

## **Raising Revenues by Closing Loopholes and Preferential Tax Breaks**

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January 2003

If I buy a car in this state I pay sales tax; if I buy a horse, I don't. On a new car I will pay a motor vehicle tax, but if I buy a ready-mix cement truck I won't. I pay sales tax on the new furnace I buy for my house, but if I am a business in Minnesota, I not only avoid sales tax but can write off the cost of the furnace on my corporate tax return.

Minnesota's tax code is filled with these types of preferential tax breaks -- 300 in all. Called *tax expenditures* by the Department of Revenue, these preferential tax breaks and loopholes are worth over \$8.5 billion a year in uncollected tax revenue.

Since 1983, the Minnesota Department of Revenue has produced a Tax Expenditure Budget every two years. This budget accounts for each tax expenditure and the estimated revenue expended on it. Like direct budget expenditures, tax expenditures can be enacted or repealed solely on the authority of state law. But unlike direct expenditures, tax expenditures do not need to be re-enacted each budget period. Thus, tax expenditures often become de facto entitlements, subject to cursory review and given a higher budget priority simply because their cost occurs long before the budget setting process begins.

Yet tax expenditures, no less than other government expenditures, seek to advance public policy goals through the tax code. Many of these policy goals are laudable and have proven effective. Data supports that the home mortgage deduction stimulates home ownership for those on the margin of being able to afford a home. Just as sales tax exemptions for food, clothing and medicine reduce the tax burden on working families struggling to maintain self-sufficiency. But the efficacy of other preferential tax breaks is often anecdotal at best and more often unknown.

With our present revenue shortfall, we need to ask whether the preferential policy aims of these tax expenditures are of higher priority than K-12 education, or health care, or housing, or any number of the myriad of public purposes we spend money on.

The accelerated depreciation deduction for business equipment and property may have merit, but does the \$340 million we spend per biennium on it foster a stronger business climate than a strong University and State College system, which will be hit by \$365 million in cuts? Does the \$400,000 we spend to make sure ski hills do not pay sales tax on their snow making equipment make Minnesota a more liveable state than school readiness programs, which will be cut about the same amount? Does the \$412 million we spend to exempt businesses from paying sales tax on capital equipment make Minnesotans more self-sufficient than ensuring health care for the 64,000 families expected to lose health insurance next year -- the result of \$323 million in cuts to MinnesotaCare? Is spending \$4.1 million to make horses and ready-mix cement trucks tax-free a higher priority than spending \$4.1 million to ensure that battered women have a safe place to go to re-build their lives?

Perhaps a rigorous debate will bear out that these tax expenditures are indeed the state's highest spending priority -- but the debate needs to occur.

Politically, the Governor has drawn a "no new taxes" line in the sand, and there will surely be those who label closing preferential tax loopholes and tax breaks as "raising taxes." (But then the same could be said about the proposed cuts to the University shifting higher fees and tuition costs onto students and their parents.) I will argue that cutting tax expenditures is no different than cutting other expenditures -- both are defined as expenditures and both cost money. The chief difference is that tax expenditures have enjoyed far less scrutiny than other forms of government spending.

The proposal is quite simple: selected tax expenditures should be sunset and undergo the same budget scrutiny as any other government expenditure. The following public purpose criteria offer a way to begin winnowing the \$17 billion per biennium in preferential tax breaks. Tax expenditures should achieve at least one of the following:

1. Support the average Minnesotan's family budget
2. Promote the health and safety of our communities.
3. Support local governments to focus their resources on essential public services.
4. Promote environmental stewardship.
5. Help sustain small community charities.
6. Support industries that are particularly hurting right now.

There are 39 tax expenditures worth \$3.2 billion over the biennium that do not appear to meet these criteria. Ultimately, through the budget process, some of these expenditures will be found meritorious and they will not be eliminated. But each should be weighed against other critical programs and services and be funded based on demonstrable merits and the advancement of the public good. Only when we examine tax expenditures with the same rigor as other government spending can we honestly say that everything is on the table.

## Appendix A

Code	Expenditure	2004 and 2005 Fiscal Impact	Brief Explanation
1.41	Accelerated Depreciation	\$138,000,000	Deduction of accelerated depreciation of capital equipment, machinery, and structures.
1.42	Expensing Depreciable Business Property	\$3,600,000	Deduction of qualified business property taken instead of depreciation
1.50	Expensing of Multi-period Timber Growing Costs	\$3,900,000	Deduction of costs of maintaining timber stand
2.02	Insurance Companies	\$41,700,000	Insurance companies are exempt from the Corporate Franchise Tax
2.07	Accelerated Depreciation	\$202,000,000	Allows deduction for accelerated depreciation on business machinery, equipment, structures, etc. on Corporate Franchise Tax.
2.08	Expensing Depreciable Business Property	\$700,000	Deduction of depreciable business property taken instead of depreciation on Corporate Franchise Tax.
2.13	Expensing of Exploration and Development Costs	\$1,400,000	Current year deduction for certain development costs like labor, fuel, site preparation, etc. for fuel exploration on Corporate Franchise Tax
2.15	Expensing of Multi-period Timber Growing Costs	\$2,400,000	Deduction of current year costs for maintaining timber stand on Corporate Franchise Tax.
2.24	Throwback Sales	\$60,000,000	Sales factor of Corporate Franchise Tax is determined by the destination of the sales, which means that some sales are not taxed at all. Twenty-four states have a "throwback" rule directing that if income from a product is not taxed in the state where it is sold, it is taxed in the state where it was made.
2.25	Single-Factor Apportionment for Mail Order Companies	\$8,700,000	Apportionment formula for Corporate Franchise Tax for mail order companies in Minnesota excluding sales outside MN.
2.26	Dividend Received Deduction	\$231,800,000	Corporations receive a deduction on

			Corporate Franchise Tax on dividends received from another corporation.
2.34	Employer Tax Credits (Enterprise Zones)	\$600,000	Refundable credit to employers on Corporate Franchise Tax who are in enterprise zones.
4.09	Publications	\$111,500,000	Exempts certain newspapers, magazine, advertising circulars, shopper guides from sales tax.
4.17	Tax Preparation	\$8,800,000	Exempts from sales tax.
4.17	Advertising and Public Relations	\$204,800,000	Exempts from sales tax.
4.17	Consumer Credit and Mercantile Reporting	\$18,600,000	Exempts from sales tax.
4.17	Collection Agencies	\$20,500,000	Exempts from sales tax
4.17	Office Administrative Services	\$126,700,000	Exempts from sales tax
4.17	Computer System Design and Related Services	\$413,800,000	Exempts from sales tax
4.17	Legal Services	\$429,600,000	Exempts from sales tax.
4.17	Engineering, Architectural, Drafting Services	\$281,900,000	Exempts from sales tax
4.17	Accounting, Bookkeeping and Payroll Services	\$205,200,000	Exempts from sales tax
4.17	Commercial Testing Services	\$20,200,000	Exempts from sales tax
4.17	Management, Scientific, Technical Consulting Services	\$213,000,000	Exempts from sales tax
4.17	Surveying and Mapping Services	\$13,900,000	Exempts from sales tax
4.17	Misc. Professional, Scientific and Technical Services	\$125,000,000	Exempts from sales tax
4.23	Capital Equipment	\$411,900,000	Exempts from sales tax.
4.24	Accessory Tools	\$15,700,000	Exempts from sales tax.
4.25	Special Tooling	\$9,800,000	Exempts from sales tax.
4.39	Ski Area Equipment	\$400,000	Exempts from sales tax.
4.40	Logging	\$1,600,000	Exempts from sales tax.
4.46	Horses	\$2,300,000	Exempts from sales tax (including race horses)
4.48	Television commercials	\$2,400,000	Exempts pre and post production from sales tax.
4.49	Advertising materials	\$16,300,000	Exempts advertising materials produced in Minnesota and shipped out of the state from

			sales tax.
4.51	Patent, Trademark and Copyright Drawings	\$200,000	Exempts certain patent drafters from sales tax
4.52	Certain Interstate Telephone Services	\$16,600,000	Exempts certain WATS lines and telemarketing firms from sales tax.
5.11	Ambulances	\$800,000	Exempts ambulances purchased by private ambulance firms from motor vehicle tax.
5.12	Ready-Mix Concrete Trucks	\$1,600,000	Exempts ready-mix cement trucks from the motor vehicle tax.
12.01	Fraternal Benefit Societies	\$8,800,000	Exempts fraternal benefit societies and associations from gross premiums tax.
	<b>TOTAL</b>	<b>\$3.2 billion</b>	