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Tax Expenditure Budgets and Reports: Best Practices

What is a "tax expenditure"?

A tax expenditure is an exemption, deduction, credit, exclusion, or other deviation from the normal tax structure. Tax expenditures may be used to economically benefit taxpayers who the government has identified as needing assistance. They may also serve as an incentive for certain economic or social behavior.

Until recently, tax expenditures were largely invisible to the public and even to policymakers. Some states still have no accounting of tax expenditures and, even in states where reports are issued, these preferential tax provisions have largely escaped the annual or periodic review considered normal and essential for direct appropriations. Increasingly, the public and policymakers agree that an accounting and review of tax expenditures should be part of regular sound budget practices.

What is a tax expenditure report?

More than two-thirds of the states now prepare regular tax expenditure budgets or reports to provide the public and policymakers with up-to-date information on the impact of preferential tax provisions (both "tax expenditures" and elements of "normal" taxation) in the tax code. In many states, tax expenditure reports simply list statutory exemptions, credits, and exclusions without identifying those provisions that are part of the normal tax structure. This is one reason why, in many states, tax expenditure reports have not been effective tools to help legislators review and improve the tax code. **In order for it to be effective, a complete and frequently updated tax expenditure report is essential for good policymaking.**

What are best practices for defining a "normal" tax provision?

While tax expenditure reports have become increasingly common, the absence of standard definitions for "tax expenditure" and "normal" tax structure has made reading tax expenditure reports complicated. The absence of a clearly identified and articulated definition of where the normal tax code ends and tax expenditures begin can lead to unsound policy choices. It has also made state-to-state comparisons exceedingly difficult.

There is no single definition of what is meant by a normal tax structure. Both within a state and across state lines, there is much debate about which provisions of a state's tax code are tax expenditures and which are part of the normal tax structure. Deductions for ordinary and necessary business expenses and sales tax exemptions for purchases of business inputs are generally considered part of the "normal" tax structure but in some states are listed as tax expenditures. Sales tax exemptions for food and clothing or property tax circuit breakers, similarly, may be considered part of the "normal" tax structure or tax expenditures.

Each state needs to determine what provisions of the tax code are foundational elements of the tax system and not deviations from it, **and this requires judgment calls by policymakers**. In order to create effective and useful tax expenditure reports, state legislators must play an integral role in defining the normal tax base. To assist in this effort, the Executive Committee Task Force on State and Local Taxation (SALT) has developed this list of questions for legislators to consider in developing a process to define the normal tax base:

1. Who should determine the normal tax structure? Should the normal tax structure be determined by a special legislative committee, a created commission, or some other authority?
2. Depending on the authority making the determination of the normal tax structure, what other procedures or controls should be built into the overall process. For example, if a commission has authority, should unelected stakeholders be included in the process? If the executive branch has authority, what is the role of the legislature in reviewing and approving executive branch recommendations?
3. How often should the "normal" tax structure definition be reviewed?
4. Which taxes should be included under the scope of the review? Should the review be limited to only taxes that are major state revenue sources, such as personal income, corporation income/franchise, sales and use, special industry, etc.? Should local taxes, such as the property tax, be included?

What are "best practices" for tax expenditure reports?

State tax expenditure reports should include information on all major state and local taxes (personal and corporate income taxes, sales and use taxes, real and personal property taxes, excise and gross receipts taxes, etc.)

To ensure that reports are accurate, informative, and transparent, there should be a protocol, codified in statute, which specifies the elements of the tax expenditure report.

It should:

1. Be easily accessible and available on-line;
2. Be completed in time for budget and policy decisions;
3. Define or describe the normal tax structure for each tax included in the report and identify deviations, both those that benefit and those that penalize a class of taxpayers;
4. Include, for each tax expenditure
    a. the date the tax expenditure was enacted,
    b. the statutory citation or federal law reference,
    c. the tax policy rationale and desired outcome, including, where specified in law and as appropriate for each tax expenditure, clearly identified metrics for assessing the effectiveness of the expenditure (e.g. number of jobs created, low-income citizens served, conflicts with federal tax policy avoided, etc.),
    d. information regarding the categories of taxpayers that benefit,
    e. an updated estimate of the revenue impact (positive or negative) of the tax expenditure,
    f. categorization of tax expenditures both by tax type and, as appropriate, budget category, and
    g. a review schedule and/or, as desired or specified in law, an expiration or sunset date;
5. Make clear the methodology and limits of estimates provided in the report.

<u>What are "best practices" for evaluating tax expenditures?</u>

While better tax expenditure reports are a critical first step, the data in these reports must be reviewed and evaluated in order to produce better public policymaking. Here, too, there are some "best practices":

1. Tax expenditures should be an integral part of the state's budgeting process, subject to a comparable regular review and approval process as other expenditures. Each tax expenditure should be reviewed regularly, with a frequency of review taking into account the trade-off between available resources to undertake the review and the cost of the tax expenditure.
2. There should be clarity about who is responsible for this review. Should it be done by a special legislative committee, a created commission, or some other authority (such as the executive branch)?
3. Evaluations should be based on measurable goals and draw clear conclusions on the effectiveness of each tax expenditure.
4. Rigorous evaluations should determine costs and benefits of each tax expenditure, and allow policymakers to ask critical questions, including:
    a) Is the purpose, cost and benefit of each tax expenditure clear?
    b) Are there clear metrics to determine the tax expenditure's effectiveness?
    c) If no readily available data exists to measure a tax expenditure, how should it be evaluated?
    d) To what extent did the tax expenditure affect choices made by taxpayers?
    e) Did the expenditure achieve its purpose?
    f) Who was affected by the tax expenditure?
    g) Did the benefits of the tax expenditure outweigh the effects of the tax increases or spending cuts needed to offset it?
5. 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.

Adopted by the NCSL Executive Committee Task Force on State and Local Taxation on January 14, 2017.