Tax Expenditures: Best Practices

I. What is a "Tax Expenditure"?

A tax expenditure is an exemption, deduction, credit, or other exclusion from the income, sales, or corporate tax code provided to specific classes of taxpayers (e.g., certain industries or business, students, seniors, low-income taxpayers, etc.) to directly offset the amount of taxes owed. Tax expenditures may be used to economically benefit taxpayers who the government has identified as needing assistance. Additionally, as taxes are sometimes used to disincentivize certain behavior, tax expenditures are designed to incentivize other economic or social behaviors. Examples of tax expenditures include income tax deductions/credits for film production, tuition, lead paint removal etc.; sales tax exemptions for groceries, clothing, and certain medical devices.

Tax expenditures may be added or removed from the tax code at any time. They provide a form of governmental assistance that is furnished through the tax code rather than by direct appropriation of government funds, but they have not received the same kind of attention in the budget process as do direct appropriations. Because there had been little attention to or debate about tax expenditures, the federal government more than 40 years ago and more recently 43 states and the District of Columbia, began the practice of preparing an annual "tax expenditure budget" to identify and, to varying degrees, account for all tax expenditures.

Tax expenditures are different (although often hard to distinguish) from provisions that are part of or help define the "normal" structure of a particular tax. For example, in the context of business income taxes, a tax law provision that allows a deduction for ordinary and necessary business expenses, such as reasonable compensation of employees or depreciation of capital equipment, is generally not viewed as a tax expenditure, because it is part of the normative structure of a tax that in its very concept is designed to tax <u>net</u> income (gross income less deductions reasonably incurred in generating that income). On the other hand, tax law provisions allowing accelerated types of depreciation, or even expensing (essentially, 100 percent depreciation in the year of acquisition), of capital plant and equipment, for the purpose of stimulating investment in such capital assets, are generally viewed as tax expenditures designed to encourage a certain type of investment.

The sales tax also presents important definitional issues about tax expenditures. For example, most states exempt from the sales tax the sale of certain inputs to the manufacture of goods. This exemption is designed to avoid sales tax pyramiding where the tax is charged multiple times through the production process. Since most state sales taxes were intended to be a sales tax on final retail purchases, this exemption is part of the definition of the normal sales tax and would not be considered a tax expenditure. Yet, many states include this exemption in their tax expenditure reports.

There some less clear examples. Exemptions from the sales tax for food and clothing, designed to offset the regressive nature of consumption taxes, could be considered part of the normal tax code or a tax expenditure that deviates from the norm to accomplish a specific policy goal. So too homestead exemptions and/or property tax circuit breakers as they impact local property tax collections.

It is important that "normal tax policy" be clearly defined and that deviations from it be recorded as tax expenditures. But this is easier said than done. Reaching consensus on the definition of the normal tax structure is difficult and decision-makers may need to continue to experiment, and in the interim, require the tax expenditure report to distinguish between tax expenditures that are structurally part of the definition of the tax versus those that are not. In this way, all provisions will be included in the report and the legislators and tax administrators can better understand and, over time, provide feedback on how individual tax expenditures are categorized.

Largely because there is no common understanding of what is a "tax expenditure" and what should be considered part of the "normal" tax structure, reading tax expenditure reports is complicated, and state-to-state comparisons are largely impossible.

II. Principles

1) The "tax expenditure budget" is one element of a tax system that should, in its entirety:
    a. Provide adequate revenue to consistently support a desired level of government services;
    b. Promote economic growth and overall economic welfare and opportunity;
    c. Be as equitable as possible, including recognition of differences in taxpayers' capacity to pay taxes;
    d. Reflect our values and our public policy objectives;
    e. Be as simple and administratively efficient as possible.
2) Tax expenditures are a form of taxpayer spending and should be subject to the same scrutiny by government policymakers as direct expenditures.
3) In the interest of simplicity and equity, the total number of tax expenditures and the total amount of forgone revenues from the tax expenditure budget (or the total cost of tax expenditures) should be limited to those that are highly effective at achieving the desired public policy purpose.
4) There should be a comprehensive, rational, policy-driven, and analytic approach to tax expenditure policy development and review that includes the following elements:
    a. Each tax expenditure should have a clearly identified public policy purpose and desired outcome for clearly identified beneficiaries;
    b. Each tax expenditure should be subject to a periodic, data-based, evaluation and cost-benefit analysis that measures success in achieving the public policy purpose and desired outcome for the intended beneficiaries;
    c. Each tax expenditure should be subject to a periodic review by the Legislature and the Governor for the purpose of determining the effectiveness of the tax expenditure and taking any action to eliminate, modify or preserve the tax expenditure that may be warranted based on that determination;
    d. Each tax expenditure, to the extent it is dependent on certain conduct of the tax beneficiary and/or is approved and awarded pursuant to the discretion of an administering agency, should be subject to well-articulated standards of accountability with appropriate enforcement mechanisms, such as clawbacks.
5) Relevant and useful data regarding the tax expenditure budget should be subject to full disclosure for the benefit of policymakers and the public, consistent with longstanding principles of taxpayer confidentiality.

III. Statistics Requirements for Tax Expenditures

1) State law should require that, for each tax expenditure, there should be:
   a. a clearly specified public policy purpose and desired outcome;
   b. a finding that the tax expenditure is expected to be highly effective at achieving the identified public policy purpose, and preferable to an alternative tax law change and/or alternative policy approach;
   c. estimates of the anticipated forgone revenue from any new tax expenditure such that these estimates can be considered by the Legislature, and the Governor in the course of their subsequent periodic evaluations of tax expenditures;
   d. clearly identified metrics for assessing the effectiveness of each tax expenditure (e.g. number of jobs created, low-income citizens served, etc);
   e. as appropriate, a provision requiring that the tax expenditure sunset and/or be reviewed periodically;
2) For each discretionarily awarded grant-like tax expenditure, state law should require:
   a. an overall annual dollar cap on forgone revenue;
   b. criteria to be applied by the administering agency in making discretionary awards within the cap;
   c. provisions for administration in accordance with certain best practices and for specific enforcement mechanisms, including:
      i. clear written conditions and commitments;
      ii. if conditions are not met, thresholds for further review and enforcement, including the possibility of "clawbacks" where appropriate;
      iii. public disclosure of recipients and tax benefits; and
      iv. a competitive award process.

IV. Tax Expenditure Reporting

States should produce regular tax expenditure reports that include information on all major state and local taxes.

1) The reports should be easily accessible and available on-line
2) This report should be ready in time for budget and policy decisions.
3) Tax expenditure reports should include, for each tax expenditure,
   a. the date the tax expenditure was enacted and the date when it will next be reviewed,
   b. the statutory citation or federal law reference,
   c. the public policy purpose and measurable desired outcome,
   d. an analysis of how effectively the tax expenditure is producing the desired outcome,
   e. an updated assessment of the revenue cost of the tax expenditure, and
   f. an updated analysis of the beneficiaries of the tax expenditure.
4) In addition, the report should indicate
   a. the total costs of all tax expenditures, and
   b. categorization of tax expenditures both by tax type and budget category.

V. Tax Expenditure Evaluation

1) Tax expenditures should be an integral part of the state's budgeting process, subject to the same regular review and approval process as other expenditures. All tax expenditures should be reviewed regularly, with a frequency of review taking into account the trade-off between available resources and the cost of the tax expenditure.
2) Evaluations should be based on measurable goals and draw clear conclusions on the effectiveness of the tax expenditures.
3) Rigorous evaluations should determine costs and benefits of each tax expenditure, and allow policymakers to ask critical questions, including:
    a. To what extent did the tax expenditure affect choices made by taxpayers?
    b. Did the expenditure achieve its purpose?
    c. Who was affected by the tax expenditure?
    d. Did the benefits of the tax expenditure outweigh the negative effects of the tax increases or spending cuts needed to offset it?
4) The Governor and appropriate legislative committees should review the reports to determine whether tax expenditures should be continued, modified or eliminated. This should be part of the state's normal budgeting process.

VI. Working with Other States

State officials should explore opportunities to engage and work with other states (and appropriate associations of state officials), regionally and nationally, on implementing best practices for reporting and reviewing tax expenditures and in deciding which tax expenditures are appropriate.

VII. Communicating

Policymakers, the press and the public alike are often heard to say "what the hell is a tax expenditure?" If you need a paragraph to answer that question, it's time for a new name. While "tax expenditure" and "tax expenditure budget" have become terms of art, they are anything but artful or understandable. As work goes on to reform practices in this important area of state budgeting and, ideally, to bring the practices and accounting systems of different states into closer alignment, so too effort needs to be devoted to how we talk about those practices and accounts.