property tax caps in 2008. Those caps reduce the amount of revenue the City can collect by limiting the property tax bill to one percent of the gross assessed value for homestead property, two percent of the gross assessed value for other residential and agricultural property, and three percent of gross assessed value for the remainder real and personal property. Effectively, the property tax caps amounted to savings for taxpayers and less revenue for local governments.

Citizens Energy Group Purchase

Faced with mounting costs and recognizing that the operation of utilities requires specialized skills not within the City's core mission, the City decided to sell the water and sewer utilities to Citizens Energy Group (formerly, Citizens Gas and Coke Utility). Founded in 1887 as Consumers Gas Trust Company, Citizens was established as a public charitable trust, controlled by a self-perpetuating Board of Trustees who appoints the company's directors. Citizens is widely regarded as a well-run utility management company, and the decision to vest control of all the city's utilities in a public trust had

much to recommend it. Citizens not only had the management depth and expertise to administer the water and sewer systems, its unusual legal status of Charitable Public Trust removed many of the concerns that attend a transfer of public functions to a for-profit third party.

The structure of the transaction, however, raises a number of disquieting questions about transparency, the locus of the tax burden, and the funding of public services generally. The Mayor promoted the sale of the utilities by promising to use the proceeds for needed infrastructure repairs (i.e., streets and sidewalks). Two legal documents governed the transfer: an MOU, or Memorandum of Understanding, and the Contract of Sale. Stripped to the essentials, the agreement called for Citizens to pay for the acquisition of the water and sewer systems by assuming their combined existing liabilities, totaling nearly 3.5 billion dollars. However, a straightforward assumption of liabilities would not have resulted in an “up front” cash windfall that the City hoped to use to repair infrastructure and supplement dwindling tax revenues.

Tax Increase Paid by Ratepayers Pays for Bond Issue

Therefore, the money for the infrastructure repairs was generated through the modification of payment in lieu taxes (PILOT) amounts payable to the City by Citizens Energy as a not for profit entity. Payments in lieu of taxes to municipalities for the foregone taxes on real estate or for changes in the taxable status of organizations are common in the U.S. As part of the transfer agreement, Citizens “voluntarily” recalculated the amount due annually to the City under the statute requiring a PILOT payment. The City then issued bonds, secured by the increased PILOT, and used the proceeds of those

bonds to repave streets and repair other decaying infrastructure. The Mayor, running for re-election, could and did claim credit for completing very visible public improvements “without raising taxes.”

The higher PILOT payments by Citizens, meanwhile, become part of the calculation of the utility’s rate base, which if increased will be passed on in rates to the utility’s clients. Under Indiana law, had Citizens simply “overpaid” for the water and sewer systems, the amount by which the purchase price exceeded the fair market value of the acquired assets would not have been an allowable basis for calculating the rate. PILOTS, however, are an allowable expense in the rate base.

This highly sophisticated financing scheme for the sale raises both legal and policy issues. The PILOT statute provides that the appropriate maximum payment will be equivalent to the property tax that would be due on tangible property owned but for that property’s exempt status. The terms of the sale—a transfer in exchange for assumption of debt—confirmed that both parties assigned a negative value to the tangible property; what Citizens was purchasing was an intangible value --the ongoing income stream of rate payments. It is by no means clear that a PILOT payor can “voluntarily” raise its payment, although when that question was raised to a member of Citizens’ board, the authors were told that the board had obtained and relied upon a legal opinion that the strategy was permissible.

Bifulco, Bunch, Duncombe, Robbins, and Simonsen (2012) recently addressed the distinction between selling government assets for the purpose of avoiding deficits (or raising additional revenue) and selling government assets that may have more value under private ownership. The problem associated with selling assets to cover current

deficits or as a revenue mechanism to cover current costs, is that it creates a fiscal illusion by masking the ongoing fiscal burden for which proceeds from the sale of the asset are being used. In the Indianapolis case, a not for profit organization financed the purchase of local government asset by taking on a tax debt with that same local government: the local government is issuing debt against the asset to pay for the purchase of the asset and its maintenance. Eventually, the purchase price will have to be covered in the maintenance and operating costs.

The upshot is that Citizens will need to raise its rates in order to pay both for necessary infrastructure improvements for the utility and the increased PILOT payments. Higher rates to cover the costs of infrastructure repair and maintenance would have been necessary in any event; that is, even if the City had retained control of the utilities, those costs would be fees borne by ratepayers

The amount by which rates must be raised to cover the additional PILOT, however, is another matter. It shifts the cost of street and infrastructure repair from property taxpayers to utility ratepayers. As a result, the linkage between the tax cost and public benefit of street and sidewalk repair is severed: ratepayers pay the upfront bill for a public good enjoyed by all taxpayers and taxpayers only pay later, if the PILOT payments do not cover the debt to be retired.

Conclusion

To the extent that accountability requires transparency, efforts to pay for public infrastructure but avoid a “tax increase” will increasingly challenge fiscal accountability. Hidden, or insulated, expenditures will feed into unrealistic public expectations about the

costs of public services. Despite a rich literature dealing with other aspects of contracting and privatization, however, these sorts of transactions, and their implications for tax policy and public finance, have received inadequate attention. We do not know how widely these strategies are being used, how much control over revenues government agencies are ceding to private actors, the effects of the shifts in tax burden, or the long-term consequences of today's "let's make a deal" approach to financing public goods. We need research to answer these and other questions raised by novel approaches to public finance and taxation.

Because accountability requires transparency we need to work on increasing transparency in practice, too. Whether we call these charges taxes, fees, or penalties, and whether we call these increasingly complicated relationships privatization, public-private partnerships, contracts for services, or outsourcing, one thing is clear: the discretion in the contracting relationship should be open and transparent to inspection by both participants and the public. It is important to specify and make readily available the actual costs of tax levies or user charges, bond issues, bond funded projects, purchase agreements, and asset transfer among many other multi-sector transactions. One thing that can be done is to require broader financial impact assessments and make these publically available before deals are made. Another is to ensure that better contracting measures are in place that force costs in the operation and financing of public enterprise to be made public. These sorts of arrangements have potential to change the face of public administration and public finance: fiscal illusion must be dispelled by letting the public in on the trick.

Notes

1. The recent U.S. Supreme Court decision from the *National Federation of Independent Business v. Sebelius*, ruled the Affordable Care Act a proper exercise of Congressional authority under the taxing power. That decision highlighted not only the surprisingly contested question of what constitutes a tax, but equally contested and blurred distinctions between a “fee,” a “penalty” and a tax.
2. It has been pointed out that “privatization,” properly understood, does not fall in this category. Privatization is the sale of government assets to the private sector. (Thatcher’s sale of steel mills to private interests in Great Britain, for example.) In the U.S., however, the term is used interchangeably with outsourcing and contracting to mean the practice of delegating public service delivery to third parties.

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