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DEPARTMENT OF REVENUE
OFFICE MEMORANDUM

DATE: March 22, 1984

TO: Sen. Doug J. Johnson, Chairman, Senate Tax Committee
Sen. Gerald L. Willet, Chairman, Senate Finance Committee
Rep. John D. Tomlinson, Chairman, House Tax Committee
Rep. James I. Rice, Chairman, House Appropriations Committee

FROM: Arthur C. Roemer
Commissioner of Revenue

SUBJECT: Tax Expenditure Study Progress Report

I. Introduction

The 1983 legislature mandated that the Department of Revenue prepare a "tax expenditure budget" for the state. The report is required every two years and is to be published as a supplement to the Governor's biennial budget.

By March 1, 1984 we are to present a progress report to each of you, indicating the proposed format, sources of data, bases of estimates, and expenditure of funds related to this year's tax expenditure budget report, to be published in early 1985. This memo fulfills that reporting requirement.

II. Background

A. Mandate: M.S., § 270.067, Subd. 2 requires that the Commissioner of Revenue prepare a tax expenditure budget for the state. It will be submitted to the legislature as a supplement to the Governor's biennial budget, at the time provided for submission of the budget in M.S., § 16A.11, Subd. 11.

We are required to provide annual revenue impact estimates for tax expenditure items for at least a three-year period including the two-year period covered in the Governor's budget.

For each item we are directed to provide the following information (at minimum):

a. estimates of revenue foregone,
b. statutory citations / legal authority,
c. year of enactment / or tax year of effect.

Additional information may be provided as desired by the Commissioner. These optional items may include, but are not limited to:

a. legislative intent,
b. analysis of effectiveness vis-a-vis intent,
c. impact on distribution of tax burdens,
d. impact on administration of the tax system.

The legislated definition of a "tax expenditure" and the scope of the study will be discussed below.

Pursuant to 1983 Laws, chapter 301
section 20

B. Organization of this report

The remainder of this progress report is presented in four sections; a) the scope of the final report, b) the nature of the final product and its timing, c) a description of what has been done to date and what remains to be done, and d) how the appropriated funds are being expended.

III. Scope of the Final Report

A. Notion of a tax expenditure

The legislature has given us a fairly broad definition of a tax expenditure:

> "Tax expenditure means a tax provision which provides a gross income definition, deduction, exemption, credit, or rate for certain persons, types of income, transaction, or property that results in reduced tax revenue."

For operational purposes we found it necessary to reflect on that definition and to contrast it with other stated definitions (from federal and other state laws) in an attempt to provide guidance for the process of identifying "tax expenditures" in our structure of taxes.

The statutory definition clearly intends to isolate and highlight all cases of preferential treatment of persons, income, transactions, or property resulting in reduced tax revenue. The intent is clear, and the language sufficiently broad, so as to cover most items normally expected in such studies.

For added insight we also looked at the federal tax expenditure definition used to guide the analysis of federal tax expenditure estimates (Appendix G, U. S. Budget) and at the work done in several other states. We also consulted with the author of Minnesota's tax expenditure bill (Rep. Paul Ogren) and selected members of legislative staff.

In brief, we found little specific help in the federal concept nor did we find overwhelming consensus resulting from our meeting with legislative staff. The federal notion considers the concept of "the normal tax structure" and treats deviations from that normal structure as tax expenditures if they result in a revenue loss. They can do this largely because they are only reviewing two taxes: the individual and corporate income taxes. We concluded that time spent trying to adequately define the "normal" Minnesota tax structure, for a much larger group of taxes, would not be a valuable or productive use of our limited resources. Instead, we have opted for a more general, though conceptually vague, method of merely listing all provisions of "special" tax treatment that result in a tax revenue loss. To that end we developed the following guidelines to determine which tax provisions will be included in our study:

a. The provision causes a revenue loss from the state's perspective.
b. The subject of the tax provision in question is an item or transaction that could be taxed by the state if it chose to do so. For example, provisions which exempt sales to the federal government or which exempt sales for shipment out-of-state would not be tax expenditures due to potential U.S. Constitutional restrictions.
c. The provision is not a mere "timing" provision which does not affect the annual liability of the taxpayer.
d. The provision in question confers preferential treatment on a subset of taxpayers. In other words; 1) all taxpayers in a similar situation with respect to the tax base (i.e., income, retail sales, purchases of gasoline, Minnesota gross estate, etc.) are not treated equally, or 2) all taxpayers are not given the same dollar amount tax reduction.

e. As regard, the corporate income tax: The provision deviates from the uniform standards embodied in UDITPA.

Generally, all of these five criteria must be met for a tax provision to be considered a tax expenditure item. We designed these five criteria to be inclusive rather than exclusive. That is to say, we felt it better to include most "questionable" items in the study rather than to leave them out. This follows directly from the broad language in the legislative definition cited above.

B. Which taxes are included in the study

The study is not limited to any particular tax or on any particular group of taxes. All statewide taxes are included for consideration, as are all taxes authorized by the state but levied by local governments generally. There are items which meet the five basic criteria in almost every tax the state administers.

In general, the tax expenditure budget will contain more than 300 items broken down into major chapter groupings. Income taxes, sales and excise taxes, gross earnings taxes, severance and tonnage taxes, and property taxes all have items that will be included in the study.

C. Things left out of the study

Because this study is the first of its kind in the state and very ambitious, its scope is somewhat restricted. Much of our time and resources were spent simply identifying the tax expenditure items and determining methods for estimating revenue losses. In many instances suitable data is not available. For this reason we specifically did not attempt to provide any of the additional, or optional, information allowed by the mandate.

Several of the optional items of information will prove useful additions to future editions of the tax expenditure budget. However, such information as legislative intent and effectiveness of tax expenditure items will be much easier to include in subsequent budgets, once the basic groundwork is in place.

Items such as licenses and fees will not be included, however, since we did not consider these to be taxes.

D. Nature of the estimates

The estimates tend to fall into one of two broad categories, depending on data sources used. The first category contains those tax expenditure items for which little or no Minnesota data are available. For these items, national data are used with an apportioned share of the economic activity being assigned to Minnesota to determine revenue losses. Because of the way Minnesota personal income tax "piggybacks" off the federal gross income, several exclusions from federal gross income fall into this category. Minnesota data, where available, is used to support or adjust the estimate, but estimates in this category are principally arrived at by extrapolation from federal data sources.

The second category contains those items for which there are good Minnesota data sources available. Information for these tax expenditures is obtained from samples of tax returns, division records, published reports, other state agencies, and numerous other sources. Examples from this category are tax credits and tax deductions. Information on these sorts of tax expenditures are already reported and summarized by the department, and therefore are fairly precise.

Unfortunately, precise and exact estimates are not the norm. Because of the problems discussed below, tax expenditure estimates are intended to be used as approximate figures and not as precise estimates. Also, as discussed below, in many instances the numbers in the study may by necessity differ from those which would be reported in fiscal notes when and if repeal legislation is considered.

E. Conceptual problems

One of the first issues that arose in the study was what exactly does a tax expenditure estimate measure? Does the number represent the amount of revenue lost through the tax provision, or the amount to be gained by the repeal of the provision? The distinction, while not immediately apparent, is nonetheless an important one. After much discussion we decided that the purpose of a tax expenditure budget is to measure the amount of assistance the state provides to taxpayers through deductions, exemptions, credits, et al., and not the amount of possible revenue to be gained. Tax expenditures are often likened to actual expenditures and viewed as subsidies or incentives. For this reason we decided on the following framework for our estimates:

> Our estimates assume that the tax expenditure item in question remains in the tax structure for the next four years (fiscal years 1984 - 1987). The estimates for each item measure, through tax revenue foregone, the amount of benefit various taxpayers receive due to the item. This is in clear contrast to estimates of potential revenue gained through repeal of an item, where such factors as taxpayer behavioral changes, enactment dates, and potential substitute devices available to taxpayers must be considered.
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> The itemized deduction for charitable contributions is a good example. Taxpayers give to charitable organizations, in part, because it reduces their income tax. If the state were to repeal this tax expenditure item, then it is likely many taxpayers would look for substitute ways to lower their taxes. They might give to organizations which remain tax deductible, such as political parties, or they may invest in tax-free bonds. Whatever the response, we can expect that the real gain would not equal the current loss because of the responsive change in behavior by taxpayers.

A related conceptual issue is that of whether or not to combine estimates to arrive at a total tax expenditure budget. While it may be desirable to combine estimates and talk about total benefits received by taxpayers, it is not recommended. There are several reasons the study will therefore not provide such totals. First, the tax expenditure budget is intentionally broad and inclusive. To give totals or subtotals of various groups of tax expenditures may overstate the extent of benefits received by taxpayers. Second, since many estimates have potentially large margins of error, combining them will give an even less reliable total. Lastly, we wish to avoid the notion that this revenue foregone is in some sense totally recoverable by the state. Again, the distinction between revenue foregone and potential revenue gained will be stressed.

IV. Nature of Final Product and its Timing

The study will be included as a supplement to the Governor's FY 86-87 budget. It will provide tax expenditure estimates for fiscal years 1984, 1985, 1986 and 1987. The bulk of the study will be divided structurally into groups of tax expenditures, or chapters. Presently five such chapters are envisioned. These are:

a. income taxes,
b. sales and excise taxes,
c. gross earnings taxes,
d. severance and tonnage taxes,
e. property taxes.

Each of these major chapters will be further broken down into subdivisions. For example, income taxes will have subdivisions for corporate and personal income tax expenditures. Finally, within each subdivision tax expenditure items will be grouped by their status within the tax, that is, by credits, deductions, exclusions, exemptions, and rates.

It will be at this lowest level of grouping that the tax expenditure items will be defined and briefly explained. The explanation will include cites of authorizing statutes and a brief history. The description will include primary data sources used for the estimates and a statement of which state fund is being affected by the item. In addition, the estimates of the revenue foregone for each of the four fiscal years will be provided here.

The format of the study has been designed to mirror the state's tax structure. The principle intent of the design is to convey new information while retaining a familiar structure.

V. What Has Been Done / What Work Remains

We are well on our way toward completion of the study. We have finished compiling the list of all tax provisions, in most cases complete with citations of authorization and the required description as well. We are presently involved in the most potentially time consuming task, that of estimating the revenue loss for the many items. Because items require revision as updated data sources become available, this portion of the work will not be completed until just prior to the actual date of publication.

The status of the study can be summarized in the following way. The conceptual framework is in place, the tax expenditure items have been identified and the fiscal impacts of the items are being estimated. We are also completing work on the final format of the report. We are projecting the first draft of the tax expenditure budget to be completed in November, 1984. There will follow at least one revision to incorporate updated estimates based on new data.

VI. How Appropriated Funds are Being Spent

The legislature appropriated a total of $100,000 for the FY 84-85 budget biennium for completion of the first tax expenditure budget, with an equal amount of $50,000 apportioned to each of the fiscal years.

FY 84

For fiscal 1984 we arbitrarily set out the following budget:

Salaries	$44,000
Computers	5,000
Supplies	1,000
Total	$50,000

Salary funds are expected to be exhausted by the end of FY 1984. Currently, there are three full time temporary analysts assigned to this project with two additional analysts to be added in April. Other permanent research staff analysts have been involved in the study, one in an ongoing supervisory capacity.

Computer funds were largely used to expand the scope of a regularly scheduled income tax sample. Our 1982 sample will be much more comprehensive than its 1980 successor, containing about 30% more data items from the returns. The cost results from the addition of two data coders and the additional keypunching.

FY 85

Fiscal year 1985 funds appear to be adequate. Most will be spent on personnel and publication costs. The balance will be used to establish computerized procedures for review and update for future editions. It is important to develop a facility to expand, improve and reissue the report every two years with great efficiency since no on-going appropriation for the study has been made.

VII. Conclusion

The report is on schedule and within budget. While its content will be more extensive than intensive in its first edition, a solid foundation is being laid for future expansion. We fully expect the report to be a valuable addition to the overall budget decision process.

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