Tax Expenditure Review Report: Bringing Tax Expenditures into the Budget Process

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Minnesota Tax Expenditure Review Report: *Bringing Tax Expenditures into the Budget Process*

Issued in February 2011 by Minnesota Department of Revenue with assistance from Marsha Blumenthal, Laura Kalambokidis, P. Jay Kiedrowski, John Spry, Judy Temple, and Jenny Bourne (Wahl)

Favorable comments:

- "Sound advice on how to think about tax expenditures and ideas for evaluating them and even 'sunsetting' some of them"
  - Former President of Growth & Justice Dane Smith
- "Tax expenditures impact the state budget in the same way as spending programs, with less scrutiny"
  - Former Revenue Commissioner Ward Einess writing in a Citizens League publication

Differences: Direct and Tax Expenditures

- Direct Expenditures

  Spending side

  Itemized

  Regularly reviewed/reauthorized via discipline of budget cycle

- Tax Expenditures (exceptions to a reference tax base)

  Revenue side ("The revenue not taken")

  Not itemized

  Rarely if ever reviewed, almost never contain sunsets

So What?

- Tax expenditures are spending by another name
- Tax expenditures are large
  - Individual Income Tax: More than half as large as revenue collected
  - Sales Tax: Greater than amount of revenue collected
- Older tax expenditures often have no stated purpose
- Tax expenditures are not transparent

Proposed Review vs. Current Tax Expenditure Budget (TEB)

- TEB offers information, not evaluation
- TEB definitions are somewhat different
- TEB does not prioritize
- TEB is not integrated into budget process

Defining Normal Tax Bases to Measure Tax Expenditures

"The most critical requirement for a tax expenditure budget is that it be driven by a clear conception of intended tax policy. In other words, before measuring the tax expenditures as deviations from the normal tax structure, the normal tax structure must be clearly defined."

- Prof. John Mikesell, Indiana University

"Identifying provisions as tax preferences is not without controversy."

- Dr. Donald Marron, Director of the Urban Institute-Brookings Tax Policy Center

Seven Criteria For Tax Expenditures

- Applies statewide, even for local taxes;
- Confers preferential treatment on certain persons, types of income, transactions or property;
- Results in reduced state tax revenue;
- Is not included as an expenditure (spending) item in the state's budget;
- Is included in the defined tax base for that tax;
- Is not subject to an alternative tax; and
- Can be amended or repealed by an amendment to state law.

Normal Tax Bases

- **Income Taxes**
  -Income from all sources less expenses that are reasonable and necessary to generate that income. If an expense is reasonable and necessary to generate income, a tax deduction for that expense is not considered to be a tax expenditure.

- **Corporate Franchise Tax**
  -Straight line depreciation over specified asset life as a proxy for economic depreciation
  -Uniform Division of Income for Tax Purposes Act(UDIPTA)
    -Equal weight apportionment (payroll, property, and sales)
    -Throw-back rule

- **Sales and Use Tax**
  The reference tax base should be consumer purchases of goods and services, not sales of intermediate goods, such as goods purchased for resale or capital goods.

Frame for Evaluation

- Tax Policy Principles
  - Allocative efficiency
  - Horizontal equity (equal treatment of equals)
  - Simplicity

- Other Public Policy Objectives
  - Vertical equity (fairness)
  - Reduction of tax burden on targeted groups
  - Promotion of specific activities or sectors
  - Promotion of overall economic development
  - Preservation of competitiveness
  - Compliance with federal directives or state constitutional provisions
  - Stability of state revenue

Information Needed

- A stated purpose for the given tax expenditure
- Direct impact
  - Number and nature of those who pay less tax
  - Change in behavior
  - Unintended results
- Indirect impact (hard to measure)
- Budget impact
  - Foregone revenue/foregone reduction in tax rates
  - Possibility of revenue-neutral tax reform
  - Static estimates easier to obtain than dynamic effects on growth
- Consideration of alternatives

Recommendations to Create Tax Expenditure Commission

- Minnesota create a Tax Expenditure Commission of policy and tax specialists to oversee the evaluation process and recommend changes based on those evaluations to the governor and the Legislature.

- Commission depend on expert staff at the Department of Revenue and other state agencies for the primary evaluation work.

- Legislature appropriate sufficient funds to pay for the 12 annual tax expenditure evaluations proposed.

- Tax Expenditure Commission define a clear and measurable purpose for each tax expenditure if one is not stated in law.

Proposed Evaluation Cycle

Proposed Evaluation Cycle *			
Year	**Tax Expenditures**	**Year**	**Tax Expenditures**
1	Six from Income Tax Six from Corporate Tax	5	Six from Property Tax More from Corporate Tax
2	Six from Sales Tax Six from Income Tax	6	More from Sales Tax More from Property Tax
3	Six from Corporate Tax Six from Sales Tax	7	Remainder from Income Tax Remainder from Corporate Tax
4	Six from Property Tax More from Income Tax	8	Remainder from Sales Tax Remainder from Property Tax

**Order of income, corporate, and sales tax is shown for illustration only. We make no recommendation about which tax type should be first.*

Budget Process Recommendations (1)

- Tax expenditures be fully integrated into the biennial budget process, requiring the governor and Legislature to make explicit decisions about whether to extend, repeal, modify or replace them.

- Revenue-neutral sunset for each tax expenditure, following its evaluation. It would expire and the rate for the tax would be adjusted downward to hold revenue constant.

- Tax expenditures be classified by core function to the extent possible, so they can be compared to direct expenditures that serve the same function.

Budget Process Recommendations (2)

- Appropriations committees examine tax expenditures alongside any direct expenditures within their purview that serve the same functions. The tax committees would need to review any suggested changes.

- State budget summaries include total tax expenditures for each tax to show their fiscal impact on gross tax revenue.

- Tax expenditures be included as a separate category in the Legislature's joint budget resolution.

Hypothetical Example of Revised Budget Format

Revised Budget Format	FY10	FY11	FY12	FY13
Balance Forward	**3,086,513**	**3,105,787**	**2,770,079**	**(1,212,436)**
Prior Year Adjustments	**80,221**	**26,304**	**25,020**	**25,020**
Adjusted Balance Forward	**3,166,734**	**3,132,091**	**2,795,099**	**(1,187,416)**
Gross Income Tax	**11,027,458**	**12,124,900**	**12,731,900**	**13,703,500**
Federal Exclusions	(2,937,500)	(3,232,700)	(3,460,500)	(3,662,000)
Federal Deductions	(390,700)	(412,100)	(447,800)	(457,200)
Federal Personal Deductions	(846,500)	(895,100)	(973,100)	(1,045,600)
Minnesota Subtractions	(33,000)	(34,000)	(36,100)	(38,200)
Credits	(288,800)	(315,600)	(315,000)	(324,000)
Net Income Tax	**6,530,958**	**7,235,400**	**7,499,400**	**8,176,500**
Gross Corporate Income Tax	**897,835**	**1,269,170**	**1,089,480**	**1,204,350**
Exempt Organizations	(27,400)	(34,200)	(40,200)	(43,000)
Federal Exclusions	(16,100)	(16,500)	(16,900)	(17,400)
Federal Deductions	(37,000)	(42,300)	(45,900)	(46,100)
Apportionment	(122,500)	(168,000)	(210,700)	(234,500)
Minnesota Subtractions	(15,930)	(20,470)	(24,280)	(25,550)
Credits	(15,400)	(19,900)	(23,700)	(24,700)
Net Corporate Income Tax	**663,505**	**967,800**	**727,800**	**813,100**

Information Access Recommendations

- We recommend that the Legislature require the Department of Revenue to disclose the beneficiaries of business tax credits online.

Recent Efforts in Other States

- Iowa: detailed annual reviews by experts of selected tax expenditures
- Washington: 10-year review cycle of all tax expenditures
- Colorado: thorough review delivered September 2020
- Vermont: full and expedited reviews of some provisions 2019
- Ohio: brief review 2018
- Massachusetts: periodic reviews of selected tax expenditures
- Rhode Island and Oklahoma: review of tax credits
- Maine: review of economic development tax provisions
- Delaware and California: some evaluation in tax expenditure budgets

We would be happy to answer your questions

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