*Making Government Work Better*

Commonwealth of Massachusetts

**Office of the State Auditor**

**Suzanne M. Bump**

# Follow the Dollars

# Tax Expenditures

Spring 2012

## Can we measure the benefit?

*Top 10 Business Tax Expenditures for FY12*

1. **$340 million** - unequal weighting of sales, payroll, and property in corporate excise apportionment formula.
2. **$227.6 million** - corporate excise tax accelerated cost recovery system for equipment
3. **$173.9 million** - sales tax exemption on containers
4. **$163.4 million** - sales tax exemption on sales of building materials & supplies used for construction.
5. **$158.9 million** - nontaxation of internet services
6. **$158.6 million** - local property tax exemption
7. **$129.9 million -** sales tax exemption for materials, etc. used in furnishing power
8. **$94.9 million** - sales tax exemption for materials, etc. used in research and development
9. **$91.6 million** - corporate excise tax net operating loss carryover
10. **$80.3 million** - corporate excise tax research and development

## AUDITOR BUMP AIMS TO BRING TRANSPARENCY AND CLARITY TO THE TAX EXPENDITURE BUDGET

### HIGHLIGHTS

In 2011, Massachusetts State Auditor Suzanne M. Bump initiated a multi-phase review of over $2 billion in revenue that the Commonwealth foregoes annually in the form of business tax expenditures. The goal was to provide the Legislature, the Governor, and the general public with insight and information to assist them in making difficult decisions in today's tough economic climate. Auditor Bump's initial review of 91 business tax expenditures showed that the tax code lacked accountability and transparency.

On April 7, 2011, Auditor Bump testified before the Joint Committee on Revenue on her findings and recommended that the Legislature and the Department of Revenue (DOR) review the entire Tax Expenditure Budget on a regular basis to ensure that a past Legislative intent remains a current one. She further suggested that tax expenditures need to be measured against a defined purpose and outcome and recommended the creation of a special committee to review and consolidate tax policy.

Later in 2011, the Legislature established the Massachusetts Tax Expenditure Commission (Section 160 of Chapter 69 of the Acts of 2011) to review and evaluate the administration and fiscal impact of tax expenditures and to make recommendations on the administrative efficiency and cost benefit of tax expenditures. The State Auditor was named as a member of the commission. A final report of the Commission's findings was issued in April 2012.

### NATIONAL PERSPECTIVE

As states face budget shortfalls across the country, tax expenditures are receiving increased scrutiny. The National Government Finance Officers Association and the United States Government Accountability Office (GAO) have called for more oversight, review, and transparency with regard to tax expenditures. In 2011, the GAO stated that coordinated reviews of tax expenditures "could help policymakers reduce overlap and inconsistencies and direct scarce resources to the most effective or least costly methods to deliver services." However, few states are examining this issue.

Based upon a review of close to 600 documents from state agencies and legislative bodies and more than 175 interviews, the Pew Center on the States found that half of the states have not taken basic steps to produce and connect policy makers with good evidence of whether tax expenditures deliver a strong return on taxpayer dollars, resulting in squandering of scare resources or missed opportunities to create jobs and attract new businesses. Nonetheless, effective approaches do exist for examining the scope and/or quality of tax expenditures, which in turn will help to inform and improve policy choices.

## BUSINESS TAX EXPENDITURE REVIEW—PHASE ONE

The first phase of the State Auditor's Office review included collecting, reviewing, and analyzing information on 91 business tax expenditures out of a possible 203 in Massachusetts' annual Tax Expenditure Budget. These expenditures included corporate excise taxes as well as personal income taxes, which are often filed by small business owners, and sales tax exemptions.

### Findings

- 83 business tax expenditures – with a value of $2.1 billion – did not include a "sunset" clause, which causes the tax provision to end after a specific period, providing the Legislature with the opportunity to evaluate its effectiveness and determine whether it should continue.

- 81 business tax expenditures – with a value of $2.1 billion – did not include a "clawback" provision, which allows the state to recoup tax benefits for unmet obligations.

- 72 business tax expenditures did not require the recipient to report to some state entity on various aspects of the expenditure or have public disclosure requirements.

- 74 business tax expenditures did not have any special, identifiable oversight procedures.

> *"The lack of accounting controls does not necessarily mean the breaks are a bad idea, or that companies have not fulfilled commitments.*
>
> *Rather, it is simply a red flag that Massachusetts has little way to know whether these taxpayer dollars are being spent wisely."*
> -Worcester Telegram & Gazette (4/10/11)

### Steps to Improving Transparency

Auditor Bump's review also included an examination of the tax expenditure budgets of other states and studies of various research organizations. This review suggested that the Massachusetts Tax Expenditure Budget could improve its transparency and delivery of information to policy decision-makers, stakeholders, and the general public. For example:

- While Massachusetts does publish a tax expenditure budget online as well as posting legal citations and attempting to make historic and prospective cost estimates, a clearly stated purpose for each of the expenditures is not readily available. This information is important for all involved to understand not only where the money is going, but also to establish specific measureable outcomes, which can then be used to assess whether a particular expenditure is meeting its goals. One important outcome from the Tax Expenditure Commission is that DOR has made public, and will continue to make public, a great deal of information relative to tax expenditures, individually and collectively.

- Other categories that would aid policy decisions surrounding tax expenditures would be an evaluation or analysis of the expenditure and also a review of any unintended consequences resulting from the expenditure as well as a breakdown of recipients by industry, by number of claimants, and by aggregate value.

- In 2010, the Legislature passed and the Governor signed Chapter 131 of the Acts of 2010, which took significant steps toward strengthening oversight and increasing accountability and transparency over 10 refundable and transferable tax credit programs. Requirements on reporting, verification, and disclosure as well as clawback and sunset provisions in new programs such as the life sciences and film tax credits also have been instituted. Applying similar measures to other tax incentives would enable policy makers and the public to make informed opinions and decisions as to their value and effectiveness.

## FROM AUDITOR BUMP

*The following is an exert from testimony delivered by State Auditor Suzanne Bump to the Joint Committee On Revenue Relative to Economic Development Tax Expenditures on April 7, 2011.*

"Every year, government spending programs are subject to review and appropriation, and then they are subject to audit by the State Auditor's Office. Once a tax break gets passed, however, it goes into a black box and seldom, if ever, does anyone look back and determine whether it is working as intended or whether there is continued public benefit.

Taxpayers shouldn't stand for this. There must be as much accountability and transparency in tax expenditures as in budget expenditures.

...

As states around the country face budget shortfalls, tax credits are receiving increased scrutiny. The total Tax Expenditure Budget in Massachusetts has grown at nearly double the rate of the state budget over the past five years. Between FY08 and FY12 the tax expenditure budget has increased by $ 5.1 billion. By way of comparison the estimated budget shortfall for FY12 is just over $2 billion, or less than half of the increase in tax expenditures.

The next phase of the work of the State Auditor's Office is to conduct audits of those programs that have accountability measures to determine the effectiveness of the tax expenditures programs in verifying eligibility for the favorable tax treatment and in accomplishing the intended results."

> *"When state officials start talking about the need to analyze how well government is doing its job - using actual numbers - we have to sit up and listen."*
> -Boston Herald (4/8/11)

## TAX EXPENDITURE COMMISSION RECOMMENDATIONS

The Commission concluded that many Massachusetts tax expenditures serve important public policy objectives. Nonetheless, they found that they have become quite complicated, and are large when compared both with Massachusetts tax revenues collected and with other states' tax expenditures in proportion to their revenues.

As such, the Commission made the following recommendations in its final report:

- The Legislature and the Governor should work together to identify and publish a clearly articulated public policy purpose and desired outcome for each tax expenditure.

- The Commonwealth Performance, Accountability, and Transparency Office (CPAT), working with the Department of Revenue, should identify metrics for assessing each tax expenditure's effectiveness, collect the necessary data, and report periodically the Governor and Legislature with recommendations for elimination or modification of tax expenditures to meet these purposes and outcomes.

- Based on these reports, the Legislature should periodically review all tax expenditures.

- Discretionary "grant-like" tax expenditures should be administered in accordance with certain best practices and subject to specific enforcement mechanisms.

- In the interest of simplicity and equity, the Legislature and Governor should work together to reduce the number of existing tax expenditures and the total amount of forgone revenue to ensure that tax expenditures are limited to those that are highly effective at achieving the identified public policy purpose.

- Before approving any new tax expenditure, the Legislature and the Governor should include in the formal legislative proposal:
    - the new tax expenditure's clearly specified public policy purpose and desired outcome;
    - a finding that the tax expenditure is expected to be highly effective at achieving the identified public policy purpose;
    - for discretionarily awarded grant-like tax expenditures, an overall annual dollar cap on forgone revenue;
    - estimates of the anticipated forgone revenue from any new tax expenditure such that these estimates can be considered by CPAT, the Legislature, and

## RECOMMENDATIONS (CONTINUED)

the Governor in the course of their subsequent periodic evaluations of tax expenditures;

- for discretionarily awarded grant-like tax expenditures, criteria to be applied by the administering agency in making discretionary awards within the cap;
- a provision requiring that the tax expenditure sunset or be reviewed periodically;
- for discretionarily awarded grant-like tax expenditures, provisions for administration in accordance with certain best practices and for specific enforcement mechanisms, including:
    - clear written conditions and commitments;
    - if conditions are not met, thresholds for further review and enforcement, including the possibility of "clawbacks" where appropriate;
    - public disclosure of recipients and tax benefits; and
    - a competitive award process.

## History and Information

Tax expenditures provide a form of governmental assistance to particular taxpayers, industries, or activities where such assistance is furnished through the tax system rather than by direct appropriations of government funds. Because the benefits accorded via tax expenditures may be substantial, and may not receive the same form of government attention in the budget process as do direct appropriations, the practice of preparing an annual "tax expenditure budget" developed.

The first tax expenditure budget was developed in 1967 by the U.S. Department of the Treasury to describe the concept of using tax breaks and to report on their usage in the federal budget process. Preparing and publishing a tax expenditure budget in Massachusetts is required by Massachusetts law, and dates back to 1986.

Today, every state has at least one tax incentive program, and most have at least several. In fact in Massachusetts alone, the total FY12 Tax Expenditure Budget is estimated to be $24.2 billion.

***"In the context of the polarization and paralysis that characterizes tax policy development at the national level, the collaborative work of this commission is both inspiring and encouraging."*** **-State Auditor Suzanne M. Bump**

*For a full copy of these reports, or for more information about the Office of the State Auditor Suzanne Bump, please visit [www.mass.gov/auditor](www.mass.gov/auditor) or call 617-727-2075*