Assessing the Effectiveness of Tax Expenditures
Lessons from Minnesota

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A PRESENTATION TO 2009 FTA REVENUE ESTIMATING CONFERENCE

SEPTEMBER 15, 2009

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Background/Setting

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- Large state budget deficit for coming fiscal biennium
- Governor pledges to veto tax increases (he has signed the ATR "tax pledge")
- Legislative leaders respond by directing committee chairs to engage in a "zero based" budget review of their respective budget areas to find savings
- Tax chair interprets this to mandate a thorough review by the committee of tax expenditures

Background/Setting (cont'd)

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- Possibility (improbability) that repealing or reducing tax expenditures would not be considered tax increases under "no new taxes" rule
- Tax chair directs nonpartisan staff (research and fiscal analysis departments) to prepare a presentation on tax expenditures that goes beyond the basic information in the regular TEB
- She requested we include information on each tax expenditure:
  - Incidence – regressivity/progressity
  - Effectiveness

Minnesota's Tax Expenditure Budget (TEB)

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Minnesota's TEB provides for each expenditure:

- A description of the provision – i.e., how it works mechanically
- Legal citation
- History of the provision – when enacted etc.
- An estimate of the reduction in revenue – in isolation and without accounting for behavioral or secondary effects

What was Missing from the TEB

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- TEB provided a very good starting point
- But typically the TEB was missing:
  - An assessment of the incidence effects of the expenditure
  - The "why" – what was the objective or rationale for deviating from the reference tax base?
  - Any assessment of whether the tax expenditure works to achieve whatever its goals are
  - Comparisons with other direct expenditures or tax expenditures intended to achieve the same or similar goals

Selecting the Tax Expenditures to Include

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- Time and resource limits prevented dealing with all tax expenditures (the TEB report is nearly 200 pp and covers hundreds of tax expenditures).
- This required going through a selection process in consultation with both DOR staff and the chair.
- Data availability for the incidence analysis was a factor.

Criteria Used in Selection

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Limit to 2 big taxes – individual income and sales taxes (conveniently eliminating messy issues with excise and business taxes), but exclude:

- Tax expenditures that are "impractical" to eliminate because of compliance and administrative issues
- Business input exemptions under sales tax – TEB treats these as tax expenditures, but the are consistent with policy that the tax should be consumption tax imposed at a uniform rate
- Sales tax exemptions for entities (gov'ts and charities)
- Newly enacted tax expenditures (not yet in TEB)

Items Covered for Each Expenditure

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The presentation provided the following for each tax expenditure:

- Description and estimated revenue loss
- Its objective or rationale
- Related direct spending programs
- Incidence information
- Evidence on cost effectiveness

Description and Estimated Revenue Loss

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- The descriptions were heavily plagiarized from the TEB. The goal was to succinctly describe how the tax expenditure is calculated and some brief history.
- Estimated revenue losses were taken directly from the amounts published by DOR in the TEB. (In few instances, it was necessary to use other estimates.)
- We calculated growth rates for a 15-year period (1994-2008) to give legislators an impression whether the item was fast or slowing growing.

Objective or Rationale

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- Necessary first step to evaluate cost effectiveness
- TEB doesn't delve into this in Minnesota
- Often unclear, particularly for older provisions
- Legislative history (staff institutional memory) typically relied on for newer provisions
- Resort to statements in literature or "conventional wisdom"
- In worst case, informed speculation

Related Direct Spending Programs

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- Tax expenditure theory:
  - Alternative to direct spending programs
  - Direct spending v. tax expenditure choice should be based on relative effectiveness of the two mechanisms
- This lead us to list direct spending programs that address similar objectives.
- Since we knew little about the direct spending programs, we couldn't say much beyond identifying them.

Incidence Information

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- These estimates were prepared by DOR staff and were inserted into the legislative document (with appropriate credit given).
- Both bar graphs and Suits indexes were used to convey the information (see example in next slide).
- Sales tax information modeled only on consumer purchases (excluding business purchases) unlike TEB numbers.
- Incidence information was not available for some included tax expenditures.

Example of Incidence Graphs Used

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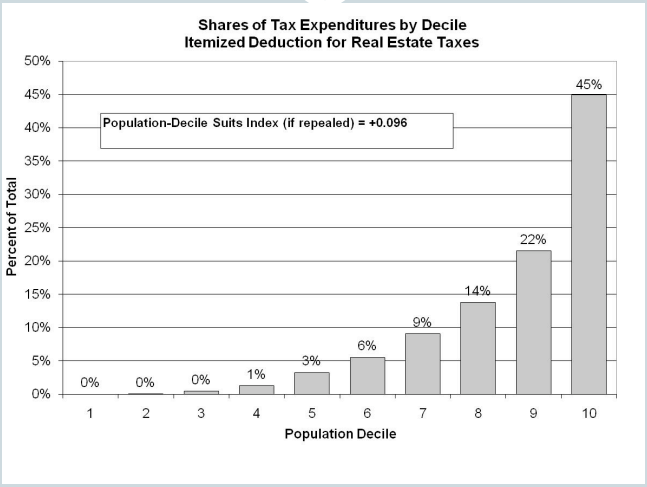

Evidence on Cost Effectiveness

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Challenges:

- Lack of clarity as to the purpose or objective of the tax expenditures
- Large amounts of literature to potentially digest
- Lack of empirical analyses of many provisions
- Political risks – (sacred cows, strong constituencies supporting some provisions, embarrassing or offending legislators who were sponsors of or are strong supporters of provisions, etc.)

Strategies and Tactics

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- Summarize academic literature (preferably peer reviewed), if it's available
  - Examples are the large volume of recent literature on long-term care credits and deductions and longstanding analyses of many personal deductions (mortgage interest, real estate taxes, etc.)
- Summarize published governmental analysis, either state or federal (e.g., analogies to federal tax expenditures that often parallel the state ones)
  - Joint Committee, OTA, CBO, and CRS publications

Strategies and Tactics (cont'd)

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- Published studies and reports often not available, particularly for newer and state specific provisions.
- In those cases, we:
  - Used common sense to evaluate the provisions with greater care because we assumed political risks were greater (w/o cover of third party published analyses).
  - Attempted to state proponents' arguments (even if they seemed pretty implausible) in a nod to journalistic style "fairness."
  - Punted and said little or nothing.

Concluding Observations

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- Presentation was done both as a written report and as a 2-day (3+ hour) oral presentation to the Taxes Committee.
- The presentation resulted in an extensive question and answer session with legislators about individual expenditures.
- Oral presentation was probably critical element, since many policy makers prefer getting information by listening and talking, rather than reading.

Concluding Observations (cont'd)

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- We generally emerged with our reputations for neutral expertise unscathed (I think).
- Independent group (funded by several large foundations) simultaneously prepared a similar analysis of a smaller subset of tax expenditures. Their findings were policy prescriptive and more controversial, deflecting some potential heat from us.
- We're considering whether to institutionalize this effort as a biennial legislative supplement to the DOR TEB.