

Tax Expenditure Budgets: An Overview

**A Report to the Legislative Finance Committee
of the New Mexico Legislature**

by

**Jim Eads
President and Executive Director
and
Manuel del Valle, Ph.D.
Research Director**



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ABOUT THE NEW MEXICO TAX RESEARCH INSTITUTE

One of the principal reasons for the existence of the New Mexico Tax Research Institute can be succinctly stated in the following two quotes, both from opinions delivered by the Supreme Court of United States.

"The power to tax involves the power to destroy" - *McCulloch v. Maryland*, 17 U.S. 316 (1819), Chief Justice John Marshall.

"Taxes are what we pay for civilized society" *Campañía General de Tabacos v. Collector*, 275 U.S. 87, 100 (1927), Justice Oliver Wendell Holmes, dissenting.

The New Mexico Tax Research Institute is a nonprofit, nonpartisan, member-supported organization dedicated to providing fact based principled research and analysis to the tax policy debate in New Mexico. We do not advocate any agenda for or against taxation. We seek only to study, inform and educate the public and tax policy makers concerning the pressing issues of taxation facing our state. We believe that well-versed policymakers and an active, informed citizenry are essential for effective representative government. We are organized and operate as a corporation pursuant to § 501(c)3 of the Internal Revenue Code and welcome individuals, businesses and organizations as members.

The creation of the New Mexico Tax Research Institute was recommended by the participants in a New Mexico First Town Hall Meeting held in May, 2001. We officially came into being in October, 2002. We are supported through the generosity of our members and through the gracious support of the McCune Charitable Foundation. We do not accept public funds inasmuch as we want to be able to be as objective as possible in our analyses and publications. Our members understand this and believe that professional, objective collection of data, analysis of that data and juxtaposition of information with sound principles enables the best decisions regarding tax and fiscal policies for our state.

You can contact the New Mexico Tax Research Institute at 505-842-1222 or Jim Eads, President & Executive Director, directly at 505-228-7129 or jimeads@nmtri.org or Manuel del Valle, Research Director at 505-238-2086 or mdelvalle@nmtri.org. Our Internet website address is www.nmtri.org. Our mailing address is P.O. Box 30483, Albuquerque, New Mexico 87190-0483.

The officers of the New Mexico Tax Research Institute are:

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INTRODUCTION

The term “tax expenditure” is attributed to Stanley S. Surrey who, as Assistant Secretary of the United States Department of the Treasury for Tax Policy, instructed his staff to compile a list of preferences and concessions in the income tax that had the nature of expenditure programs. His goal was straightforward: to draw attention to these items in hopes of building momentum for tax reform, which would redirect the tax system toward its core function of raising revenues.¹

The first such list for the federal income tax was published in 1967. Later, the congressional Budget Act of 1974 mandated that the Administration should publish a list of tax expenditures as part of its annual budget submission. At the state level, California was the first state to require such a list, starting in 1971.² In 1985 the New Mexico Taxation and Revenue Department prepared a tax expenditure budget that was part of the budget submission. That was the only year in which it was done in New Mexico. A copy of the report prepared for New Mexico in 1985 is attached to this report. Today more than 30 states prepare and publish a form of tax expenditure budget.

The classic definition of a tax expenditure budget was stated by Stanley Surrey and coauthor, Paul R. McDaniel, in their 1985 seminal treatise on the subject, which only dealt with tax expenditure budget as it might apply to income taxes:

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class or persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.³

A definition for all taxes using the Surrey-McDaniel terms could be: “A TEBs consists of an organized list of departures from the normal tax structure. The departures; which are designed to favor a particular industry, activity or class of persons; take different forms, such as deductions, deferrals, exclusions, credits or special rates.”

¹ *Is the Tax Expenditure Concept Still Relevant?*, Leonard E. Burman, Senior Fellow, The Urban Institute, Co-Director, The Tax Policy Center; *National Tax Journal*, September, 2003

² *Tax Expenditure Budgets, Budget Policy and Tax Policy: Confusion in the States*, John L. Mikesell; *Public Budgeting and Finance*, Winter 2002

³ *Ibid*, Mikesell

Basically, the tax expenditure budget is a document that is intended to be a useful source of information that will allow the legislative body to subject indirect “expenditures” of public resources to the same degree of scrutiny as direct expenditures of public funds. The major issue, of course, is the determination of the standard against which these expenditures are measured. The federal experience is not completely helpful inasmuch as the federal tax expenditure document does not have to take into consideration the retail and excise taxes that often make up a majority of state revenue flows.

TAX EXPENDITURES BUDGETS IN THE STATES

Professor Mikesell has done a great service to the state tax and fiscal community with the publication of his work in 2002 that examines the use of tax expenditure budgets in the states and successfully attempts to critique their usefulness. He points out that the reports are generally prepared by the executive branch (often either by the tax agency or administrative body) but some are prepared by the legislative branch (*e.g.* California and Connecticut). In Texas and Illinois, the elected Comptroller prepares the report (note that in Texas the Comptroller is the tax collector for the state). He points out that the reports usually cover only state taxes, not local levies and that they often do not include all state taxes, usually just corporate income, personal income and sales taxes.

As to the usefulness of the document, as of 2002, only Idaho, New York, Ohio, Oregon, Pennsylvania, Tennessee and Wisconsin actually transmitted the tax expenditure report along with or as a part of the budget document. While, the inclusion of the TEB in the budget is an indicator of its importance, its exclusion should not be construed as a measure of its usefulness. It can be a useful tool in most cases. In all other states the tax expenditure report was a separate report, even though it might be a part of the budget debate.

As is obvious from the definition of a tax expenditure budget noted above, the heart of the process is determining the norm from which the deviations or “expenditures” are measured. Professor Mikesell notes that the states tend to use three different approaches. They are:

Conceptual Baseline. This is the approach used by the Joint Tax Committee in preparing its estimate of tax expenditures for the federal government. It identifies a benchmark “normal” tax base or “normal income tax law” and measures the deviations from that norm to determine the “expenditures” that exist in the tax law. This approach is said to be less constrained by existing law than the approaches noted below. Idaho, Minnesota and West Virginia are reported to be the states that use this approach.

Reference Law Baseline. This approach measures deviations or “expenditures” based on existing exemptions or exclusions from the tax base, but some are considered “normal” and are part of the base and thus are not counted as “tax expenditures”. The U.S. Treasury Department uses a form of this approach as does Connecticut.

Revenue Reducer List. This approach identifies existing reducers of revenue through exemption, exclusion or deduction and quantifies the revenue loss without reference to a “normal” standard. Thus, the costs are identified without any attempt being made to reference

them so some standard which may have shaped their enactment. At least one state tax policy organization, the Washington Research Council, has criticized this approach in their state as being a way of overturning what were decent policy decisions at the time of their enactment based on short term revenue expediency.

Some reasons as to why a tax expenditure budget could be useful are as follows:

- 1) It introduces a useful systematic way of looking at the “departures” from “standard” tax policy. These “departures”—exemptions, deductions, deferrals credits, reductions of the tax base or selective tax rates—are in a way government expenditures, and arguably should be subject to the same transparency standards as more explicit expenditures.
- 2) It is an organized listing of all the “departures” from normal taxes, and as such is an important source of public information.
- 3) In times of fiscal constraint the TEB can be used to select the “departures” that could be subject to reduction or elimination.
- 4) Questions regarding the citizenry can be quickly answered, referring to a TEB. For example, how much is the State forgoing revenues with a specific exemption?
- 5) It is a dynamic document that each year includes the tax policy packages enacted by the legislature.

Some of the issues that would need to be considered if the preparation and publication of a tax expenditure budget were to be institutionalized are as follows:

- 1) The decision as to who should prepare the document needs to be made. Executive branch, Legislative branch, both, academic institution, non-partisan consultant are all options.
- 2) In times of fiscal constraint the tax expenditure budget can become a “shopping list that can be used to select the “departures” that could be subject to reduction or elimination, sometimes without remembering the underlying policy.
- 3) The expertise and data for an initial preparation can be a costly and employee intensive task.
- 4) The policy reasons as to the “departures” can become lost in the numerical calculation of the “costs”.

SUMMARY

Tax expenditure budgets, tax expense reports, tax preference cost reports-whatever you may call these documents, could be a useful tool to the New Mexico Legislature in determining the long term impact of existing laws and proposed new laws on the fiscal well-being of our state. Such a report would contribute to the transparency of government. On the other hand such a list could become a laundry list for revenue raising under difficult conditions that do not sufficiently consider the underlying policy decisions that caused the “expenditure” to be enacted. Information, knowledge and principles should always be at the disposal of policy makers, for their wise and beneficial use.