May 2, 2011

Summary of Policy 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 – or "tax spending" – violate the principles of transparency, equity and efficiency to a much greater degree than "appropriation spending" programs typically do.

The Citizens League concludes that changes must begin now if we are to get expenditures (tax spending) under control 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** this year along the lines of the February 15, 2011 report "Bringing Tax Expenditures into the 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 first cycle of the evaluation process in subsequent years so that they are evaluated along with any tax expenditures that remain in law.

- **Cuts in tax expenditures (tax spending) should be part of the budget solution this biennium** and should be considered part of the spending cuts – along with appropriations spending – that balance the budget for the upcoming biennium. We realize that this does not address the question of whether tax increases (raising rates) should also be part of the budget solution, but whatever part of the budget solution is considered spending cuts must include cuts in tax expenditures.

Statement on Tax Expenditures:

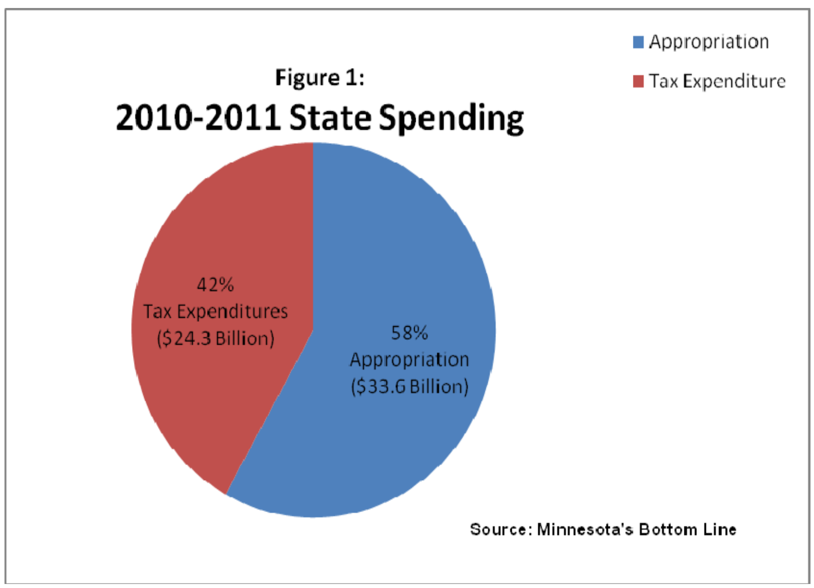
Cuts in "tax spending" should be considered for budget solution

Most Minnesotans know that state government is facing historic spending cuts and/or tax increases to balance the 2011-2012 biennial budget. What most Minnesotans don't realize is that legislators and the governor have only been considering about 60 percent of the entire "pie" of government spending that should be on the table for whatever part of the solution comes from cuts in government benefits.

Government benefits delivered through "tax expenditures" are the other 40 percent that are being discussed but haven't been directly considered yet (see Figure 1). This "tax spending" 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



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 should not be considered tax cuts.

[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
- Efficiency (Simplicity)

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

Principle #1: Accountability (Transparency)

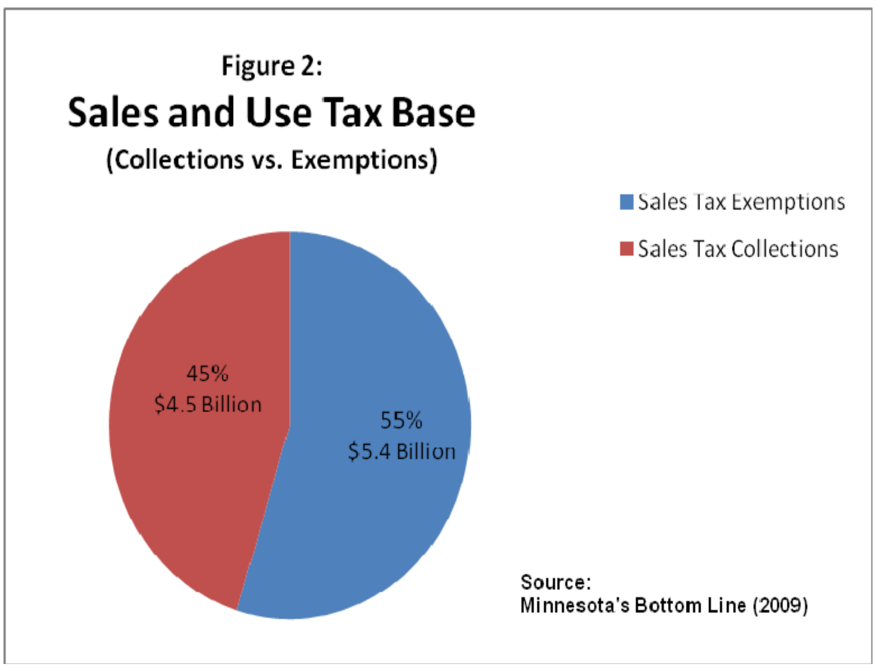
Tax expenditures result in costs to the state that are passed through – with little or no transparency – to those who do not receive the benefit. Tax expenditures are not typically evaluated in terms of public purpose (which may or may not exist) or ability to meet goals. **Unlike spending that is appropriated through the legislature, tax expenditures do not need to be re-authorized every biennium. Tax expenditures (tax spending) should be scrutinized alongside appropriation spending.**

Basic measures of accountability and transparency that have been developed on "appropriation spending" are just entering the "tax spending" 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 tax policy 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 groundwork laid 20 years ago. But there is momentum now from the efforts that led us to the 2010 law change and the report from the Department of Revenue. **A process to begin evaluating all tax expenditures needs to be put in place this year.**

Since spending programs are scrutinized at least every two years, tax expenditures (tax spending) 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 than writing a check through the appropriations process.

Principle #2: Equity

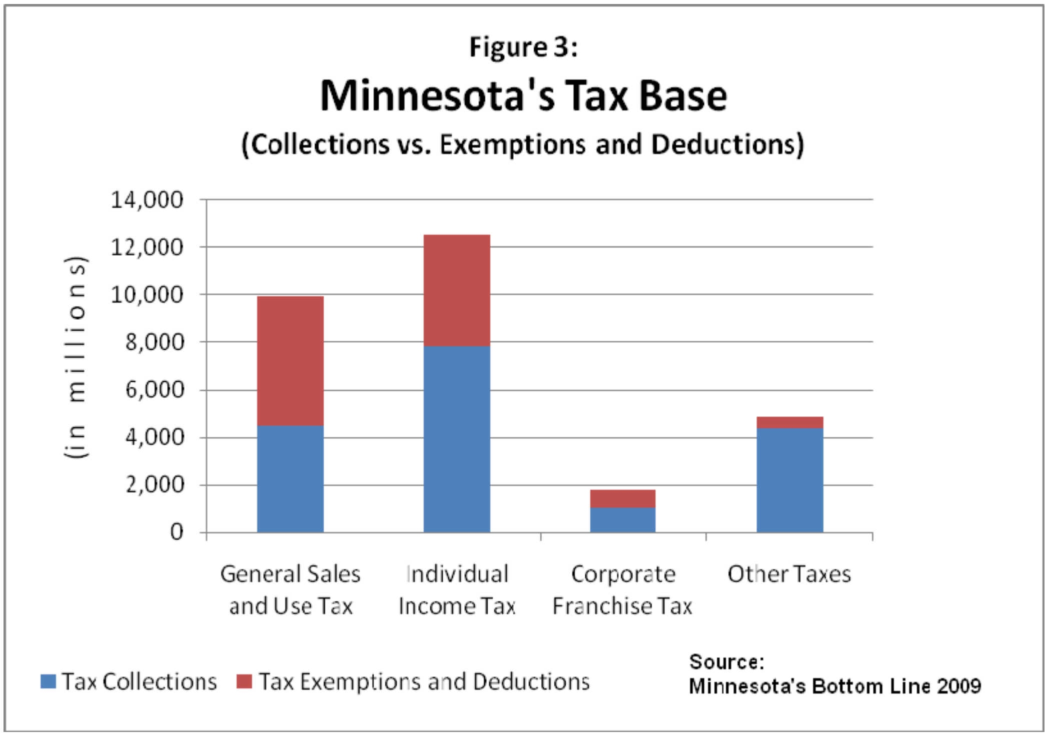
Those who receive the exemption think of a particular tax expenditure as a tax cut, but **the real impact of certain items and activities receiving exemptions from taxes is to raise taxes on everyone who does not benefit from the exemption.** Minnesota's extraordinary exemptions to the service economy 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, it has the strong potential to decrease equity 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.

<u>Principle #3: Efficiency (Simplicity)</u>

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. Less 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 three recommendations that must happen now if we are to get tax expenditures (tax spending) under control and 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 being evaluated and having to be authorized 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 be included in the evaluation process in subsequent years so that they are evaluated along with any tax expenditures that remain in law.

- **Cuts in tax expenditures (tax spending) should be part of the budget solution this year** and should be considered part of the spending cuts – along with appropriations spending – that balance the budget for the upcoming biennium. We realize that this does not address the question of whether tax increases (raising rates) should also be part of the budget solution, but whatever part of the budget solution is considered spending cuts must include cuts in tax expenditures.

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