Summary Statement on Tax Expenditures:

The Citizens League finds that tax expenditures confer preferential treatment on certain persons, types of income, transactions or property and are a government benefit that should be evaluated for achieving public purposes similar to programs funded by government appropriation.

The Citizens League finds that tax expenditures are a significant share of the total revenues available to the state for operations and warrant evaluation and authorization as part of the biennial budget process.

The Citizens League finds that under the current arrangement in Minnesota, tax expenditures violate the principles of transparency, equity and efficiency to a much greater degree than spending programs typically do.

The Citizens League concludes that changes must begin now if we are to evaluate expenditures and stabilize the state budget for the long-term.

The Citizens League recommends that the Legislature establish a process for long-term evaluation of tax expenditures in 2013 along the lines of the February 15, 2011 report "Bringing Tax Expenditures into the Budget Process." This includes the following:

- That evaluation cycles for different types of tax expenditures are established.
- Then legislators must decide on those cycles whether to continue specific tax expenditures or those tax expenditures "sunset."
- If an expenditure sunsets, the automatic mechanism would be rate reduction for that tax so it would require an additional action by the legislature for the sunset to result in increased revenue for the state.

Citizens League
Common ground. Common good.

Statement on Tax Expenditures:

Tax expenditures should be part of the state budget process

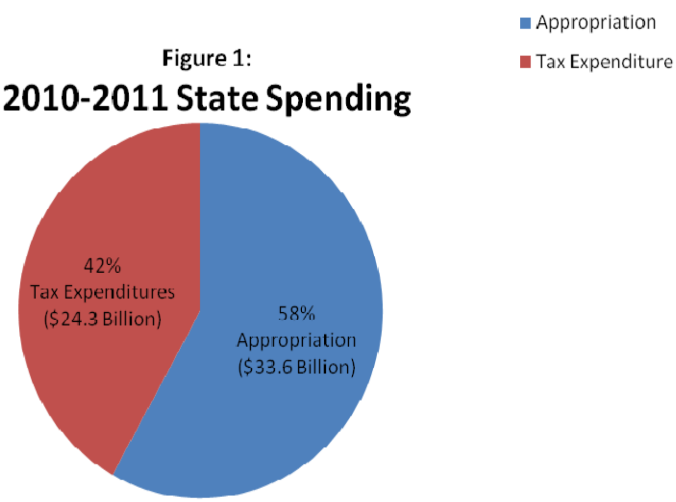
Most Minnesotans know that state government faces an ongoing structural budget problem and that spending cuts and/or tax increases are needed to balance the 2013-2014 biennial budget. What most Minnesotans don't realize is that legislators and the governor only consider about 60 percent of the entire "pie" of government benefits in the legislative budget process.

Government benefits delivered through tax expenditures are the other 40 percent that are starting to be discussed more but still are not part of the budget process (see Figure 1). Tax expenditures are is made up of provisions in the state tax code that provide "special treatment to special interests"[1] and don't usually provide a measurable outcome for the costs they create.

Tax expenditures are created when the legislature makes a law to provide exemptions or deductions to an activity or type of income that would otherwise be part of the tax as it was established. In order to be considered a tax expenditure, a tax provision must meet all seven of the criteria established by the Minnesota Department of Revenue for its biennial Tax Expenditure Budget (TEB) report. The provision must:

- Apply statewide
- Confer preferential treatment on certain persons, types of income, transactions or property
- Result in reduced state tax revenue
- Not be included as a spending item in the state's budget
- Be included in the defined tax base for that tax
- Not be subject to an alternative tax
- Be able to be amended or repealed in state law

Figure 1:
2010-2011 State Spending



Source: Minnesota's Bottom Line

As such, tax expenditures often have a much different impact in terms of who benefits and who pays than lowering or raising the rates on a broad-based tax. Government is choosing to confer a benefit in a way that is easier and less accountable than "writing a check." In general, this is why tax expenditures are not the same as tax cuts which reduce the rate on an existing tax.

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[1]"The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform." December 2010. Retrieved from http://www.fiscalcommmission.gov. Erskine Bowles and Alan Simpson co-chaired the commission.

The Citizens League focuses on three principles in particular that should be the foundation for our tax and revenue systems.

- Accountability (Transparency)
- Equity (Fairness)
- Efficiency (Simplicity)

These principles are well-defined over 25 years of reputable tax policy work, and tax expenditures often violate these principles to a much greater degree than spending by appropriation for the following reasons.

<u>Principle #1: Accountability (Transparency)</u>

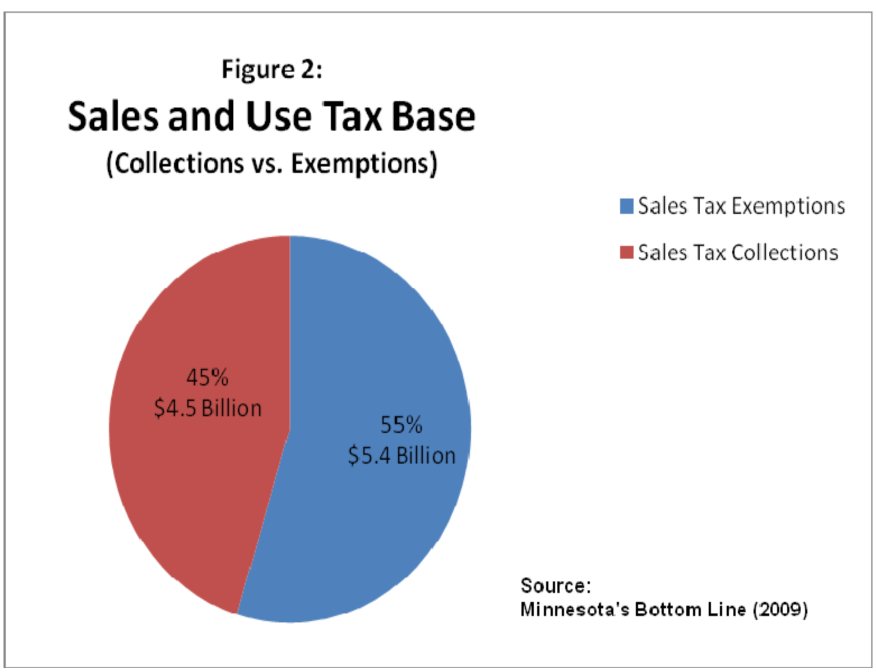
Tax expenditures result in costs to the state that are passed through – with little or no transparency – to those who do not receive the benefit. Tax expenditures are not typically evaluated in terms of public purpose (which may or may not exist) or ability to meet goals. Unlike spending that is appropriated through the legislature, tax expenditures do not need to be re-authorized every biennium. **From a fiscal policy perspective, tax expenditures are essentially on auto-pilot with little to no accountability.**

Basic measures of accountability and transparency that are in place for spending programs are just entering the tax expenditures landscape in Minnesota through a law passed in 2010 that requires future tax expenditures to state a purpose and suggest a way for measuring how that purpose would be met. Minnesota is a leader in this area as we began publishing a Tax Expenditure Budget (TEB) 20 years ago that has grown more nuanced over time. To actually begin evaluating tax expenditures is a baby step in terms of accountability from the groundwork laid 20 years ago. But there is momentum now from the efforts that led us to the 2010 law change and the 2011 report from the Department of Revenue.

Since spending programs are scrutinized at least every two years, tax expenditures fail on the principle of accountability in a dramatic fashion. This lack of accountability is a big reason why tax expenditures are much easier for policymakers to approve than "writing a check" through the appropriations process. **Tax expenditures should be scrutinized and prioritized alongside spending programs. A process to begin evaluating all tax expenditures needs to be put in place this year.**

<u>Principle #2: Equity</u>

Those who receive an exemption or deduction think of that particular tax expenditure as a tax cut, but **the real impact of certain items and activities receiving exemptions from taxes is to raise taxes on everyone who does not benefit from the exemption.** Minnesota's extraordinary exemptions to the service economy result in the state collecting from less than half of the defined sales and use tax base (see Figure 2). This means that all the activities

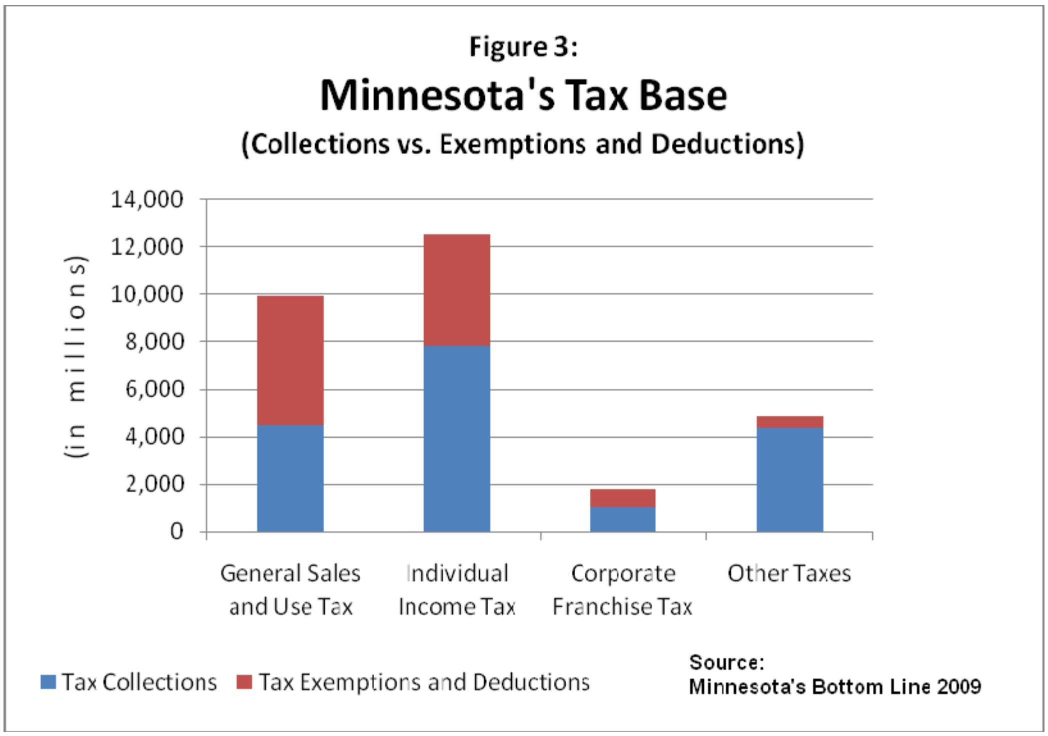


where the sales tax is applied pay a much higher rate than they would if the tax was applied to most, or all, of the base.

And because tax expenditures are usually not focused on a measurable policy goal with the accompanying targets and outcomes, this "narrow base" applied to the sales tax has the strong potential to decrease equity over the long term with little awareness to policymakers or the public. Table 1 on the last page (Distribution of Selected Tax Expenditures) shows the impact on equity for about $3.7 billion in tax expenditures (where distributional impact could be calculated). It is unlikely that the other $7-8 billion would be distributed much differently since many of the tax expenditures can only be claimed by those who itemize deductions or have a greater impact on those who spend more.

Principle #3: Efficiency (Simplicity)

The hallmark of an efficient tax system is one that has few exemptions and keeps the tax rate that is applied as low as possible. This leads to greater simplicity and efficiency to the entire economy and reduces violation of the equity and accountability principles. The volume of exemptions and deductions in the sales and income tax areas (see Figure 3) create a complex mélange of rules and eligibilities. Fewer exemptions and deductions that are better targeted to policy outcomes will also have a benefit to any entity that must navigate the current administration of these taxes.



The Citizens League has two general recommendations that must happen this year to make tax expenditures part of the solution to stabilize the state budget for the long-term.

- **The Legislature should establish a process for long-term evaluation of tax expenditures** this year along the lines of the February 15, 2011 report "Bringing Tax Expenditures into the Budget Process." Given their significance as a share of the total revenues available to the state for operations, tax expenditures warrant evaluation and authorization as part of the biennial budget process.

- **Any actions taken this year should be tied to long-term evaluation**, meaning that if any tax expenditures are eliminated or changed this biennium they should still be included in the evaluation process in subsequent years so that they are evaluated along with any tax expenditures that remain in law.

Background

The Citizens League Tax Expenditure Advancement Group was charged by the Executive Committee of the Board of Directors on February 21, 2011 with developing a more specific position based on Recommendation #8 of the Pathways to Prosperity Project.[2]

Recommendation #8 of the Pathways to Prosperity Project states:

- *Minnesota must provide a transparent and comprehensive representation of all government benefits, including tax expenditures, for public discussions about state spending and include all such benefits in any decisions to reallocate state expenditures*.

In an effort to provide relevant advice and direction to the Legislature regarding the role of tax expenditures in the current biennial budget, the Citizens League will form a short-term advancement group within the Pathways to Prosperity Project and recommend a principled course of action based on (but not limited to) the following resources:

- The recommendation of the Pathways to Prosperity committee regarding "a new definition of government benefits" (2010)
- The recommendations in the recent report by the Department of Revenue "Bringing Tax Expenditures into the Budget Process" (Feb. 15, 2011)
- The findings from the statewide Common Cents meetings (2010-2011)
- The final report of the Budget Trends Study Commission (January 2009)
- The Governor's 21st Century Tax Reform Commission (2009)
- The work of Minnesota's Bottom Line project (2009) and its 2011 update.
- The Citizens League report "Cut Tax Exemptions, Boost Equity and Accountability" (1988)
- The Citizens League report "Minnesota's Budget Problem: A Crisis of Quality, Cost and Fairness" (1993)

Members of the Tax Expenditure Advancement Group:

- John Adams — Citizens League Policy Advisory Committee
- Bob Armstrong — Citizens League Policy Advisory Committee
- Bright Dornblaser — Citizens League Policy Advisory Committee, Pathways to Prosperity Project
- Dan Hoxworth — Citizens League Pathways to Prosperity Project
- Geoff Maruyama — Citizens League Pathways to Prosperity Project
- Jeff Peterson — Citizens League Board of Directors, Policy Advisory Committee
- Nena Street — Citizens League Board of Directors

[2] The Board of Directors discussed and directed further development to the Executive Committee on February 14, 2011. The Executive Committee approved a process to produce a policy statement on March 21, 2011. A draft statement was discussed at the Board Retreat on April 29, 2011. A summary of the statement was approved by the Citizens League Board of Directors on May 9, 2011.

Table 1: Distribution of Selected Tax Expenditures (by income decile)

Type of Tax	Name	**FY2010** $ Amount	**% of benefit** top 20%	**$ amount** calculated	**% of benefit** top 50%	**$ amount** calculated	**% of benefit** bottom 50%	**$ amount** calculated	**% of benefit** bottom 20%	**$ amount** calculated
Income										
Income	Interest on MN State and Local Government Bonds	$55,200,000	90%	$49,680,000	99%	$54,648,000	1%	$552,000	0%	$0
Income	Charitable Contribution Deduction	$246,200,000	80%	$196,960,000	97%	$238,814,000	3%	$7,386,000	0%	$0
Income	JOBZ Income Subtraction	$4,800,000	74%	$3,552,000	87%	$4,176,000	13%	$624,000	0%	$0
Income	Marriage Credit	$64,600,000	72%	$46,512,000	100%	$64,600,000	0%	$0	0%	$0
Income	Subtraction of K-12 Education Expenses	$18,800,000	69%	$12,972,000	97%	$18,236,000	3%	$564,000	0%	$0
Income	Itemized Deductions for Real Estate Taxes	$191,000,000	67%	$127,970,000	96%	$183,360,000	4%	$7,640,000	0%	$0
Income	Mortgage Interest Deduction	$495,300,000	63%	$312,039,000	94%	$465,582,000	7%	$34,671,000	0%	$0
Income	Itemized Deductions for Other Taxes	$14,300,000	62%	$8,866,000	93%	$13,299,000	8%	$1,144,000	0%	$0
Income	Credit for Long Term Care Insurance Premiums	$7,500,000	56%	$4,200,000	94%	$7,050,000	7%	$525,000	0%	$0
Income	Social Security Benefits	$172,600,000	36%	$62,136,000	83%	$143,258,000	17%	$29,342,000	2%	$3,452,000
Income	Subtraction for Military Pay	$7,930,000	27%	$2,141,100	68%	$5,392,400	31%	$2,458,300	2%	$158,600
Income	Subtraction of Charitable Contributions by Non-Itemizers	$8,300,000	24%	$1,992,000	82%	$6,806,000	18%	$1,494,000	1%	$83,000
Income	Elderly or Disabled Exclusion	$700,000	2%	$14,000	4%	$28,000	96%	$672,000	7%	$49,000
Income	Working Family Credit	$194,800,000	0%	$0	3%	$5,844,000	96%	$187,008,000	32%	$62,336,000
Income	Child and Dependent Care Credit	$15,840,000	0%	$0	2%	$316,800	99%	$15,681,600	23%	$3,643,200
Income	Credit for K-12 Education Expenses	$13,100,000	0%	$0	1%	$131,000	99%	$12,969,000	20%	$2,620,000
Income Total		**$1,510,970,000**	**55%**	**$829,034,100**	**80%**	**$1,211,541,200**	**20%**	**$302,730,900**	**5%**	**$72,341,800**
Sales	**Percent of Expenditures**									
Sales	Household Goods Repair Services	$36,100,000	62%	$22,382,000	84%	$30,324,000	15%	$5,415,000	3%	$1,083,000
Sales	Accounting Services	$165,900,000	47%	$77,973,000	77%	$127,743,000	22%	$36,498,000	5%	$8,295,000
Sales	Exemption for Clothing and Wearing Apparel	$396,100,000	46%	$182,206,000	76%	$301,036,000	25%	$99,025,000	7%	$27,727,000
Sales	Personal Services (hair, nail, tattoo, etc.)	$88,000,000	44%	$38,720,000	75%	$66,000,000	24%	$21,120,000	6%	$5,280,000
Sales	Exemption for Publications	$65,200,000	42%	$27,384,000	73%	$47,596,000	26%	$16,952,000	6%	$3,912,000
Sales	Motor Vehicle Repair and Maintenance	$165,500,000	41%	$67,855,000	75%	$124,125,000	25%	$41,375,000	6%	$9,930,000
Sales	Exemption for Groceries	$729,000,000	32%	$233,280,000	66%	$481,140,000	34%	$247,860,000	11%	$80,190,000
Sales	Funeral Services	$19,900,000	30%	$5,970,000	62%	$12,338,000	38%	$7,562,000	12%	$2,388,000
Sales	Exemption of Home Heating Fuel	$163,200,000	29%	$47,328,000	58%	$94,656,000	42%	$68,544,000	16%	$26,112,000
Sales	Residential Water and Sewer Exemptions	$44,800,000	27%	$12,096,000	58%	$25,984,000	41%	$18,368,000	15%	$6,720,000
Sales	Exemption of Drugs, Medicines and Medical Devices	$272,000,000	25%	$68,000,000	60%	$163,200,000	39%	$106,080,000	11%	$29,920,000
Sales Total		**$2,145,700,000**	**37%**	**$783,194,000**	**69%**	**$1,474,142,000**	**31%**	**$668,799,000**	**9%**	**$201,557,000**
Total		**$3,656,670,000**	**44%**	**$1,612,228,100**	**73%**	**$2,685,683,200**	**27%**	**$971,529,900**	**7%**	**$273,898,800**

* = percent of sales tax burden

sources:
Minnesota House of Representatives Research Department
Minnesota House of Representatives Fiscal Analysis Department
Minnesota Department of Revenue