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

MINNESOTA · REVENUE

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To the Members of the Legislature of the State of Minnesota:

It is my pleasure to submit to you the Tax Expenditure Review Report, as required by *Minnesota Laws 2010*, ch. 389, art. 10, sec. 5. The recommendations in this report are designed to improve oversight of tax expenditures. Broadly speaking, the report advocates that the Legislature and governor take steps to:

- Evaluate whether tax expenditures are meeting their purpose.
- Enhance the Minnesota Tax Expenditure Budget in ways that support evaluating the effectiveness of tax expenditures.
- Bring tax expenditures into the biennial budget process.
- Make information on tax expenditures more accessible to the public.

Tax expenditures – those state and local tax provisions that provide preferential tax treatment for certain types of taxpayers or activities – are not inherently unsound. Indeed, they can be useful tools that support important public policy goals.

Minnesota is considered a leader in tracking tax expenditures. However, we – like other states – have historically struggled to provide firm oversight once these provisions are enacted. Such oversight is a crucial part of sound fiscal policy – but it should not be seen as just a way to repeal them and either increase state revenue or lower tax rates. Instead, our ultimate goal as public servants is to ensure we are managing the state's resources wisely on behalf of the taxpayers we all serve.

To produce this report, the Department of Revenue contracted with a group of eminent economists and public policy researchers from across the spectrum. This study team was responsible for drafting the Tax Expenditure Review Report and the recommendations within. The department provided a range of support and appreciates the study team's significant work in completing this report for the Legislature.

Minnesota Statutes, sec. 3.197, specifies that a report to the Legislature must include the cost of its preparation. The approximate cost of preparing this report was $60,000.

The report is available on the Department of Revenue website at www.revenue.state.mn.us/research_stats/Pages/Reports.aspx.

Sincerely,

Daniel A Salomone

Dan Salomone
Acting Commissioner

Acknowledgments

To complete the Tax Expenditure Review Report, the Minnesota Department of Revenue contracted with the following individuals to undertake the study in collaboration with the department:

- Marsha Blumenthal, Professor Emerita, Economics, University of St. Thomas
- Laura Kalambokidis, Associate Professor, Applied Economics, University of Minnesota
- P. Jay Kiedrowski, Senior Fellow, Humphrey School of Public Affairs, University of Minnesota
- John Spry, Associate Professor, Business Economics, University of St. Thomas
- Judy Temple, Associate Professor, Applied Economics & Humphrey School of Public Affairs, University of Minnesota
- Jenny Wahl, Professor, Economics, Carleton College

The study team began meeting in mid-July 2010. The study team met once in August, then every two weeks starting in September. The Department of Revenue wishes to thank the study team for the significant work done to prepare this report for the Legislature. A complete list of the team's recommendations can be found in Appendix A.

The following department staff provided assistance to the study team:

- Tax Research Division – Phillip Anthony, Mary Buechner, Carolyn Carlson, Rod Hoheisel and Paul Wilson
- Property Tax Division/Property Tax Research – Lonn Moe and Eric Willette
- Communications Division – Larry Mastbaum
- In addition, members of the department's operational divisions also provided useful feedback and information.

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Executive Summary

The term "tax expenditures" refers to tax provisions that are exceptions to a broadly-defined tax base – often referred to as the "reference tax base." For example, the reference tax base for the income tax would include all forms of income. Tax expenditures include any tax provision that exempts certain forms of income, any tax deduction that favors particular forms or uses of income, and tax credits that reward particular behavior.

Each tax expenditure narrows the tax base, resulting in either less revenue or higher tax rates. Tax expenditures are not inherently unsound. In fact, they can be useful tools to support important public policy goals. But there is general agreement that tax expenditures receive less scrutiny than direct expenditures. This report starts by making the case for bringing tax expenditures into the budget process and subjecting them to the same level of review as direct expenditures. It then recommends ways to accomplish that goal.

As discussed in Chapter 1, Minnesota's Tax Expenditure Budget report (TEB) is among the nation's best. The 2010 report provides useful information on each of 296 tax expenditures, but it makes no attempt to evaluate whether those tax expenditures succeed in achieving their goals. Moreover, the TEB's cost estimates for these provisions do not appear in any of the state's biennial budget documents.

Defining what is (and is not) a tax expenditure can be controversial. Chapter 2 reviews definitional issues. The definitions proposed in this report generally (though not always) agree with the list of tax expenditures provided in the TEB. Chapter 3 defines criteria to be used when evaluating tax expenditures, and it describes the additional information that would be required.

Given the large number of tax expenditures, an evaluation process must determine which of them should be reviewed earliest. Chapter 4 recommends a process for setting those priorities. Chapter 5 proposes an ongoing evaluation process and recommends ways to bring tax expenditures into the normal budget process.

A full list of recommendations can be found in Appendix A of this report. They include:

- Establish an eight-year evaluation cycle during which each tax expenditure would be reviewed.
- Create a Tax Expenditure Commission to oversee the evaluation process and make recommendations to the Legislature and governor.
- Prioritize which tax expenditures to evaluate earliest using the six criteria described in Chapter 4.
- Require the Tax Expenditure Commission to define a clear and measurable purpose for each tax expenditure if one is not stated in law.
- Require evaluations to list and analyze selected alternatives to the current provision.
- Provide adequate funding to the Department of Revenue and other state agencies, that would be responsible for completing the evaluations.
- Set a "revenue-neutral" sunset date at completion of each evaluation. Unless the tax expenditure is extended by that sunset date, it would expire and the tax rate for the affected tax would be adjusted downward to hold revenue constant.
- Fully integrate tax expenditures into the biennial budget process and include total expenditures for each tax in state budget summaries to show their fiscal impact on gross tax revenue.

Chapter 1 – Introduction

Overview

Minnesota, like other states, uses tax expenditures as well as direct spending programs to achieve state policy objectives. Direct expenditures and indirect tax expenditures both affect the state's budget, yet only the former undergo regular review and reauthorization. In fact, current practice allows tax expenditures to escape any semblance of normal budget discipline.

This asymmetry arises from the nature of the budget process itself. Direct spending is itemized on the expenditure side and continues only if the Legislature appropriates funds for the budget period. In contrast, tax expenditures occur on the revenue side and are not itemized; reported revenue is net of any tax expenditures. What is more, tax expenditures rarely specify an expiration date. While periodic oversight of direct spending is easily accomplished as part of the budget cycle, the same is not true for indirect spending through the tax code. [1]

The need for regular review and reauthorization of tax expenditures is clear. Well-known tax-policy expert Stanley Surrey put it this way: "Unless attention is paid to tax expenditures, a country [or state] does not have its tax policy or its budget policy under full control."[2] This need for attention is especially true in times of fiscal stress.

In a recent *Wall Street Journal* article, economist Martin Feldstein called for Congress to take a serious look at the issue, stating that "Cutting tax expenditures is really the best way to reduce government spending" and that eliminating many tax expenditures "would increase overall economic efficiency ... [and] greatly simplify tax filing."[3]

Even more recently, the bipartisan National Commission on Fiscal Responsibility and Reform called for comprehensive review and reduction of tax expenditures, saying that they "not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth and competitiveness, our current [tax] code ... provides special treatment to special interests. The code presents individuals and businesses with perverse economic incentives instead of a level playing field."[4]

Expenditures made via Minnesota tax provisions are quite large – those conducted through the individual income tax are more than half as large as total revenue collected, whereas those made via the sales tax

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[1] We recognize that some direct expenditures are "open appropriations" that can increase within a biennium with no action by an appropriation committee. But open appropriations are budget lines, and the expected level of each open appropriation must be approved as part of the biennial budget. This is far different from tax expenditures, which never show up in the budget documents and which can increase without anyone noticing.

[2] Surrey, Stanley S. and Paul R. McDaniel, "The Tax Expenditure Concept and The Legislative Process." In *The Economics of Taxation*, edited by Henry J. Aaron and Michael J. Boskin (Brookings Institution Press, 1980). Surrey served as Assistant Secretary of the Treasury for Tax Policy; he coined the term "tax expenditure" and offered a concise discussion of tax expenditures in *Pathways to Tax Reform* (Harvard University Press, 1973).

[3] Feldstein, Martin, "The 'Tax Expenditure' Solution for our National Debt." Wall Street Journal, July 20, 2010. Retrieved from http://online.wsj.com/article/SB10001424052748704518904575365450087744876.html.

[4] "The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform." December 2010. Retrieved from http://www.fiscalcommmission.gov. Erskine Bowles, former chief of staff under President Clinton, and Alan Simpson, former U.S.Senator (R-Wyo.), co-chaired the commission.

actually exceed the amount of revenue collected. Yet tax expenditures have only rarely been part of an open discussion as to how Minnesota uses state resources.

The Minnesota Legislature's requirement for a Tax Expenditure Review Report aims to establish a means by which tax expenditures will undergo a regular comprehensive review process similar to that for direct expenditures. Such a process will help ensure that tax expenditures constitute sound public policy and meet the objectives for which they were created. It may also offset the institutional bias toward using tax expenditures (which yield lower revenue and thus a perception of smaller government) rather than direct expenditures (which generate greater costs and thus an apparently larger government). Because tax expenditures are simply spending by another name, they should be scrutinized as such.

The following chapters set forth details of the suggested process, including a set of evaluation principles that can be applied to tax expenditures. We envision that the process will achieve two goals:

- To give the governor, legislators, public officials, and the general public access to all available relevant information on tax expenditures and to provide these parties new information as needed.

- To require approval – or non-renewal – of tax expenditure provisions by the governor and the Legislature.

Legislative History

In 2010, the Minnesota Legislature mandated this Tax Expenditure Review Report under a provision of the omnibus tax bill (*Laws of Minnesota 2010*, ch. 389, art. 10, sec. 5).[5] The language setting forth the requirement appears in subdivision 1:

> *By February 15, 2011, the commissioner of revenue shall provide a report to the chairs and ranking minority members of the house of representatives and senate tax committees with jurisdiction over taxes suggesting a process for the periodic review and sunset or extension of tax expenditures on an ongoing basis.*

Subdivision 2 lists requirements for the contents of the report:

(a) The report shall include the following information for every tax, as defined in Minnesota Statutes, section 270C.11, subdivision 6:
  - *(1) a definition of the tax base for the tax;*
  - *(2) a definition of a tax expenditure for each tax; and*
  - *(3) a list of existing provisions in law that meet the definition of tax expenditure for each tax.*

(b) The report shall include a suggested list of information, currently not included in the tax expenditure budget under Minnesota Statutes, section 270C.11, needed to allow evaluation of the effectiveness of new and existing tax expenditures in meeting not only the stated goal of the tax expenditure but also the general tax principles of
  - *(1) transparency and understandability;*
  - *(2) simplicity and efficiency;*

[5] Retrieved from: https://www.revisor.mn.gov/laws/?id=389&year=2010&type=0.

(3) *equity;*
(4) *stability and predictability;*
(5) *compliance and accountability;*
(6) *national and global competitiveness; and*
(7) *conformity of the expenditure with corresponding federal taxes and multistate agreements.*

(c) *The report shall also include recommendations on specific procedures for periodic review of tax expenditures, including the need for additional reports, study or oversight groups, and fiscal or other resources, and a suggested timetable for systematic review of the tax expenditures in the various tax areas.*

Two other initiatives offer background and perspective on the Legislature's intent:

- An earlier version of the enabling legislation consists of a more ambitious proposal that mandated the sunset review and expiration of all existing tax expenditures in staggered 10-year cycles.[6] That version also would have established a Tax Expenditure Advisory Commission appointed by the governor to consider the reviews annually and to hold public hearings and vote to recommend the continuation or repeal of each expenditure scheduled to expire.
- A new law requiring more evaluation of the state's property tax system was enacted in 2010.[7] The passage of this law indicates the heightened level of interest among Minnesota legislators for creating an accountable and efficient property tax system. The law establishes a working group that will use an expanded set of informative tools to make recommendations for simplifying and clarifying the property tax system, shortening the assessment calendar, and determining the costs and benefits of property tax components. The Property Tax Working Group will submit its recommendations by Feb. 1, 2012.

Distinctions Between the Suggested Review Process and the Existing Tax Expenditure Budget

Minnesota Statutes, sec. 270C.11, requires the Minnesota Department of Revenue to issue a Tax Expenditure Budget (TEB) as a supplement to the biennial budget. The department issued its first report to the Legislature in 1985; the law changed in 1996 so that the TEB is now issued in even-numbered years (rather than odd-numbered budget years).

For each included tax,[8] the TEB outlines the legislative history, reports the most recent year's collection, and defines its tax base. The TEB lists each qualifying provision for each tax, describing its legal source, its history, and the mechanics of how it is applied. The TEB also estimates the magnitude of fiscal impact for the current and three future years. The number of taxpayers affected is noted, if known.

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[6] H.F.3785 (Liebling) / S.F. 3413(Bakk). Minnesota Legislation & Status, Office of the Revisor of Statues (86th Legislature, 2009-2010). Retrieved from http://www.leg.state.mn.us/leg/legis.aspx. The bill was re-introduced in 2011 as H.F. 271 (Liebling) / S.F. 220 (Reinert). *Ibid.*

[7] *Minnesota Laws 2010*, ch. 389, art. 2, sec. 3 [270C.991]: Property Tax System Benchmarks and Critical Indicators. Retrieved from https://www.revisor.mn.gov/laws/?id=389&year=2010&type=0.

[8] The included taxes are: individual income, corporate franchise, estate, general sales and use, motor vehicle sales, highway fuels excise, alcoholic beverages, cigarette and tobacco, mortgage registry, deed transfer, lawful gambling, insurance premiums, local property, airflight property, motor vehicle registration and aircraft registration.

Minnesota's TEB has an outstanding national reputation. According to a recent evaluation of state tax expenditure reports, Minnesota, Oregon, and Connecticut "publish relatively comprehensive and informative reports that could serve as a model for other states."[9] A noted tax economist, Professor John Mikesell of Indiana University, praises Minnesota as one of only three states (with Idaho and West Virginia) that carefully define a benchmark tax base grounded in tax principles.[10] This conceptual base divides typical tax provisions from preferential deviations to focus on the latter in the TEB.

The purpose of the TEB differs in four ways from that of the tax expenditure review process we propose in this report, however.

- The definition of tax expenditures in the TEB differs slightly from what we propose for the review process. In some cases, the TEB definitions are more expansive than necessary for our purpose. [11] On the other hand, the TEB omits some tax provisions that we think should be included in the review process. Chapter 2 elaborates upon our recommended definitions of tax expenditures for the review process.

- The TEB offers considerable information about tax expenditures but does not explicitly evaluate them. We propose a set of principles in Chapter 3 to apply in reviewing and determining whether to renew tax expenditures. An evaluation based on these principles will require information beyond what is included in the TEB. Chapter 3 includes a discussion of those information needs.

- The TEB does not prioritize tax expenditures for review. In setting up a review process, we suggest concentrating efforts on those tax expenditures that are, in some sense, more important. In chapter 4, we propose a suggested ranking system based on the magnitude or growth of lost revenue, potential for replacement by direct spending, administrative difficulty and other criteria.

- The TEB is not integrated into the budget process. The budget impact of tax expenditures is not shown on any of the current budget documents, and the TEB is completed in non-budget years. Chapter 5 includes recommendations on how to integrate the TEB into the budget process.

Chapter 5 also includes recommendations concerning the review process itself. It addresses questions of who should be responsible for completing the reviews, how reviews should be timed, and what resources are needed to make such reviews successful.

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[9] Levitas, Jason, Nicholas Johnson, and Jeremy Koulish. "Promoting State Budget Accountability Through Tax Expenditure Reporting." Center on Budget and Policy Priorities (April 2009), p. 2.

[10] Mikesell, John, "Tax Expenditure Budgets, Budget Policy, and Tax Policy: Confusion in the States." Public Budgeting and Finance (Winter 2002), pp. 34-51.

[11] We do not suggest altering the definitions used to produce the Tax Expenditure Budget (TEB). Though some provisions reviewed in the TEB may not precisely fit our definition of tax expenditures, the information there provided is valuable. The TEB generally includes provisions in cases where some people (if not all) might consider them tax expenditures.

Chapter 2 – Defining the Reference Tax Base and Tax Expenditures

The legislative language mandating this Tax Expenditure Review Report requires that we address the following for each tax:

1. a definition of the tax base for the tax;
2. a definition of a tax expenditure for each tax; and
3. a list of existing provisions in law that meet the definition of tax expenditure for each tax.

Preparation of this report has provided the opportunity for a thorough and detailed consideration of each of these three items. The first logical step is to identify the reference tax base, because tax expenditures are classified as provisions that deviate from that base. As Professor John Mikesell notes in a recent article:

> *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.*[12]

Current Practice in Minnesota and Other States

States that publish tax expenditure budgets vary widely as to what provisions qualify as tax expenditures. Much of that variation stems from differences in how states define the reference tax base. Some states start with a careful description of the ideal tax base and limit tax expenditures to deviations from that base. Other states simply classify any tax provision that reduces revenue as a tax expenditure, without any consideration of the base.

If current law were defined as the reference tax base, no tax expenditure would exist. But listing every tax provision that reduces revenue as a tax expenditure – without consideration of a reference tax base – is unsatisfactory. This approach fails to differentiate between provisions that define the normal tax base and provisions that provide tax preferences. The resulting list provides little if any guidance for evaluating or restructuring tax policy.

Various criteria may be used to define a tax expenditure, so state differences are not due solely to variations in the reference tax base. The Minnesota Tax Expenditure Budget (TEB) lists seven criteria – all of which must be met – for a provision to qualify as a tax expenditure. The provision:

- . 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;

[12] Mikesell, John. "A State Tax Expenditure Framework to Improve Fiscal Discipline," *State Tax Notes* (Nov. 8, 2010), p. 413.

- is not subject to an alternative tax; and
- can be amended or repealed by an amendment to state law.

These criteria have three important ramifications regarding the definition of tax expenditures in Minnesota's report:

- A tax exemption or credit that provides preferential treatment is not included in Minnesota's TEB if no one claims it. Preferential tax provisions are not on the list of tax expenditures if they do not reduce anyone's tax – because no one is expected to make use of the provision.
- State constitutions can affect what is counted as a tax expenditure. In Minnesota the sales tax exemption for food prepared at home is listed as a tax expenditure because it can be repealed by a change in state law. However, Ohio's food exemption would not be listed as a tax expenditure under this definition because the Ohio constitution prohibits a sales tax on food.
- Federal tax provisions to which Minnesota conforms are counted as Minnesota tax expenditures if they meet all the other conditions. In contrast, many states exclude such provisions from their tax expenditure reports.

What to Preserve and What to Change

The Minnesota TEB offers a good starting point for the definition of reference tax bases and tax expenditures in this report. Yet "[i]dentifying provisions as tax preferences is not without controversy," notes Donald Marron, director of the Urban-Brookings Tax Policy Center. [13] Challenging judgment calls may arise when a tax provision clearly satisfies six of the criteria defining tax expenditures, yet disagreement arises regarding the seventh. In addition, controversy about the proper definition of the reference tax base can affect the list of tax expenditures.

General Discussion

In general, we agree with the criteria the TEB uses to define tax expenditures.[14] We agree with the TEB's inclusion on the tax expenditure list of all federal tax expenditures to which Minnesota chooses to conform. In other words, these federal provisions should not automatically be considered part of the reference tax base. Minnesota has adopted federal itemized deductions for property taxes, mortgage interest, medical care, and charitable contributions, but fewer than half of other states with an income tax have chosen to do so.[15]

On the other hand, we disagree with the TEB's omission of items with zero cost from the list of tax expenditures. For example, Minnesota's tax statutes still include a set of tax preferences that were

[13] Marron, Donald B., "Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction," Testimony before the U.S. Senate Committee on the Budget (Feb. 2, 2011). Retrieved from http://taxpolicycenter.org/UploadedPDF/1001492-Marron-Cutting-Tax-Preferences.pdf.

[14] Appendix C includes a list of tax expenditures based on those in the current TEB and our suggested changes.

[15] We concur with Professor John Mikesell that defining such provisions as part of the reference tax base tends to reduce the usefulness of tax expenditure reports and cede control over the design of state tax policy to the federal government. Mikesell, John. "A State Tax Expenditure Framework to Improve Fiscal Discipline," *State Tax Notes* (Nov. 8, 2010), p. 414.

enacted in 2005 to create a regional distribution center for international freight at or near the Minneapolis-St. Paul International Airport; that project was never undertaken.[16] Provisions like these could have a cost in the future if a taxpayer discovered a clever way to apply them to an unforeseen situation. **We recommend** that a list of these preferential but zero-cost provisions be included in the TEB and evaluated for potential repeal or modification.

For the most part, we also agree with how the TEB defines the reference tax base. Nevertheless, some significant differences emerge. These are addressed in detail below, as we discuss how the reference tax base should be defined for each major tax.

Personal Income Tax

The TEB's reference tax base for the individual income tax is a comprehensive measure of income, similar to the standard definition used by public finance economists (referred to as the Haig-Simons definition of income).[17] The TEB definition includes "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."[18]

The TEB considers the rate structure of the personal income tax to be a normal feature of the tax. It is included in the reference tax base, so it is not viewed as creating tax expenditures. The rate structure includes the standard deduction and personal exemptions, graduated tax brackets, definitions of filing status, and the alternative minimum tax. Though some people would argue that some of these should be considered tax expenditures,[19] we are comfortable with the TEB's treatment.[20]

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[16] See *Minnesota Statutes 2010*, sec. 469.321-329 [International Economic Development Zone]. Retrieved from: https://www.revisor.mn.gov/statutes/?id=469. The legislation was designed to promote expanded air freight business at the Minneapolis-St. Paul International Airport. The statute provides property, sales and income tax incentives for 12 years. Enacted in 2005, the provision was never used yet covers seven pages in Minnesota statutes.

[17] According to the Haig-Simons definition, income is defined as "the money value of the net increase in an individual's purchasing power." Economists Robert Haig and Henry Simons developed this concept of income in the first half of the 20th century. A detailed discussion of the Haig-Simons definition of income can be found in any standard public finance textbook.

[18] For a discussion of tax expenditures related to depreciation costs, see the Corporate Franchise Tax section of this chapter.

[19] Some public finance economists note that the standard deduction, personal exemptions, and graduated tax brackets could be included in the list of personal income tax expenditures because they provide a preference for those whose income varies little from year to year. Such an individual pays less tax over her lifetime than someone with highly variable income, even though both have the same lifetime income.

The Minnesota Tax Expenditure Budget does not consider this treatment to be preferential: "If a provision is not preferential, it is not a tax expenditure. The personal exemption for the individual income tax is not preferential because the amount of the exemption is the same for each taxpayer, spouse, and dependent. Likewise, the graduated rate structure of the individual income tax is not considered a tax expenditure because each taxpayer with the same amount of tax base pays at the same rate." State of Minnesota Tax Expenditure Budget: Fiscal Years 2010-2013, (Minnesota Department of Revenue, 2010), p.2.

For more information about these issues see Altshuler, Rosanne, and Robert D. Dietz. "Tax Expenditure Estimation and Reporting: A Critical Review." National Bureau of Economics Working Paper 14263 (August 2008).

A related provision – the marriage penalty credit – is currently listed as a tax expenditure. The marriage penalty credit is an alternative to increasing the width of the Minnesota tax brackets for married couples to twice the width for single taxpayers. The marriage penalty credit *could* be considered part of the rate structure (and therefore not a tax expenditure). Nevertheless, given its complexity compared to adjusted bracket widths, we are content to have it included as a tax expenditure and subject to review.

Under the TEB's own criteria, the list of tax expenditures could well include two more significant items:

1. **Imputed value of ownership of homes and durable goods**

   The imputed value of ownership of homes and durable consumer goods is equal to their annual rental value. The owner of a home or other durable good receives a stream of services from their ownership. As explained in a leading public finance textbook: "The net monetary value of these services – imputed rent – is equal to the rental payments that would have been received had the owner chosen to rent the house out, after subtracting maintenance expenses, taxes, and so on."[21]

   The TEB does not define the failure to tax the imputed value of homeownership as a tax expenditure. But it does list the itemized deductions for property taxes and mortgage interest – both of which would be allowable expenses if the imputed value of ownership were considered taxable income.

2. **Deferral of capital gains**

   Under current law, capital gains are taxed only when an asset is sold. A comprehensive definition of income includes capital gains as they accrue. Taxing capital gains at realization allows taxpayers to defer the tax, providing a tax benefit relative to other types of capital income. The TEB does not list deferral of capital gains as a tax expenditure.

While we think each of these provisions should in principle be defined as tax expenditures, neither should be a high priority for policy evaluation. Taxing imputed value of home ownership would be administratively difficult, as would taxation of accrued (but unrealized) gains. The current approach taken by the TEB is reasonable. Yet the omission of these provisions from the TEB is somewhat arbitrary, as the report lists neither administrative complexity nor political acceptability as criteria for defining what is – or is not – a tax expenditure.

Corporate Franchise Tax

The TEB defines the base of the corporate franchise tax as "income from all sources less expenses that are reasonable and necessary to generate that income." We accept this definition of the tax base, noting that all types of corporate income *excluded* from the corporate franchise tax base and all deductions that *exceed* reasonable expenditures necessary to generate income should be considered tax expenditures.

Economic ("true") depreciation is considered a deductible cost. Any acceleration of depreciation beyond economic depreciation is a tax expenditure. This includes provisions that allow immediate expensing.

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[20] Several members of the team suggested that the Department of Revenue should provide information on the tax benefits provided by the rate structure, exemptions, and standard deduction.

[21] Rosen, Harvey S. and Ted Grayer. Public Finance, 8th ed (McGraw Hill Higher Education, 2008), p. 383.

The TEB assumes that economic depreciation is straight-line depreciation over specified asset lives,[22] so depreciation in excess of such straight-line depreciation is a tax expenditure. We agree with the TEB's treatment of depreciation.

We propose only one possible change in the TEB list of tax expenditures for the corporate franchise tax. The TEB defines the entire dividend received deduction as a tax expenditure. We believe that a portion of that deduction may instead be a normal part of the corporate income tax base and therefore not a tax expenditure.

Neither of the federal tax expenditure budgets (produced by the Joint Tax Committee and the Treasury Department Office of Tax Analysis[23]) lists the dividend-received deduction as a tax expenditure. The normal corporate income tax should tax corporate income once – and only once – no matter the number of layers of corporate ownership. Because the deduction does not apply to the relatively few cases where dividends are paid from untaxed income, the federal dividend received deduction does not confer preferential treatment and is not a deviation from the reference tax base for corporate income.

The federal logic seems to apply at the state level for some dividends – but not for all. If dividends are received from a Minnesota corporation that has already paid Minnesota's corporate income tax, then the federal logic would apply. It would not apply, though, to dividends received from a corporation with no nexus in Minnesota, because that company's income has not been subject to Minnesota tax.

At the state level, the dividend-received deduction raises very complex issues. For this reason, it should remain on the list of tax expenditures. This deduction should be a priority for evaluation to determine what portion of it should be defined as a tax expenditure.

Two other provisions warrant additional discussion. Both involve how the income of a multistate company is allocated to Minnesota for tax purposes. Constitutionally, Minnesota (or any other state) can only tax income that is connected to the state. Thus the corporate franchise tax must define what portion of a multistate company's income is subject to state taxation. The TEB's benchmark for this apportionment is the Uniform Division of Income for Tax Purposes Act (UDITPA).[24]

1. Weighted Apportionment

A three-factor apportionment formula is used to calculate the share of multistate income that is taxable by Minnesota, based on how much of a corporation's (a) labor, (b) capital, and (c) sales are located in the state.

[22] For machinery and equipment, asset lives are defined as the midpoint of the asset depreciation range (ADR) system in effect from 1971 to 1981. For structures, a life of 40 years is assumed.

[23] See Altshuler, Rosanne, and Robert D. Dietz. "Tax Expenditure Estimation and Reporting: A Critical Review." National Bureau of Economic Working Paper 14263 (August 2008), p. 8.

[24] UDIPTA is a model state law for state corporate income taxes drafted by the National Conference of Commissioners on Uniform State Laws in 1957 For additional information, see the Multistate Tax Commission website at http://www.mtc.gov/About.aspx?id=86.

The standard set forth in both UDIPTA and the Multistate Tax Compact is to weight the three measures equally – 1/3 labor, 1/3 capital, and 1/3 sales.[25] However, Minnesota currently over-weights sales (at 90 percent), with the other factors each weighted 5 percent, and will move to 100 percent sales apportionment in 2014. The increased weight on sales reduces tax burdens for some corporations (and reduces state revenue).[26]

There is some uncertainty about what the "correct" weights should be to accurately apportion income to the state where corporate income is earned. But there is no question that 90 percent exceeds a weight on sales that would most accurately measure the share of multistate income earned in Minnesota. Therefore, we agree with the TEB's classification of Minnesota's over-weighting of the sales factor as a tax expenditure.

2. Throwback rule

If a multistate corporation with property and payroll in Minnesota sells to customers in a state where it has no nexus (or taxable connection), those sales are not attributed anywhere for tax purposes. Minnesota does not have a throwback rule, which would tax such income (except any portion that is taxable in another state).

The Tax Expenditure Budget, UDITPA, and Multistate Tax Compact all include a throwback rule in the reference tax base for corporate income – so we agree with the TEB's treatment of Minnesota's lack of a rule as a tax expenditure. The revenue impact of a throwback rule increases as Minnesota moves toward 100 percent sales apportionment.

Sales and Use Tax

The TEB defines the reference sales tax base to include all "final" purchases of goods or services. As a result, many business purchases of intermediate inputs are excluded. Among them are the exemptions of "purchases for resale" and "raw materials, component parts, and products consumed directly in industrial or agricultural production." The TEB does not consider these exemptions to be tax expenditures.

On the other hand, some business purchases are considered final. These include: capital equipment used for manufacturing, fabrication, mining or refining; restaurant purchases of dishes; purchases of office supplies; and purchases of building materials. The TEB defines exemptions for any of these business purchases as tax expenditures.

Economists and public policy analysts generally think of the sales tax as a consumption tax. As such, it should be levied only on sales to consumers, and not on sales between businesses. Taxing intermediate purchases – including capital equipment, office supplies, and building materials – will cause tax pyramiding as one business passes the tax cost along to the next. Ultimately, this creates an additional

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[25] *Ibid*. Minnesota is a member of the Multistate Tax Compact, an agreement that aims to promote tax consistency and fairness among members of the Multistate Tax Commission.

[26] Although the higher sales factor weight reduces state revenue, it also reduces tax liability for some taxpayers while increasing tax liability for others. Technically, the tax expenditure includes only reductions in tax liability, even though the provision's budget impact is partially offset by the increases.

(and hidden) tax burden on consumers who purchase the final goods and products, as noted in a 2009 presentation to lawmakers:

> *Pyramiding occurs when a tax applies at multiple levels of business production and distribution. The result of this typically would be to pass the tax along in higher prices at the next level of production (e.g., a manufacturer who sells to a wholesaler). The tax burden "pyramids" or cascades at each level, so that the total burden on the consumer is higher than the statutory or nominal rate. Pyramiding favors vertically integrated or larger businesses. These businesses can minimize the multiple levels of tax by performing functions – that would be taxable if purchased from a third party – with employees. Pyramiding also undercuts statutory exemptions (e.g., the sales tax paid by grocers gets passed along in higher grocery prices, despite the exemption for food products) that are intended to reduce regressivity or exempt necessities.*[27]

We consider the sales and use tax to be a consumption tax. As such, we would prefer a narrower approach than the TEB, reducing the number of exemptions listed as tax expenditures. For example, exemptions (or refunds) for capital equipment or business purchases of services would no longer be included.

For two reasons, we do not recommend simply removing them from the TEB. First, many of these exemptions are very narrowly defined, applying to only one or a few businesses or to a very limited geographical area. Narrow preferences need to be justified. Second, the broader exemptions (such as those for many purchases of capital equipment) might be improved, and an evaluation can focus on identifying desirable modifications.

Though policymakers increasingly consider the sales tax a consumption tax, this perspective is not universal. Historically, the tax has often been viewed as a tax on final purchases – whether made by consumers or businesses. Given the different perspectives, it is reasonable to continue listing exemptions for business purchases of final goods and services in the TEB. As explained in Chapter 4, however, we would consider many of these exemptions for business purchases to be low priorities for review.

Aside from its treatment of business purchases, we generally agree with the TEB's list of tax expenditures for the sales and use tax. We concur with its treatment of purchases by local governments and nonprofit organizations. Such exemptions should be considered tax expenditures.[28] We agree that all consumer services should be included in the reference tax base, and would include consumer purchases of digital goods in the reference tax base.[29]

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[27] "A Review of Selected Tax Expenditures." Minnesota House Research Department and Fiscal Analysis Department. March 16, 2009. Retrieved from http://www.leg.state.mn.us/docs/2009/other/090469.pdf.

[28] Exemption of purchases by state government from state sales tax is not considered a tax expenditure, however, because it has no net impact on the state budget. For discussion on such no-cost provisions, see the What to Preserve and What to Change section of this chapter.

[29] Under current law, digital goods are often exempt even if the tangible equivalent is subject to tax. Examples include digital downloads of music, books, movies and games. Though not included in past editions, future editions of the TEB will include the failure to tax such digital goods as a tax expenditure.

Generally, if a consumer good or service is subject to a lower sales tax rate, the rate differential is considered a tax expenditure. One exception would be if an alternative tax applies – though if the rate is lower, then the rate differential should be considered a tax expenditure. A gross receipts tax is so similar to the sales tax that Minnesota's gross receipts taxes on medical services (at 2 percent) and insurance premiums (generally at 2 percent) should be considered lower-rate sales taxes. The sales tax on motor vehicles raises a similar issue. In Minnesota the sales tax on motor vehicles is administered as a separate tax, distinct from the general sales tax. This is an artificial distinction. The lower tax rate for motor vehicles (6.5 percent rather than 6.875 percent) should also be considered a tax expenditure. **We recommend** that each of these rate differentials be listed in the TEB as tax expenditures and evaluated for potential repeal or modification.

The TEB includes a tax expenditure for the category "selected services" – which means some are not selected. Those excluded from the latest report include medical services, educational services, and some construction services. **We recommend** services excluded from the report be identified and that a rationale for their exclusion be provided if they are not included in the future.

Property Tax

The TEB defines the reference tax base for the local property tax as "the market value of real property." The reference tax base excludes personal property (such as machinery and equipment, furnishings, inventories, or vehicles). Preferences included as expenditure lines in state budget documents are not listed as tax expenditures. This includes property tax refunds to homeowners and renters, homestead and agricultural market value credits, the disparity reduction credit, and the disaster aid credit.

The property tax can be characterized as a tax on wealth, albeit one with a very narrow base. Just as the sales tax fails to tax a significant share of consumption (e.g. services), the current Minnesota property tax fails to tax many forms of wealth. It only taxes real property. In the past the state's property tax base was a more comprehensive measure of wealth. Most tangible personal property was included in the base (e.g. inventories, livestock, jewelry, pianos). Public stocks, securities, and annuities were taxable personal property. Even money was included in the property tax base until 1911 and taxed separately by the state until 1943.

We are comfortable with the TEB's limitation of the reference tax base to real property and recommend no change.

We recommend that the state property tax and local property taxes be combined in any discussion of tax expenditures. The 2010 TEB did not include an analysis of the state property tax, an additional tax levied against only a subset of property types. It was omitted because – if considered as a stand-alone tax – it was difficult to define the reference tax base. Combining state and local taxes would define the exclusion of some property types from the state property tax base as a tax expenditure – essentially part of the property tax classification system that levies tax at rates that vary by type of property.

We recommend that two additional property tax provisions be included as tax expenditures: the Fiscal Disparities tax base sharing program and the Veteran's Exclusion.

We discussed adding some direct expenditure programs (such as the Property Tax Refunds and the Market Value Credit) to the list of provisions to be reviewed as part of the tax expenditure evaluation process. We concluded that it is best to maintain the distinction between direct expenditures and tax expenditures. Nevertheless, given the complex interactions between the direct expenditure programs and the tax expenditures that affect net property tax payments, it would be difficult to evaluate tax expenditures in a vacuum, without simultaneously evaluating the related direct expenditures. **We recommend** an integrated evaluation that includes direct expenditure programs to the degree necessary when evaluating tax expenditures for the property tax.

Summary

A tax expenditure budget gives relevant information about tax expenditures to the governor, legislators, public officials, and the general public. To provide truly useful information, this type of report must both clearly define the normal tax structure and identify tax expenditures as preferential deviations from that structure. The Minnesota TEB is one of the few such state reports to do so.

We generally agree with the identification of tax expenditures in the TEB. Our review produced a few quibbles with the TEB's definition of the reference tax base or list of tax expenditures. We advocate a few changes that may improve the TEB as a tool for evaluating the effectiveness of tax expenditures.

Chapter 3 – Evaluation of Tax Expenditures

Tax policy has three guiding principles: efficiency, equal treatment of equals, and simplicity. Tax expenditures by their nature tend to violate one or more of these principles, yet lawmakers may nonetheless use them to achieve an expanded set of public policy objectives. In this chapter we discuss the three principles of tax policy, then outline additional policy goals that the governor and Legislature may wish to fulfill via the use of tax provisions. Then we suggest a set of criteria for evaluating tax expenditures and discuss possible information needed in the evaluation process.

Tax Policy: General Principles

Allocating economic resources toward their most productive use is perhaps the chief advantage of free markets. This allocative efficiency is, in effect, a way of making the economic pie as large as possible. One goal of a successful tax system is to interfere as little as possible with this process. A mark of effective tax policy, therefore, is the preservation of incentives for individuals and businesses to make decisions on the basis of productivity rather than for pure tax benefit.

Equal treatment of equals is a second guiding tenet for tax policy.[30] Under this principle, those with equal incomes should pay equal income taxes regardless of the source of their income, for example. Similarly, taxpayers with equal consumption should pay equal consumption tax no matter what items they buy. Violating this standard gives taxpayers incentives to seek low-taxed sources of income (or buy untaxed products) for tax rather than economic reasons.

Simplicity is the third principle that directs good tax policy. The simpler the system, the more easily taxpayers can comply with it. A simple tax system is also easy to administer and enforce, thus preserving public resources. A simpler tax system is also likely to be more transparent to voters and their elected representatives.

These three basic principles may conflict, of course. Achieving allocative efficiency may require a fairly complicated set of tax rules, for example. And a simple tax code may fail to yield equal treatment in a world of complex financial assets and multi-year operations. Despite these potential snags, the three principles of efficiency, equal treatment of equals, and simplicity offer a useful framework for conducting good tax policy.

A tax system based on these three principles would have far fewer tax expenditures than currently exist. Efficiency and equal treatment of equals both favor broad tax bases with low rates. Justified tax expenditures would include only tax provisions that offset a market failure or externality or that decrease the cost of tax administration by enough to offset lost efficiency or equity.

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[30] Economists refer to this concept as "horizontal equity."

Other Relevant Public Policy Objectives

Lawmakers often view tax policy in broader terms than outlined in the section above: taxes – and tax expenditures – can be used as tools to accomplish a larger set of public policy objectives and thus may violate basic tax-policy principles in order to achieve another goal. These additional goals include:

- fairness;[31]
- reduction of the tax burden on targeted groups;
- promotion of specific activities or sectors of the economy;
- promotion of overall economic development;
- preservation of the state's competitiveness within constraints posed by policies implemented in other states;
- compliance with federal directives or state constitutional provisions; and
- stability of state revenues.

Tax expenditure provisions often lack explicit, stated objectives. Minnesota statutes rarely include statements of purpose. One might infer, however, that legislatures enact provisions such as the sales tax exemption on groceries so as to benefit lower-income households. As another example, the mortgage interest deduction might have been intended to promote home ownership. Taxation of capital gains on a realization rather than an accrual basis is probably for administrative ease and comportment with federal and other states' treatment of capital gains. Though selective exemptions/deductions and realization-based capital-gains taxation violate basic tax principles, they may nevertheless be acceptable to policymakers and taxpayers because they fulfill some other worthy purpose.

Information Needed to Evaluate a Particular Tax Expenditure

1. Purpose

Evaluating a given tax expenditure therefore requires it to have a stated purpose. If it does not, evaluating its effectiveness in achieving that purpose is impossible. Unfortunately, a tax expenditure's purpose is not always clear. For evaluation, the purpose must be stated precisely. For example, is the purpose of the income tax deduction for mortgage interest to increase the number of homeowners? Or is the purpose more general – to support the real estate market and home values by increasing the demand for housing? Success in meeting the latter may not reflect success in the former if the primary impact is larger homes for those who would have been homeowners anyway. [32]

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[31] This concept might be thought of as "unequal treatment of unequals" – that is, if taxpayers are not similarly situated, we would not want to treat them as if they were. Economists sometimes refer to this notion as "vertical equity."

[32] This example also highlights the pitfalls of divining legislative intent years, or even decades, after a tax provision is enacted. "When the modern federal income tax was enacted in 1913 shortly after ratification of the 16th Amendment to the U.S. Constitution, all interest payments were made deductible on the grounds that interest payments were an expense of earning business and investment income. … The deduction had little effect on housing investment before World War II because only the very highest-income individuals paid any income tax." Toder, Eric, Magery A. Turner, Katherine Lim, and Lisa Getsinger, "Reforming the Mortgage Interest

A purpose that is too narrowly stated ("to reduce taxes paid by industry X") is not particularly useful. Identifying *why* we desire reduced taxes for industry X (rather than for other industries) is important. On the other hand, too broad a statement of purpose ("fairness" or "economic development") may also make evaluation difficult. What is meant by "fairness"? How is success in "economic development" measured?

A complete evaluation should also investigate how the objective of a tax expenditure comports with the tax principles and policy goals listed in the two sections above. It should point out cases where the stated goal is inconsistent with those principles.

In some cases, tax expenditures may be enacted in response to tax policy in other states. What other states are doing could well be relevant, and summaries of similar provisions in other states may be useful information. Still, stating that the purpose is "to match the incentive offered by Wisconsin" is not helpful in evaluating the provision's success.

2. Direct impact

Evaluating success requires measuring the tax provision's impact on the stated purpose. The actual information required will vary, but several broad categories of information can be identified. These include the following:

a. *Number and nature of those who pay less tax as a result*

For business-related tax expenditures, this may focus on the number, size and geographic location of enterprises that benefit. For tax expenditures related to individuals, it may pay particular attention to the number and income of those who benefit. In some cases, the distribution of benefits by age, household type, or location may also be relevant.

b. *Change in behavior as a result of the tax expenditure*

If the purpose is (at least in part) to change behavior, then the degree of that change is important. Yet direct measurement of behavioral change is rarely possible. Inferences based on comparisons across states (or before and after enactment) must be made with care. In some cases, however, empirical studies from experience in other states (or the nation) may be useful.

c. *Unintended results*

Evaluation should pay special attention to unintended consequences. For example, does the tax expenditure reduce taxes for a broader (or different) group than was originally intended? Or does it cause confusion for taxpayers, compliance problems or unacceptable administrative costs?

3. Indirect or secondary impact

Proponents of tax expenditures often claim that such provisions will increase the growth of employment or income in Minnesota. These impacts are particularly difficult to determine, in part because available economic models are often blunt tools, not designed to estimate the effect of a particular tax provision. Existing economic models are generally unable to differentiate among alternative – and very different –

Deduction." Urban Institute and Urban-Brookings Tax Policy Center (April 2010), p. 1. In 1987, deductions for non-business interest were limited to interest on (first or second) homes. Credit-card interest and car loan interest was no longer deductible.

tax incentives. Yet the impact of a $100 million tax cut for a specific industry presumably will depend on the structure of that incentive, not just its magnitude.

What is more, tax expenditures generally result in reduced tax revenue, but the state budget must be balanced. The impact of a single tax expenditure must be evaluated as part of a balanced-budget scenario. An exemption from sales tax either means a higher sales tax rate, an increase in some other tax, or a reduction in state expenditures.[33] It is not obvious what assumption should be used to make the budget balance. Assuming that nothing else changes clearly is not legitimate, however.

No one disputes the fact that some tax structures are more likely to stimulate economic growth than others. However, it is unrealistic to expect that the tax expenditure evaluation process will be able to pinpoint the secondary impacts of alternative tax expenditures on the state's economic performance.

4. Budget impact (change in revenue or rate)

Success in attaining a goal must always be compared to cost. The TEB includes static estimates of the cost of each tax expenditure, measured as foregone revenue. When that impact is large, it is useful to describe the budget impact in terms of a foregone reduction in tax rates. For example, a sales tax provision with an annual cost of $135 million could be described as requiring a tax rate that is 0.2 percentage points higher, in the sense that repealing it would allow a revenue-neutral rate reduction of that magnitude. Similarly, an income tax provision that costs $110 million could be described as "costing" an additional 0.1 percentage point increase in all three existing state tax rates. The evaluation process should not lose sight of the potential for revenue-neutral tax reform – the simultaneous repeal of a number of tax expenditures and cut in the tax rate.

The costs reported in the TEB do not take account of either a tax expenditure's effect on economic growth or – alternatively – any growth stimulated by repeal coupled with a revenue-neutral reduction in the relevant tax rate. Such feedback effects, if they occur, would generally change the estimated cost – increasing them in some cases and reducing them in others. In such cases, the "static" cost estimates (which ignore those feedback effects) will differ from "dynamic" cost estimates (which try to account for such feedback). Dynamic revenue estimates are the cost-side equivalent of measuring secondary effects on the benefit side. Though dynamic estimates would be desirable in theory, they will generally require costly development of Minnesota-specific models that do not now exist. At times, though, their relative importance might be gleaned from existing tax policy literature. For example, economic studies of the impact of the research and development credit at the federal or state level may suggest how Minnesota's version of that credit might stimulate investment and economic growth in Minnesota.

5. Consideration of alternatives

The evaluation process should include consideration of alternatives to any particular tax expenditure – either a direct expenditure or a modified tax expenditure. That is, the evaluation should consider more possibilities than repeal or a simple extension of the existing provision. It should determine whether another method could achieve the same objective more economically. A direct expenditure or a modified

[33] Even if the state has a budget surplus which is used to fund the tax expenditure, that surplus could alternatively have been used to cut a tax rate, to fund a different tax expenditure, or to increase direct expenditures.

tax expenditure might generate similar results at a lower cost, thus saving state resources. Even a "successful" tax expenditure may be more expensive or less effective than one of these alternatives.

We recommend that each evaluation include a listing and analysis of selected alternatives to the current tax expenditure. The consideration of alternatives should not be shortchanged as a way to reduce the costs of an evaluation.

An Essential Point: Information Comes at a Cost

A careful evaluation of tax expenditures will require staff with both knowledge of tax policy and advanced skills in program evaluation. An evaluation of the quality proposed in this report will require additional staffing, regardless of where those workers are located. Requiring evaluations without providing the necessary resources will give poor results.

Summary

Tax expenditure evaluations must start by defining the purpose of the particular tax provision. The purpose (or purposes) must be stated precisely, and the purpose itself should be evaluated in terms of the general tax policy principles discussed in this chapter.

An evaluation must estimate both benefits and the costs, and it must compare the current tax expenditure to several possible alternatives: a direct expenditure program, a modified tax expenditure, or repeal.

Chapter 4 –Which Tax Expenditures Should Be Evaluated Earliest?

In this chapter, we lay out our recommendations for determining which tax expenditures should be evaluated earliest. We also discuss the design of an evaluation cycle spread over eight years.

The Need to Set Priorities

Tax expenditure evaluation is not free. Using the evaluative criteria we have proposed will require significant additional resources. New state government staff, with expertise in program evaluation and specialized tax system knowledge, must either be hired or be redirected from their usual assignments. In some cases, additional information must be collected and analyzed. Often, staff will need to consult stakeholders both within and outside of government. Because Minnesota is unlikely to have sufficient resources to evaluate all of its tax expenditures at once, efficiency requires setting priorities.

Six Criteria to Prioritize Evaluations

We recommend that six criteria (discussed in detail below) be used in setting priorities for evaluations. We believe these criteria can identify those tax expenditures for which evaluations promise the largest potential gains to the state. A tax expenditure should receive a higher priority if the provision:

- Is an exception to the TEB reference tax base as defined in Chapter 2.
- Could be easily replaced with a direct expenditure, maintaining its benefit distribution.
- Has a large annual revenue impact or a high annual rate of growth.
- Has been the subject of recent legislative proposals for modification or repeal.
- Is difficult to administer.
- Could be repealed or modified without creating new administrative problems.

Is an exception to the reference tax base, as we have defined it in Chapter 2.

Although we have generally concurred with the list of tax expenditures in the Tax Expenditure Budget, we offer one major exception. Because we assume that the sales tax is a tax on consumption, we assume that business purchases should be exempt from tax as part of the basic structure of the tax. We acknowledge the possibility of cases in which taxing business inputs is actually a way to tax part of final consumption – and thus more consistent with the reference tax base than exempting those inputs from tax. For example, taxing construction materials used in homes effectively taxes a portion of housing consumption, which is itself exempt. In general, though, taxing business purchases results in an undesirable pyramiding of tax, as described in Chapter 2.

For two reasons we do not recommend simply removing exemptions for business purchases from the list. First, many of these exemptions are very narrowly defined, applying to only one or a few businesses or to a very limited geographical area. Narrow preferences need to be justified. Second, the broader exemptions (such as those for capital equipment) might be improved, and an evaluation can focus on identifying desirable modifications. However, we would generally put a lower priority on evaluation of broadly-defined sales tax exemptions for business inputs.

Could be easily replaced with a direct expenditure, maintaining its benefit distribution.

Some tax expenditures are only thinly veiled direct expenditures. Examples include the refundable credit for Military Service in a Combat Zone, the Working Family Credit, and the capped annual tax credits authorized by the Department of Employment and Economic Development (DEED). In such cases, the primary question for evaluation is whether there is any good reason for administering these programs through the tax system. The tax system should be used to deliver benefits only if it provides clear administrative advantages. Otherwise, direct expenditures are preferred because their costs are more transparent.

Has a large annual revenue impact or a high annual rate of growth.

Granting priority to tax expenditures with large annual revenue impacts is often consistent with efficiency, yielding a higher benefit/cost ratio. Assuming that the cost of evaluating a tax expenditure does not vary much with its revenue impact, evaluating tax expenditures with a high revenue impact is cost effective. Either modification or repeal offers greater potential savings. Identifying ways to more carefully target the benefits of a large tax expenditure might yield particularly significant benefits.

Some tax expenditures create both winners (taxpayers with smaller liabilities) and losers (taxpayers with higher liabilities), so the total swing in revenue can exceed the tax expenditure estimate. In such cases, priority should be based on the total swing in its revenue, not just the impact on net revenue. This distinction is most commonly associated with tax expenditures for property taxes – where swings may be large despite a net impact of zero. However, examples also exist with other tax types, such as corporate apportionment.

We advocate giving higher priority to items that are growing rapidly. They may currently have a small revenue impact, but their impact may become large quite quickly. High priority should be given, in particular, to tax expenditures whose growth was unanticipated and can be attributed to either (a) a change in technology or (b) active promotion by national accounting firms.

Has been the subject of recent legislative proposals for modification or repeal.

The likelihood that an evaluation will produce meaningful action is clearly higher if legislators have recently indicated an interest in either recasting or repealing a particular tax expenditures. Such legislative interest is demonstrated through the introduction and hearing of bills requiring modification or repeal. We advocate assigning higher priorities to tax expenditures where such a legislative commitment for reform has been demonstrated.

Is difficult to administer.

For some tax expenditures, administrative costs are large relative to the tax benefits. We met with representatives of the department's operational divisions, who described their most serious administrative concerns. A tax expenditure can create administrative difficulty in several ways.

First, tax expenditures may increase filing complexity, increasing costs for tax filers and the department. For example, an income tax provision may require a new form or a new schedule, and it generally adds a new line on the form – even if it benefits only a few taxpayers. In the sales tax, a new tax expenditure can require department personnel to engage in difficult line drawing. Additional time must be spent explaining the rules to taxpayers, who, of course, also then bear increased compliance costs. The added complexity may make it difficult for even a well-intentioned taxpayer to comply with the law. A cursory look at the department's sales tax fact sheets reveals how complicated the lines between taxable and nontaxable categories can become. Each tax expenditure makes it necessary to define another set of lines.

Second, in a world of aggressive tax planning, each tax expenditure also offers an avoidance opportunity. Administrative difficulties increase if a tax expenditure gains a broader reach over time than was initially intended – either because the enabling legislative language is interpreted more broadly by the courts or because new qualifying products or ways to package income have been created.

When a tax expenditure expands to reach "unintended beneficiaries," administrative resources will be directed toward devising ways to contain it. Audit activity increases in response. The history of several corporate tax provisions (the foreign royalty deduction, Foreign Operating Corporations, and exemption for insurance companies) illustrates such a pattern

Could be repealed or modified without creating new administrative problems.

Repeal of tax expenditures would generally reduce administrative costs, but we note some critical exceptions. Sometimes, a tax expenditure *reduces* administrative cost and its *repeal* would add to administrative burdens. We identify two broad categories: (1) federal income tax provisions that affect the timing of tax liability and (2) federal income tax exclusions for which either the taxpayer or the department lacks information.

Minnesota's income tax law piggybacks on many of the federal tax expenditures that affect the timing of tax liability. Such provisions include accelerated depreciation, expensing, deferred compensation, pension contributions, and individual retirement accounts (IRAs), Repealing any of these Minnesota tax preferences would require taxpayers to keep two sets of books over many years – one for federal tax and another for state tax. The department would also need to track the difference between the federal and state deductions over long periods of time. As a result, **we recommend** that federal conformity provisions that involve timing across years be considered a low priority for evaluation.

The repeal of federally conforming income tax exclusions may also raise a second issue – the lack of required information. In most cases, income excluded from federal income tax will not be reported on a taxpayer's W-2, Form 1099, or federal tax return. If the taxpayer does not have easy access to the cost of, for example, a particular employee fringe benefit, then requiring the taxpayer to include its value in Minnesota taxable income would be difficult. Two other examples are taxing capital gains on home sales (requiring homeowners to keep records on the cost of improvements even though most expect these gains to be exempt federally) and taxing veterans' pensions or Medicare benefits (on which information would be particularly difficult to obtain). The two tax expenditures discussed in Chapter 2 as possible additions to the list in the current Tax Expenditure Budget would pose serious administrative problems. Taxing capital gains as they accrue (rather than at realization) and taxing the imputed value of homeownership would both pose overwhelming information challenges.

In some cases, Minnesota could reduce these information problems by requiring employers to report the information both to employees and the Department of Revenue in a "Minnesota W-2," but this would add to employer costs. On the other hand, in cases where the currently exempted income is paid by Minnesota agencies (workers compensation and welfare) or regulated utilities (rebate for those buying efficient appliances), requiring such reporting would be relatively easier.

Even if income not reported on a W-2 or Form 1099 is nevertheless information known to the taxpayer, repeal may raise compliance issues. Taxpayers who fail to report such income may be difficult to identify. If the dollars involved on an individual return are small, audit costs may exceed the potential benefit. Beliefs that "no one else is reporting this income" can undermine trust in the tax system and erode voluntary compliance. Examples from the TEB include the following fringe benefits: employer-provided meals, employee awards, employer-paid life insurance, employer-paid transportation benefits, cafeteria plans, and employer-provided education assistance. None of these creates timing issues like those discussed above, but the employer provides no information on the dollar benefits on the employee's W-2.

We recommend that federal conformity provisions for which lack of information makes administration of nonconformity difficult be lower priorities for evaluation.

Federal tax reform could make some of these issues moot. If federal action modified or repealed current tax expenditures involving timing or information problems, administrative cost would argue for us to do the same.

The two categories discussed above –conformity provisions that involve timing across years or for which lack of information makes administration of nonconformity difficult – do not include all federal tax expenditures. Information on many federal deductions and some federal exclusions is currently available either directly from the federal tax return or from W-2 or Form 1099, and modifications or repeal would create no timing issues for many of them. As federal income tax policies change, some Minnesota tax expenditures with information challenges may become easier to repeal. One illustrative change, affecting a federally conforming exclusion, is the requirement, beginning in tax year 2011, that employers report their contributions to employer-paid medical insurance premiums. As a rule, repeal of Minnesota-specific income tax subtractions and credits generate no information problems. For sales and property taxes, repeal of almost any tax expenditure would reduce administrative costs.

Evaluation Priorities Based on the Six Criteria

Listing criteria is fairly easy. Creating a list of high-priority tax expenditures is more difficult. The process requires some way to measure how well each tax expenditure satisfies each of the six criteria, but it also calls for a decision about the relative importance of each of those criteria. If two people disagree about how to weight the criteria, they will also differ on how they rank the tax expenditures,

We spent considerable time trying to rank tax expenditures based on the listed criteria. We simplified the assignment by ranking tax expenditures only within tax categories, rather than across categories. We also found it helpful to consider related tax expenditures as a combined group, ranking the group rather than each individual tax expenditure. In rare cases (most notably JOBZ) we combined tax expenditures from different tax types.

Which Tax Expenditures Should Be Evaluated Earliest?

To a large extent, we agreed on priorities. We offer our lists of the top 12 in each of the major tax categories below, recognizing that others may come up with different items. We list tax types in the order they appear in the TEB – income tax first, followed by corporate tax, sales tax, and property taxes. However, as discussed below, this does not suggest that the evaluation process should necessarily start with the income tax.

We must emphasize: these are not "hit lists." We do not suggest that the listed provisions are prime candidates for repeal. The list simply identifies these tax expenditures as ones that should be examined earliest. Although an evaluation should consider the option of repeal, it should also focus on ways to modify a tax expenditure to increase its effectiveness. For example, should the Working Family Credit retain its unique two-tier structure, or should it be simplified by making it a flat percentage of the federal credit (as other states do)? Can the Research and Development Credit be simplified while maintaining or increasing the incentive it creates? We believe the lists identify tax provisions (or groups of provisions) for which an evaluation offers the greatest potential gain.

Individual Income Tax: Top 12

Tax Expenditure	TEB Reference Number(s)
Working Family Credit	1.83
State and Local Bond Interest	1.32
Child and Dependent Care (Credit and exclusion)	1.82 and 1.03
Charitable Deductions (Itemized and Non-Itemizer)	1.65 and 1.68
Mortgage Interest Deduction	1.64
K-12 Education Credit and Subtraction	1.84 and 1.67
Long Term Care Credit	1.78
Property Tax Deduction	1.62 and 1.63
Medical Expense and Insurance Preferences	1.61, 1.06, 1.57 and 1.81
Preferences for Seniors and Disabled	1.22, 1.60, 1.69 and 1.21
Credit for Past Military Service	1.80
Marriage Penalty Credit	1.77

Half of the items on the individual income tax list (above) are Minnesota credits; half are federal provisions to which Minnesota conforms. Their costs (in fiscal year 2013) range from $8 million to over $1 billion. Although six have costs exceeding $100 million, six others with costs over $100 million are not on the list. The six absent high-cost tax expenditures are all federal provisions where deviating from the federal tax treatment would create serious administrative difficulties. All of the federal itemized deductions make the list. New federal requirements that employers report the cost of employer-provided health insurance on W-2s helped convince us to put the medical and insurance group on the list. The three low-income refundable credits are listed partly based on compliance-related concerns shared by representatives of the Department of Revenue's operational divisions.

The angel investment credit (enacted in 2010) is not on the list because an evaluation is already required under current law. JOBZ provisions were combined and prioritized along with corporate tax provisions.

Corporate Tax: Top 12	
Tax Expenditure	**TEB Reference Number(s)**
Weighted Apportionment	2.23 & 2.25
JOBZ (all provisions within all tax types)	2.29, 2.23, 1.73, 1.86, 4.66, and 5.16
Foreign Source Royalties	2.27
R&D Credit	2.31
Throwback Sales	2.24
Foreign Operating Corporations	2.28
Enterprise Zone Credits	2.37 and 1.87
Insurance Companies	2.02
Employer Transit Pass	2.39 and 1.79
Credit for Bovine Tuberculosis	2.35
Dividend Received Deduction	2.26
Credit Unions	2.01

Because the corporate tax yields fewer tax expenditures than the individual income tax, this is a fairly deep list (above). It includes all but one of the nine tax expenditures that cost more than $10 million. (The exception is federal conformity to accelerated depreciation.) It also includes three small items that cost under $1 million (though none make the top half of the list).

The dividend-received deduction is on the list, despite disagreement about whether this meets the definition of a tax expenditure. The evaluation of this deduction should help clarify whether it is.

Sales Tax: Top 12	
Tax Expenditure	**TEB Reference Number(s)**
Residential Heating Fuels	4.14
Clothing	4.02
Drugs & Medical Devices	4.03, 4.04, and 4.05
Repair Services	4.18 (part)
Food Products	4.01
Legal Services (non-business)	4.18 (part)
Nonprofit Organization Exemptions	4.58, 4.60. 4.75, 4.83-84, and 5.13-15
Personal Care Services	4.18 (part)
Textbooks & Computers Required for School	4.10 and 4.11
Publications	4.09
Accounting / Brokerage & Investment Counseling	4.18 (part)
De Minimus Use Tax Exemption	4.12

Given the decision to assign low priority to exemptions for purchases by business, it is not surprising the sales tax list (previous page) is dominated by exemptions for consumer goods and services. Missing from the list is the exemption for motor fuels (which are subject to a substantial excise tax) and a number of exemptions for purchases by local governments.

Property Tax: Top 12	
Tax Expenditure	**TEB Reference Number(s)**
Green Acres (Agricultural Land)	13.06
Exempt Property	13.01
Classification System (including state property tax)	13.05
Fiscal Disparities	(not currently included)
Disabled Veterans Exclusion	(not currently included)
Tax Increment Financing	13.09
Open Space Property	13.07
Taconite Homestead Credit	13.11
Powerline Credit	13.12
Metropolitan Agricultural Preserves Land	13.08
Conservation Tax Credit	13.14
Metropolitan Agricultural Preserves Credit	13.13

The above list includes all property tax expenditures, including two that have not previously been included in the TEB: the Fiscal Disparities tax base sharing program and the Disabled Veterans' exclusion. The Fiscal Disparities program is currently undergoing a separate review. The Disabled Veterans' exclusion is a new program, and will be included in future TEB reports.

Two recommendations from Chapter 2 should be noted. Given the complex interactions between the direct expenditure programs and the tax expenditures that affect net property tax payments, we recommended integrated evaluations that include direct expenditure programs to the degree necessary. We also recommended that the evaluation of the property tax system include the class-specific impact of the state property tax, which is levied on only a subset of property types.

The Property Tax Working Group was established in 2010 to study ways to simplify and improve the state's property tax system. The work of this group will include a review of tax expenditures in the property tax.[34] **We recommend** that evaluation of property tax provisions be delayed until after the Property Tax Working Group has completed its work.

Eight-Year Evaluation Cycle

If evaluations are to be useful, they will almost certainly need to be spread across a number of years. **We recommend** an eight-year cycle that focuses on high priority tax expenditures in the early years. We

[34] See *Minnesota Statutes 2010,* sec. 270C.991 subd. 4. The Property Tax Working Group's report to the Legislature is due by Feb. 1, 2012.

have no recommendation about which tax (income, corporate, or sales) should be given highest priority, though we do suggest delaying property tax evaluations until later in the cycle (as recommended).

For illustrative purposes, the cycle we propose below assumes that:

- tax types are reviewed in the same order as they appear in the TEB – income tax, corporate tax, and sales tax; and
- our "Top 12" provisions for each tax type (listed in the sections above) will be evaluated before moving on to lower-priority items.

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.*

We see advantages in structuring the eight-year cycle by tax type, focusing on a number of tax expenditures from each tax type in the same year. This helps keep the focus on the potential for larger tax reform, and it is the way tax expenditure discussions have usually been structured. Evaluating all of the income tax itemized deductions at the same time makes it easier to consider modifications that could affect all of them (such as conversion to credits). On the other hand, some might prefer to evaluate several tax expenditures from each tax type during each year of the cycle.

Completing quality evaluations of all tax expenditure over an eight-year cycle will be a challenge. New tax expenditures are likely to be enacted over the cycle as well, and those could be evaluated in later years. Successful completion of comprehensive evaluations will require adequate funding.

Summary

Given the large number of tax expenditures, we recommend that evaluations be spread over a recurring eight-year cycle. We identify six criteria to use in determining which evaluations should have the highest priority. We list the 12 tax expenditures (or groups of tax expenditures) within each tax type that we believe have the highest priority, based on those criteria.

Chapter 5 – Process

> *There is a key difference...between direct spending and tax expenditures. States typically require extensive documentation of how much direct spending they do each year, and their budget processes entail evaluation of each item. Tax expenditures usually receive far less scrutiny. For the most part, policymakers do not regularly examine tax expenditures, nor do states document their effectiveness the same way they do for on-budget expenditures.*
>
> (Levitas, Johnson, and Koulish, 2009)

Though Minnesota's Tax Expenditure Budget (TEB) is widely considered to be much better than similar reports in other states, our overall assessment of tax expenditures remains weak. Tax expenditures are not integrated into the budget process, and they do not receive the kind of regular review by the governor and Legislature that direct expenditures do.

Yet periodic review of Minnesota tax expenditures is vital. Citizens for Tax Justice (2009) characterized tax expenditures as "the hidden entitlements," and Davis (2010) called the continued creation of new tax expenditures "tax deform." Despite their size and growth, tax expenditures in Minnesota (as in most states) are not reported in state budget documents. This results in little or no prioritization. Unlike direct expenditures, they are not appropriated every two years. But, operating on autopilot as part of the permanent tax code, their costs can grow dramatically years after enactment.

For example, consider tuition assistance for college students. A tuition grant program requires the governor and Legislature to appropriate money every budget cycle. Officials face a clear question: Should the program be increased, decreased, modified, or even eliminated? A decision is made every two years. On the other hand, a tuition tax credit of equal cost would have no regular review after it is enacted. It could double in cost with little notice. Its cost appears nowhere in the budget documents, and it is not included in state spending totals. It takes legislative action to fund the grant program; it takes only inaction to fund the tax credit (once enacted).

This chapter recommends actions to bring tax expenditures into the budget process and reduce existing procedural biases in favor of tax expenditures. As Davis (2010) noted, "Although political biases are likely the more important contributor to the tax expenditure addiction afflicting so many state lawmakers, procedural biases must be addressed first." The goal of each recommendation we make is not to eliminate or alter any particular tax expenditure, but rather to ensure that tax expenditures face the same level of scrutiny as direct expenditures so that state policy better reflects the deliberate decisions of the people's elected representatives.

Tax Expenditure Evaluations: Whose Responsibility?

Successful evaluations require three things: Staff with the required set of skills, staff whose work will be considered nonpartisan (or trusted), and a way to get the public and policymakers to pay attention to the results.

The Department of Revenue's Tax Research Division is one possible source of staffing for the evaluation. Though the division publishes the TEB, that report does not include any performance evaluation of tax expenditures. Nor are current staff in the Research Division specifically trained to do such work. As Citizens for Tax Justice has noted:

> *Performance reviews are substantially different from tax law enforcement or revenue estimation and measurement. Even though a revenue agency may be skilled at administering a tuition tax credit, for example, it may still lack the tools and expertise needed to judge the educational outcomes of that credit. Program evaluation training … [is] more important than an intimate familiarity with tax law.*[35]

Despite such concerns, Minnesota differs in important ways from other states. It has a history of independent research staff in the executive branch. The Tax Research Division provides the official estimates on revenue impacts of tax proposals, and Minnesota Management and Budget's research staff produces the state revenue forecast. It is unusual among states for executive-branch agencies to have sole responsibility for such roles.

Yet concerns may still arise about the political independence of agency research staff. For example, will an analysis of the governor's favorite tax expenditure be trusted if the responsibility for evaluation lies completely within the executive branch?

We are also concerned that expenditure evaluations may be too easily ignored if they are solely the responsibility of the Department of Revenue. Will they be considered just another report? Will their results engage the public?

For these reasons, **we recommend** that Minnesota create a Tax Expenditure Commission of policy and tax specialists appointed by the governor and Legislature to oversee the evaluation process**.** The commission should have the authority to set priorities for tax expenditure evaluations and be required to recommend changes based on those evaluations to the governor and the Legislature. The commission could be organized along the lines of some other recent groups, with the governor, House and Senate each appointing five members. It should be a standing commission, given the ongoing nature of its work. Members might serve four-year staggered terms.

The Tax Expenditure Commission should supervise and release its evaluation reports. But **we recommend** that the commission depend on expert staff at the Department of Revenue and other state agencies for the primary evaluation work. Objective evaluations must be based on full information, and only Department of Revenue staff will have direct access to non-public tax information.

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[35] Citizens for Tax Justice, "Judging Tax Expenditures: Spending Programs Buried Within the Nation's Tax Code Need to be Reviewed" (November 2009), p. 23.

We recommend that the Tax Expenditure Commission define a clear and measurable purpose for each tax expenditure if one is not stated in law. The enacting legislation for any new tax expenditure (enacted after 2010) should define its purpose and describe how to measure whether the provision is meeting that purpose. As noted throughout this report, however, few existing tax expenditures have a stated purpose. If the Legislature does not agree with the commission's "stated purpose" for these existing provisions, it could endorse a new one. **We recommend** that the stated purpose for each tax expenditure, once defined, be included in the TEB.

We recommend that the Legislature appropriate sufficient funds to ensure the tax expenditure evaluations proposed in this report achieve their purpose. These evaluations will generate new responsibilities for staff at the Department of Revenue and other agencies. They may require the use of consultants, new economic models, or hiring of additional staff with the requisite training in performance evaluation. The recommended evaluation process is an ongoing one, so funding should be ongoing too.

The $100,000 in funding recently allocated by the Legislature for evaluation of the so-called Angel Tax Credit provides some guidance on the expected costs of detailed evaluation.[36] For similarly comprehensive evaluations of 12 tax expenditures a year – as proposed in this report – we suggest $1.2 million in annual funding.

Integrating Tax Expenditures into the Budget Process

> *[T]ax expenditure budgets should be integrated into the normal budget process on a timely basis.*
>
> (Mikesell, 2002)

Though a Tax Expenditure Commission and ongoing evaluations will focus attention on tax expenditures, other changes will be necessary to bring them into the budget process.

Currently, the biennial budget documents created by Minnesota Management and Budget do not include the TEB or any mention of the fiscal impact of tax expenditures. In recent years the TEB has not even been published in the same year the budget is enacted!

Perhaps it should come as no surprise that tax expenditures are largely ignored when designing the budget. Such disregard is typical across the country:

> *[I]n only a few states (Idaho, New York, Ohio, Oregon, Pennsylvania, Tennessee, and Wisconsin) is the tax expenditure budget transmitted with the direct expenditure budget, either as a component of the budget document or along with the spending document.*
>
> (Mikesell, 2002)

This is not to say that tax expenditures are totally ignored in Minnesota. The governor may focus on a few tax expenditures as part of his budget package, and legislative tax committees may take a close look

[36] See *Minnesota Statutes 2010* [Small Business Investment Tax Credit], sec. 116J.8737, subd. 10. Retrieved from: https://www.revisor.mn.gov/statutes/?id=116J.8737. The provision requires an evaluation of the credit's effectiveness, to be completed by January 2014. The credit has a sunset date of Dec. 31, 2014 under subd. 12.

at selected provisions. The House Tax Committee's careful review of a large number of tax expenditures in 2009 is a striking example.[37] But, under the current budget process, such attention is rare.

We recommend that tax expenditures be fully integrated into the biennial budget process. Doing so would require a change in timing of the TEB. To allow time for adequate review by the administration before the budget is developed, the TEB should be transmitted to the governor and Legislature in the fall of each even-numbered year.[38]

Minnesota Management and Budget should include reviews of both proposed direct expenditures and tax expenditures in its recommendations to the governor. The governor should explicitly consider both types of expenditures when making budget decisions and transmitting those recommendations to the Legislature. In turn, the Legislature should consider tax expenditure recommendations in a manner similar to those concerning direct expenditures.

We recommend that tax expenditures be classified by core function to the extent possible, so they can be compared to direct expenditures that serve the same function. This would improve the review of tax expenditures by Minnesota Management and Budget and by legislative committees, both of which are generally organized by function.

We recommend that total tax expenditures for each tax be included on budget summaries of state tax revenue. Budget documents currently report only the revenue raised by each tax (net of tax expenditures); we suggest that they instead show:

a. gross tax revenue;

b. the estimated total fiscal impact of tax expenditures; and

c. net tax revenue after tax expenditures.

Listing tax expenditures this way in budget summaries will help increase transparency. By offering this detailed information, the governor would signal an intent either to maintain all current tax expenditures or to recommend increases, reductions, or repeal.[39]

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[37] Dalton, Pat, Nina Manzi, Joel Michael, and Cynthia Templin. *A Review of Selected Tax Expenditures: A Presentation to the House Taxes Committee* (2009). Retrieved from: http://plus.mnpals.net/vufind/Record/006842628/Holdings.

[38] Currently, the Tax Expenditure Budget is due by Feb. 1 of each even-numbered year. The Tax Incidence Study is due by March 1 of each odd-numbered year. Substantial time and resources are required for the Department of Revenue's Research Division to complete each report. As a result, shifting the statutory due date for the Tax Expenditure Budget as proposed in this report would also require changing the due date for the Tax Incidence Study (to March 1 of even-numbered years).

[39] Department of Revenue staff cautions that tax expenditure estimates differ from revenue estimates. Due to interactions among state tax provisions, the total fiscal impact of a set of tax expenditures is not simply the sum of their individual impacts. As such, any "total" fiscal impact estimate will be somewhat imprecise.

The department is not troubled by inclusion of aggregate grouped amounts – as proposed here – for informational purposes. The department would have concerns about including individual tax expenditure estimates directly in budget documents, however.

We recommend that each tax expenditure have a revenue-neutral sunset date. Unless the tax expenditure is extended by that sunset date, it would expire and the rate for the tax would be adjusted downward to hold revenue constant. This recommendation would promote careful consideration of tax expenditures and treat them more like direct expenditures since they could not be extended or modified without action by the governor and Legislature. Sunset dates should reflect the schedule for evaluations, so that a tax expenditure would not expire before it could be evaluated.

Revenue neutrality is crucial for sunset dates to work within the budget process. Without it, budget forecasts would have to assume that provisions expire on the designated date. This would show substantial – but misleading – revenue increases in future years, presenting an inaccurate picture of the state's long-run budget situation.

The Legislature's Role in Evaluating Tax Expenditures

To the extent that the Legislature has reviewed existing tax expenditures, tax committees have typically done the work. This is certainly appropriate, but many tax expenditures are substitutes for direct expenditures. In such cases, **we recommend** that appropriations committees examine those tax expenditures along with direct appropriations that serve the same function(s).

An appropriations committee has the expertise to consider the effectiveness of a tax expenditure when it has a purpose that falls within the committee's purview. The tax committee would need to review any suggested changes to ensure they do not violate good tax policy.

We recommend that tax expenditures be included as a separate category in the Legislature's joint budget resolution adopted in March of each budget (odd-numbered) year. A response to the governor's proposed budget, the resolution currently sets two targets – spending and revenue – that provide a foundation for budget negotiations among the House, Senate and governor. We suggest a more comprehensive resolution that includes three targets: direct expenditures (equivalent to the current spending target); tax expenditures; and gross tax revenue (before subtracting tax expenditures).

This three-part resolution will help fully integrate tax expenditures into the budget process by requiring the governor and Legislature to make explicit recommendations about the desired level of tax expenditures.

Making Tax Expenditures Transparent

Transparency is an important goal for the tax system. Transparency enables interested citizens and organizations to be more involved in evaluating the state budget. Under recently enacted law, Minnesota is required to post both direct and tax expenditures online in a searchable database.[40]

While the enacting legislation contains no hard deadline, **we recommend** that the Department of Revenue and MMB move as quickly as possible to put this into effect. Classification of tax expenditures by core function (as recommended above) would make such an online searchable database more useful.

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[40] See *Minnesota Statutes 2010,* sec. 16A.056 [Web Site With Searchable Database on State Expenditures]. The statute requires the departments of Revenue and Minnesota Management and Budget to create a database, starting with expenditures for fiscal year 2010. The statute does not stipulate when the full database must be online.

Reporting aggregate categories of tax expenditures provides important information, but it does not go far enough. Lack of transparency is of particular concern as it relates to business tax credits. If a direct expenditure program awards grants to businesses to promote economic development, those grants are generally public information. In contrast, if a tax expenditure is used for the same purpose, that information may be considered non-public data.

Though a few other states disclose such information, Minnesota does not. **We recommend** that the Legislature require the Department of Revenue to disclose the beneficiaries of business tax credits.[41] Such information could be provided online, as is done at the State of Oklahoma website.[42]

Summary

To oversee the evaluation process, we recommend the creation of a Tax Expenditure Review Commission. The commission would set priorities for the review process and advise the governor and Legislature based on those evaluations. Adequate funding for staff support is required to ensure meaningful assessment.

Each tax expenditure should be subject to a revenue-neutral sunset provision based on the evaluation schedule. In addition, the TEB should be fully integrated into the budget process, and information about tax expenditures should be easily accessible to the public.

[41] In some cases, doing so would require changes to Minnesota's data classification statute. A wide range of tax information is classified as private, protected or non-public data under *Minnesota Statutes,* sec. 13.02.

[42] See https://www.ok.gov/okaa/tax/app/search.php.

Appendix A – List of Recommendations

Evaluate whether tax expenditures are meeting their purpose

We recommend that all tax expenditures be formally evaluated, with evaluations spread over a recurring eight-year cycle that focuses on high-priority tax expenditures in the early years. (Chapter 4)

We recommend that 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. (Chapter 5)

We recommend that the commission depend on expert staff at the Department of Revenue and other state agencies for the primary evaluation work. (Chapter 5)

We recommend that the Legislature appropriate sufficient funds to pay for the 12 annual tax expenditure evaluations proposed in this report. (Chapter 5)

We recommend that six criteria be used in setting priorities for evaluations. A tax expenditure evaluation should receive a higher priority if it:

- Is an exception to the reference tax base, as we have defined it in Chapter 2.
- Could be easily replaced with a direct expenditure, maintaining its benefit distribution.
- Has a large annual revenue impact or a high annual rate of growth.
- Has been the subject of recent legislative proposals for modification or repeal.
- Is difficult to administer.
- Could be repealed or modified without creating new administrative problems. (Chapter 4)

We recommend that tax expenditures due to federal conformity provisions that involve timing across years be considered a low priority for evaluation. (Chapter 4)

We recommend that tax expenditures due to federal conformity provisions for which lack of information makes administration of nonconformity difficult be a low priority for evaluation. (Chapter 4)

We recommend that the Tax Expenditure Commission define a clear and measurable purpose for each tax expenditure if one is not stated in law. (Chapter 5)

We recommend that each tax expenditure evaluation both list and analyze selected alternatives to the current provision. (Chapter 3)

We recommend that state and local property taxes be combined in any discussion of tax expenditures. (Chapter 2)

We recommend that evaluations of property tax expenditures include (as needed) direct expenditures that affect net property tax payments to allow analysis of the complex interactions between them. (Chapter 2)

We recommend that evaluation of property tax provisions be delayed until after the Property Tax Working Group has completed its report, due Feb. 1, 2012. (Chapter 4)

Bring Tax Expenditures into the Budget Process

We recommend that 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. To allow time for adequate review by the administration before the budget is developed, the TEB should be shifted to the fall of each even-numbered year (Chapter 5)

We recommend a revenue-neutral sunset for each tax expenditure, following its evaluation. Unless the tax expenditure is extended by the sunset date, it would expire and the rate for the tax would be adjusted downward to hold revenue constant. (Chapter 5)

We recommend that tax expenditures be classified by core function to the extent possible, so they can be compared to direct expenditures that serve the same function. (Chapter 5)

We recommend that 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 to ensure they do not violate good tax policy. (Chapter 5)

We recommend that state budget summaries include total tax expenditures for each tax to show their fiscal impact on gross tax revenue. (Chapter 5)

We recommend that tax expenditures be included as a separate category in the Legislature's joint budget resolution adopted in March of each budget (odd-numbered) year. (Chapter 5)

Enhance the Tax Expenditure Budget

We recommend that the stated purpose for each tax expenditure, once defined, be included in the TEB. (Chapter 5)

We recommend the creation of a list of no-cost provisions that deviate from the reference tax base but are omitted from the TEB. The evaluation process should determine whether these no-cost provisions should be repealed. (Chapter 2)

We recommend that sales tax exemptions for services that are excluded from the TEB be identified and that a rationale for their exclusion be provided if they are not included in the future. (Chapter 2)

We recommend that, in the TEB, gross receipts taxes on medical care and insurance be treated as alternatives to the sales tax, and that the artificial distinction between the general and motor vehicle sales taxes be ignored. (Chapter 2)

We recommend that two additional property tax provisions be included as tax expenditures: the Fiscal Disparities tax base sharing program and the Veteran's Exclusion. (Chapter 2)

Make Information on Tax Expenditures More Accessible to the Public

We recommend that the Department of Revenue and Minnesota Management and Budget move as quickly as possible to meet the statutory requirement to post both direct and tax expenditures by the state online in a searchable database (*Minnesota Statutes 2010*, sec. 16A.056*)*. (Chapter 5)

We recommend that the Legislature require the Department of Revenue to disclose the beneficiaries of business tax credits online. (Chapter 5)

Appendix B – Tax Expenditure Evaluations In Other States

Several other states have done more work in evaluating tax expenditures and bringing tax expenditures into the budget process than Minnesota has done. We can learn from their experience.

Washington

Washington has the most extensive process of tax expenditure review. Their Citizen Commission for Performance Measurement of Tax Preferences (CCPMTP) was established as a permanent commission in 2006. The CCPMTP is charged with developing a 10-year schedule to review all tax expenditures, which is revised annually. Tax expenditures are subject to full review if their biennial impact exceeds $10 million, a less-complete expedited review if they cost between $2 million and $10 million, and an expedited light review if they cost less than $2 million.

Initially, tax expenditures were reviewed in the order they were enacted. In 2010, a Washington study of the process recommended that the CCPMTP be permitted to use other criteria. It also recommended that (a) expedited reviews be permitted for some tax expenditures with costs over $10 million and (b) tax preferences that are "critical to defining the tax structure" be identified and omitted from the review process. In 2010, the CCPMTP's 10-year schedule was based on the following:

- 52 tax preferences would not be reviewed – either exempted from the review process by statute or determined to be a critical part of the tax structure
- Full review for an average of 128 tax preferences over 10 years
- Expedited review for an average of 102 tax preferences over 10 years
- Expedited light review for an average of 322 tax preferences over 10 years

The enacting statute identifies 10 questions to be addressed in evaluating each tax expenditure:

- What are its objectives?
- What evidence is that that the objectives are achieved?
- Will continuing the tax preference help achieve these objectives?
- If the objectives are not being achieved, can the tax preference be modified so as to do so?
- Who are the entities whose tax liabilities are directly affected by the tax preference?
- To what extent does the preference provide unintended benefits?
- What are the past and future tax revenue and economic impacts of the tax preference?
- How would ending the tax preference affect tax revenue and the economy?
- How would ending the tax preference affect the distribution of the tax liability?
- Do other states have a similar tax preference?

The evaluations are conducted by the Joint Legislative Audit and Review Committee (JLARC). A good example of the depth of their evaluations is their 2009 evaluation for the sales tax exemption for newspapers, which is available on the JLARC's website at: http://www.leg.wa.gov/JLARC/AuditAndStudyReports/2009/Documents/09-11.pdf#page=83

The JLARC is required to recommend one of the following:

- Continue tax preference
- Modify tax preference
- Add an expiration date and conduct another review prior to expiration;
- Terminate the tax preference

The 2010 schedule called for 10 full reviews and 10 expedited reviews, along with 38 expedited light reviews. Of the 20 full and expedited reviews, JLARC recommended that 12 be continues and six be repealed. They recommended that the Legislature re-examine or clarify the intent of the other two reviewed preferences. No recommendations were made for any of the 38 expedited light reviews, and the information provided for those 38 simply duplicated what was available in their regular tax expenditure report.

Public comment sessions and joint hearings of the legislative fiscal committees are also required.

More information on the Washington tax evaluation process is available on the CCPMTP website at: http://www.citizentaxpref.wa.gov/whatsnew.htm

Iowa

Iowa's evaluation process has focused solely on tax credits. The Iowa Department of Revenue has completed in-depth evaluations of six tax credits – the Earned Income Credit (2007), Research Activities Credit (2008), Historic Preservation Credit (2009), two Bio-Fuels Credits (2009), and the New Jobs Credit (2010). These studies are available online: www.iowa.gov/tax/creditstudy.html.

In 2009, Iowa's Governor designated a seven-member Tax Credit Review Panel (all from state agencies) to complete a comprehensive review of the State's 37 tax credits. The panel held public hearings and received written comments from the public. Their 2010 report recommended major changes:

- Eliminate transferability for all tax credits and eliminate refundability for the Research Activities Tax Credit
- Establish a 5-year sunset for all tax credits
- Cap all currently uncapped tax credits
- Repeal eight of the existing 37 credits
- Develop effective return on investment calculation for all tax credits.

The report is available online at: www.dom.state.ia.us/tax_credit_review/index.html.

Maine

In 2010, the Maine Legislature enacted a resolution "To Increase Transparency and Accountability and Assess the Impact of Tax Expenditure Programs." It required a working group in the executive branch to:

- Identify tax expenditure programs for review
- Design a data collection method to measure the economic impact of tax expenditure programs, including comparison of economic gain to revenue loss, jobs created, and administrative burdens
- Develop recommendations for regular reporting and review of performance data

The report from the working group noted that "until the early part of this decade, the Legislature's Taxation Committee was required to review tax expenditures on a rolling basis. One year, review focused on the income tax, two years later it was sales tax and two years after that, property taxes." Because "as a practical matter, little was gained from this effort," that review was replaced by a requirement for a biennial tax expenditure budget.

Given this history, the working group recommended a review focused narrowly on 11 tax provisions whose purpose is economic development. Each of the 11 would be reviewed at least once every four years. They recommend that reviews be "conducted by a non-partisan body, with assistance from the relevant agencies of State government." The working group pointed out that stringent confidentiality requirements for taxpayer information could make evaluation difficult and suggested that "some type of exception" to those rules would be required "to allow meaningful review to take place."

Completed reviews would be presented to four specific legislative committees, who would hold a public hearing on each report. The reviews themselves would include no recommendations for changes in the tax credits, which is left to the legislative process.

It is too early to tell if action will be taken on these recommendations. The report is available online at: http://maine.gov/legis/ofpr/taxation_committee/materials/impact_tax_expenditure_programs.pdf.

Rhode Island

A 2008 law requires the Rhode Island Department of Revenue to provide detailed information about six tax credits for corporations. They were required to:

- List the names and addresses and credit amounts for all who received one of the six tax credits during the previous fiscal year
- Publish annually comprehensive information about the costs and benefits of the tax credits, including the number of jobs created and wage and benefit levels
- Present the tax credit information in the state budget so they can be considered as part of the budget process

Despite the statutory requirement, only the first of these requirements has been satisfied.[43]

[43] The Poverty Institute, Rhode Island College School of Social Work. "Tax Incentive Disclosure and Accountability" (September 2009).

Oklahoma

The nine-member Incentives Review Committee (IRC), created in 2004, is charged with conducting a review each year of one or more tax incentives. The IRC has adopted formal criteria for evaluating tax incentives and has published four annual reports, which include recommendations.

Oklahoma is best known, though, for the information it provides on-line about the recipients of tax credits. The openbooks.ok.gov website provides lists of each individual or business receiving one of over three dozen income tax credits, along with the amount received. This was required under the Taxpayer Transparency Act, enacted in 2007. [44]

Delaware and California (Franchise Tax Board)

A recent review of state tax expenditure budgets complimented these two states for including "meaningful" tax expenditure evaluations in their regular tax expenditure budgets. Though brief, these evaluations go well beyond what is available in other state TEBs. A few other states are required to include evaluations in their reports, but they "do a less exemplary job, simply rubber-stamping most expenditures without much apparent analysis" (Oregon and Louisiana) or "ignoring the requirement entirely" (Wisconsin).[45]

It is noteworthy that the two exemplary studies do not include the sales tax. Delaware has no sales tax and the California Franchise Board TEB includes only individual and corporate income taxes.

Summary

Washington State's approach to evaluating tax expenditures comes closest to what is recommended in this report. The process includes a rolling 10-year evaluation of all tax expenditures.

Iowa, Rhode Island, and Oklahoma focus the evaluation effort entirely on tax credits – a decision that has been recommended in Rhode Island as well.

The evaluation process and other changes recommended in this report would certainly make Minnesota a leader in tax expenditure evaluation and the integration of tax expenditures into the budget process.

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[44] A good summary of Oklahoma's provisions can be found at http://okpolicy.org/files/taxexpend_full.pdf .

[45] Levitas, Jason, Nicholas Johnson, and Jeremy Koulish, "Promoting State Budget Accountability Through Tax Expenditure Reporting," Center for Budget and Policy Priorities (April 2009), pp. 26-28.

Delaware's TEB is available online at http://finance.delaware.gov/publications/2007_tax_prefer/2007_report.pdf. California Franchise Board's TEB is available online at: http://www.ftb.ca.gov/aboutftb/taxExp08.pdf.

Appendix C – List of Tax Expenditures

This appendix lists all the tax expenditures included in the 2010 Minnesota Tax Expenditure Budget, along with estimated costs for fiscal years 2012 and 2013. (Asterisks signify a cost less than $50,000). The full TEB study, which includes more information about each provision, is available online at: http://taxes.state.mn.us/legal_policy/Documents/other_supporting_content_2010_tax_expenditure_links.pdf

Since the most recent TEB report was published in February 2010, there have been some changes to state tax laws that are worth noting here. During the 2010 legislative session, one item on the list in this appendix was repealed (#1.89/Lower-income motor fuels credit) and several new tax expenditures were enacted. These provisions, which do not appear on the list, include:

- Angel investment credit (individual income tax)
- Historic structure rehabilitation credit (individual income tax, corporate franchise tax, insurance premiums tax)
- Research and development credit (individual income tax)
- Exemption for a aerospace defense manufacturing facility (sales tax)

The costs of specific tax expenditures may ebb and flow over time as the associated provisions (some of them in federal law) are extended, repealed or modified. Among them:

- Several items on the list had costs in fiscal years 2010 and 2011, but show no costs for fiscal years 2012 and 2013. Examples include #4.70/Sales tax exemption for the Minnesota Twins Ballpark and #4.71/Sales tax exemption for the University of Minnesota football stadium.
- Several of the listed provisions show zero costs under current law but will in the future. Some were extended in 2010 (e.g., #4.69/Sales tax exemption for hydroelectric generating facility); others are likely to be extended in 2011 (e.g., #1.12/Income tax exemption for employer-provided education assistance).

The list does not include some provisions that this report recommends be treated as tax expenditures and added to the next TEB study (due in 2012). Among them.:

- Sales tax exemption for some additional services (including medical services)
- Sales tax exemption for digital books, movies, and games
- Fiscal disparities (property tax)

Some of the changes proposed in this report may affect the estimated cost for several tax expenditures on the list. These include:

- #2.23/Corporate weighted apportionment
- #2.26/Corporate dividends received deduction
- #13.3/Property Tax classification System.

Tax Expenditure Summary List (from 2010 TEB)

Estimates for Fiscal Year Impact are in dollars/ denotes minimal impact (under $50,000)*

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	Fiscal Year Impact 2013
	Individual Income Tax			
	Federal Exclusions			
1.01	Employer-Provided Meals and Lodging	1933	7,500,000	7,900,000
1.02	Housing Allowances for Ministers	1945	5,900,000	6,200,000
1.03	Employer-Provided Dependent Care	1982	11,000,000	11,500,000
1.04	Employee Awards	1987	1,400,000	1,400,000
1.05	Employer Pension Plans	1933	669,800,000	731,600,000
1.06	Contributions by Employers for Medical Insurance Premiums and Medical Care	1933	1,044,400,000	1,110,700,000
1.07	Employer-Paid Accident and Disability Premiums	1955	23,500,000	24,900,000
1.08	Employer-Paid Group Term Life Insurance Premiums	1933	19,400,000	19,500,000
1.09	Employer-Paid Transportation Benefits	1985	31,900,000	33,900,000
1.10	Cafeteria Plans	1975	319,300,000	327,100,000
1.11	Employer-Provided Adoption Assistance	1997	*	*
1.12	Employer-Provided Education Assistance	1979	0	0
1.13	Miscellaneous Employee Fringe Benefits	1985	48,800,000	52,100,000
1.14	Income Earned Abroad by U.S. Citizens and Foreign Housing Costs	1933	31,900,000	33,600,000
1.15	Certain Allowances for Federal Employees Abroad	1945	4,200,000	4,400,000
1.16	Benefits and Allowances to Armed Forces Personnel	1933	15,200,000	15,500,000
1.17	Medical Care and Tricare Medical Insurance for Military Dependents and Retirees	1933	10,600,000	11,400,000
1.18	Veterans' Benefits	1933	32,200,000	34,000,000
1.19	Military Disability Pensions	1933	600,000	700,000
1.20	Workers' Compensation Benefits	1933	85,800,000	92,200,000
1.21	Special Benefits For Disabled Coal Miners	1971	*	*
1.22	Social Security Benefits	1939	199,700,000	206,800,000
1.23	Medicare Benefits	1965	291,400,000	318,000,000
1.24	Foster Care Payments	1983	4,400,000	4,800,000
1.25	Public Assistance	1933	16,800,000	18,100,000
1.26	Scholarship and Fellowship Income	1955	14,300,000	14,900,000
1.27	Education Savings Accounts	1998	1,000,000	1,000,000
1.28	Qualified Tuition Plans	1997	6,800,000	7,900,000
1.29	Certain Agricultural Cost-Sharing Payments	1979	300,000	300,000
1.30	Discharge of Indebtedness Income for Certain Farmers	1987	1,400,000	1,400,000
1.31	Investment Income on Life Insurance and Annuity Contracts	1933	161,700,000	166,100,000
1.32	Interest on Minnesota State and Local Government Bonds	1933	72,900,000	77,400,000
1.33	Capital Gains on Home Sales	1998	100,300,000	108,700,000
1.34	Capital Gains at Death	1933	162,100,000	194,800,000
1.35	Capital Gains on Gifts	1933	53,700,000	12,900,000
1.36	Permanent Exemptions from Imputed Interest Rules	1985	3,000,000	3,200,000
1.37	Like-Kind Exchanges	1933	7,100,000	6,900,000
1.38	Special Rules for Magazine, Paperback, and Record Returns	1979	100,000	100,000
1.39	Energy Conservation Subsidies Provided by Public Utilities	1993	100,000	100,000
	Federal Deductions			
1.40	Accelerated Depreciation	1959	77,100,000	84,100,000
1.41	Expensing Depreciable Business Property	1983	32,900,000	*
1.42	Excess of Percentage Over Cost Depletion	1933	600,000	600,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
1.43	Five-Year Amortization of Business Organizational and Start-Up Costs	1977	6,100,000	6,300,000
1.44	Expensing of Research and Development Costs	1955	900,000	1,000,000
1.45	Expensing of Magazine Circulation Expenditures	1951	*	*
1.46	Expensing of Exploration and Development Costs	1933	300,000	300,000
1.47	Cash Accounting and Expensing for Agriculture	1933	3,300,000	3,300,000
1.48	Expensing of Multiperiod Timber Growing Costs	1933	100,000	100,000
1.49	Special Rules for Mining Reclamation Reserves	1985	*	*
1.50	Cash Accounting Other than Agriculture	1933	6,500,000	6,900,000
1.51	Installment Sales	1933	4,200,000	4,600,000
1.52	Completed Contract Rules	1933	100,000	100,000
1.53	Employee Stock Ownership Plans	1975	3,000,000	3,100,000
1.54	Individual Retirement Accounts	1975	151,600,000	164,900,000
1.55	Keogh Plans	1963	87,100,000	95,800,000
1.56	Health Savings Accounts	2005	26,000,000	34,700,000
1.57	Self-Employed Health Insurance	1987	40,300,000	43,000,000
1.58	Interest on Student Loans	1998	7,600,000	8,300,000
1.59	Per Diem Amounts Paid to State Legislators	1959	100,000	100,000
	Federal Personal Deductions			
1.60	Additional Standard Deduction for the Elderly and Blind	1987	16,800,000	17,400,000
1.61	Medical Expenses	1933	73,100,000	79,300,000
1.62	Real Estate Taxes	1933	198,700,000	213,000,000
1.63	Other Taxes	1933	12,000,000	12,900,000
1.64	Home Mortgage Interest	1933	464,100,000	500,200,000
1.65	Charitable Contributions	1933	207,500,000	221,900,000
1.66	Casualty and Theft Losses	1933	900,000	900,000
	Minnesota Subtractions			
1.67	K-12 Education Expenses	1955	14,400,000	14,800,000
1.68	Charitable Contributions for Nonitemizers	1999	5,900,000	6,400,000
1.69	Income of the Elderly or Disabled	1988	500,000	400,000
1.70	Active Duty Military Service	2005	4,600,000	4,900,000
1.71	National Guard and Reserve Pay	2005	3,600,000	3,800,000
1.72	Expenses of Living Organ Donors	2005	*	*
1.73	Job Opportunity Building Zone Income	2003	7,000,000	7,800,000
1.74	Disposition of Farm Property	1985	*	*
1.75	AmeriCorps National Service Education Awards	2008	100,000	100,000
	Preferential Computation			
1.76	Five-Year Averaging of Lump Sum Distributions	1975	*	*
	Credits			
1.77	Marriage Credit	1999	65,500,000	69,700,000
1.78	Credit for Long-Term Care Insurance Premiums	1997	7,900,000	8,100,000
1.79	Employer Transit Pass Credit	2000	100,000	100,000
1.80	Credit for Past Military Service	2008	11,000,000	11,000,000
1.81	Credit for New Participants in a Section 125 Employer Health Insurance Plan	2009	700,000	700,000
1.82	Child and Dependent Care Credit	1977	12,800,000	12,800,000
1.83	Working Family Credit	1991	178,000,000	182,400,000
1.84	Credit for K-12 Education Expenses	1997	13,200,000	12,800,000
1.85	Credit for Military Service in a Combat Zone	2006	1,800,000	1,800,000
1.86	Job Opportunity Building Zone Jobs Credit	2003	800,000	900,000
1.87	Enterprise Zone Employer Tax Credits	1983	*	*
1.88	Credit for Bovine Tuberculosis Testing	2006	100,000	100,000
1.89	Lower Income Motor Fuels Tax Credit	2008	31,100,000	32,000,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
	Corporate Franchise Tax			
	Exempt Organizations			
2.01	Credit Unions	1937	8,200,000	8,700,000
2.02	Insurance Companies	2001	32,000,000	34,300,000
	Federal Exclusions			
2.03	Permanent Exemptions from Imputed Interest Rules	1985	*	*
2.04	Investment Income on Life Insurance and Annuity Contracts	1933	7,800,000	8,100,000
2.05	Like-Kind Exchanges	1933	9,000,000	9,200,000
2.06	Special Rules for Magazine, Paperback, and Record Returns	1979	100,000	100,000
	Federal Deductions			
2.07	Accelerated Depreciation	1959	74,300,000	92,000,000
2.08	Expensing Depreciable Business Property	1983	5,100,000	200,000
2.09	Excess of Percentage Over Cost Depletion (Mining Occupation Tax)	1989	1,600,000	2,700,000
2.10	Amortization of Organizational and Start-Up Costs	1955	*	*
2.11	Expensing of Research and Development Costs	1955	18,800,000	21,800,000
2.12	Expensing of Magazine Circulation Expenditures	1951	*	*
2.13	Expensing of Exploration and Development Costs	1967	800,000	800,000
2.14	Cash Accounting and Expensing for Agriculture	1933	100,000	100,000
2.15	Expensing of Multiperiod Timber Growing Costs	1933	800,000	800,000
2.16	Special Rules for Mining Reclamation Reserves	1987	100,000	100,000
2.17	Cash Accounting Other than Agriculture	1933	100,000	100,000
2.18	Installment Sales	1933	3,900,000	4,200,000
2.19	Completed Contract Rules	1933	1,800,000	2,000,000
2.20	Charitable Contributions	1933	9,500,000	9,800,000
2.21	Employee Stock Ownership Plans	1975	3,300,000	3,500,000
2.22	Capital Construction Funds of Shipping Cos.	1987	*	*

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
	Apportionment			
2.23	Weighted Apportionment	1939	191,600,000	213,900,000
2.24	Throwback Sales	1973	19,100,000	20,600,000
2.25	Single-Factor Apportionment for Mail Order Companies	1985	*	*
	Minnesota Subtractions			
2.26	Dividend Received Deduction	1947	103,800,000	108,600,000
2.27	Foreign Source Royalties	1984	90,500,000	95,100,000
2.28	Foreign Operating Corporations	1988	43,900,000	46,600,000
2.29	Job Opportunity Building Zone Income	2003	4,600,000	5,200,000
2.30	Disposition of Farm Property	1985	*	*
	Credits			
2.31	Research and Development Credit	1981	21,500,000	22,500,000
2.32	Employer Transit Pass Credit	2000	500,000	500,000
2.33	Job Opportunity Building Zone Jobs Credit	2003	1,300,000	1,300,000
2.34	Enterprise Zone Employer Tax Credits	1983	300,000	300,000
2.35	Credit for Bovine Tuberculosis Testing	2006	100,000	100,000
	Estate Tax			
	Preferential Valuation			
3.01	Special Use Valuation	1979	300,000	300,000
	Exclusions			
3.02	Life Insurance Proceeds	1979	13,900,000	15,200,000
3.03	Annuities	1979	*	*
3.04	Social Security Benefits	1979	*	*
	Deductions			
3.05	Marital Deduction	1979	125,400,000	131,100,000
3.06	Charitable Gifts	1979	15,500,000	16,200,000
	General Sales and Use Tax			
	Exemptions - Particular Goods and Services			
4.01	Food Products	1967	729,700,000	766,700,000
4.02	Clothing and Wearing Apparel	1967	311,400,000	327,100,000
4.03	Drugs and Medicines	1967	289,200,000	304,200,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	Fiscal Year Impact 2013
4.04	Medical Devices	1967	6,500,000	6,700,000
4.05	Prescription Eyeglasses	1967	37,300,000	38,600,000
4.06	Baby Products	1967	500,000	500,000
4.07	Feminine Hygiene Items	1981	3,000,000	3,000,000
4.08	Caskets and Burial Vaults	1967	4,700,000	4,700,000
4.09	Publications	1967	67,000,000	67,900,000
4.10	Textbooks Required for School Use	1973	26,800,000	29,000,000
4.11	Personal Computers Required for School Use	1994	800,000	900,000
4.12	*De Minimis* Use Tax Exemption for Individuals	1996	12,600,000	13,600,000
4.13	Motor Fuels	1967	624,600,000	673,500,000
4.14	Residential Heating Fuels	1978	136,700,000	145,000,000
4.15	Residential Water Services	1979	17,200,000	17,800,000
4.16	Sewer Services	1967	42,700,000	44,700,000
4.17	Used Manufactured Homes	1984	600,000	600,000
4.18	Selected Services	1967	2,652,100,000	2,760,100,000
4.19	Capital Equipment	1989	272,900,000	300,600,000
4.20	Accessory Tools	1973	10,000,000	10,500,000
4.21	Special Tooling	1994	5,300,000	5,500,000
4.22	Telecommunications Equipment	2001	30,000,000	32,500,000
4.23	Resource Recovery Equipment	1984	*	*
4.24	Used Motor Oil	1988	1,100,000	1,300,000
4.25	Taconite Production Materials	1971	*	*
4.26	Wind Energy Conversion Systems	1992	2,100,000	2,500,000
4.27	Air Cooling Equipment	1992	0	0
4.28	Solar Energy Systems	2005	400,000	500,000
4.29	Airflight Equipment	1967	20,000,000	19,800,000
4.30	Large Ships	1992	100,000	100,000
4.31	Repair and Replacement Parts for Ships and Vessels	1990	200,000	200,000
4.32	Light Rail Transit Vehicles and Parts	2001	3,900,000	2,300,000
4.33	Commuter Rail Vehicles and Parts	2008	*	*
4.34	Petroleum Products Used by Transit Systems	1992	3,500,000	3,800,000
4.35	Petroleum Products Used in Passenger Snowmobiles	1993	*	*
4.36	Ski Area Equipment	2000	400,000	400,000
4.37	Logging Equipment	1998	1,600,000	1,600,000
4.38	Farm Machinery	1998	39,000,000	41,400,000
4.39	Repair and Replacement Parts for Farm Machinery	1985	10,400,000	11,000,000
4.40	Petroleum Products Used to Improve Agricultural Land	1985	*	*
4.41	Farm Conservation Programs	1991	500,000	500,000
4.42	Horses	1994	1,600,000	1,600,000
4.43	Prizes at Carnivals and Fairs	1999	200,000	200,000
4.44	Television Commercials	1999	1,400,000	1,400,000
4.45	Advertising Materials	1973	9,200,000	9,400,000
4.46	Court Reporter Documents	1997	500,000	500,000
4.47	Patent, Trademark, and Copyright Drawings	2000	200,000	200,000
4.48	Packing Materials	1973	*	*
4.49	Property for Business Use Outside Minnesota	1967	*	*
4.50	Automatic Fire-Safety Sprinkler Systems	1992	300,000	300,000
4.51	Firefighter Personal Protective Equipment	1994	800,000	800,000
4.52	Building Materials for Residences of Disabled Veterans	1971	*	*
4.53	Chair Lifts, Ramps, and Elevators in Homesteads	1989	*	*
4.54	Parts and Accessories to Make Motor Vehicles Handicapped Accessible	1993	1,200,000	1,200,000
4.55	Maintenance of Cemetery Grounds	2000	*	*
4.56	Trade-In Allowance	1967	9,000,000	9,400,000
	Exemptions - Sales to Particular Purchasers			
4.57	Local Governments	1967	139,600,000	143,300,000
4.58	Nonprofit Organizations	1967	91,500,000	94,700,000
4.59	Hospitals and Outpatient Surgical Centers	1967	74,000,000	77,500,000
4.60	Veterans' Organizations	1980	300,000	300,000
4.61	Construction Materials for Low-Income Housing	2001	1,900,000	1,900,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	Fiscal Year Impact 2013
4.62	Public Safety Radio Systems	1997	600,000	200,000
4.63	Biosolids Processing Equipment	1998	700,000	800,000
4.64	Ambulances Leased to Private Ambulance Services	1990	*	*
4.65	Certain Purchases by Private Ambulance Services	2001	100,000	100,000
4.66	Job Opportunity Building Zones	2003	9,300,000	8,300,000
4.67	Enterprise Zone Construction Materials	1983	*	*
4.68	Waste Recovery Facilities	2005	*	*
4.69	Hydroelectric Generating Facility	2006	0	0
4.70	Minnesota Twins Ballpark	2006	0	0
4.71	University of Minnesota Football Stadium	2006	0	0
4.72	Central Corridor Construction Materials	2008	6,900,000	2,700,000
	Exemptions - Sales by Particular Sellers			
4.73	Isolated or Occasional Sales	1967	45,000,000	47,200,000
4.74	Institutional Meals	1967	42,800,000	44,000,000
4.75	Fundraising Sales by Nonprofit Organizations	1985	15,600,000	16,300,000
4.76	Admission to Artistic Events	1980	6,300,000	6,400,000
4.77	Admission to School-Sponsored Events	1985	1,900,000	1,900,000
4.78	Admission to the Minnesota Zoo	2001	400,000	400,000
4.79	Cross Country Ski Passes for Public Trails	1988	*	*
4.80	YMCA, YWCA, and JCC Membership Dues	1987	4,400,000	4,600,000
4.81	Minnesota Amateur Sports Commission Events	1994	*	*
4.82	Admission to Charitable Golf Tournaments	1994	*	*
4.83	Candy Sales by Certain Organizations	1984	*	*
4.84	Sacramental Wine Sold by Religious Organizations	1991	*	*

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	Fiscal Year Impact 2013
	Reduced Sales Price			
4.85	New Manufactured Homes	1984	600,000	500,000
	Motor Vehicle Sales Tax			
	Exemptions			
5.01	Gifts Between Individuals	1971	27,600,000	28,900,000
5.02	Vehicles Acquired by Inheritance	1971	3,900,000	4,000,000
5.03	Persons Moving into Minnesota	1971	8,400,000	8,500,000
5.04	Transfers Between Joint Owners	1971	8,200,000	8,500,000
5.05	Transfers in Divorce Proceedings	1974	1,200,000	1,200,000
5.06	Sales to Disabled Veterans	1971	100,000	100,000
5.07	Corporate and Partnership Transfers	1975	2,400,000	2,400,000
5.08	Transit Vehicles	1971	4,700,000	4,800,000
5.09	Town Road Maintenance Vehicles	1998	900,000	900,000
5.10	Bookmobiles	1994	*	*
5.11	Private Ambulance Services	1990	700,000	700,000
5.12	Ready-Mixed Concrete Trucks	1998	800,000	800,000
5.13	Automotive Training Programs	1988	100,000	100,000
5.14	Donations to Exempt Organizations	1997	200,000	200,000
5.15	Trucks, Buses, and Vans Purchased by Charities	2000	1,000,000	1,100,000
5.16	Job Opportunity Building Zones	2003	200,000	200,000
	Reduced Purchase Price			
5.17	Price Reduced by Value of Trade In	1971	72,400,000	73,800,000
5.18	Handicapped-Accessible Modifications	1992	500,000	500,000
	Preferential Computations			
5.19	Flat Taxes on Older Cars and Collector Vehicles	1985	47,500,000	49,400,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
	Highway Fuels Excise Taxes			
	Exemptions			
6.01	Transit Systems	1977	4,800,000	4,900,000
6.02	Motor Vehicles Not Requiring Registration (Special Fuels)	1951	700,000	800,000
6.03	Ambulance Services	2001	300,000	300,000
6.04	Reciprocal Agreements for Out-of-State Purchases	1961	*	*
	Credit			
6.05	Border Area Credit	1981	500,000	700,000
	Alcoholic Beverage Taxes			
	Exemptions			
7.01	Consumer Purchases Made Out of State	1947	100,000	100,000
7.02	Home Production and Use	1957	*	*
7.03	Sales to Food Processors and Pharmaceutical Firms	1988	*	*
7.04	Consumption on Brewery Premises	1941	*	*
7.05	Wine for Sacramental Purposes	1937	*	*
7.06	Shipments of Wine for Personal Use	1993	*	*
	Credit			
7.07	Credit for Small Brewers	1985	500,000	500,000
	Cigarette and Tobacco Taxes			
	Exemption			
8.01	Consumer Purchases Made Out of State	1949	13,100,000	13,100,000
	Mortgage Registry Tax			
	Exemptions			
9.01	Agricultural Loans	2001	700,000	700,000
9.02	Government Housing Programs	2001	900,000	900,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
	Deed Transfer Tax			
	Exemptions			
10.01	Property Partitioned Between Co-Owners	1984	*	*
10.02	Distributions by Personal Representatives	1975	*	*
10.03	Cemetery Lots	1961	100,000	100,000
10.04	Exchange of Permanent School Fund Lands	1991	*	*
10.05	Mortgage or Lien Foreclosure Sales	1993	5,500,000	4,700,000
10.06	Decree of Marriage Dissolution	1997	300,000	300,000
	Lawful Gambling Taxes			
	Exemptions			
11.01	Bingo at Certain Organizations	1985	*	*
11.02	Bingo at Fairs and Civic Celebrations	1984	*	*
11.03	Infrequent Bingo Occasions	1984	*	*
11.04	Smaller Raffles	1984	100,000	100,000
11.05	Raffles by Certain Organizations	1984	*	*
11.06	Lawful Gambling Under Certain Conditions	1986	1,700,000	1,700,000
	Credit			
11.07	Credit for Certain Raffles	2000	*	*
	Insurance Premiums Taxes			
	Exemptions			
12.01	Fraternal Benefit Societies	1907	4,300,000	4,500,000
12.02	Farmers' Mutual and Township Mutual Fire Insurance Companies (Surcharge on Fire Safety Premiums)	2006	400,000	400,000
12.03	Minnesota Comprehensive Health Insurance Plan	1976	2,700,000	2,800,000
	Reduced Rates			
12.04	Health Maintenance Organizations and Nonprofit Health Service Plan Corporations	1992	65,100,000	66,800,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
12.05	Smaller Mutual Property and Casualty Insurance Companies	1988	9,000,000	9,300,000
12.06	Life Insurance	2005	10,000,000	10,300,000
	Preferential Computation			
12.07	Smaller Mutual Property and Casualty Insurance Companies (Surcharge on Fire Safety Premiums)	2006	300,000	300,000
	Credit			
12.08	Credit for Guaranty Association Assessments	1994	500,000	700,000
	Local Property Tax			
	Exemptions			
13.01	Exempt Real Property	1851	1,461,400,000	1,549,000,000
13.02	Job Opportunity Building Zone Property	2003	10,900,000	11,700,000
	Preferential Valuations			
13.03	Classification System	1913	N/A	N/A
13.04	Green Acres Treatment of Agricultural Land	1967	73,300,000	77,000,000
13.05	Open Space Property	1969	15,100,000	15,900,000
13.06	Metropolitan Agricultural Preserves Land	1980	8,300,000	8,700,000
13.07	Tax Increment Financing	1947	364,000,000	383,000,000
	Preferential Computation			
13.08	Auxiliary Forest Tax	1927	200,000	200,000
	Credits			
13.09	Taconite Homestead Credit	1969	11,500,000	11,500,000
13.10	Powerline Credit	1979	100,000	100,000
13.11	Metropolitan Agricultural Preserves Credit	1980	300,000	300,000
13.12	Conservation Tax Credit	1986	200,000	200,000

TEB Ref. #	Tax Expenditure	Year Enacted	Fiscal Year Impact 2012	2013
	Airflight Property Tax			
	Preferential Computation			
14.01	Commuter Airlines	1969	*	*
	Preferential Valuation			
14.02	Certain Airlines	1987	500,000	500,000
	Motor Vehicle Registration Tax			
	Exemptions			
15.01	Local Government Vehicles	1921	7,700,000	7,900,000
15.02	School Buses	1933	500,000	500,000
15.03	Nonresident Military Personnel	1967	100,000	100,000
15.04	Medal of Honor Recipients and Former Prisoners of War	1983	*	*
15.05	Disabled Veterans	1941	*	*
15.06	Transport of Disabled Persons by Nonprofit Charities	1987	*	*
15.07	Driver Education Programs at Nonpublic High Schools	1990	*	*
15.08	Commercial Driving Schools	1999	100,000	100,000
15.09	Private Ambulance Services	1990	600,000	600,000
	Preferential Computation			
15.10	Buses Contracted for Student Transportation	1971	500,000	500,000
	Aircraft Registration Tax			
	Exemption			
16.01	Civil Air Patrol Aircraft	1957	*	*
	Preferential Computation			
16.02	Maximum Tax For Agricultural Aircraft	1999	*	*