

# Evaluating Tax Expenditures

Presented by

Prof. Laura Kalambokidis

To Tax Expenditure Review Commission

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# Overview

- The 2011 Tax Expenditure Review Report
- Defining the reference tax base
- Components of a quality review
- Developing a review schedule

# Tax Expenditure Review Report: Bringing Tax Expenditures into the Budget Process

## Report:

- Published in 2011 by MN Department of Revenue with assistance from economics/public policy professors Marsha Blumenthal, Laura Kalambokidis, Jay Kiedrowski, John Spry, Judy Temple, Jenny Bourne
- Required by Minnesota Laws 2010, ch. 389, art. 10, sec. 5

## Problem:

- A broad tax base with low rates improves **allocative efficiency**, that is, it limit the tax system’s interference in economic decisions. (p.15) (Report acknowledges that efficiency is not the only goal of tax policy.)
- “Tax expenditures receive **less scrutiny** than direct expenditures;” i.e., no review and reauthorization. (p.1,2)
- There may be an “**institutional bias** toward using tax expenditures (which yield lower revenue and thus a perception of smaller government) rather than direct expenditures (which generate costs and thus an apparently larger government).” (p.3)
- Need a process to “help ensure that tax expenditures constitute **sound public policy** and **meet the objectives** for which they were created.” (p.3)

## Goals:

- To give the governor, legislators, public officials, and the general public access to all available relevant information on tax expenditures and to provide these parties new information as needed.
- To require approval – or non-renewal – of tax expenditure provisions by the governor and the Legislature.

# Tax Expenditure Review Report: Bringing Tax Expenditures into the Budget Process

The report:

- Discusses the **reference tax base** for each major tax
- Explains **tax policy principles** and other **policy objectives** against which to evaluate tax expenditures and the **resources needed** to do that work
- Identifies **criteria for prioritizing evaluations** (which tax expenditures to evaluate first)
- Describes a process for **integrating tax expenditures into the budget process**

# Allocative efficiency, tax policy, and reference tax base

“Allocating economic resources toward their most productive use is perhaps the chief advantage of free markets. [**Allocative efficiency**] is, in effect, a way of making the economic pie as large as possible...A mark of effective tax policy...is the preservation of incentives for individuals and businesses to **make decisions on the basis of productivity rather than for pure tax benefit.**” (p.15)

“In the longer run, a tax system with **low rates and a broad base** is more likely to promote prosperity than one with high rates and a narrow base.” <https://www.taxpolicycenter.org/briefing-book/what-do-economists-agree-and-disagree-about-effects-taxes-economic-growth>

So, economists tend to define the reference tax base in the broadest way: What tax base would generate revenue while interfering the least in people’s decisions?

**A broad tax base** interferes less in decision-making, because:

- It can collect the same amount of revenue with lower tax rates on income, sales, profits, etc., and so is less of a factor in choices about how much to work, what to buy, what to sell.
- There is no way for a taxpayer to avoid the tax by making a different choice.

**A tax expenditure** narrows the tax base and influences decision-making. Of course, sometimes the very purpose of the tax expenditure is to influence choices (e.g., a tax credit for electric cars), so there is tension between allocative efficiency and other goals.

# Components of a quality review (p. 17-19)

Identify the **purpose** of the tax provision.

Measure the tax provision's **impact** relative to the stated purpose.

- Number and characteristics\* of those who pay less tax as a result

- Change in behavior as a result of the tax expenditure

- Unintended results

Measure the net **indirect impact** of the provision within balanced budget context. (Indirect impacts are changes in economic, social, or environmental conditions.)

Calculate **revenue-neutral rate reduction** that would be possible with repeal of the provision

Consider **alternatives** to the tax provision that might have similar impact

\*What characteristics? Income, location, age, race, ethnicity, gender, industry, profession, etc.

# Components of a quality review (p. 17-19)

**Measuring direct and indirect impacts may require considerable effort, cost, and time.**

Behavioral science and economic research on the impact of tax provisions on household and business choices.

- Multivariate regression analysis, comparisons across time or jurisdictions
- Microsimulations using tax return data, supplemented with imputations of other relevant data, such as on consumer purchases or saving.
- Field experiments, random control trials

Research on the impact of behavioral changes on economic, social, or environmental conditions in a balanced budget context (i.e., must consider the impact of offsetting tax increases or spending reductions)

- Multivariate regression analysis, comparisons across time or jurisdictions
- Input-output modelling

**Examining the results of peer-reviewed research on similar provisions in other jurisdictions can provide a lot of information.**

## Developing a review schedule (p. 20-27)

A tax expenditure should receive a **higher priority** if the provision:

- Is an exception to the Tax Expenditure Budget reference tax base
- Could be easily replaced with a direct expenditure
- Is costly, or its cost is growing quickly
- Has drawn legislative interest for modification or repeal
- Is difficult to administer
- Repeal would not pose significant problems (e.g., federal conformity provisions with timing and information issues are low priority)

Evaluation schedule is not a “hit list.” (p.24) Evaluation may lead to **improved public policy** through modifying or repealing tax expenditures OR by transparently affirming that the provision is doing what it is supposed to do.