

Tax Expenditure Budget

State of Minnesota
FY 2020-2023

Tax Research Division
Minnesota Department of Revenue

Presentation to the House Tax Committee Feb. 25, 2020

A full copy of the report can be found on the Department of Revenue website at:
<https://www.revenue.state.mn.us/tax-expenditure-reports>

Legislative Mandate

17th Minnesota Tax Expenditure Budget

- Due February 1 of even-numbered years
- Released January 31, 2020
- Major project—Includes estimates for 312 separate items
 - 15 analysts & an intern
 - Led by Randy Sanford, Curtis Walker, and Nick Greene
 - Most work done in summer & fall of 2019

Outline

- “Tax Expenditure” as a Concept
- Uses of the Tax Expenditure Budget
 - Budgeting Perspective
 - Tax Reform Perspective
 - Revenue Perspective
- Tax Expenditure Changes

“Tax Expenditure” as a Concept

- If the only goal were to raise revenue, then it would be best to have a broad income tax base & low rates.
- But want to...
 - encourage home ownership → Mortgage Interest Deduction
 - help pay for child care → Child Care Credit
 - recognize/reward combat veterans → Combat Credit
 - increase business start-up funds → Angel Investment Credit
 - help beginning farmers buy land &/or farm assets → Beginning Farmer Credit
- Could design a direct expenditure program to meet each of these goals.

Tax Expenditures ≠ Direct Expenditures

- No line in the budget
- No regular review process
- Generally no limit on growth over time (“auto-pilot”)
- Authorized by different committees
- More limited public access to program information
- Difference of perception: “Cut taxes” rather than “Increase gov. spending”
 - Given need to balance the budget, a tax expenditure generally results in either lower revenue (thus reducing funding for direct expenditures) or higher tax rates.

Number of Tax Expenditures by Tax:

• Individual Income Tax	102
• Corporate Franchise Tax	30
• Estate Tax	6
• General Sales & Use Tax	93
• Motor Vehicle Sales Tax	18
• Excise Taxes (motor fuels, alcohol, tobacco)	16
• Mortgage & Deed Taxes	8
• Gambling Taxes	6
• Insurance Taxes	8
• Property Taxes	13
• Motor Vehicle Registration Tax	10
• Air-Flight Property & Registration Taxes	<u>2</u>
TOTAL	312

1.67 Home Mortgage Interest

Legal Citation

Minnesota Statutes, Sections 290.0122, Subd. 2 and 5 and 290.0132, Subd.19(b)

Description of Current Law

A taxpayer may take an itemized deduction for interest paid on debt secured by a principal or second residence. Mortgage interest is deductible on up to \$750,000 of debt used to buy, build, or improve a principal or second residence. If the debt is used for any other purpose, the limitation is \$100,000 of debt. If more than one home is involved, the limitations apply to the total amount. This deduction is one of several deductions subject to the limitation of itemized deductions for higher-income taxpayers.

History

Home mortgage interest was deductible without limitation until restrictions were enacted in 1987. In 2018, the federal limitation was temporarily decreased from \$1 million to \$750,000 in debt. In 2019, Minnesota established its own itemized deduction for home mortgage interest, with a limit of \$750,000.

Number Affected

An estimated 142,700 returns will claim this deduction in tax year 2019.

Dollar Impact

Fiscal Year	2020	2021	2022	2023
State General Fund	\$83,400,000	\$83,400,000	\$89,100,000	\$97,300,000

Defining a Tax Expenditure

It's a tax expenditure [in the TEB] only if:

- Tax applies statewide
 - excludes local taxes except local property tax
- Provides preferential treatment
- Has a revenue impact
 - Sales tax exemption for Super Bowl admissions is only included when relevant
 - includes provisions that defer tax (such as accelerated depreciation)
- Is not subject to an alternative tax
 - excludes sales tax exemptions for motor vehicles, cigarettes, solid waste, & lottery tickets
- Is not counted as a direct expenditure
 - excludes PTR, Political Contribution Credit

Defining a Tax Expenditure

It's a tax expenditure [in the TEB] only if:

- Legislature has authority to impose tax
 - Excludes income tax exemption for federal bond interest
 - Excludes property tax exemption for schools & churches (MN Constitution)
- It is included in the definition of the tax base
 - Income Taxes: *Income from all sources less expenses that are reasonable & necessary to generate that income*
 - deduction allowed only for “true” depreciation
 - personal & dependent exemptions & standard deduction assumed part of basic tax structure
 - graduated rates & different tax brackets by filing status assumed part of basic tax structure
 - for corporate tax, equal-weight apportionment & throwback rule
 - Sales Tax: Base includes all final purchases of tangible goods or services
 - business purchases of capital equipment are in the base

Uses of the TEB

- Budget Perspective:
 - Compare effectiveness of direct expenditures & tax expenditures of similar purpose
- Tax Reform Perspective:
 - How much reduction in tax rates if we repealed/modified selected tax expenditures?
- Revenue Perspective:
 - How can we raise more revenue without raising tax rates?

Budget Perspective

Facilitate Review of Tax Expenditures

“Bringing Tax Expenditures Into the Budget Process” (Tax Expenditure Review Report, 2011) recommended:

- Ongoing review of all tax expenditures over 8 years, administered by a Tax Expenditure Review Commission
- Evaluation should address the following questions:
 - What is the goal?
 - Could the tax expenditure be redesigned to achieve the goal in a more cost-effective & transparent way?
 - Could a direct expenditure program achieve the goal in a more cost-effective & transparent way?
 - Should existing direct expenditure programs with similar goals be better integrated with the tax expenditure?
 - Should the tax expenditure be expanded, modified, or repealed?

Budget Perspective

Minnesota TEB includes no evaluation of tax expenditures

House Research Department's "Review of Selected Tax Expenditures" (November 2013) includes evaluation of 25 income tax & 19 sales tax items

- Review includes:
 - Discussion of tax expenditure's objective
 - Related direct spending programs
 - Distribution of benefits (incidence analysis) **from DOR**
 - Evidence of effectiveness in meeting objective

Tax Reform Perspective: Income Taxes

Three reasons for caution

1. Repeal of some tax expenditures would significantly increase complexity
 - MN piggybacks on many federal provisions that affect the timing of taxes
 - Decoupling from federal law would require two sets of books — often for a very long time
 - Examples: accelerated depreciation, deferred compensation, pension contributions, IRAs

Tax Reform Perspective: Income Taxes

2. Repeal of some tax expenditures would create compliance issues
 - If (1) not taxed federally, (2) not reported on the federal tax return, & (3) not subject to federal reporting requirements, then taxpayers may not know the amount & DOR will struggle with compliance
 - Examples: many employee fringe benefits, Medicare benefits

Tax Reform Perspective: Income Taxes

3. Interactions: repealing multiple itemized deductions raises less than sum of the estimates shown separately

- Example: itemized deductions

Simple sum (items 1.64-1.69)	\$287 mill.
Adjust for interactions:	<u>-96 mill.</u>
Tax expenditure for all combined:	\$191 mill.

Effect of 2019 Tax Bill on Itemized Deductions

Provision	2018 Tax Expenditure Budget		2020 Tax Expenditure Budget		
	Counts (TY2017)	Amount (FY2018)	Counts (TY2019)	Amount (FY2020)	
1.64 Medical Expenses	109,200	\$57,000,000	44,500	\$48,400,000	-59%
1.65 Real Estate Taxes	601,800	\$160,600,000	160,000	\$50,000,000	-73%
1.66 Other Taxes	465,400	\$14,200,000	11,300	\$1,300,000	-98%
1.67 Home Mortgage Interest	540,700	\$227,600,000	142,700	\$83,400,000	-74%
1.69 Casualty and Theft Losses	700	\$800,000	700*	\$1,000,000	
1.68 Charitable Contributions	562,800	\$238,400,000	145,800	\$103,200,000	-74%
1.71 Charitable Contributions for Non-Itemizers	212,900	\$9,600,000	756,000	\$73,000,000	255%

*count from 2017; 2019 not available.

Tax Reform Perspective

- Broaden Tax Base & Lower the Tax Rate

\$ in millions

Individual Income Tax				FY 2020
Gross Revenue				\$ 19,249.9
Tax Expenditures*				6,737.9
Repeal would pose few or no administrative problems			1,430.4	21%
Repeal would create significant administrative problems			5,307.5	79%
Net Revenue				\$ 12,512.0

*Adjusts for interactions among itemized deductions.

*MN base broadening has potential to reduce rates proportionally
 from 5.35%/ 6.8%/ 7.85% /9.85%
 to 4.55%/ 6.0%/ 7.05% /9.05%
 by repealing all that pose few or no administrative problems.*

Tax Reform Perspective

- Broaden Tax Base & Lower the Tax Rate

\$ in millions

Corporate Franchise Tax					FY 2020
Gross Revenue					\$2,382.9
Tax Expenditures					898.9
Repeal would pose few or no administrative problems				679.6	76%
Repeal would create significant administrative problems				219.3	24%
Net Revenue					\$ 1,484.0
Note: No adjustment for interactions.					

Base broadening has potential to reduce rate from 9.8% to roughly 6.7% without decoupling from any more federal timing provisions (depreciation, etc.).

Tax Reform Perspective: Sales Taxes

Two reasons for caution

1. Tax expenditures include any non-taxable “sale of tangible personal property or services to the final user.”
 - For capital equipment & for business services, the “final user” is generally a business
 - Reformers who define the sales tax as a consumption tax oppose repeal of many existing sales tax exemptions for businesses
2. TEB includes “selected” services, but excludes medical, education, housing, & construction.

Tax Reform Perspective

- Broaden Tax Base & Lower the Tax Rate

\$ in millions

General Sales Tax (All Funds)				FY 2020
Gross Revenue			127% of collections	\$ 14,211.2
Tax Expenditures	57% of collections			7,937.4
Purchases by Consumers (primarily)		3,569.1	45%	
Purchases by Government		347.4	4%	
Purchases by Nonprofits		221.2	3%	
Purchases by Businesses		3,799.7	48%	
Net Revenue				\$ 6,273.8

Base broadening has potential to reduce rate from 6.875% to below 4.4% even if base expansion were limited to consumer goods & services (& limited to consumer services listed in the TEB).

Revenue Perspective

Caution in Using TEB as a Menu of Alternatives

Unlike revenue estimates, tax expenditure estimates:

- Ignore interactions among provisions
- Ignore any impact on other taxes
 - Example: vehicle registration tax changes can have an impact on income tax collections
- Do not adjust for “effective dates”
 - For items involving tax deferral, estimates can still be quite different!
- Do not generally take collectability into account
 - Example: isolated or occasional sales (4.79)
- Are updated only every two years

Remember administrative complexity

Revenue Perspective: Property Tax

- Tax expenditures result in tax shifts, not changes in tax levels
- Largest tax expenditures are classification & exemptions
 - Classification system determines how tax levies are shared among types of property
- Report does not include property exempted under federal law or the MN Constitution (schools & churches)

PROPERTY TAX

CLASSIFICATION SYSTEM & ALTERNATIVE TAX BASES

Total–State and Local Levies	
Fiscal Year	2020
Farm Homestead	
Home, Garage, and One Acre	-\$800,000
Remaining Land and Buildings	337,900,000
Farm Non-Homestead	93,600,000
Timber	3,100,000
Seasonal Recreational Residential	22,400,000
Residential Homestead	946,900,000
Residential Non-Homestead	139,200,000
Apartments	82,500,000
Commercial/Industrial	
1 st Tier	-\$58,000,000
2 nd Tier	-1,280,900,000
Commercial Seasonal Recreational	1,400,000
Public Utility	-77,900,000
Railroad	-43,700,000
Mineral	-100,000
Personal	-171,300,000

Pages 188-189
of the TEB

Property Tax - Exemptions

Pages 185 of
the TEB

Fiscal Year	2020
Hospitals	\$113,800,000
Public Burial Grounds	8,100,000
Charitable Institutions	94,700,000
State and Local Forests, Parks, and Wildlife Refuges	52,400,000
Public Property Used for Public Purposes	610,500,000
Other Exempt Property	12,500,000
Total–Shift in Tax Burden	\$892,000,000

Conclusions

TEB can be useful for those interested in:

- Budget Reform
- Tax Reform
- Revenue Increases

Those using the report should:

- Read the (short) introduction
- Be aware of potential pitfalls in use of the numbers

Tax Expenditure Changes from the 2018 TEB

Enacted

Tax	Description	Item	Enacted
General Sales & Use	Aquatic Herbicides	4.78	2019

Extended

Tax	Description	Item	Enacted
Individual Income	Angel Investment Credit	1.94	2010

Inactive

Tax	Description
General Sales & Use	Admission to the Super Bowl & Related Events

47 States & DC have Tax Expenditure Budgets

"Oregon, Minnesota, & the District of Columbia publish relatively comprehensive & informative reports that could serve as a model for other states."

Center for Budget & Public Priorities, May 2011

Thank you!

Eric Willette, Director Tax Research Division