



Commonwealth of Massachusetts  
Office of the State Auditor  
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*Making government work better*

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## Initial Review of Business Tax Expenditures



In an effort to increase transparency and oversight, State Auditor Suzanne Bump initiated a multi-phase review of over \$2 billion in revenue that the Commonwealth foregoes in the form of business tax expenditures, classified across the three categories of the annual Tax Expenditure Budget: personal income taxes,<sup>1</sup> corporate excise taxes, and sales tax exemptions. One goal of this initial review was to provide the Legislature, the Governor, and the general public with insight and information on an overlooked public resource in order to assist them in making difficult budget and policy decisions.

The first phase of the project included collecting, reviewing and analyzing information on 91 of the 203 tax expenditures that can be of value to Massachusetts businesses, collectively valued at \$2.2 billion. The 91 business tax expenditures examined include all of the corporate excise tax expenditures in the fiscal year 2012 Tax Expenditure Budget as well as personal income tax and sales tax exemptions with significant business ramifications. The objective of the initial review was to create a database that will enable the users to gain basic information about accountability and transparency measures that have been included in the provisions of law that establish these tax expenditures and to provide the Auditor's staff with information necessary to identify those programs or oversight agencies that should be audited in the second phase of the review to evaluate the effectiveness of those accountability measures that are in place. The database that resulted from the first phase includes, for each of the 91 tax expenditures that were reviewed, a description of the business tax expenditure, the legal citation of its origin, a three-year cost estimate (if available), the responsible agency, any reporting requirement, any stated verification of the reporting, any public disclosure, who the recipients are, and if any clawback or sunset provisions exist.

Among the findings in the review:

- Eight business tax expenditures of the 91 reviewed include a sunset clause, which causes the tax provision to end after a specific period, provides the Legislature the opportunity to evaluate its effectiveness and determine whether it should continue.
- The 83 business expenditures reviewed without any sunset clause have a value of \$2.1 billion. Where industries, the Commonwealth's economic development goals, and public finances change, a periodic review of the effectiveness of each tax expenditure would ensure that a past legislative intent remains a current one.

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<sup>1</sup> Often, small business taxes are filed as personal income taxes, and tax expenditures thus utilized have business ramifications.

- Ten of the 91 reviewed tax expenditures have “clawback” provisions which allow the state to recoup tax benefits for unmet obligations, worth just over \$100 million.
- The 81 expenditures reviewed without a “clawback” provision have a value of \$2.1 billion.
- Nineteen of the 91 reviewed tax expenditures require the recipient to report to some state entity on various aspects of the expenditure.
- Nineteen of the 91 reviewed tax expenditures have public disclosure requirements.
- Only 17 of the 91 business tax expenditures reviewed have any special, identifiable oversight procedures.
- The Tax Expenditure Budget identifies some tax expenditures as having expired. However, two items— Nos. 1.302 and 2.302 Accelerated Depreciation for Rehabilitation of Low-Income Housing<sup>2</sup>—remain on the books of the annual tax expenditure budget with the appearance of being active despite the fact that their enabling statute, United States Code Title 26, Sec. 167 (k), was repealed nearly 21 years ago on Nov. 5, 1990.<sup>3</sup> While it does not appear this item has cost any money,<sup>4</sup> it highlights the need for periodic review.
- Sixty-four of the 203 total items in the tax expenditure budget have “N.A.” or “negligible” listed as a cost estimate. While understandably some estimates are impossible, some appear to have solutions on the surface – such as the exemption for cement mixers, the Registry of Motor Vehicles should have annual inspection records of such, which would make a cost estimate possible; the same for the exemption on sales of buses.

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. The state budget has increased a total of 13.8% from \$26.8 billion in FY 08 to the \$30.5 billion the governor has proposed for FY 12. Over that same time, tax expenditures have grown by 26.7%, from \$19.1 billion in FY 08 to an estimated \$24.2 billion in FY 12.

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<sup>2</sup> Some tax expenditures are classified as both personal income and corporate excise expenditures.

<sup>3</sup> Public Law 101-508 Sec. 11812 (a)(1)

<sup>4</sup> Fiscal Year 2012 Tax Expenditure Budget has “N.A.” listed for cost for FY 10, 11 and 12.

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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.

Since publication of its Best Budgeting Practices in 2000, the National Government Finance Officers Association urges governments to “periodically estimate the impacts and potential foregone revenue as a result of policies that exempt from payment, provide discounts and credits, or otherwise favor particular categories of taxpayers or service users.”

Since 1994, the GAO has been calling for more analysis of tax expenditures. Just last month, 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.<sup>5</sup>

The next phase of this project by the State Auditor’s Office will be to conduct audits of tax credits and oversight agencies to understand the current level of oversight and assess if certain tax expenditures require more scrutiny.

## OVERVIEW

**T**ax expenditure often is used interchangeably with tax credit which is a dollar for dollar deduction off a taxpayer’s tax liability. However, a tax expenditure includes any vehicle – a deferral, incentive, deduction, exemption or a credit – in which the state foregoes revenue. Each dollar used as a tax expenditure is a dollar that does not get appropriated through the budget for a program. Public dollars that go through the budget process get reviewed annually through the legislative process including multiple public hearings.

In total, Massachusetts has 203 tax expenditures (business-related and otherwise) in the FY 12 budget valued at an estimated \$24.2 billion.<sup>6</sup> By way of comparison, the governor’s budget proposal for FY 12 was \$30.5 billion. Three items comprise more than half (\$12.8B) of the tax expenditure budget: sales tax exemption of certain personal services, sales tax exemption of transfer of property and sales tax exemption of rental of property.

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<sup>5</sup> Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue, GAO-11-318SP, March, 2011, pp. 75-77

<sup>6</sup> Fiscal Year 2012 Massachusetts Tax Expenditure Budget

The database that resulted from our review of business-related tax expenditures was constructed in conjunction with a review of a wide range of information from the Tax Expenditure Budget: the Massachusetts General Laws; Code of Massachusetts Regulations; the Internal Revenue Code; various policy studies; meetings with legislators and stakeholders; studies, reports and laws from other states; and various sources from the Department of Revenue – the 2010 Corporate Excise Report, various technical information releases (TIR's), and the corporate excise section of the DOR website.

The purpose of the review was not to assess the worthiness of these various programs or to make public policy judgments about them, but to assess the amount of information available and the level of accountability and transparency in connection with business-related tax expenditures so that policy-makers and the public may be better informed in their decision making about these expenditures.

## TAX EXPENDITURE BUDGET

**A**n examination of the tax expenditure budgets of other states and the studies of various research organizations, suggests that the Massachusetts Tax Expenditure Budget can improve its transparency and delivery of information to policy decision-makers, stakeholders and the general public.

Massachusetts does well by regularly publishing a tax expenditure budget, making it available online, including a wide breadth of expenditures, posting legal citations, and attempting to make historic and prospective cost estimates.

Improvements, however, can be made by including a clearly stated purpose for each expenditure. This is important so that all involved can understand where the money is going, and to establish a foundation to develop measurable outcomes to assess whether the expenditure is meeting its goals. Also helpful would be a breakdown of recipients by industry, by number of claimants, by aggregate value and with industry employment levels. 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 through use of the expenditure.

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## STATE VS. FEDERAL

Many tax expenditures are a result of the Commonwealth coupling its tax provisions with federal tax provisions. Over time, various federal provisions have been both adopted and decoupled. For example, Massachusetts has repeatedly adopted so-called “Section 179 expenses” which allows for the expensing of business assets rather than treating them as capital expenditures. Meanwhile, Massachusetts decoupled from the IRS on educator expense deductions which allowed teachers to deduct a capped amount of out-of-pocket spending on classroom supplies.

We recommend that the Legislature and DOR review the Tax Expenditure Budget on a regular basis to ensure past policy decisions are still consistent with current goals and to assess the impact that past policy decisions have on present budgeting and economic development.

## STRONGER TRANSPARENCY AND ACCOUNTABILITY

Last year, 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: (1) brownfields tax credit; (2) dairy farmer tax credit; (3) U.S.F.D.A. user fees credit; (4) film tax credit; (5) historic rehabilitation tax credit; (6) life sciences investment tax credit; (7) low-income housing tax credit; (8) medical device tax credit; (9) refundable research credit; and (10) economic development incentive program.<sup>7</sup> The law created annual reporting requirements which include disclosure of recipients’ identities, the amount received by each taxpayer and project, and the date received by each taxpayer and project.

In addition, under Chapter 240 of the Acts of 2010, the law extends to any refundable or transferable credits established after July 1, 2010, under M.G.L. Chapters 62 and 63. Accordingly, the provisions will also apply to the certified housing development credit.

The Legislature and Governor also strengthened the accountability of the Economic Assistance Coordinating Council, which administers the Economic Development Incentive Program, in Chapter 166 of the Acts of 2009 and Chapter 240 of the Acts of 2010. Some of the improved provisions included: capping EDIP credits at \$25 million per year; giving the EACC flexibility in its awards based on job creation numbers (previously the award was a fixed 5% investment tax credit); requiring that approved

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<sup>7</sup> Massachusetts Department of Revenue, Technical Information Release 10-11, Aug. 6, 2010

projects have significant sales outside the state, thereby increasing the amount of in-state economic development; redefining the type of projects eligible; and instituting review and clawback provisions.

The Legislature and the Governor have also instituted requirements of reporting, verification and disclosure as well as clawback and sunset provisions in new programs such as the life sciences and film tax credits. This information should enable policy makers and the public to make informed opinions and decisions as to their value and effectiveness.

Applying strong transparency and accountability measures to other tax incentives would provide value to the public and policy makers.

## EQUITY

As constituted, the tax expenditure budget has a variety of special treatments for different industries. The tax expenditure budget has sales exemptions for “materials, tools, fuels and machinery” used in:

- manufacturing,
- research and development,
- furnishing power,
- newspaper printing,
- agricultural production,
- commercial fishing, and
- commercial radio and TV broadcasting.

The industry-specific treatment in our tax budget raises questions about what other industries have been left out, and why. For example, why is there a sales tax exemption for the purchase of cement mixers but not for water trucks, landscaping fertilizer trucks, or armored cars? Why is there a sales tax exemption for aircraft and aircraft parts,<sup>8</sup> but not for automobiles and trains and their related parts? Each tax dollar that is foregone through a tax expenditure provision is a dollar of tax burden that gets shifted onto another taxpayer. Without accountability and transparency, it is not possible to determine whether the costs of government are fairly apportioned.

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<sup>8</sup> Governor Patrick’s FY 12 budget proposal would eliminate the sales tax exemption for aircraft and parts.

## CONCLUSION

In assembling this database and reviewing the business tax expenditures for various transparency and accountability measures in phase one of our study of tax expenditures, we found that the statutes that have recently been enacted have made great strides in requiring the type of reporting, verification and disclosure that policy makers and the public need to evaluate these programs. However, many expenditures lack information as basic as a purpose or how much they cost which leave their evaluation impossible.

Often, much information is difficult to find because it is contained in various reports on various websites of various agencies, and often even more difficult to understand. Drawing comparisons from some publicly available information is impossible as it does not compare apples to apples. For instance, the DOR corporate excise report is a tax/calendar year report while the Tax Expenditure Budget is a fiscal year report.

Various states including Washington, South Carolina, California and New Jersey have recently empowered special committees to review and consolidate tax policy. This may be a useful approach for Massachusetts as well.