COST
COUNCIL ON STATE TAXATION

State Tax Expenditure Reports

Policy Position

Position: State "tax expenditure" reports are increasingly used as tools by state policymakers when undertaking reform of the tax code. While the value of tax expenditure reports has been questioned at both the state and federal levels, it is imperative that these reports, when used, not mislead policymakers with an incomplete or inaccurate picture of a state's existing tax structure. Tax expenditure reports should only include items that are not normal deductions within the nature of the tax. In particular, when defining the "normal" tax base, tax expenditure reports should not account for features that allow the tax to operate as intended (for example, business-to-business exemptions for a retail sales tax). Further, these reports must be dynamic if they are to have value in quantifying the revenue impact of eliminating tax expenditures.

Explanation: The term "tax expenditures" was first coined in the mid-1960s, as the U.S. Department of Treasury became interested in tracking and accounting for certain features in the income tax it deemed to be in the nature of expenditure programs. Tax expenditure reports are now a near ubiquitous feature of the state and local finance landscape. However, key features of these reports are often left to the discretion of the estimator or not addressed at all, threatening whatever value might be derived by policymakers.

Even a comprehensive tax expenditure report will be worthless if it misidentifies the "normal" tax base against which to measure the expenditure. The guiding principle must be an objective and comprehensive statement of the purpose and intended operation of the particular tax. For example, a tax on final consumption should not count as a "tax expenditure" any exemption for the intervening steps of production of the good or service.

To the extent that existing tax systems violate an agreed statement as to the purpose and intended operation of a tax to the benefit of the public fisc, "negative tax expenditures" should be reflected in the tax expenditure report. In the above example, a tax on final consumption that includes business-to-business transactions in the tax base contains a negative tax expenditure. Other examples include discriminatory or excess tax payments, which are often offset with a credit (e.g., credits for excess property taxes on communications equipment or for special surcharges on the insurance industry.) Importantly, this designation would inform would-be reformers as to the additional burdens imposed on taxpayers beyond the "normal" tax base.

Finally, tax expenditure reports must be dynamic to have any value in quantifying the revenue impact of tax expenditures. For example, where one tax expenditure is eliminated, it may result in an increased expenditure in another area (for example, eliminating the mortgage interest deduction may result in more taxpayers taking the standard deduction, inflating the cost of that expenditure). Further, there could be tax effects from eliminating multiple expenditures not anticipated when totaling the estimated individual cost of each expenditure (for example, eliminating multiple expenditures might push more taxpayers into higher tax brackets). More fundamentally, eliminating tax expenditures is likely to impact taxpayer behavior, such as investment decisions and tax planning. Failing to use dynamic modeling of tax expenditure elimination will at best result in an incomplete assessment of its revenue effects; at worst, it could lead to a serious miscalculation of the economic impact to states and localities.

122 C Street, N.W., Suite 330 ● Washington, DC 20001-2109 ● Tel: 202/484-5222 ● Fax: 202/484-5229