

# **A Review of Selected Tax Expenditures**

A Presentation to the House Taxes Committee

March 16, 2009

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# Review of Tax Expenditures

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## Introduction

This presentation was prepared, at the request of the chair of the committee, to provide committee members with some background information on tax expenditures as you make budget balancing decisions. It parallels the effort by the Property and Local Sales Tax Division to examine the entire catalogue of state aids and credits that are within its jurisdiction.

## Selection of Tax Expenditures to Review

Although we were requested to prepare information for this presentation in December 2008 (when it was obvious that the state had very serious budget problems), time and resource limits prevented us from comprehensively examining all tax expenditures or tax types. Similar constraints (or perhaps more) applied to Department of Revenue (DOR) staff, who prepared all of the incidence materials and information that are in this presentation. Given these limitations, in consultation with the chair, we limited the presentation to tax expenditures under the two largest state taxes – the individual income and general sales tax. The largest amount of the state’s tax expenditures are under those two taxes.

Furthermore, in reviewing tax expenditures under these two taxes, we omitted considering tax expenditures from the analysis based on the following criteria:

- Under the income tax, we excluded tax expenditures that we considered to be impractical to modify or reduce for administrative or compliance reasons. This category largely consists of items that carryover from federal law. Most of these items involve issues of timing, valuation, reporting, and recording keeping. For example, it includes the depreciation rules, pension and retirement plan rules, taxation of fringe benefits (which involve serious valuation issues in many cases), and similar provisions.
- Under the sales tax, we excluded tax expenditures from the review that predominantly consist of business purchases or would tax business inputs. Standard tax policy principles argue that intermediate business purchases should not be subject to consumption taxation. This follows from the purpose of the tax, to tax consumption, and the principle of horizontal equity – i.e., to tax taxable consumption on an equal basis or only once. Taxing business inputs causes the sales tax to pyramid. (See the box at the right for a description of pyramiding.) Thus, we assumed that the committee would likely not want to consider repealing tax expenditures that are really overwhelmingly intermediate business inputs. Alternatively, we limited the discussion to the portion of each tax expenditure that consists of consumer purchases.

### Pyramiding

Pyramiding occurs when a tax applies at multiple levels of business production and distribution. The result of this typically would be to pass the tax along in higher prices at the next level of production (e.g., a manufacturer who sells to a wholesaler). The tax burden “pyramids” or cascades at each level, so that the total burden on the consumer is higher than the statutory or nominal rate. Pyramiding favors vertically integrated or larger businesses. These businesses can minimize the multiple levels of tax by performing functions – that would be taxable if purchased from a third party – with employees. Pyramiding also undercuts statutory exemptions (e.g., the sales tax paid by grocers gets passed along in higher grocery prices, despite the exemption for food products) that are intended to reduce regressivity or exempt necessities.

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- We did not review the sales tax exemptions for entities, such as governmental units or charities. Because of shifting issues, the effect of repealing these exemptions on incidence is not clear. Moreover, these exemptions may serve unclear or multiple objectives that are difficult to evaluate.
- We excluded tax expenditures which were just enacted in 2008 and have not gone into effect. We assumed that the legislature would not want to revisit these decisions so soon. However, we did include descriptions of 2008 legislative modifications to pre-existing tax expenditures.

## Information Provided

For each tax expenditure we attempted to provide information on the following:

- **A brief description of the provision** – in many cases these descriptions borrow liberally from the DOR *Tax Expenditure Budget (2008)* or from House Research Department publications.
- **The dollar amount of projected revenue lost** – these amounts, unless noted otherwise, are taken from the DOR *Tax Expenditure Budget (2008)* (“TEB”). Note that these numbers for the sales tax include business purchases. By contrast, the data used to prepare the incidence graphs are limited to information on consumer purchases only (i.e., they do not include estimates of the shifting of business purchases that are subject to the sales tax). Also it is important to note that the revenue raising potential from repealing multiple tax expenditures are not necessarily additive under the income tax. Combining repeal of two or more tax expenditures may raise either more or less than the sum of their TEB amounts, depending upon the type and situation. Also, in some case, numbers from the TEB may differ from revenue estimates prepared by DOR for a legislative proposal. For example, TEB numbers do not take into account behavioral responses to repeal, which revenue estimates may. Finally, the TEB numbers were prepared in 2007-08 (in most cases using the November 2008 Department of Finance forecast baseline). Thus, they do not reflect the effects of the recession.
- **An objective or rationale for the tax expenditure** – these are based on our knowledge of points made by the proponents or conventional wisdom (e.g., the literature) and include some information on the history of the provision. In many cases, it is simply not really clear what the purpose, objective, or rationale was for some tax expenditures and it is necessary to speculate about possible purposes or to simply say we don’t know.
- **Related direct spending programs** – where we were aware of direct spending programs that address some of the same purposes or rationales as the tax expenditures, we attempted to list these.<sup>1</sup> The legislature may wish to consider tax expenditures and direct expenditures focused on similar purposes together to determine more cost effective ways to achieve the objectives or to determine the best way to reduce the combined expenditures.
- **Incidence information** – these graphs and the Suits index measures were prepared by DOR staff in the Research Division, using information they used in preparing the *Tax Incidence Study*. The Suits index for a tax expenditure shows the impact of repealing that tax expenditure alone, thus raising revenue. A negative Suits means that change by itself would make the overall tax

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<sup>1</sup> Given tax staff’s lack of knowledge about direct spending programs, these listings are likely very incomplete and most do not attempt to describe the direct spending programs in any detail.

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structure more regressive. A positive Suits means that change by itself would make the overall tax structure less regressive. For an income tax expenditure if the Suits is positive but less than the Suits for the income tax, a simple repeal would make the income tax less progressive but the overall system less regressive (by growing a progressive tax). For the sales tax, a similar comparison needs to be made to determine if repeal would make the tax more or less regressive. But since the sales tax is more regressive than the overall Minnesota tax system, increasing revenues from the sales tax (by repealing a sales tax expenditure) would typically make the overall system more regressive by growing a regressive tax.

As noted above, the incidence information is limited to consumer purchases for sales tax items and does not include the effect of the shifting of taxes on business inputs, if such a tax expenditure were repealed wholesale. Thus, this incidence information is most useful in considering repeal of a tax expenditure, which preserves an exemption for business purchases.

- **Evidence on cost effectiveness** – where we were aware of published or other studies by neutral observers or analysts (typically academics or government agencies) of the effectiveness of an tax expenditure, we attempted to include this information in the presentation. In some other instances, we added what we considered to be common sense observations regarding the likely effectiveness of tax expenditures. The discussion of sales tax expenditures covers this point generically at the beginning the sales tax section and does not do so for each item of tax expenditure, since most of the points are common to all of the sales tax expenditures.

# Review of Tax Expenditures

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## Individual Income Tax Expenditures

### Social Security Benefits

#### Description of provision

Minnesota follows the federal law in determining the portion of social security benefits that is taxable. Under these rules, up to 85 percent of Social Security benefits are subject to federal and state income tax, depending on the taxpayer's income. All Social Security benefits are exempt from taxable income for taxpayers with incomes under \$25,000 (\$32,000 for married joint taxpayers). For incomes between \$25,000 and \$34,000 (\$32,000 and \$44,000 for married joint taxpayers), up to 50 percent of Social Security benefits may be subject to tax. For incomes over \$34,000 (\$44,000 for married joint taxpayers), up to 85 percent of Social Security benefits may be included in taxable income. Income for purposes of these rules is income from taxable sources, plus tax exempt bond interest, and one-half of social security benefits. The 15 percent of benefits that remain exempt from taxation regardless of taxpayer income represents an approximate value for recovery of the individual's contributions to social security, while the up to 85 percent that may be included in taxable income represents the employer's contributions and transfers.

In 2005 approximately 786,000 Minnesota residents received social security benefits and excluded part or all of those benefits from taxable income.

#### Projected Tax Expenditure: Social Security Benefits (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$159,200	\$165,600	\$172,600	\$183,500

The tax expenditure for social security benefits has increased in nominal terms (unadjusted for inflation) by 19.3% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

#### Objective or Rationale

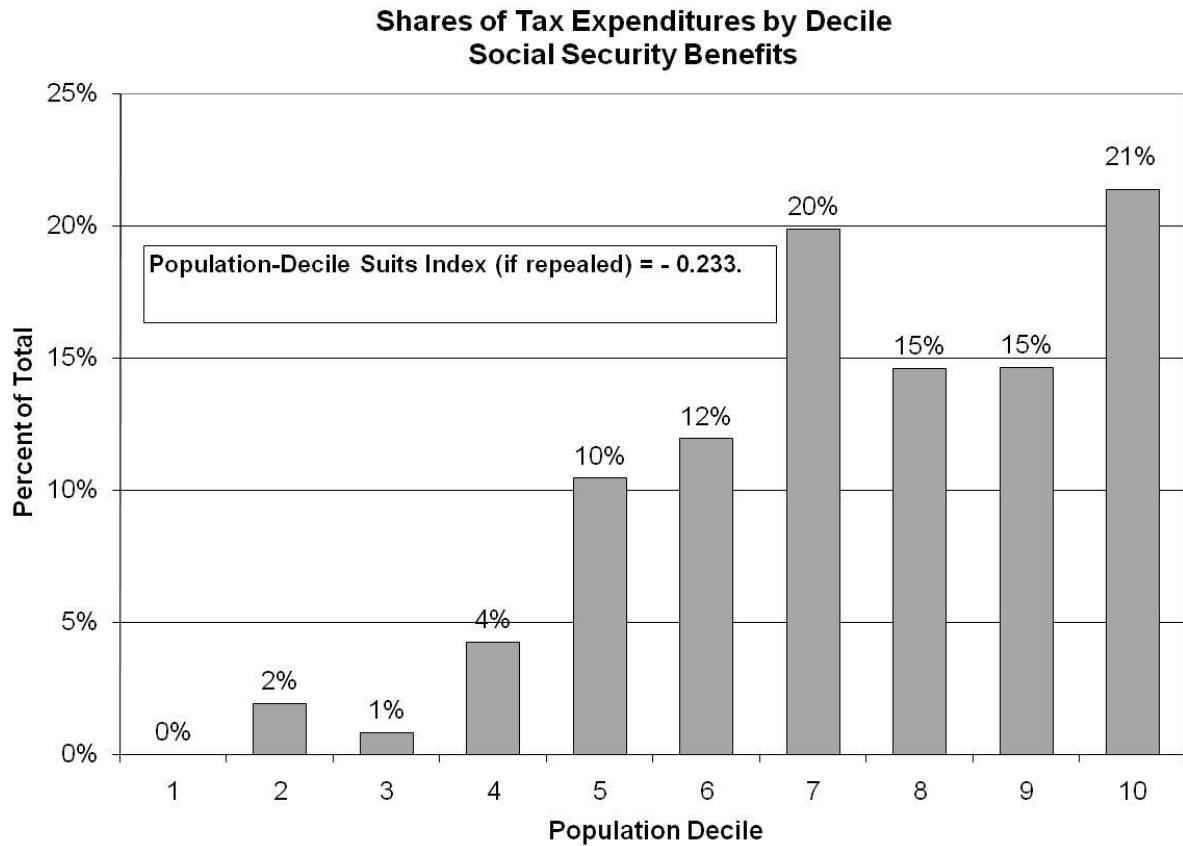
The rationale for the exemption for social security benefits is not clear. Under federal and state law, social security benefits were initially totally exempt from taxation. It may have been thought of as a way to enhance the value of social security benefits, which were initially very modest. Or it may have been a way to provide a preference to senior citizens who (in the past) were, on average, poorer than the rest of the population. Congress partially withdrew the total exemption from taxation (in 1983 and 1993) as a way to shore up the financing for the social security system in a modestly progressive way. Minnesota has conformed to these federal changes both as a way to maintain the simplicity of the Minnesota tax system and to provide revenue and added progressivity.

#### Related Direct Spending Programs

None

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006, and Tax Incidence Study database; excludes tax expenditure for social security recipients who do not file income tax returns.

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### Evidence on Effectiveness in Meeting Objective

Given the lack of clarity of the rationale for the exemption, it is difficult to assess whether the exemption is effective in achieving those goals.

# Review of Tax Expenditures

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## Mortgage Interest Deduction

### Description of provision

Minnesota follows federal law in allowing an itemized deduction for home mortgage interest. Interest on loans of up to \$1 million to purchase or improve a principal or second residence (and secured by a mortgage on the residence) may be deducted. Interest on mortgage debt used for other purposes (home equity loans) is deductible up to a principal amount of \$100,000. Mortgage interest is not deductible in calculating the Minnesota AMT.

The deduction reduced taxes on about 766,000 Minnesota returns in tax year 2007.

### Projected Tax Expenditure: Mortgage Interest Deduction (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$400,900	\$448,600	\$495,300	\$543,900

The tax expenditure for mortgage interest has increased in nominal terms (unadjusted for inflation) by 75.7% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Objective or rationale

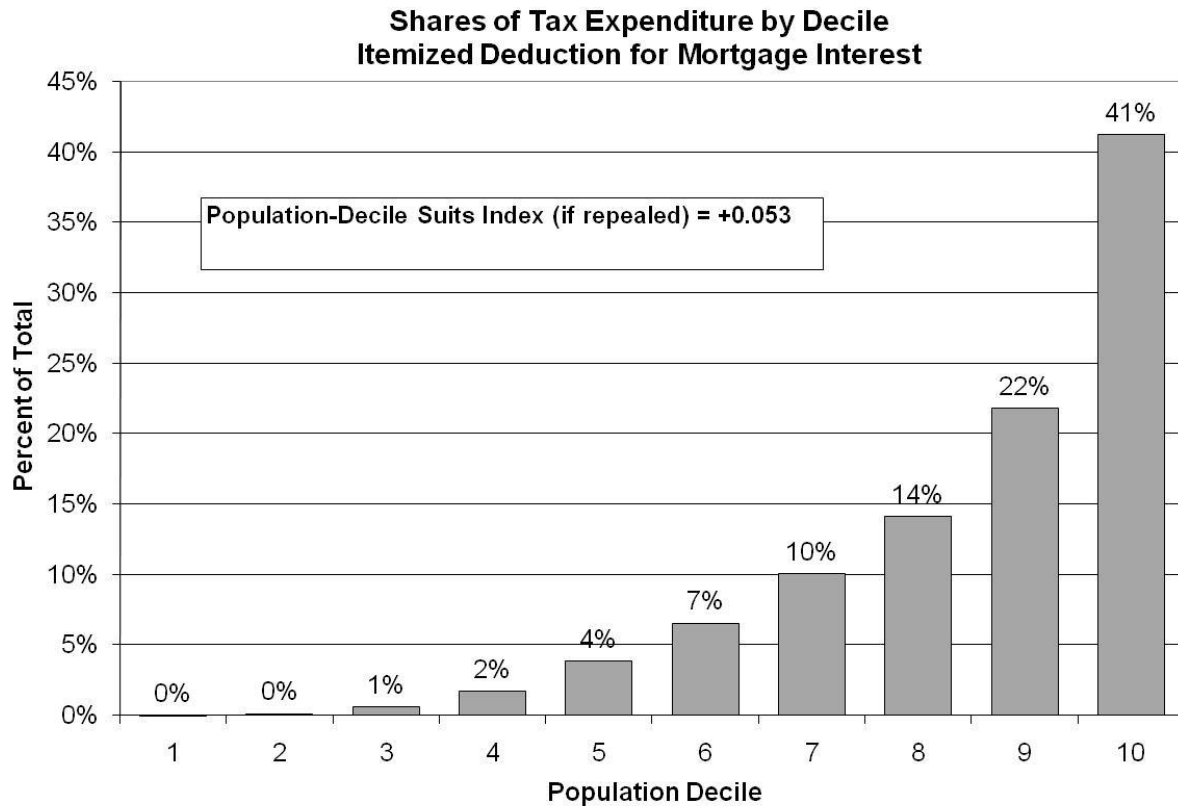
The mortgage interest deduction has been a feature of the Minnesota income tax since its inception. The original law allowed all interest to be deducted; restrictions to mortgage interest, along with the dollar limits, were enacted since the 1986 federal tax reform and mirror federal law. The original purpose or rationale for the interest deduction is unclear. It is commonly thought that the deduction is intended either to increase the rate of homeownership or to encourage improvement or better maintenance of homes.

### Related Direct Spending Programs

Minnesota provides a variety of direct spending and other tax expenditure programs to assist or encourage homeownership through the Minnesota Housing Finance Agency (MHFA) and through tax exempt bonds and mortgage credit certificates issued by MHFA and local government units.

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## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

The federal mortgage interest deduction has been the subject of extensive empirical studies. Minnesota's allowance of the deduction is likely to have similar effects to the results found for the federal deduction. Economic studies have generally found that the deduction has weak or little effect on the level of homeownership, but that it does increase the amount of housing consumption. At least one study found that the size of state subsidies for homeownership (i.e., mortgage interest deductions and higher state tax rates) did not have a measurable effect on homeownership. Edward L. Glaser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, Harvard Institute of Economic Research, Discussion Paper 1979 (October 2002).

The deduction does tend to confer large benefits on higher income taxpayers, since they are in higher tax brackets, tend to be itemizers for other reasons, and usually have a preference for single family



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detached housing. It also tends to encourage purchase of larger homes or more housing. Glaeser and Shapiro suggest:

[T]he home mortgage interest deduction is not really pro-homeownership policy in any meaningful sense. It subsidizes housing consumption, but its impact on the homeownership rate appears to be minimal. \* \* \* As such, the home mortgage interest deduction needs to be judged on other grounds. Is it desirable as a means of making the income tax schedule less progressive? Is it desirable as a subsidy to housing consumption? *Ibid.* at 41.

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## Itemized Deductions for Real Estate and Other Taxes

### Description

Minnesota allows individuals who itemize their deductions under the federal income tax to deduct real estate taxes (e.g., paid on their principal residence or vacation properties), as well as the ad valorem portion of the tax on personal property – e.g., the part of the motor vehicle registration tax that is based on value (above the flat amount and the service fee) or the tax on a mobile home on a rented lot. This treatment follows the rule under federal law.

The deduction for real estate taxes benefitted an estimated 796,000 returns in tax year 2007.

The deduction for other taxes benefitted an estimated 637,000 returns in tax year 2007.

### Projected Tax Expenditure: Deduction for Real Estate Taxes (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$156,000	\$176,000	\$191,000	\$208,600

The tax expenditure for real estate taxes has increased in nominal terms (unadjusted for inflation) by 129.2% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Projected Tax Expenditure: Deduction for Other Taxes (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$12,200	\$13,300	\$14,300	\$15,600

The tax expenditure for other taxes has increased in nominal terms (unadjusted for inflation) by 47.9% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Objective or Rationale

This deduction has been a feature of the Minnesota tax since its enactment in 1933. Since 1987, Minnesota has tied its deduction the federal rules. (Prior to that for some periods of time, Minnesota allowed the deduction of some minor taxes when they were not allowed under federal law.)

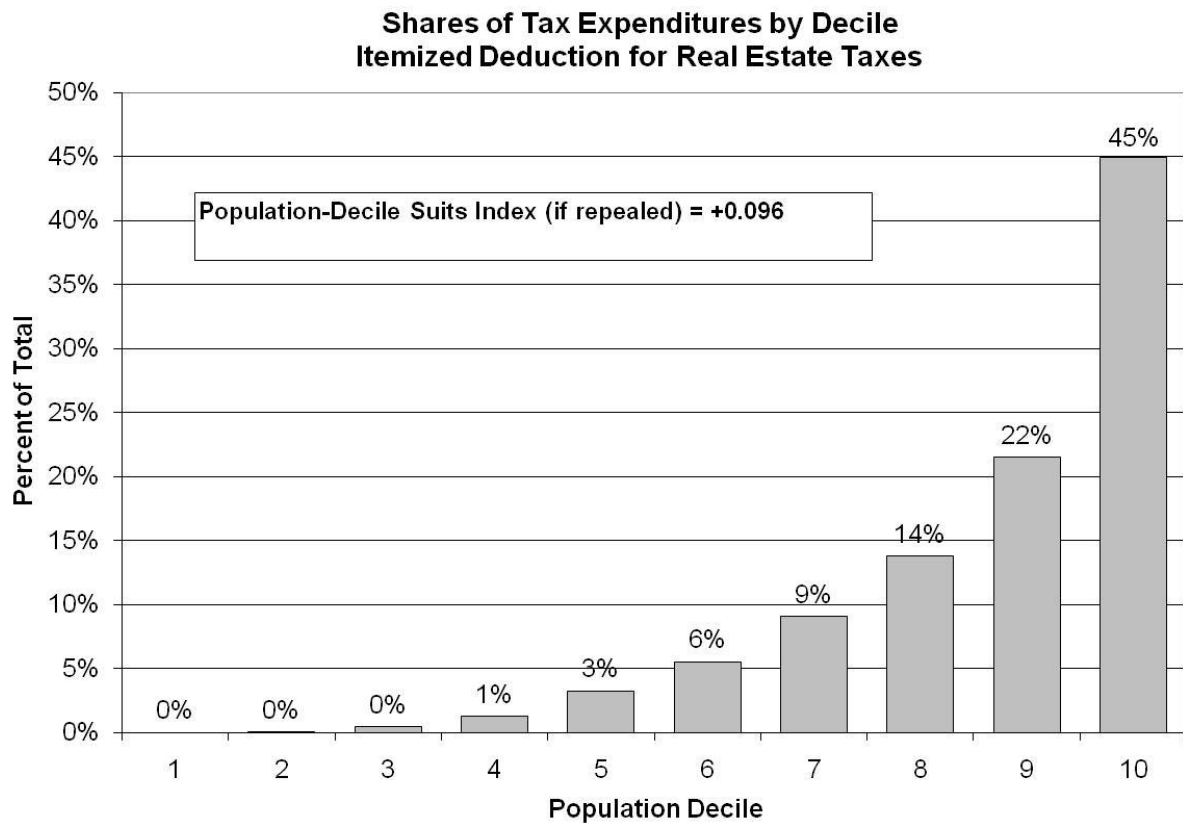
The rationale for the deduction is somewhat unclear. Economists and tax analysts generally view the federal deduction as a way of providing implicit aid to state and local governments. The general notion is that some of these services may provide spillover benefits (benefits that go to individuals who are not residents of the local government or to those who do not bear the local taxes) and that federal or state policies should offset some of this effect. The deduction could also be viewed as a mechanism for providing property tax relief.

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## Related Direct Spending Programs

Minnesota provides extensive intergovernmental aid to cities, counties, and school districts. In addition, it provides direct aid to homeowners to offset their property taxes through the property tax refund and the market value credit for homestead properties.

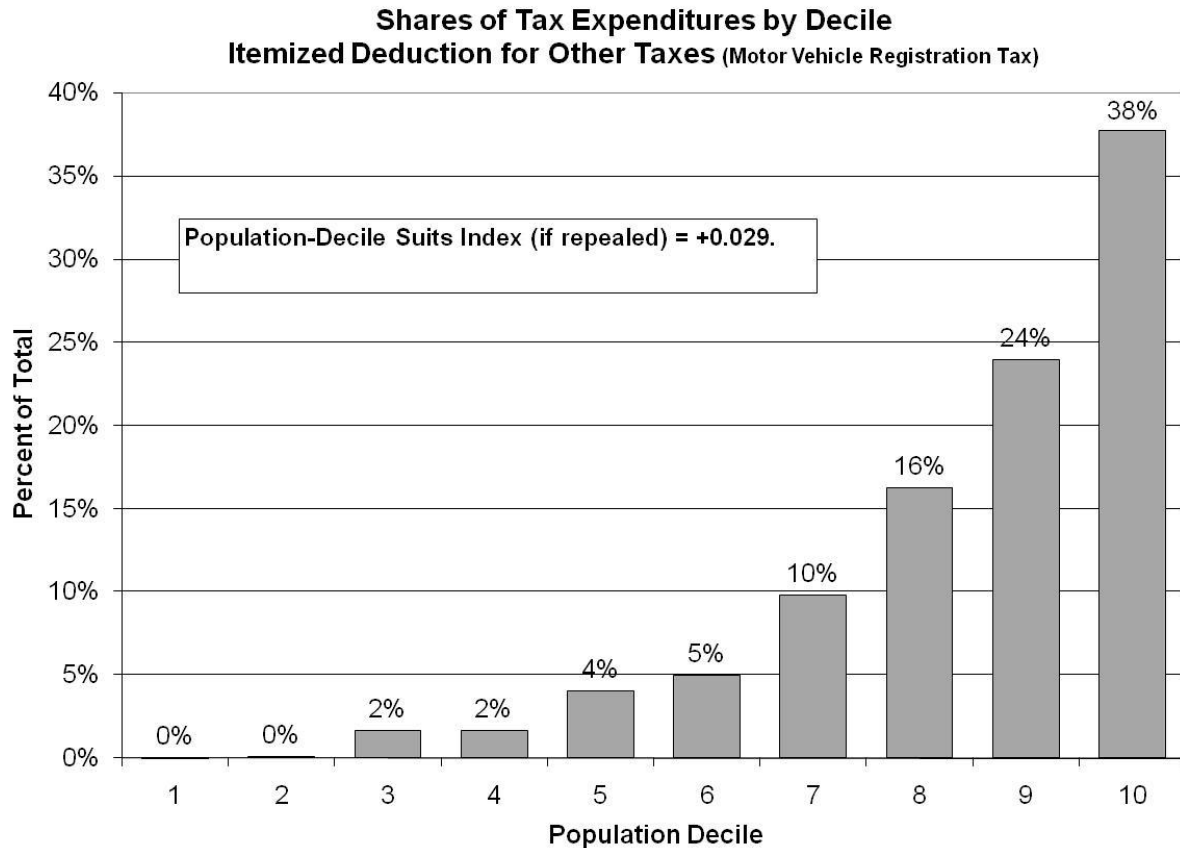
## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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Source: HITS Model for 2006,  
and Tax Incidence Study database.

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## Evidence on Effectiveness in Meeting Objective

Viewed as a mechanism for providing state intergovernmental aid to local government units, the deduction for real estate taxes has some limitations. It provides more aid to communities with more homeowners (since renters cannot deduct their taxes), with more itemizers, and with more taxpayers in higher tax brackets. These characteristics probably are not related to whether or not those communities provide more or less services with spillover benefits. Nor are they related to the local unit's "need" or capacity to pay (if anything, they may be negatively correlated with capacity to pay, since communities with greater concentrations of high income homeowners likely have lower need). Moreover, deductibility distorts local governments' fiscal choices – e.g., by encouraging local governments to impose deductible real estate taxes, rather than using non-deductible taxes or user fees.

If the rationale for the deduction is to provide homeowners with property tax relief, the amount of relief is minimal (never more than 7.85% of the taxes) and is inversely related to an income-based

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measure of need – i.e., individuals with higher incomes typically receive more relief and lower income individuals less.

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## Charitable Contribution Deduction

### Description of Provision

Minnesota follows federal law in allowing contributions to organizations that are religious, charitable, educational, scientific, or literary in purpose to be claimed as an itemized deduction. The deduction is limited to a maximum of 50% of federal adjusted gross income, and other limitations apply to specific types of contributions. Contributions that exceed these limits can be carried forward for up to five years.

The deduction reduced taxes on about 759,500 Minnesota returns in tax year 2007.

### Projected Tax Expenditure: Deduction for Charitable Contributions (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$208,500	\$229,800	\$246,200	\$269,600

The tax expenditure for charitable contributions increased in nominal terms (unadjusted for inflation) by 168.7% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Objective or Rationale

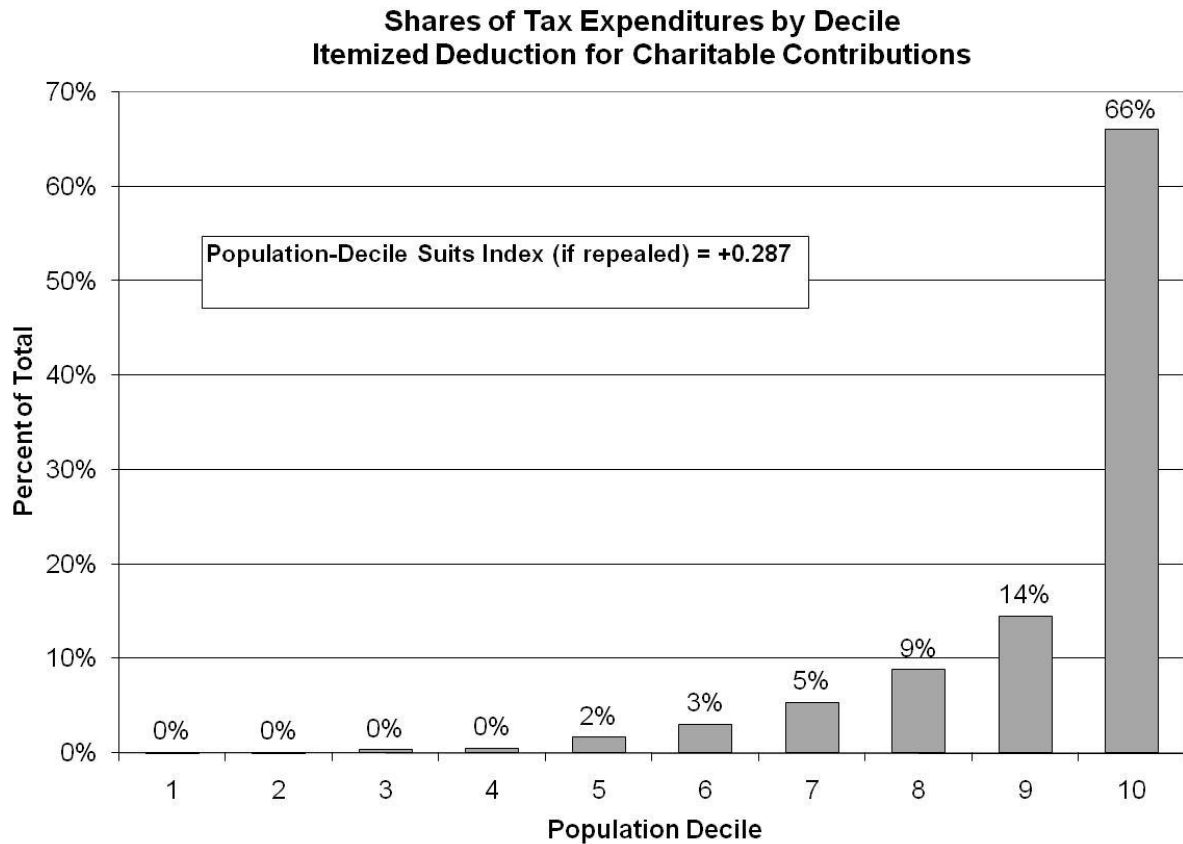
The charitable contribution deduction has been a feature of the Minnesota tax since its inception. The generally accepted purpose of the deduction is to encourage taxpayers to make charitable contributions. The assumption is that reductions in the price or cost of making charitable contributions will induce or cause taxpayers to contribute more to charities and governmental units.

### Related Direct Spending Programs

None

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## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

Extensive studies of the effects of the federal charitable contribution deduction have been made. In general, these studies find that the deduction does increase the amount of charitable giving; donors do respond to a lower price for gifts by increasing their giving. It seems reasonable to conclude that the Minnesota deduction has a similar effect.

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## Subtraction for Charitable Contributions by Non-Itemizers

### Description

Taxpayers who do not itemize deductions are allowed to subtract 50% of their charitable contributions over \$500. The contributions must meet the requirements for deductible charitable contributions under the federal income tax. The \$500 threshold applies to the total amount of contributions made in the tax year.

An estimated 168,000 returns benefit from this provision in tax year 2007.

### Projected Tax Expenditure: Non-itemizer subtraction for charitable contributions (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$7,100	\$7,700	\$8,300	\$9,100

The tax expenditure for charitable contributions made by non-itemizers has increased in nominal terms (unadjusted for inflation) by 129.0% from FY 2000, when the subtraction took effect, to FY 2008, compared with a 45.1% nominal increase in personal income over the same time period.

### Objective or Rationale

This provision was enacted in 1999 and is intended to equalize the treatment of itemizers and non-itemizers and to encourage more individuals to make itemized deductions. The disallowance of the first \$500 of contributions was based on a notion that this reflected an approximate proportion of the standard deduction for charitable contributions.

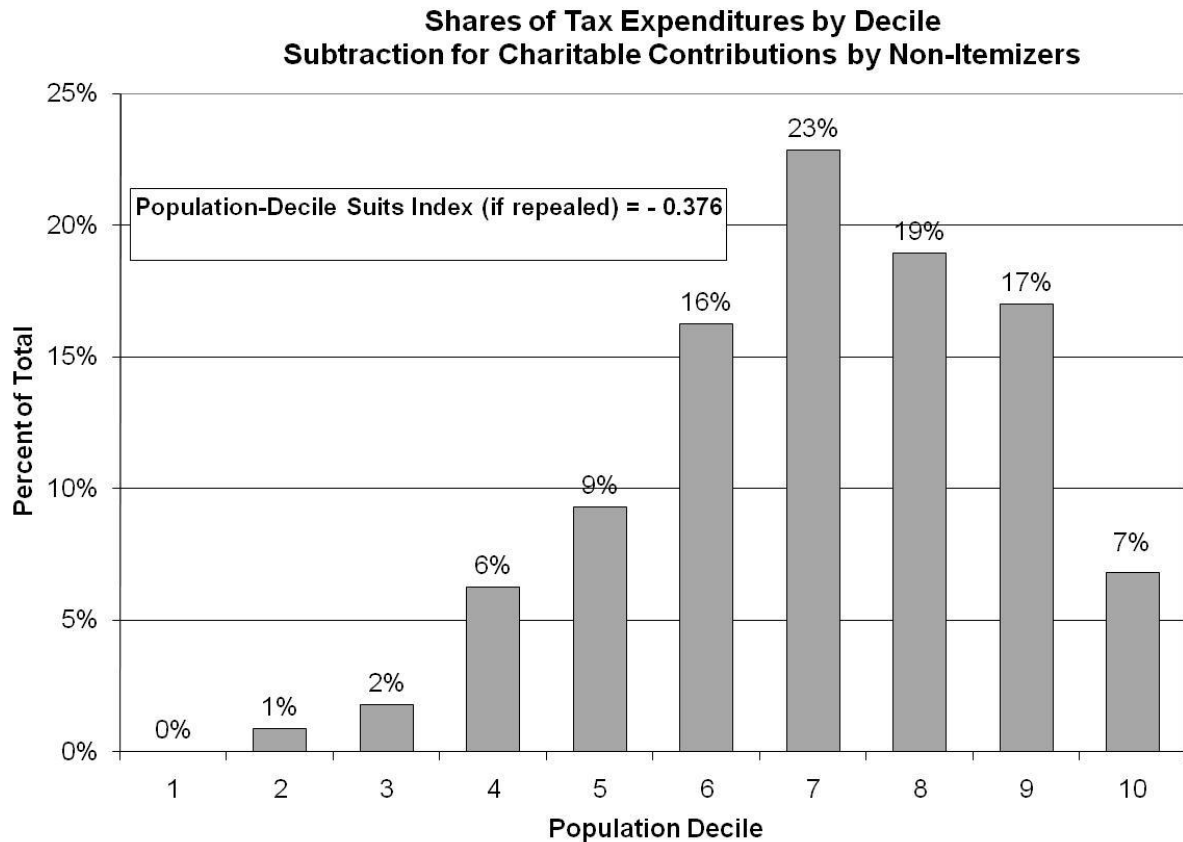
### Related Direct Spending Programs

None



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## Incidence Information



Source: HITS Model for 2006,  
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### Evidence on Effectiveness in Meeting Objective

The subtraction does not fully equalize the tax benefits of making charitable contributions by non-itemizers and itemizers – both because it allows only one-half of contributions to be subtracted and because individuals who itemize, but who would derive a larger benefit from the non-itemizer subtraction are not allowed to claim the subtraction. Also see the discussion under the itemized deduction for charitable contributions for a discussion of whether these types of deductions likely increase contributions.

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## Interest on Minnesota State and Local Government Bonds

### Description of provision

Interest paid on bonds issued by Minnesota governmental units is exempt from taxation. (Interest on bonds issued by non-Minnesota governmental units must be added to federal taxable income and is subject to tax.) The exemption applies to general obligation bonds, as well as qualifying private activity bonds. These include revenue bonds issued for housing and various other purposes permitted under federal law, although interest on some of these private activity bonds may be subject to taxation under the alternative minimum tax or AMT.

About 74,000 returns benefited from the exemption in tax year 2007.

### Projected Tax Expenditure: Interest on MN Bonds (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$50,600	\$51,900	\$55,200	\$58,700

The tax expenditure for interest on Minnesota state and local government bonds has increased in nominal terms (unadjusted for inflation) by 10.6% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Objective or Rationale

This provision was enacted as part of the original Minnesota income tax. Since the 1960s, Minnesota has followed federal law in determining which bonds qualify for the exemption and/or are taxable under the AMT.

The original objective or rationale for the Minnesota provision is unclear; the exemption may have been adopted to follow the practice under the federal income tax or to treat Minnesota bonds as favorably as U.S. Treasury bonds (which federal law prohibits states from taxing). Most economists assume and proponents of continuing the exemption argue that it now has three purposes:

- To lower the borrowing costs for state and local governments
- To provide implicit state aid to the local governments through lower interest costs for their debt
- To subsidize specific “private activity” projects (e.g., housing revenue bonds issued by MHFA and local governments and bonds issued for nonprofit organizations’ capital projects, such as nonprofit hospitals, colleges, museums, and similar).

### Related Direct Spending Programs

For state general obligation bonds, the state directly pays the interest on these bonds through appropriations. A tax exemption is another way to pay, in effect, more interest (i.e., the forgone state income taxes on the interest) on those bonds. With regard to interest on local government bonds, the

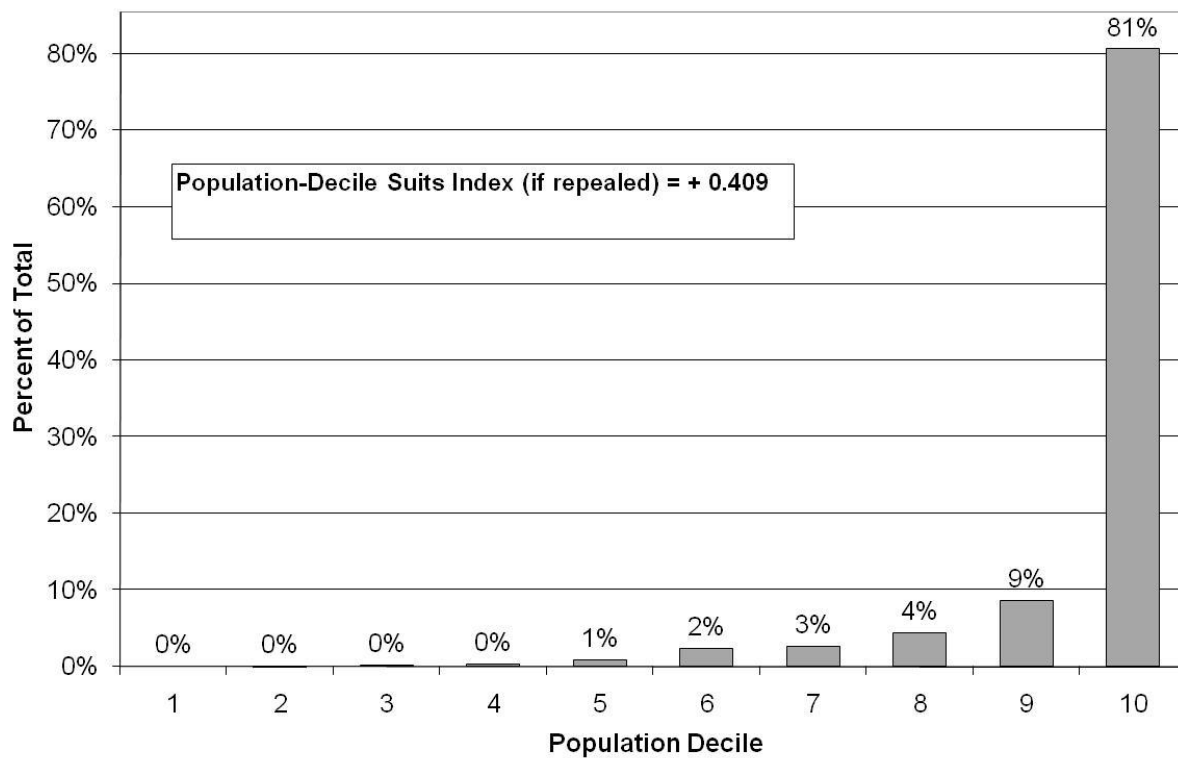
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state pays substantial general purpose aid to cities, counties, and schools. The state also pays debt service equalization aid to schools to offset part of the borrowing costs of school districts.

The state also appropriates money to MHFA and some other borrowers for purposes similar to the subsidy provided through the tax exemption for some types of revenue bond interest. In addition, some nonprofit entities (e.g., hospitals and private colleges), which are also frequent users of tax exempt bonds, receive some direct or indirect assistance from the state.

## Incidence Information

**Shares of Tax Expenditures by Decile  
Interest on Minnesota State and Local Bonds**



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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## Evidence on Effectiveness in Meeting Objective

One way to assess the effectiveness of the tax exemption would be to evaluate the extent to which the revenue reductions from the exemption exceed the reductions in borrowing costs. A variety of these types of studies have been done of the similar federal income tax exemption for state and local bond interest. All the studies find the forgone revenues exceed the interest savings by 10 percent to 40

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percent. See, e.g., Joint Committee on Taxation, Present Law and Background Relating to State and Local Government Bonds 4 – 8 (March 14, 2006) for a description of the effect of the federal exemption. A few similar studies have been done of state tax exemptions. In general, they find that the revenue reductions exceed the interest savings by larger percentages than under the federal exemption. See, e.g., Mary E. Loverly and Michael J. Wasylenko, “State Taxation of Interest Income and Municipal Borrowing Costs,” *National Tax Journal*, vol. 45, no. 1, 37ff (1992) (finding approximately half of the revenue reduction translates into lower interest paid). If these analyses are accurate, the state could realize budget savings (perhaps half of the revenue cost) by taxing bond interest and paying higher interest on its bonds. With regard to local government bonds, the state could more cheaply provide state aid payments to local governments to offset their higher borrowing costs, if interest were taxed.

The reason for this substantial mismatch between the revenue reduction from the tax exemption and the interest rate savings on governmental borrowing likely stems from three factors:

1. Some bonds must be priced to sell to out-of-state investors who derive little benefit from the Minnesota tax exemption because they don't pay Minnesota taxes. As a result, the interest rates on these bonds probably are not much, if any, lower because of the state tax exemption. But Minnesota investors also buy these bonds and when they do, they get both the higher interest rate needed to attract the out-of-state investors and the tax exemption.
2. The value of the exemption depends upon the taxpayer's marginal rate. The tax exemption is more valuable to an investor in the top bracket than to someone in the middle or bottom bracket. If the bonds need to be priced to attract investors in the lower brackets, top bracket investors get the higher interest rate and the more valuable tax exemption.
3. Because of the federal itemized deduction for state income taxes, the tax exemption is less valuable to many investors than its cost to the state. An investor in the top federal income tax bracket (35%) who itemizes deductions only effectively pays 65% of the cost of the state tax after the federal deduction is taken into account. Such an investor will be willing to accept a lower interest rate that compensates for only 65% of the costs of the exemption, but the state forgoes the full amount of the revenue. Most investors in municipal bonds are higher income individuals who typically itemize deductions.

Proponents of the exemption typically make two arguments in favor of continuing the exemption, notwithstanding its low cost effectiveness:

1. The interest exemption is an entitlement that applies to all local tax exempt borrowings. State aid appropriations are unreliable and local governments could not count on them in making decisions to issue long term bonds.
2. If states begin to repeal their exemptions for bond interest, this might undercut political support for the federal tax exemption in Congress, creating the potential for its repeal or reduction and costing states valuable federal assistance for their borrowing costs.

Another factor to consider is that the state likely would not want to repeal the exemption for outstanding bonds, since investors probably perceive that the state made a commitment to not tax their

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interest as long as the bonds are outstanding. If this practice is honored, it would take a long time to phase-in taxation of Minnesota bonds. Bond lawyers have also suggested that repealing the exemption for outstanding bonds could raise issues of violation of securities law by the state or local governments that issued the bonds and made representations as to their state tax exempt status.

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## Expenses of Living Organ Donation Subtraction

### Description of Provision

Organ donors are allowed a subtraction from federal taxable income for certain costs incurred when donating all or part of liver, pancreas, kidney, intestine, lung or bone marrow. Expenses related to the donation that can be subtracted are for travel, lodging, and lost wages net of sick pay. The maximum subtraction is the lesser of the actual expenses or \$10,000 for each organ donation.

An unknown number of Minnesota returns benefit from this provision.

### Projected Tax Expenditure: Organ donor subtraction (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
Less than \$50	Less than \$50	Less than \$50	Less than \$50

### Objective or Rationale

This subtraction was enacted in 2005. The rationale for this provision is to provide tax incentives to alleviate the shortage of transplantable organs.

### Related Direct Spending Programs

The federal Organ Donor Recovery Improvement Act (“ODRIA”) provides limited funding to reimburse donors for expenses incurred in donating organs. In general, this is restricted to donors and recipients whose incomes are at or below 200 percent of the poverty level and is not an entitlement.

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

We are aware of no studies of the effectiveness of the subtraction in encouraging organ donations. The subtraction may have been motivated more by providing a token recognition of the costs and sacrifices that donors incur, rather than to provide an incentive for changing behavior. This goal (or the goal of providing incentives to encourage donations) could be equally well or better served by a direct spending program, so that the benefits are not dependent on the donor having Minnesota tax liability and do not vary by the donor’s tax bracket. Such a program could be administered in a manner similar to the federal ODRIA law.

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## Disposition of Farm Property Subtraction

### Description of Provision

A subtraction from federal taxable income is provided for income realized on a sale or exchange of farm property if the taxpayer is insolvent at the time of the sale and the proceeds are used solely to discharge indebtedness of the property sold.

An unknown number of returns benefit from this subtraction.

### Projected Tax Expenditure: Disposition of Farm Property (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
Less than \$50	Less than \$50	Less than \$50	Less than \$50

### Objective or Rationale

This provision was enacted in 1985, repealed in 1987, and later re-enacted in 1988. The rationale for this subtraction is that it provides a modest tax offset for farmers who are likely in serious financial distress and who do not qualify for relief under the federal rules providing exemptions from discharge of indebtedness income. This provision is very similar to the exclusion allowed under federal law (which flows through to Minnesota tax through to the use of federal taxable income). However, the federal exclusion is limited to discharge or cancellation of indebtedness income, while the Minnesota exemption also extends to capital or other gain realized on the sale or exchange of farm property.

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

This provision provides relief to farm owners who are insolvent and sell or transfer their property, realizing a gain, rather than obtaining relief from cancellation or discharge of indebtedness from their lenders. The extent to which this situation occurs is unclear and it is not clear why only farms (and not other types of businesses) should qualify for this special treatment.

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## Subtraction for K-12 Education Expenses

### Description of Provision

A state income tax subtraction is allowed for K-12 education-related expenses. Qualifying expenses include:

- Tuition, including nonpublic school tuition, after-school enrichment, academic summer camps, music lessons, and tutoring
- Textbooks, including instructional materials and supplies, musical instrument rental and purchase, and up to \$200 of computer hardware and educational software
- Transportation (paid to others for transporting children to school)

The deduction is for up to \$2,500 for each dependent in grades 7-12 and up to \$1,625 for each dependent in grades K-6.

An estimated 230,000 returns benefitted from this provision in 2007.

#### Projected Tax Expenditure: K-12 education expense subtraction (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$18,400	\$18,600	\$18,800	\$19,100

The tax expenditure for K-12 education expenses has increased in nominal terms (unadjusted for inflation) by 457.6% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period. This time period includes a significant expansion of both the subtraction amount and qualifying expenses (1998).

### Objective or Rationale

An education deduction was first enacted in 1955. The constitutionality of the dependent education expense deduction was challenged in *Mueller v. Allen* in 1983. The U.S. Supreme Court upheld the deduction finding that it did the following:

- Offset parents' educational expenses and helped ensure an educated populace
- Helped ensure the financial health of nonpublic schools and relieved the financial burden on public schools
- Promoted "wholesome competition" between public and nonpublic schools and provided a high-quality education for all children

The deduction was increased in 1976, 1981, and most recently in 1998. One argument in favor of the 1976 and 1981 expansions was that tax assistance to parents sending their children to private schools would alleviate overcrowding in public schools, and help private schools remain in operation. (Anderson, Betty Malen, "Politics of Persistence: the legislative process resulting in Minnesota's tuition tax concession statutes for elementary-secondary education", University of Minnesota PhD thesis, 1983)



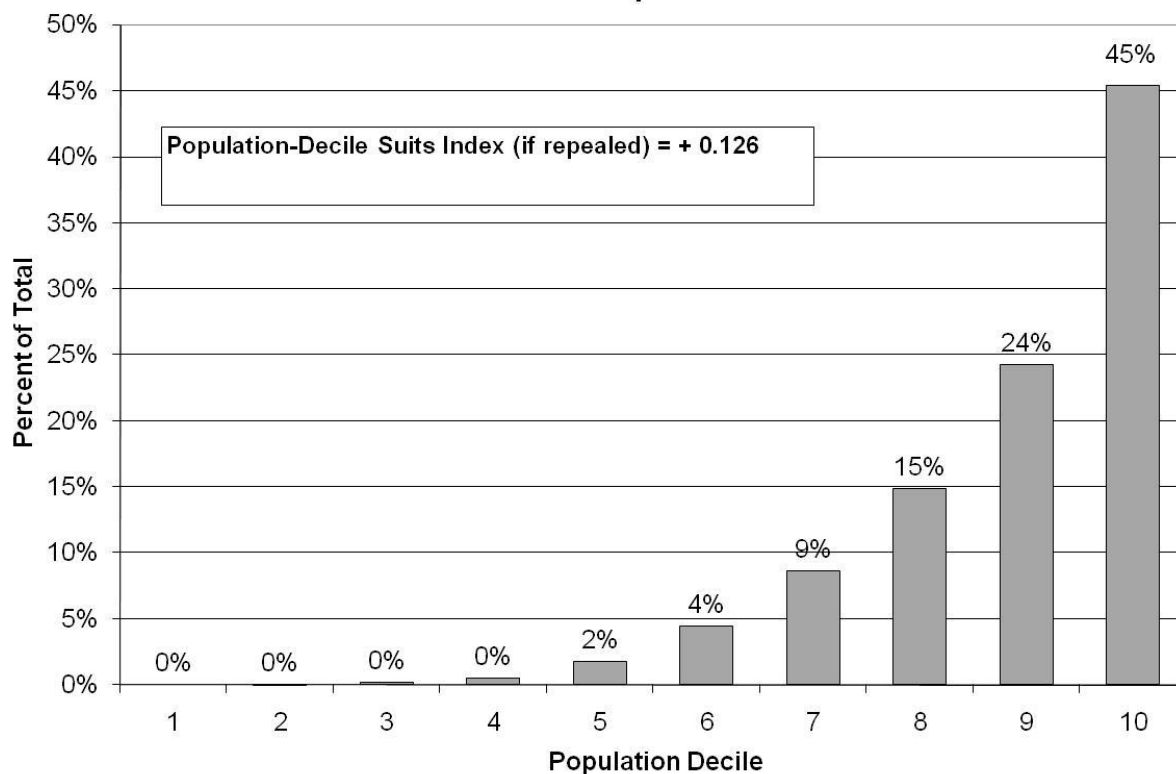
# Review of Tax Expenditures

## Related Direct Spending Programs

The state provides funding for public education. In addition, public school districts are required to provide nonpublic school pupils with textbooks, individualized instructional materials, and standardized tests, all of which must be secular in nature. A district must provide the same health services it provides to public school students to nonpublic school students. Nonpublic secondary students must be offered guidance and counseling services by public secondary schools. (Minnesota Statutes §§ 123B.40 to 123B.48) The appropriation for these items equaled \$16.6 million in FY 2009. Districts must also provide equal transportation to nonpublic school students (Minnesota Statutes §§ 123B.84 to 123B.86). The appropriation for nonpublic school student transportation aid equaled \$21.0 million in FY 2009. In addition, districts must offer nonpublic school students limited English proficiency programs on the same terms as public school students, and must provide nonpublic school students with various other forms of assistance; the appropriations for these smaller items are included in the general appropriations and not easily separated.

## Incidence Information

**Shares of Tax Expenditures by Decile  
K-12 Education Expense Subtraction**



Source: HITS Model for 2006,  
and Tax Incidence Study database.

Tax Research Division  
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# Review of Tax Expenditures

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## **Evidence on Effectiveness in Meeting Objective**

We are aware of no studies assessing the effectiveness of the subtraction in meeting its objectives. The maximum tax savings under the subtraction for a taxpayer are relatively modest at less than \$200 per child. For taxpayers who itemize their deductions, the federal offset further dilutes this benefit. It seems unlikely that these small amounts will have much effect in changing behavior to the extent that is the objective of the subtraction. With the rise of charter schools as alternatives and current enrollment levels it seems unlikely that the deduction plays a significant role in preventing crowding in public schools.

# Review of Tax Expenditures

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## AmeriCorps Education Awards Subtraction

### Description of Provision

A subtraction is allowed for amounts received as national service education awards from the National Service Trust for service in an approved AmeriCorps National Service Program.

About 600 returns benefit from this provision.

### Projected Tax Expenditure: AmeriCorps subtraction (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
N/A	\$110	\$110	\$120

### Objective or Rationale

This subtraction was initially enacted in 1997 for benefits under the Minnesota Youth Works program. It was repealed in 2005 and re-enacted in 2008. The rationale for this provision is not clear, but it may have been to provide a tax incentive to increase participation in state and later national service efforts or to provide some basic recognition for the efforts and economic sacrifices of individuals who served in these programs (e.g., similar to the preferential tax treatment for military pay).

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

Given the lack of clarity about the precise objective for the provision, it is difficult to assess whether it is effective in meeting its objective. Direct payment of a small stipend might be a more effective manner of providing recognition for this service or to provide an incentive to participate in the program. The value of a subtraction to a recipient will depend upon whether and how much other income the recipient has and what tax bracket she/he is in. The subtraction will have no value to participant in the program who moves out of Minnesota to seek employment or additional education or who is attending school and has little or no taxable income.

# Review of Tax Expenditures

## Elderly or Disabled Exclusion

### Description of Provision

Persons who are age 65 or over or totally disabled are allowed a subtraction from federal taxable income. This subtraction is equal to a base amount that varies by filing status and whether both spouses are over 65 or disabled. The base amount is reduced by (1) nontaxable social security benefits and (2) one-half of adjusted gross income over threshold amounts. These amounts are shown in the table below.

Filing status	Income		
	Base amount	Phase-out threshold	Maximum income eligible
Married joint, both over 65 or disabled	\$12,000	\$18,000	\$42,000
Married joint, one over 65 or disabled	\$12,000	\$14,500	\$38,500
Married separate	\$6,000	\$9,000	\$21,000
Single, head of household, and qualifying widow or widower	\$9,600	\$14,500	\$33,700

An estimated 8,000 returns benefit from this provision in 2007.

### Projected Tax Expenditure: Elderly exclusion (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$1,000	\$800	\$700	\$500

The tax expenditure for income of the elderly and disabled has decreased in nominal terms (unadjusted for inflation) by 86.7% from FY 1994 to FY 2008, compared with a 113.4% nominal increase in personal income over the same time period.

### Objective or Rationale

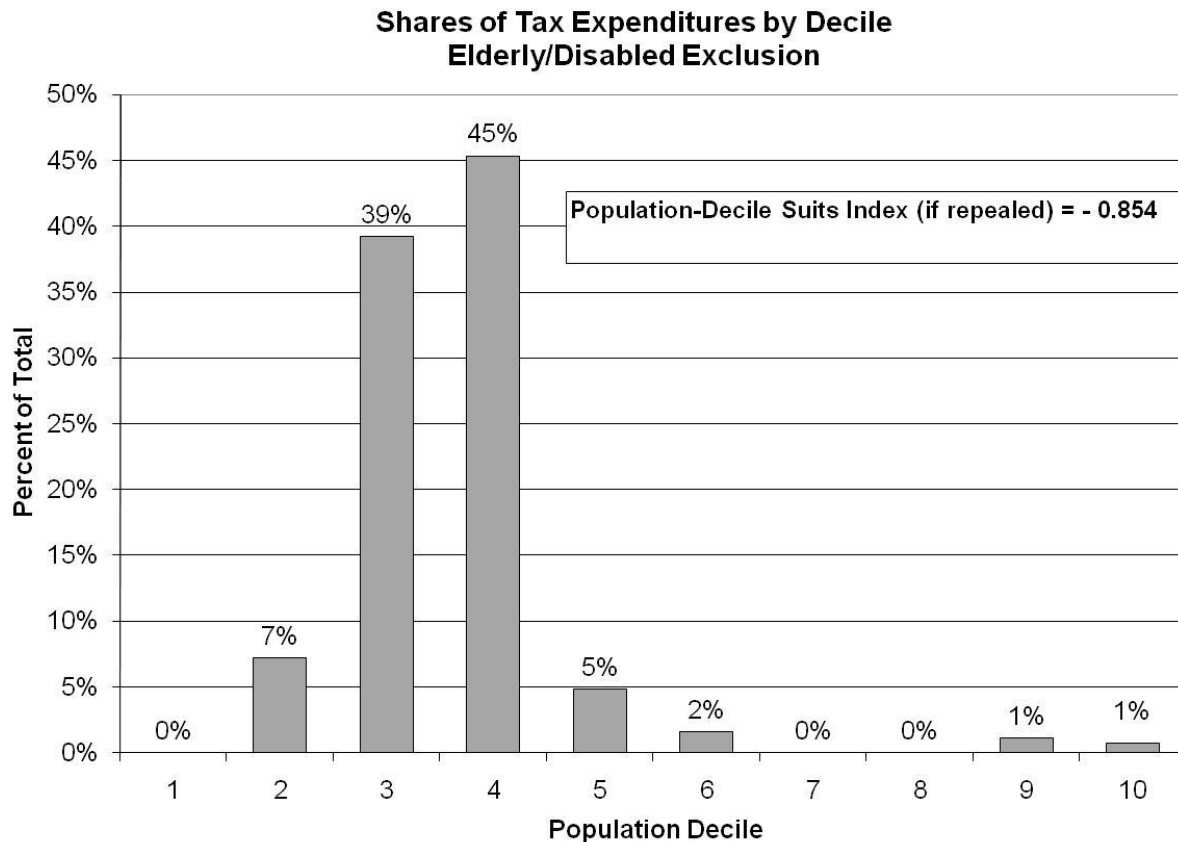
The subtraction benefits low-income taxpayers who have more of their income from taxable sources such as pensions and interest than from nontaxable sources such as social security. Public pension benefits were exempt from Minnesota income tax from the inception of the tax in 1933 through 1977. From 1978 to 1986, a subtraction for all pension income was allowed, limited to a maximum amount with qualifying offsets. In 1988, the elderly or disabled subtraction was enacted. In 1994, the base amounts and income thresholds were increased by 20 percent. One rationale for this provision may be to provide an exclusion to low-income seniors who don't receive social security benefits to roughly approximate the exemption for social security benefits.

# Review of Tax Expenditures

## Related Direct Spending Programs

None

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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## Evidence on Effectiveness in Meeting Objective

Given a rationale of equalizing the taxation of the low-income elderly and disabled who receive nontaxable income, such as social security, and those who derive most or all of their income from taxable sources, the exclusion likely has limited success. A substantially larger and more generous exclusion would be necessary to make a material difference. The combined exemptions for social security and veterans' benefits reduce state taxes by more than \$185 million (FY 2009), while the elderly exclusion reduces tax liability by less than \$1 million per year. In addition, there is some evidence that taxpayers who are not entitled to the exclusion claim it anyway, because they fail to deduct their tax exempt social security benefits as required in the computation. (The incidence graph, suggesting some

## Review of Tax Expenditures

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individuals in the highest two income decile receive the subtraction, may tend to support this inference, although other explanations for this are possible.) Further, because more and more classes of workers have come into the social security system over time, each year there are fewer and fewer retirees who do not receive social security benefits and who are eligible to claim the elderly exclusion. The number estimated to claim this subtraction has fallen from 11,000 in tax year 2003 to 8,000 in tax year 2007.

# Review of Tax Expenditures

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## Subtraction for Military Pay

### Description of Provision

Minnesota allows a subtraction from taxable income for military pay for active service performed by members of the full-time military, National Guard, and reserves, including weekend drill and summer training of members of the National Guard and reserves.

An estimated 14,000 returns per year claim the subtraction for in-state National Guard and reserve active service, including drill and summer camp, and an unknown number of returns claim the other components of the subtraction.

### Projected Tax Expenditure: Subtractions for military pay (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$4,300	\$4,425	\$7,930	\$8,400

The tax expenditure for military pay has decreased in nominal terms (unadjusted for inflation) by 2.3% from FY 2002, the year after it was enacted as a removal of the filing requirement for individuals stationed outside Minnesota for the entire year, to FY 2008, when it was allowed as a subtraction for active service, compared with a 31.0% nominal increase in personal income over the same time period.

### Objective or Rationale

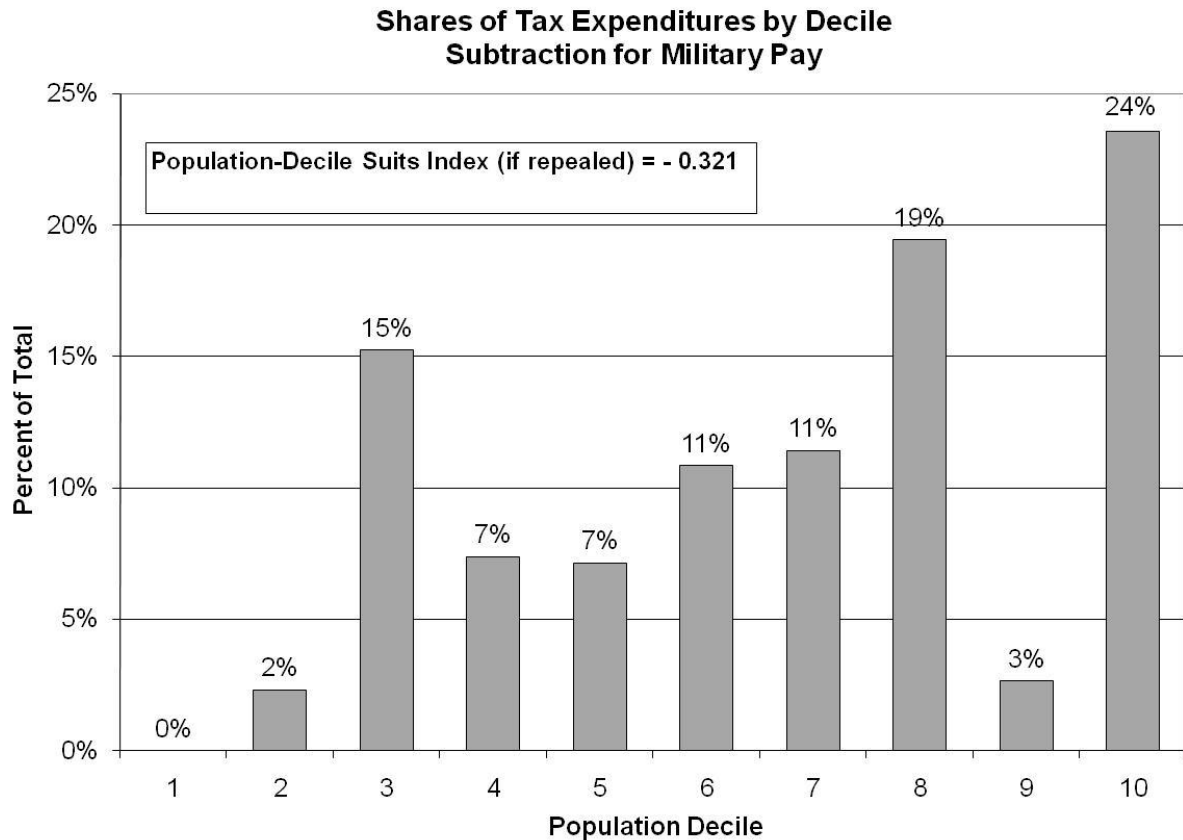
The subtraction in current law has been enacted in stages since 2001, starting with exemption of military pay for service performed outside of Minnesota. One objective was to simplify filing for individuals in the full-time military who are stationed outside of Minnesota throughout the tax year. With the onset of the wars in Iraq and Afghanistan, this objective expanded to include simplifying the lives of Minnesota guard and reserve members deployed overseas. Since nearly all full-time military, National Guard, and reserve pay is set and administered through the U.S. Department of Defense, the Minnesota Department of Military Affairs would not have the capacity to administer a pay increase for National Guard members, which would be an obvious alternative to the current law tax exemption.

### Related Direct Spending Programs

None

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

The objective of the initial exemption for service out-of-state was to encourage more full-time members of the military to maintain Minnesota residency and be more likely to consider returning to Minnesota after they left the service. We are not aware of any follow-up research on the maintenance of Minnesota residency by members of the military. It does seem likely that full exemption of military pay for Guard and reserve members deployed overseas simplifies tax preparation and lessens the burden of the required separation from their families, homes, and jobs. The portion of the subtraction for service performed in-state (largely drill and summer camp pay) acts as a wage supplement, and may help compensate for foregone wages from civilian employment in longer periods of in-state service, such as required for airport security following the September 11<sup>th</sup>, 2001 attacks.



# Review of Tax Expenditures

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## Subtraction for U.S. Bond Interest

### Description of Provision

Federal law requires states to provide a subtraction for interest on U.S. bonds.

#### Projected Tax Expenditure: U.S Bond Interest (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$38,300	\$36,500	\$32,500	\$36,500
Estimates prepared using House Income Tax Simulation Model and assumptions of February 2009 forecast			

### Objective or Rationale

The exemption may be intended to reduce federal borrowing costs or to prevent states from discriminating against federal obligation interest.

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

If the purpose of the exemption is to lower federal borrowing costs, it seems safe to conclude that it has little effect in that regard. A large portion of Treasury securities are purchased by investors that do not benefit from the state tax exemptions – e.g., corporations, foreign entities, and individuals resident in states without state income taxes. Thus, it seems unlikely that the state tax exemption has much, if any, effect on the prices of (interest rates on) Treasury securities.

# Review of Tax Expenditures

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## Subtraction for Railroad Retirement Benefits

### Description of Provision

Federal law requires states to provide a subtraction for railroad retirement benefits.

#### Projected Tax Expenditure: Railroad retirement benefits (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$7,700	\$7,900	\$8,200	\$9,200
Estimates prepared using House Income Tax Simulation Model and assumptions of February 2009 forecast			

### Objective or Rationale

Since railroad retirement is administered separately from social security, this mandated subtraction is roughly equivalent to the exemption of all or part of social security benefits. The rationale is not clear but dates back to the adoption of the railroad retirement program and may have been based on notions of intergovernmental immunity, since this program is mandated by and administered by the federal government, or to provide equivalent treatment with social security benefits. However, the exemption is considerably more generous than the exemption for social security benefits, since the analogue or component of the benefits that are similar to a private pension are exempted.

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

Not applicable

# Review of Tax Expenditures

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## Subtraction for On-reservation Earnings of Tribal Members

### Description of Provision

Federal law requires states to provide a subtraction for on-reservation earnings of enrolled tribal members.

### Projected Tax Expenditure: On-reservation earnings (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$19,000	\$19,400	\$18,900	\$19,300
Estimates prepared using House Income Tax Simulation Model and assumptions of February 2009 forecast			

### Objective or Rationale

The exemption is derived from federal constitutional law and the sovereign status of tribal governments.

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

Not applicable

# Review of Tax Expenditures

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## Job Opportunity Building Zone Income Subtraction

### Description of Provision

A subtraction from federal taxable income is allowed for net income from the operation of a qualified business in a designated Job Opportunity Building Zone. The types of income that qualify for the individual income tax exemption are:

1. Net rents derived from either real or personal property used in the zone
2. Business income derived from operating a qualified business in the zone
3. Capital gains realized on a sale or exchange of (a) real property located in the zone, (b) personal property used in the zone, or (c) an ownership interest in a qualified business operating in a zone.

This subtraction is allowed for twelve years which is the maximum duration of the zone. The duration of the zone is extended by three years for an ethanol producer if the business subsidy agreement was executed after April 30, 2006.

An unknown number of returns benefit from this provision.

### Projected Tax Expenditure: JOBZ subtraction (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$3,200	\$4,000	\$4,800	\$5,700

The tax expenditure for net income in a JOBZ zone has increased in nominal terms (unadjusted for inflation) by 220.0% from FY 2006, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2008, compared with an 11.9% nominal increase in personal income over the same time period.

### Objective or Rationale

This subtraction was enacted in 2003. The impetus for this provision is driven by economic theory that suggests that lower taxes and less regulation will increase jobs and incomes in the zone by attracting capital, labor and economic activity.

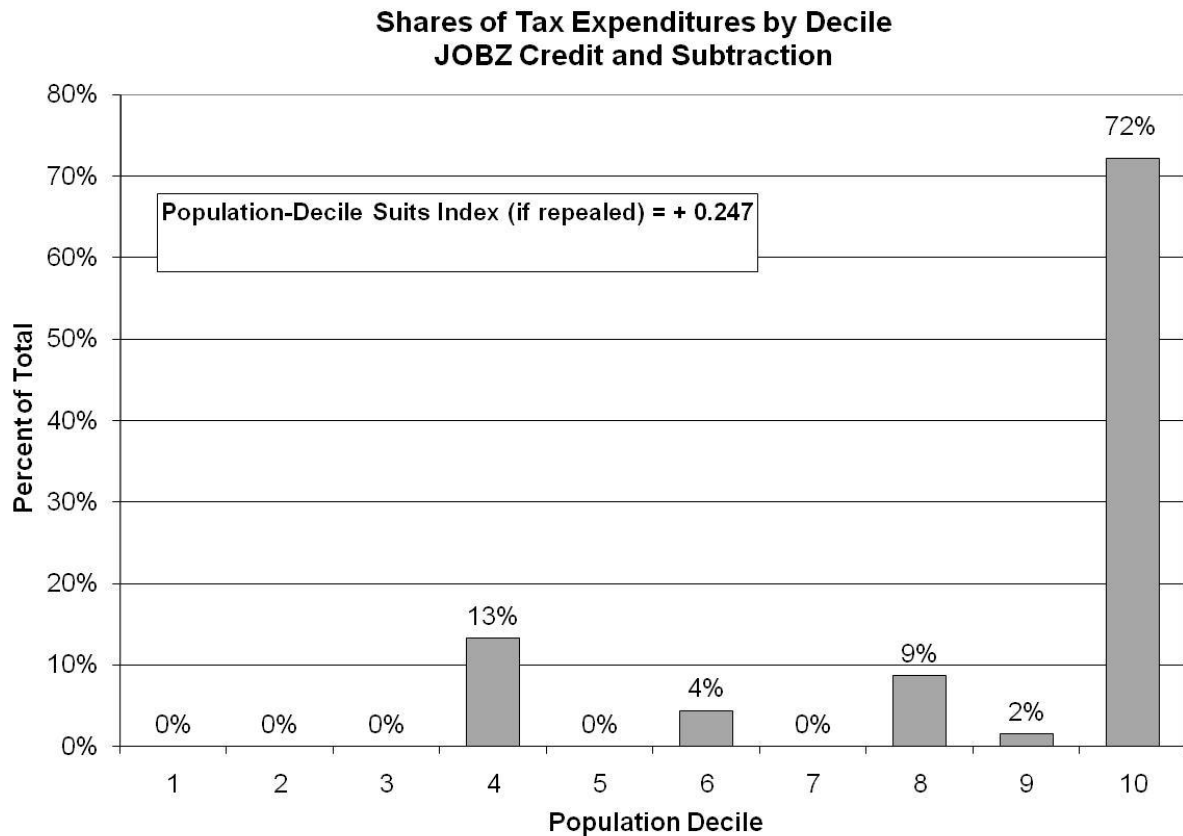
### Related Direct Spending Programs

The state offers a variety of direct spending programs directed at encouraging economic development or business investment in Minnesota, such as the Minnesota Investment Fund.

# Review of Tax Expenditures

## Incidence Information

Incidence graph combines the JOBZ subtraction and the JOBZ credit.



Source: HITS Model for 2006,  
and Tax Incidence Study database.

Tax Research Division  
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## Evidence on Effectiveness in Meeting Objective

The Office the Legislative Auditor conducted a program evaluation of the JOBZ program in 2007. This evaluation found that the JOBZ program “has helped to attract some out-of-state businesses to Greater Minnesota and kept some Minnesota business from leaving the state. However, the program has not been focused on those goals and has been used to provide tax breaks to some businesses that would have expanded in Greater Minnesota without JOBZ.”<sup>2</sup>

<sup>2</sup> Office of the Legislative Auditor, *Evaluation Report JOBZ Program* (February 2008), p. ix [page references omitted], available on the Internet here: <http://www.auditor.leg.state.mn.us/ped/pedrep/jobz.pdf>.

# Review of Tax Expenditures

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## Job Opportunity Building Zone Jobs Credit

### Description of Provision

A refundable credit is allowed against the individual income tax for a qualified business located in a Job Opportunity Building Zone. The credit is 7 percent of the increase in payroll since designation of the zone for jobs paying more than \$30,000, but the credit is not allowed on the amount paid to an employee in excess of \$100,000. These dollar amounts are annually adjusted for inflation. For tax year 2008, the adjusted amounts were \$33,630 and \$112,110.

An unknown number of returns benefit from this provision.

### Projected Tax Expenditure: JOBZ credit (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$800	\$900	\$1,000	\$1,000

The tax expenditure for the JOBZ credit has increased in nominal terms (unadjusted for inflation) by 300.0% from FY 2006, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2008, compared with an 11.9% nominal increase in personal income over the same time period.

### Objective or Rationale

This credit was enacted in 2003. It was likely intended to encourage qualified businesses under JOBZ to hire employees at wages well above the poverty level and/or to make it more attractive for businesses that employ individuals being paid more than \$30,000 to participate in JOBZ.

### Incidence Information

See section on JOBZ subtraction

### Evidence on Effectiveness in Meeting Objective

Studies of national and state programs lead some to suggest that job tax credits may result in modest increases in employment.<sup>3</sup> See also the discussion under the Job Opportunity Building Zone Income Subtraction.

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<sup>3</sup> Dagny Faulk, "Do State Economic Development Incentives Create Jobs? An analysis of state employment tax credits," *National Tax Journal* vol. 55, no.2 (2002): 263-80.

# Review of Tax Expenditures

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## Marriage Credit

### Description of Provision

A nonrefundable credit is allowed against the individual income tax for a married couple filing a joint return if both spouses have earned income or taxable pension or taxable social security income and their situation results in a marriage penalty due to the size of the income tax brackets.

Approximately 383,000 returns claimed the credit for tax year 2006.

### Projected Tax Expenditure: Marriage credit (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$58,600	\$61,500	\$64,600	\$68,700

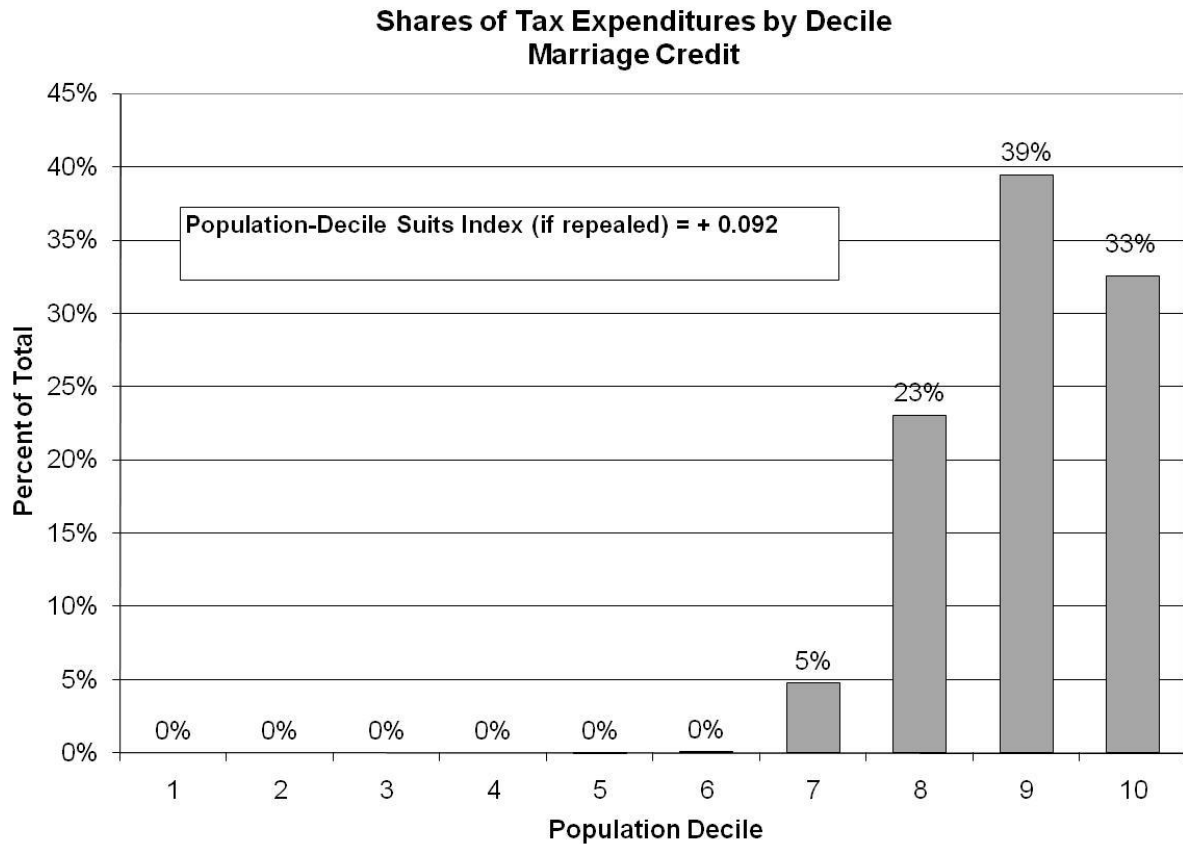
The tax expenditure for the marriage credit has increased in nominal terms (unadjusted for inflation) by 26.8% from FY 2000, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2008, compared with an 45.1% nominal increase in personal income over the same time period.

### Objective or Rationale

The credit was enacted in 1999 and to help offset the marriage penalty in the state income tax system. A marriage penalty occurs when a married couple pays a higher tax than they would if each spouse could file as a single and pay the tax on his/her income.

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

The credit is effective in eliminating the marriage penalty that results from differences in the married joint and single bracket widths (i.e., the married brackets are not twice as wide as the single brackets) and in the standard deduction (i.e., the married joint standard deduction is not twice as large as the single standard deduction) without creating additional marriage bonuses. It does not address marriage penalties resulting from other features of the Minnesota tax (e.g., in the dependent care or working family credits) and does not address marriage penalties that are embedded in federal taxable income that carryover to Minnesota. It only applies to marriage penalties in the bracket widths when both spouses have earned income, defined as wages, self-employment income, pension income, and social security benefits. Thus, it does not address marriage penalties attributable to unearned income.



# Review of Tax Expenditures

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## Credit for Long Term Care Insurance Premiums

### Description of Provision

Credit equals 25 percent of long term care (LTC) insurance premiums paid to the extent the premiums were not deducted as an itemized deduction. The maximum credit is \$200 for married joint filers (\$100 per beneficiary) and \$100 for all other filers. The insurance must meet the requirements of federal tax law, including providing a lifetime benefit of at least \$100,000.

In 2006, the credit was claimed by approximately 56,000 returns.

### Projected Tax Expenditure: Long-term care credit (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$7,300	\$7,400	\$7,500	\$7,700

The tax expenditure for the long-term care credit has increased in nominal terms (unadjusted for inflation) by 386.7% from FY 2000, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2008, compared with an 45.1% nominal increase in personal income over the same time period.

### Objective or Rationale

This provision was enacted in 1997. At that time, its proponents contended that encouraging taxpayers to purchase LTC insurance would yield state savings under Medical Assistance (MA), Minnesota's Medicaid program, which pays for a large portion of LTC costs of Minnesotans. Proponents of later legislative proposals to expand the credit (by increasing the maximums) have made similar claims.

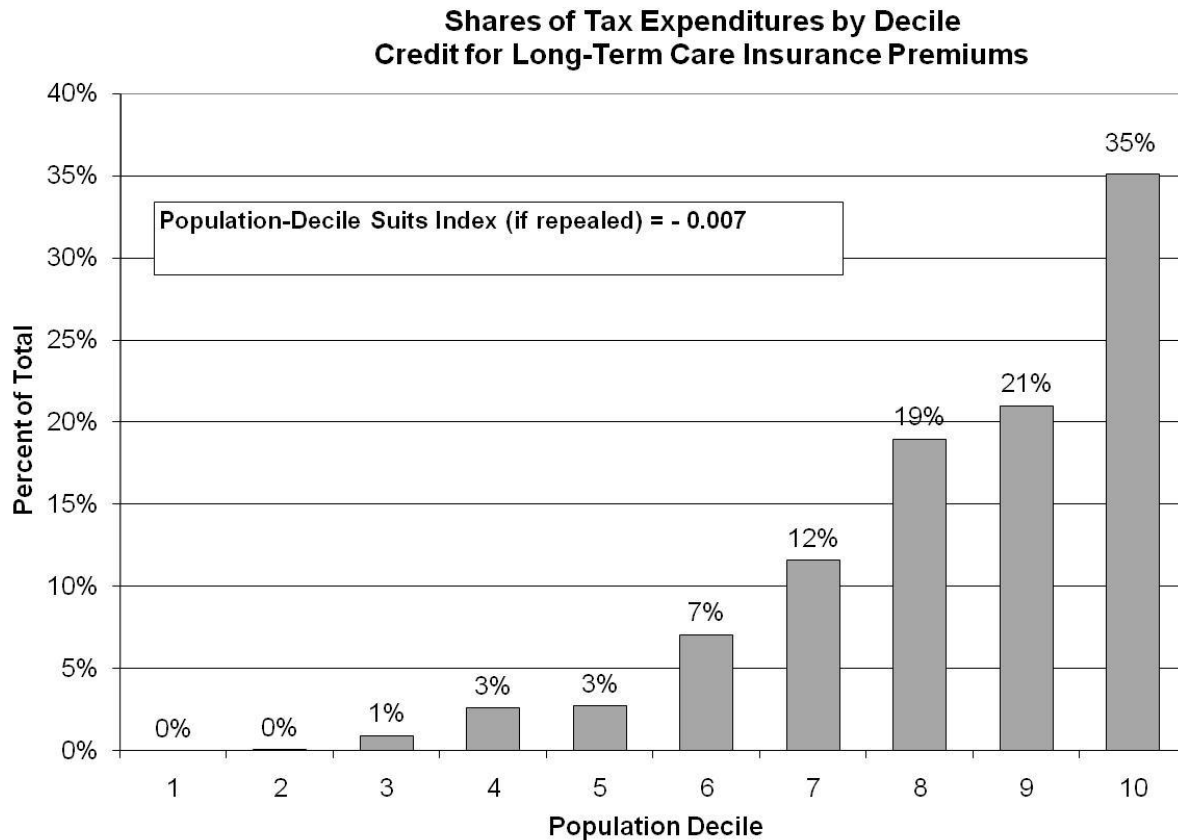
Alternative justifications would be to encourage individuals to provide for their own care without the need to impoverish themselves to qualify for MA or to help correct the imperfections in the market for LTC insurance that result from its relatively low market penetration and the potential for adverse selection.

### Related Direct Spending Programs

The state encourages purchase of LTC insurance by offering a "partnership program." This program was enacted in 2006 and allows individuals whose qualifying LTC insurance pays for LTC to exempt an equal amount from the MA spend down requirements.

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

Since the LTC credit was enacted in 1997, a number of academic studies have been done of LTC insurance and the use of tax incentives to encourage its purchase. All of these empirical studies (except one) have found that various tax incentives (the federal itemized deduction and state credits) are effective in encouraging purchase of LTC insurance. However, the effects are relatively small. The studies find varying sensitivities or elasticities to price changes, such as allowing a tax credit or deduction. But in all cases, the cost of the deductions or credits (in reduced federal or state tax revenues) exceed the savings realized in state and federal spending on Medicaid programs:

1. Charles Courtemanche and Daifeng He, "Tax Incentives and the Decision to Purchase Long-Term Care Insurance," *Journal of Public Economics* (forthcoming): Federal itemized deduction for LTC insurance increased take-up rate of LTC insurance for eligible individuals by 3.3 percentage

## Review of Tax Expenditures

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points. But the net of effect was to reduce revenue by \$187 (per senior) and to reduce Medicaid spending by \$91 (per senior). Thus, for every dollar of tax expenditure, 49 cents of Medicaid savings were realized.

2. Gopi Shah Goda, "Public and Private Financing of Long-Term Care: Do Tax Subsidies for Insurance Save Governments Money?" (paper presented at the 2008 annual meeting of the National Tax Association) (November 2008): Her simulations suggest that \$1 in tax expenditures could produce \$.84 in Medicaid savings (\$.50 in federal savings and \$.34 in state savings).
3. Anne Theisen Cramer and Gail Jensen, "Why Don't People Buy Long-Term Care Insurance?" *Journal of Gerontology*, vol. 61B, no. 4 S185-S193 (2006): They found price was a "small but significant factor in the decision to purchase LTC insurance." (A credit reduces the price of insurance.) But "the inelastic nature of both price and potential price increases suggests that in the current environment, initiatives that rely on lowering price are likely to meet with limited success." A 25 percent discount in price (e.g., a credit like Minnesota's, but without a maximum dollar limit) would increase purchases of insurance by 0.5% percentage points.
4. David Nixon, "State Programs to Encourage Long Term Care Insurance," University of Hawaii Policy Paper #001 (November 2006): He found no statistically significant relationship between the availability of state tax incentives and purchases of LTC insurance.

These empirical results are consistent with intuition and with related finding regarding LTC insurance and tax incentives:

- From a state perspective, most of the savings accrue to the federal government. The federal government pays half of the cost of Medicaid programs and thus realizes half of the savings in direct spending. In addition, a tax credit reduces the amount of the itemized deduction for state income taxes, increasing federal income tax revenues. As a result, Goda found that less than 40 percent of the savings accrue to state government.
- LTC insurance has high underwriting and sales costs. Taking into account the number of policies that lapse (because the purchasers ultimately drop them or cannot pay the premiums), the average "load" may be over 50 percent of the premium. Jeffrey R. Brown and Amy Finkelstein, "Why is the Market for Long-Term Care Insurance So Small?" *Journal of Public Economics*, vol. 91, no. 10, pp. 1967 – 91 (2007) (finding a 51 percent load). These high costs mean that less than half of the credit actually goes to buy care that reduces MA spending.
- The tax credit targets more of its benefits to individuals who are less likely to use MA services. The incentives are most effective in encouraging middle and higher income and net worth individuals to purchase LTC insurance. Studies suggest that the individuals with incomes and assets in the middle range – not the poorest or richest – are the best market for LTC. (Cramer and Jensen) The highest income and net worth individuals can self-insure and the lower income and net worth individuals have few assets to protect with LTC insurance. But individuals in this target market are less likely to consume enough LTC to go on MA, reducing the savings potential.
- Some who claim the credit would have purchased insurance without an incentive.

## Review of Tax Expenditures

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- Others will purchase the insurance, but move out of the state (e.g., to retire or change jobs) before needing LTC. In this case, the credit helps another state realize savings.
- Minnesota's long term care partnership program will further dilute the savings from the credit's effect to induce more LTC insurance purchases.

Perhaps, more fundamentally, the structure of Medicaid has the effect of "crowding out" private insurance to such an extent that it would be very difficult to induce extensive LTC insurance purchases through tax incentives. Jeffrey R. Brown and Amy Finkelstein, "The Interaction of Public and Private Insurance: Medicaid and the Long Term Care Insurance Market," *American Economic Review*, vol. 98, no. 3 1083-1102 (June 2008): "Our findings also suggest that reforms that substantially reduce or eliminate Medicaid's implicit tax [i.e., the spend-down requirements] are necessary conditions for stimulating the private market [for LTC insurance]. We do not, however, make the stronger claim that reductions in Medicaid's implicit tax would be sufficient to substantially increase private coverage."

# Review of Tax Expenditures

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## Working Family Credit

### Description of Provision

A refundable credit is allowed against the individual income tax allowed to taxpayers who are eligible for the federal earned income tax credit. To qualify, the taxpayer must have income from wages or self employment, and total earned income cannot exceed a maximum amount. The credit equals a percentage of earned income, rather than a percentage of the federal credit.

The working family credit was claimed on about 265,000 returns for tax year 2006.

**Projected Tax Expenditure: Working Family credit (\$ thousands)**

FY 2008	FY 2009	FY 2010	FY 2011
\$174,900	\$184,500	\$194,800	\$189,000

The tax expenditure for the working family credit has increased in nominal terms (unadjusted for inflation) by 781.1% from FY 1994 to FY 2008, compared with an 113.4% nominal increase in personal income over the same time period. This time period includes several significant expansions of the credit (1997, 1999, 2000).

### Objective or Rationale

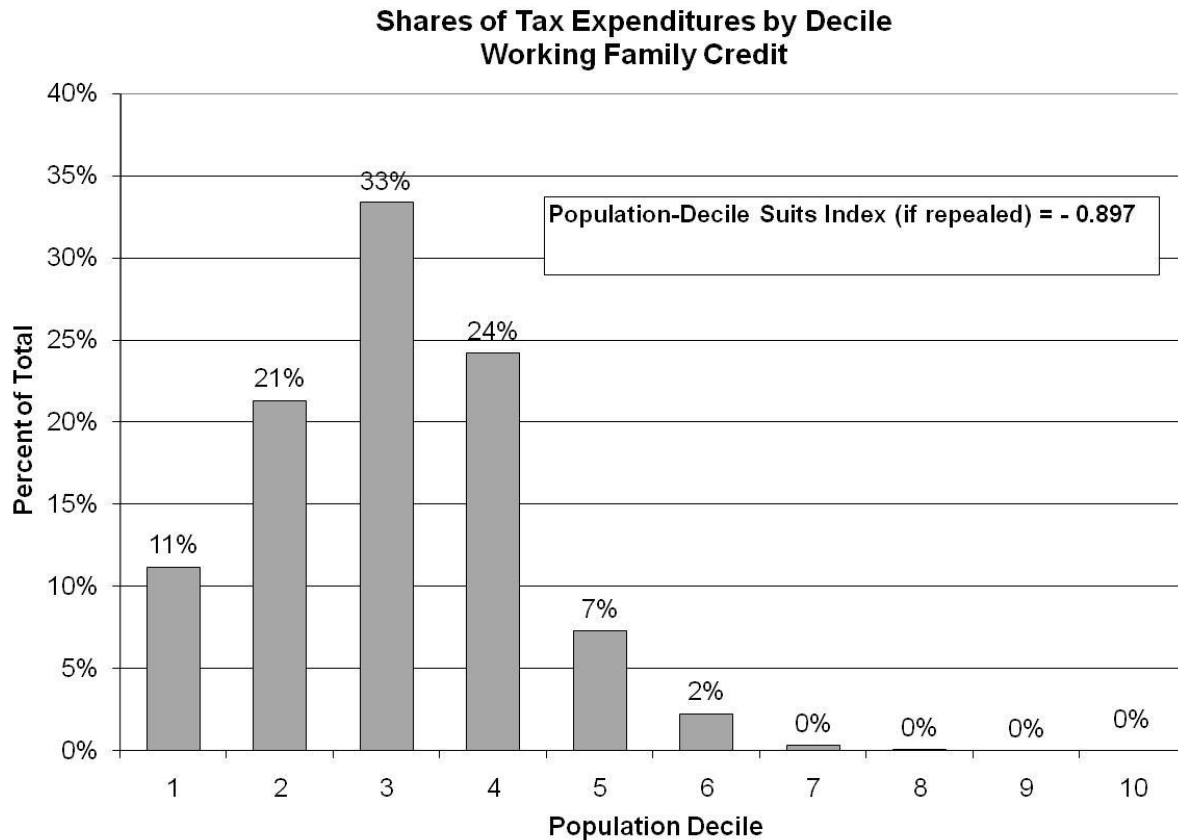
This credit was first enacted in 1991 and is intended both to encourage work and to help families raise their income above the poverty guideline levels.

### Related Direct Spending Programs

A variety of state and federal programs provide assistance to low income families, including food assistance through food stamps, housing assistance under various programs, and income assistance under the MFIP program.

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

To the extent the main objective of the credit is to encourage increased work, a substantial number of studies of the very similar federal earned income credit have found that generally the credit results in increased amounts of work overall. This research is summarized in a House Research publication.<sup>4</sup> The credit also results in single parents working full-time at minimum wage having combined income from wages and tax credits above the poverty guidelines, and moves other filer types at the minimum wage closer to the poverty guidelines. Note that married couples with two full-time workers are at or above the poverty guidelines without the assistance of tax credits.

<sup>4</sup> House Research, *The Federal Earned Income Tax Credit and the Minnesota Working Family Credit* (December 2007), pp. 20 – 23, available at: <http://www.house.leg.state.mn.us/hrd/pubs/feicwfc.pdf>.

# Review of Tax Expenditures

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## Child and Dependent Care Credit

### Description of Provision

A refundable income tax credit is allowed for a portion of dependent care expenses if those expenses were necessary to hold or look for a job. A dependent must be a child under age 14 or a dependent of any age or a spouse who is disabled. The Minnesota credit is linked to the federal credit, but has a lower maximum, different income limits, and is subject to a complete phase-out. The maximum Minnesota credit is \$720 for one dependent and \$1,400 for two or more. For tax year 2009, the Minnesota credit begins to phase out when income reaches \$23,330, and is not available to families with incomes over \$36,980. A Minnesota family can receive the maximum credit, even if the family has little or no income tax liability.

This credit was claimed on approximately 35,500 returns filed for tax year 2006.

### Projected Tax Expenditure: Child and Dependent care credit (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$14,930	\$15,375	\$15,840	\$14,325

The tax expenditure for the child and dependent care credit has increased in nominal terms (unadjusted for inflation) by 23.9% from FY 1994 to FY 2008, compared with an 113.4% nominal increase in personal income over the same time period.

### Objective or Rationale

The Minnesota dependent care credit is targeted to low-and moderate income families, making it easier for them to work. The authorizing statute does not assign an explicit purpose or goal to the Minnesota dependent care credit. However, the credit may be assumed to have a least two policy goals:

- To recognize dependent care costs as a necessary expense of working
- To encourage low-and moderate income individuals to work

### Related Direct Spending Programs

The state and counties fund a basic sliding fee child care (BSFCC) program. This program pays direct child care assistance to lower income parents or their child care providers. BSFCC is not an entitlement program; enrollment is limited by available funding. For fiscal year 2009, the appropriation for BSFCC was about \$118 million (\$69 million federal, \$45 million state and the rest county). In addition, federal and state funding provides for MFIP child care assistance; the projected amounts for FY 2009 are \$47.1 million federal, and \$64.5 million state. Individuals who meet MFIP work requirements are eligible for MFIP child care assistance as an entitlement. They may forego receiving MFIP cash grants in order to avoid having months of assistance count against their 60 month lifetime benefit limit. The income limits for both BSFCC and MFIP child care are somewhat similar to that under the credit. In TY 2009, the

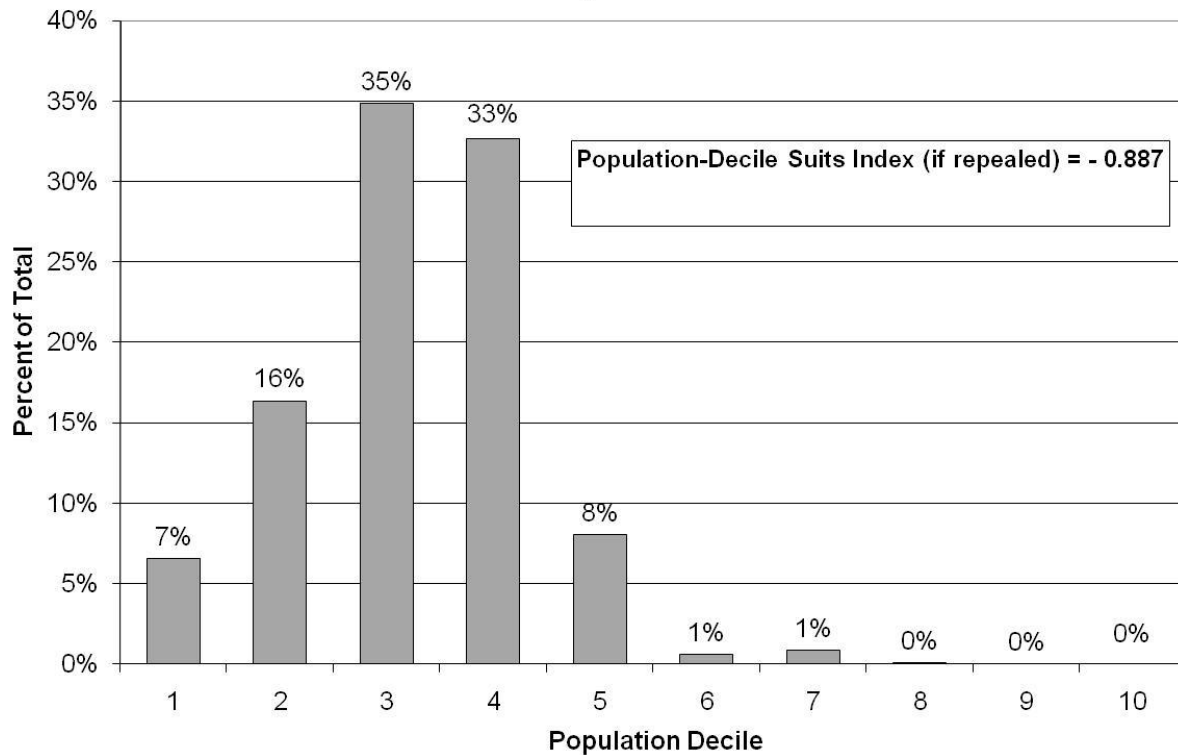
# Review of Tax Expenditures

credit is available for incomes up to \$36,980. The table shows the maximum incomes for BSFCC and MFIP child care by family size for 2009.

Family size	Maximum income	
	MFIP child care	BSFCC (when entering program)
1	\$15,612	\$26,040
2	\$20,448	\$32,167
3	\$24,672	\$38,294

## Incidence Information

**Shares of Tax Expenditures by Decile  
Child and Dependent Care Credit**



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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# Review of Tax Expenditures

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## Evidence on Effectiveness in Meeting Objective

We are aware of no studies of the effectiveness of the federal or Minnesota dependent care credits in encouraging work, if that is the rationale for the credit. The average amount of expenses claimed on the credit is about \$2,000. Because these low income taxpayer must wait until the following year to receive their credit as a refund (about 2/3<sup>rd</sup> of the credits are paid as refunds, rather than reductions in tax liability), this likely creates cash flow challenges and may dilute the incentive effect of the credit – particularly as compared to a direct spending program, such a BSFCC or MFIP child care, which can provide more timely reimbursement of the dependent care costs.

If the goal of the credit is provide recognition that child care expenses are a cost of earning income, it seems a bit incongruous to restrict the credit only to low income parents. But perhaps this was done to minimize cost or to add progressivity to the tax system. The federal dependent care credit, it has been reported, was adopted and modified to increase the progressivity of the federal tax. Amy E. Dunbar, “Child Care Expenses: the child care credit,” *The Encyclopedia of Taxation & Tax Policy* 66 – 69 (2<sup>nd</sup> ed. 2005). If that is the goal of the Minnesota credit, it does add a progressive element to the tax.

# Review of Tax Expenditures

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## Credit for K-12 Education Expenses

### Description of Provision

A refundable state income tax credit is allowed for 75 percent of K-12 education-related expenses. The credit is for up to \$1,000 for each child in grades K-12, with parents allowed to allocate expenses among children as they choose. The credit is subject to an income-based phase-out. It begins to phase out when income exceeds \$33,500. For families claiming the credit for one or two children, it is fully phased out when income reaches \$37,500. The phase-out extends for an additional \$2,000 of income for each additional child claimed (i.e., to \$39,500 for three children, \$41,500 for four children, etc.).

The same expenses qualify for the credit as for the deduction, except nonpublic school tuition does not qualify for the credit.

An estimated 55,000 returns claimed the credit in 2006.

**Projected Tax Expenditure: K-12 education credit (\$ thousands)**

FY 2008	FY 2009	FY 2010	FY 2011
\$14,000	\$13,600	\$13,100	\$12,700

The tax expenditure for the K-12 education credit has decreased in nominal terms (unadjusted for inflation) by 30.0% from FY 2000, when it first appeared in the *Tax Expenditure Budget* following enactment, to FY 2008, compared with an 45.1% nominal increase in personal income over the same time period. This time period includes a reduction in the credit rate from 100% to 75% (2002).

### Objective or Rationale

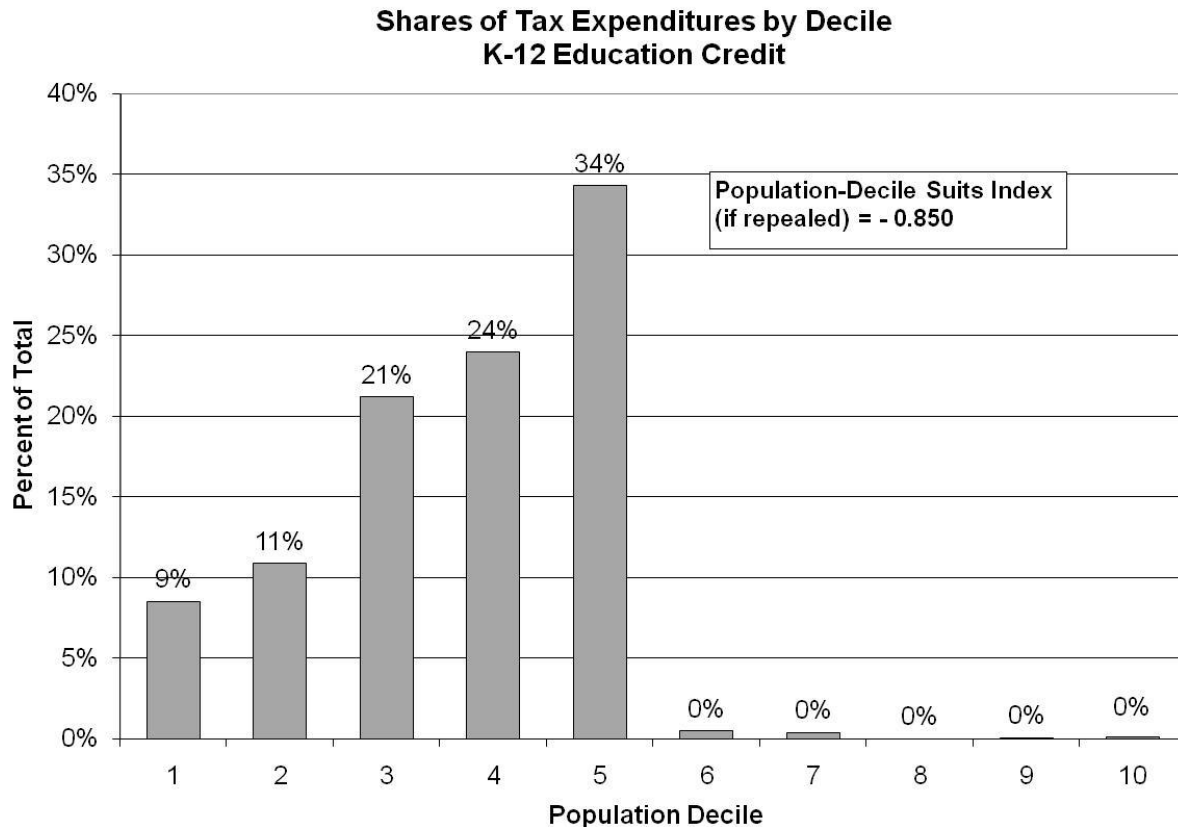
The credit was intended to help lower income families provide educational opportunities for their children. As originally proposed, the credit would have been limited to tuition; this was changed to other educational expenses in response to constitutional concerns. After the proposal shifted from tuition to other expenses, it was suggested that the credit could play a role in bridging the digital divide by providing \$200 for educational hardware and software.

### Related Direct Spending Programs

Some school districts fully fund all-day kindergarten, while others offer half-day kindergarten and allow parents to pay extra to expand to all-day kindergarten through community education. Anecdotal evidence is that some families use the K-12 credit to pay for all-day kindergarten through community education.

# Review of Tax Expenditures

## Incidence Information



Source: HITS Model for 2006,  
and Tax Incidence Study database.

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### Evidence on Effectiveness in Meeting Objective

The credit has fallen short of initial expectations for usage. Initial estimates were that close to 200,000 families would claim the credit; actual usage has fluctuated between 50,000 and 60,000, who have claimed a relatively low average amount of between \$200 and \$300 claimed per family. In the years following the credit's enactment, there was concern that income-eligible families were unable to pay for the qualifying education expenses during the tax year in anticipation of receiving a credit when they later filed their return. This led to enactment of the refund assignability provisions, and reports of some local banks and nonprofits setting up revolving funds to make temporary loans to parents.

# Review of Tax Expenditures

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## Credit for Military Service in a Combat Zone

### Description of Provision

Minnesota provides a refundable credit equal to \$120 for each month of service in a designated combat zone or qualified hazardous duty area. Eligible areas include: Arabian Peninsula Areas, the Kosovo area, Afghanistan, and supporting areas. The credit was enacted in 2006, and the credit amount was increased from \$59 per month beginning in January 2009. The credit is retroactive to service since September 11<sup>th</sup>, 2001.

An estimated 2,660 individuals claim the credit annually.

### Projected Tax Expenditure: Credit for combat zone service (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$1,100	\$1,100	\$2,200	\$2,200

### Objective or Rationale

The credit can be viewed as being in-lieu of a cash bonus payment. Minnesota paid bonuses to veterans of past wars, generally by application following the end of the war. The bonuses required an application, and were not awarded until well after service was completed. The credit can be seen as providing more immediate recognition of service in combat zones than was possible with a bonus.

### Related Direct Spending Programs

None

### Incidence Information

Not available

### Evidence on Effectiveness in Meeting Objective

The number of individuals claiming the credit has not met expectations based on information on the number serving in combat zones. It's not clear if an after-the-fact bonus would result in a higher participation rate than does the credit.

# Review of Tax Expenditures

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## Credit for Bovine Tuberculosis Testing

### Description of Provision

A refundable income tax credit is allowed to an owner of cattle in Minnesota equal to one-half of the expenses incurred to conduct tuberculosis testing on those cattle. The credit is reduced to one-quarter of the expenses for corporate owners of cattle, including shareholders of an S corporation. This testing credit will only be available during years when cattle tuberculosis testing is mandated by government agencies.

The credit benefits an unknown number of returns per year.

### Projected Tax Expenditure: Bovine tuberculosis testing credit (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$100	\$100	\$100	\$100

### Objective or Rationale

This refundable credit is intended to offset the costs of the testing.

### Related Direct Spending Programs

Federal and state assistance for testing is available within the designated bovine tuberculosis zone, but testing is required statewide.

### Incidence Information

Not available

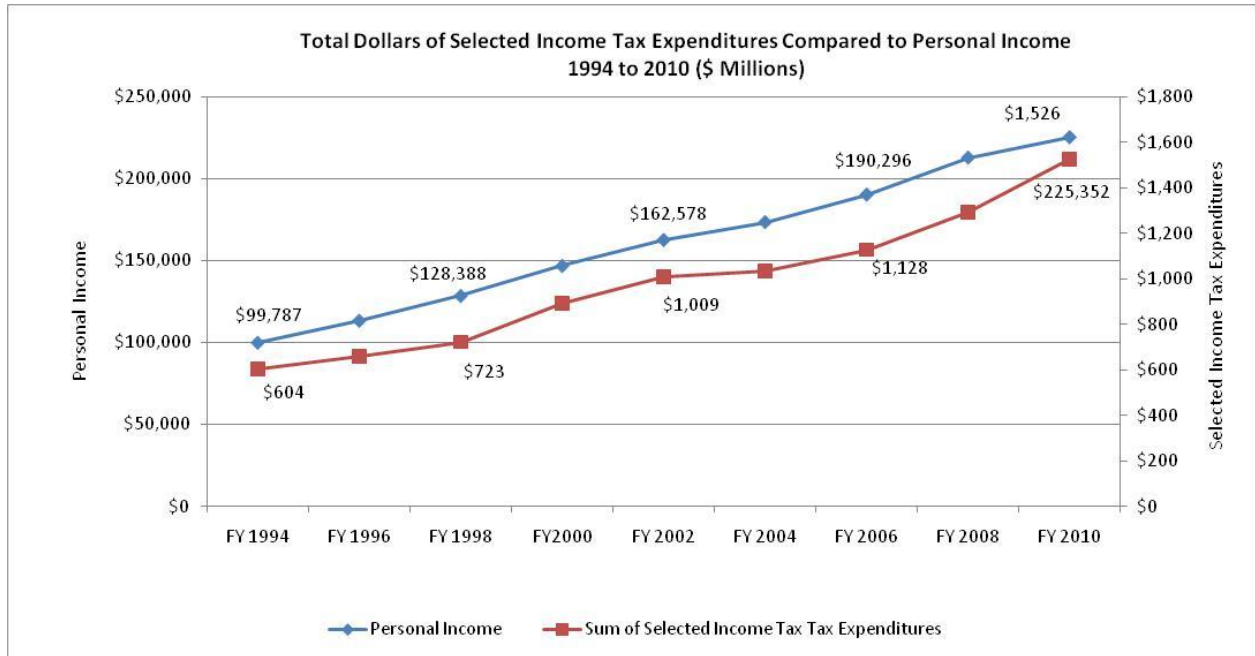
### Evidence on Effectiveness in Meeting Objective

No evidence is available. The credit could be evaluated against a standard of whether it is easier and more cost effective (for both farmers and the state) to reimburse farmers for these expenses through a tax credit or by having the Agriculture Department make direct payments.

# Review of Tax Expenditures

## Growth in the Selected Income Tax Expenditures

The graph shows the growth of the selected income tax expenditures relative to the growth of Minnesota personal income. As can be seen, the tax expenditures have grown at similar rates over the last 15 years or so.



Source: Tax Expenditure Budget data; Minnesota Price of Government.

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 MN Department of Revenue  
 House Fiscal and House Research Departments  
 March 16, 2009

# Review of Tax Expenditures

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## Sales Tax Expenditures

### Overview

When the sales tax was enacted in 1967, it was primarily envisioned as a tax on tangible goods. Services generally were not subject to tax. The only non-tangible items taxed under the original law were:

- Admissions and charges to places of amusement and sporting events
- Lodging
- Electricity
- Local telephone service.

Exemptions in the original law were mainly limited to (1) business inputs, (2) general exemptions for governments and charitable organizations, or (3) items that may have been deemed a “necessity” such as food, prescription drugs, and clothing. Many of the existing sales tax exemptions are a product of the sales tax history - they are services that have never been taxed or “necessities” that have never been reexamined. A number of sales tax exemptions may have no policy rationale at all and are a product of simple inertia.

The exclusion of necessities from the sales tax is a particularly difficult policy goal to assess because to some extent “necessity” is inherently subjective (a judgment call) rather than something that can be empirically measured. What is a necessity? For example, the Minnesota sales tax exempts the sales of natural gas as residential home heating fuel as a necessity, but does not exempt the electricity used to make the electronic thermostat or ignition switch on the gas furnace work. To the extent that the share of income used to purchase “necessities” decreases as income increases or to the extent one assumes that the exemption for “necessities” was intended to make the tax less regressive, the “necessity” can be partially evaluated by looking at the tax incidence and the impact of the exemption on tax regressivity.

Moreover, it is worth noting that it would be more cost-effective (and improve tax administration and compliance in many cases) to tax all or nearly all consumption expenditures and, then, provide a rebate or refund to low-income households, if the principal goal is to reduce the regressivity of the tax. This would result in collecting tax from middle and upper income households when they purchase “necessities” and provide relief only to low-income households. This approach does have the disadvantage of requiring application and administration of a rebate or refund program. It also creates cash flow challenges for low-income families who must pay the tax at the time of purchase and apply for the rebate or refund later.

The policy rationale for sales tax exemptions falls into three basic categories:

- Making the sales tax less regressive – this is one argument made for exempting “necessities.” How well a specific exemption achieves this policy objective is determined by the incidence of taxing that item.

## Review of Tax Expenditures

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- Tax equity and avoiding economic distortions – possible distortions include tax pyramiding and providing incentives for certain types of business organizations or consumption patterns. See the description of this in the introduction to the presentation. Avoiding tax pyramiding is the main rationale for current business exemptions and is an argument for repealing only the consumer portion of some service exemptions such as legal services and car repair.
- Ease of compliance and administration – some items are very difficult to define or, because of their delivery mechanism, are hard to appropriately tax. This is an argument for exempting some items purchased mainly by businesses since it may be difficult to separate and track business and consumer purchases. As part of national sales tax simplification effort, Minnesota has joined the Streamlined Sales and Use Tax Agreement (SSUTA). This agreement does not require certain items to be taxed or exempt but it does require the state to adopt standard definitions use in defining the tax base and exemptions. This effort to simply tax compliance has influenced some of our current exemptions such as food, clothing, and medicine.



# Review of Tax Expenditures

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## Exemption for Clothing and Wearing Apparel

### Description of Provision

Clothing is excluded from the Minnesota sales and use tax base. This exemption applies to inner and outer wear, footwear, headgear, gloves and mittens, neckwear, belts, hosiery, and other items customarily worn for general use. It does not apply to furs or to jewelry, handbags, billfolds, sports clothing sold exclusively for use in a sporting activity, or work related safety items.

### Projected Tax Expenditure: Clothing and Wearing Apparel (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$361,900	\$378,700	\$396,100	\$413,200

Expenditures on clothing and wearing apparel have increased in nominal terms (unadjusted for inflation) by 88.0% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

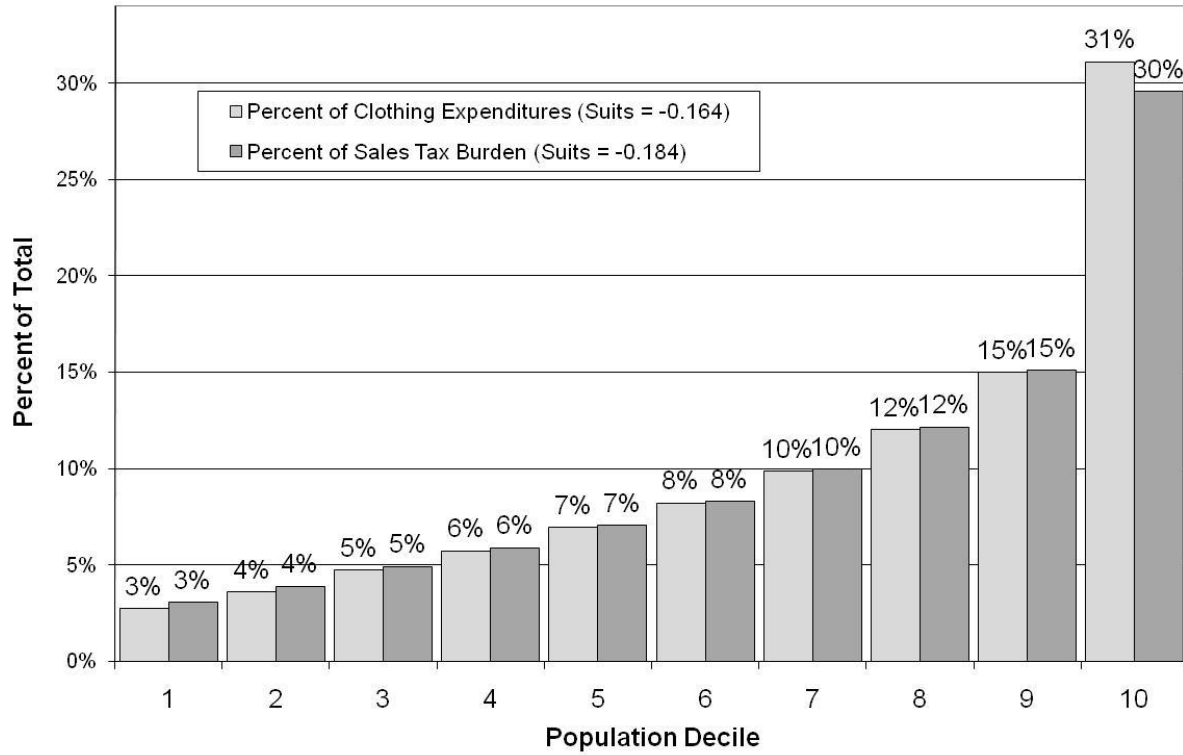
### Objective or Rationale

This exemption was enacted as part of the original sales tax in 1967. The rationale is not clear but it is widely assumed to be intended as an exemption for a basic necessity and to reduce the regressivity of tax. The definition was changed slightly to conform to SSUTA requirements.

# Review of Tax Expenditures

## Incidence Information

### Shares of Clothing Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

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## Exemption for Groceries

### Description of Provision

Food and food ingredients for human consumption are generally exempt from the sales and use tax. This exemption also applies to bakery items, ready-to-eat meats and seafood and foods that require cooking before consumption. It does not apply to restaurant and prepared food, to candy and soft drinks, dietary supplements, or food sold through vending machines.

### Projected Tax Expenditure: Groceries (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$663,500	\$695,900	\$729,000	\$761,600

Expenditures on groceries have increased in nominal terms (unadjusted for inflation) by 116.1% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

### Objective or Rationale

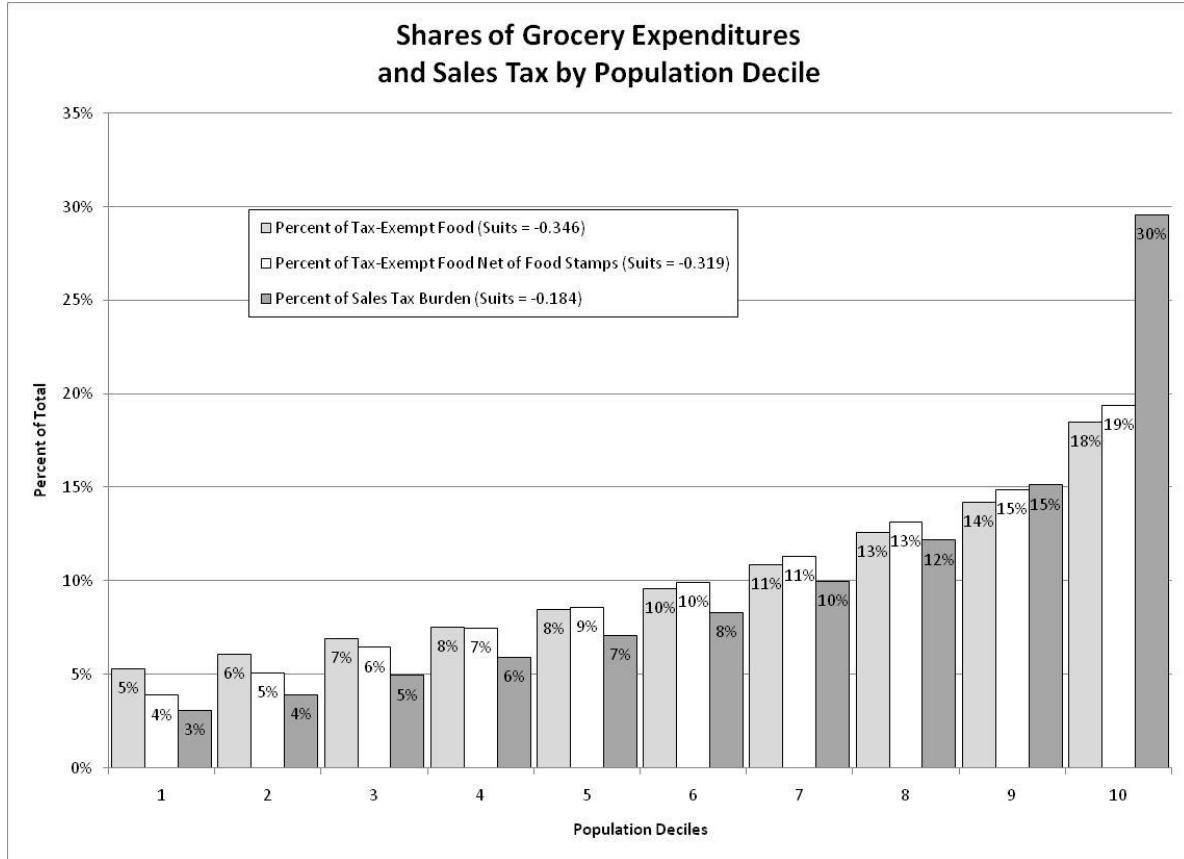
This exemption was enacted as part of the original sales tax in 1967. Candy and soft drinks were eliminated from the exemption in 1982. The types of food exempted under this provision underwent several modifications between 2001 and 2005 as the state attempted to conform to SSUTA definitions while minimizing changes to the state tax base. The rationale of the exemption is not clear but it is widely assumed to be intended as an exemption for a basic necessity and to reduce the regressivity of tax.

### Related Direct Spending Programs

The Food Stamp and Women, Infants, and Children (WIC) programs, funded by the federal government, provide food support for low income families and individuals.

# Review of Tax Expenditures

## Incidence Information



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey.

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# Review of Tax Expenditures

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## Exemption of Home Heating Fuel

### Description of Provision

All fuel oil, coal, wood, steam, hot water, propane gas, and liquefied petroleum gas sold to residential customers for residential heating are exempt from sales and use tax. For the billing months of November through April, purchases of natural gas and electricity for residential heating are exempt.

### Projected Tax Expenditure: Home Heating Fuels (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$159,100	\$164,100	\$163,200	\$162,200

Expenditures on home heating fuel have increased in nominal terms (unadjusted for inflation) by 132.0% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

### Objective or Rationale

This exemption was enacted in 1978 and was expanded to include hot water in 1984. The exemption was enacted as an exemption for a basic necessity and to reduce the regressivity of tax.

### Related Direct Spending Programs

The Low Income Home Energy Assistance Program (LIHEAP), funded by the federal government, provides assistance to low income families to pay their heating bills. In some years, the state has supplemented the federal money.

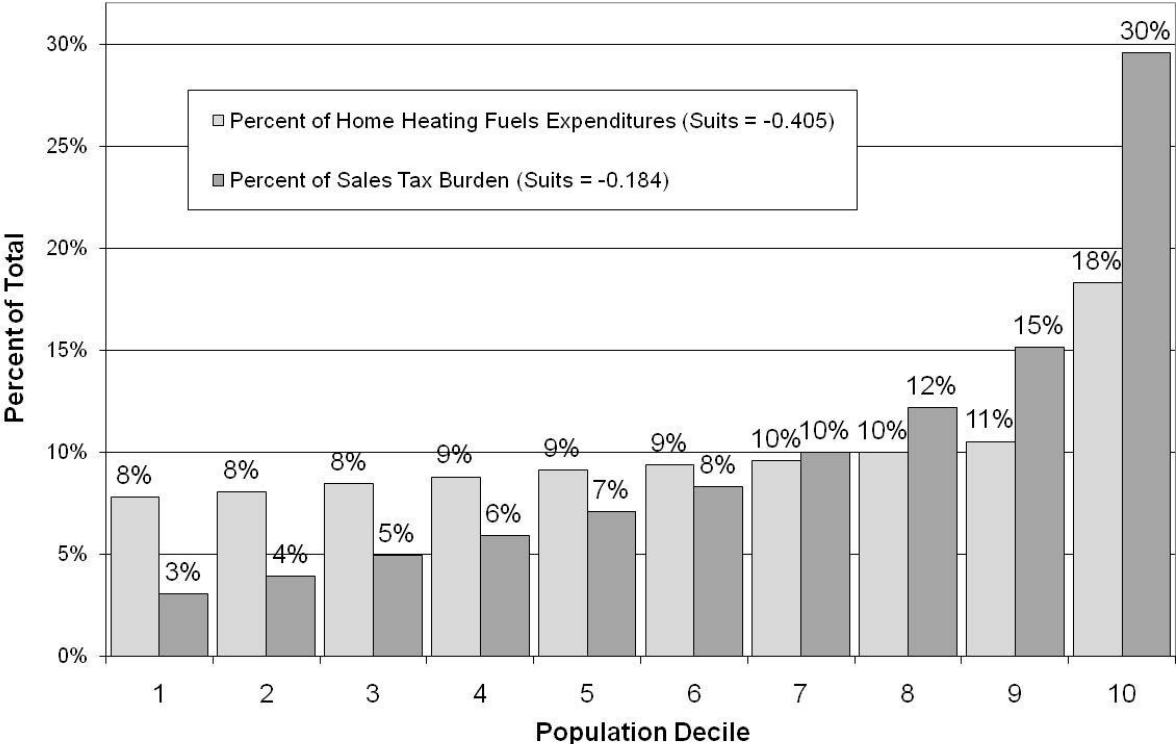
### Evidence on Cost Effectiveness

Revenues from repeal of the tax expenditure could be used, in part, to supplement assistance under LIHEAP. This would provide assistance that is better targeted to low income households, while collecting the tax from middle and upper income households. It would also eliminate a side effect of the exemption that it discourages conservation by slightly reducing the price of energy (compared with other types of consumption that are subject to sales tax).

# Review of Tax Expenditures

## Incidence Information

**Shares of Home Heating Fuels Expenditures and Sales Tax by Population Decile**



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
 MN Department of Revenue  
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# Review of Tax Expenditures

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## Exemption for Publications

### Description of Provision

Regularly issued publications (issued at time intervals not exceeding three months) are exempt from sales and use tax. The exemption applies, for example, to newspapers, including advertising supplements, subscription magazines, and to advertising circulars. Excluded from this exemption are magazines and periodicals sold over the counter.

### Projected Tax Expenditure: Publications (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$61,300	\$63,200	\$65,200	\$67,300

Expenditures on publications have increased in nominal terms (unadjusted for inflation) by 141.8% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

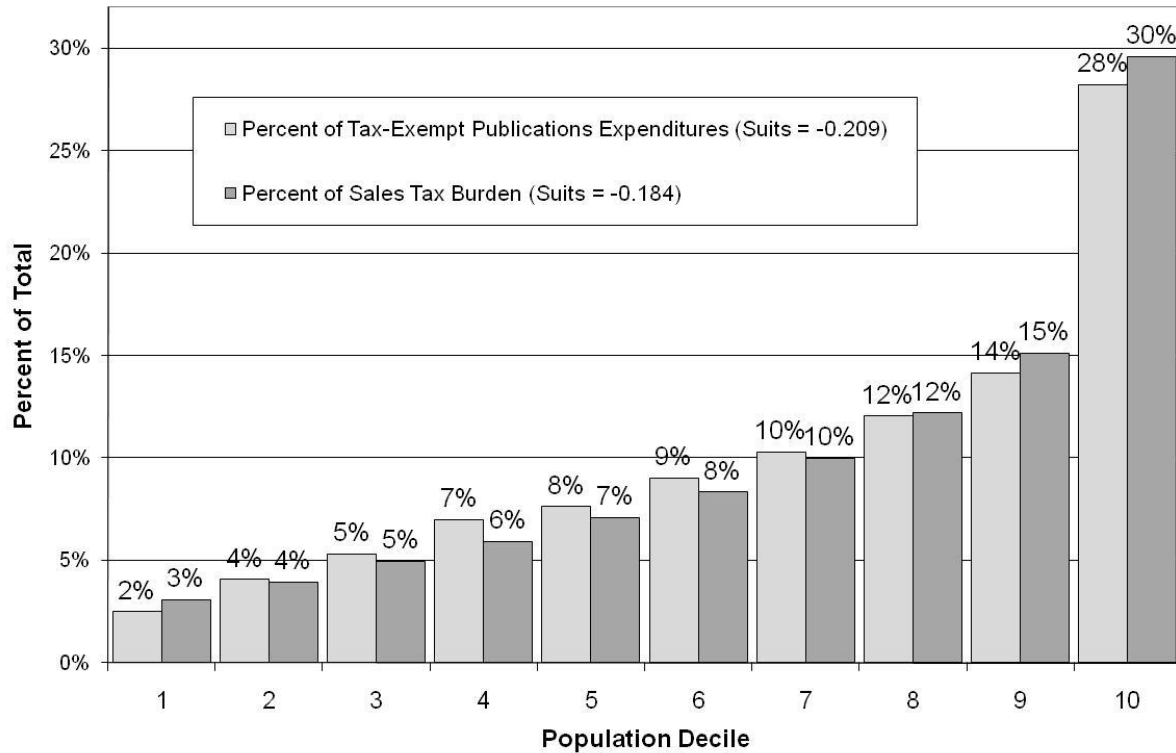
### Objective or Rationale

This exemption was enacted in 1967. In 1983, magazines and periodicals sold over the counter became taxable. Publications are considered an information service. The original law stated that advertising related to publications was “deemed to be a service and not tangible personal property” and therefore not subject to sales tax. The rationale for that portion of the exemption was clearly based on the view that this was a tax on goods and not on services. Many of the items included in the exemption (e.g., catalogs and advertising materials) are business inputs that conventional tax policy says should not be subject to a consumption tax to avoid the distortions that result from “pyramiding.” Taxing magazines sold over the counter while exempting magazine subscriptions raises efficiency issues since it distorts consumer behavior.

# Review of Tax Expenditures

## Incidence Information

### Shares of Tax-Exempt Publications Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

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## Exemption of Drugs, Medicines, and Medical Devices

### Description of Provision

Drugs, medicine, insulin, medical oxygen for human use, durable medical equipment for home use, mobility enhancing equipment and prosthetic devices, and prescription eyeglasses are exempt from sales and use tax.

#### Projected Tax Expenditure: Drugs, Medicine, and Medical Devices (\$ thousands)

	FY 2008	FY 2009	FY 2010	FY 2011
<b>Drugs and medicine</b>	\$228,200	\$243,200	\$261,000	\$280,500
<b>Medical devices</b>	\$9,900	\$10,300	\$11,000	\$11,000

Expenditures on prescription drugs, nonprescription drugs, and eyewear have increased in nominal terms (unadjusted for inflation) by 358.3% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

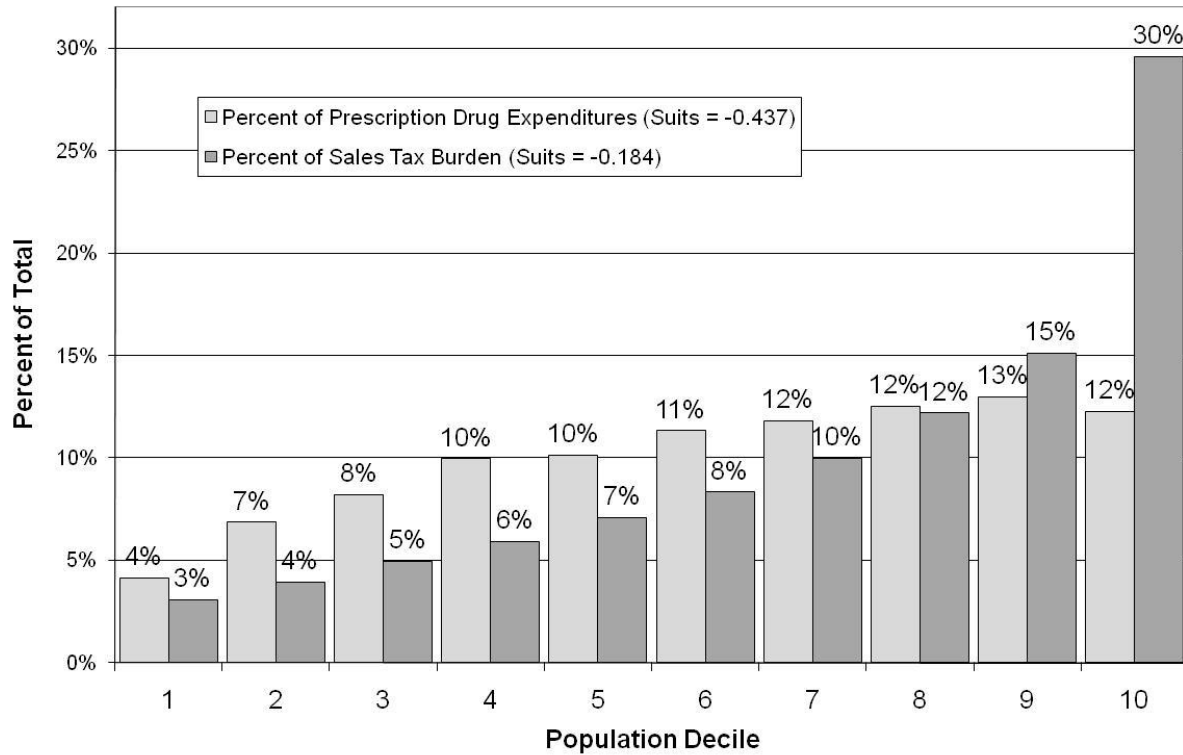
### Objective or Rationale

This exemption was as part of the original sales tax in 1967. In 1987, nonprescription drugs were subjected to tax, except medical insulin. In 1988, nonprescription analgesics (aspirin, ibuprofen, and so forth) were exempted from taxation. In 2005, due to SSUTA definitions that require all over the counter medicines to be treated equally, the exemption was extended once again to all nonprescription drugs. It should be noted that many items exempted under this provision (e.g., legend drugs) are subject to the 2 percent health care provider tax. Items exempt from both the sales tax and the health care provider tax include over the counter medication, and most of the durable medical equipment for home use and residential and motor vehicle mobility enhancing equipment. The rationale of the exemption it is an exemption for a basic necessity and to reduce the regressivity of the tax. It is not clear that the rationale holds up well for all parts of the exemption, particular for over-the counter medicines. Exempting the items subject to the health care provider tax avoids some tax pyramiding that would otherwise occur.

# Review of Tax Expenditures

## Incidence Information

### Shares of Prescription Drug Expenditures and Sales Tax by Population Decile

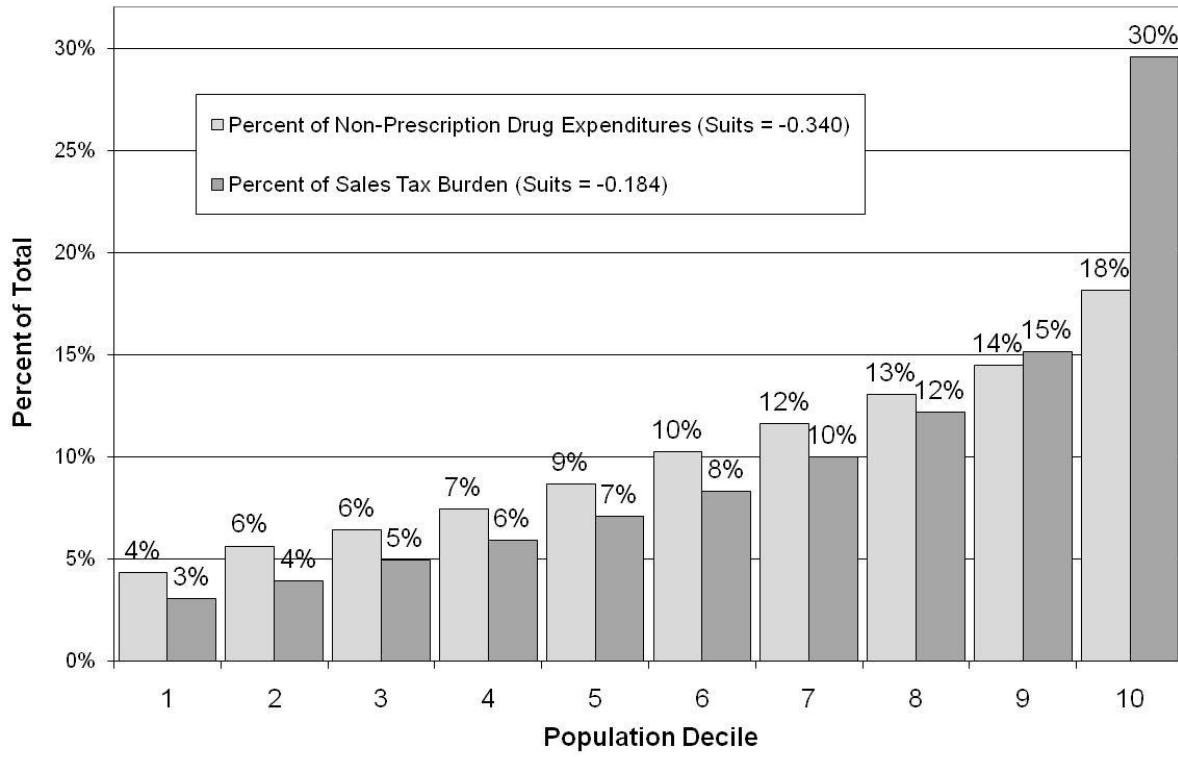


Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

## Shares of Non-Prescription Drug Expenditures and Sales Tax by Population Decile

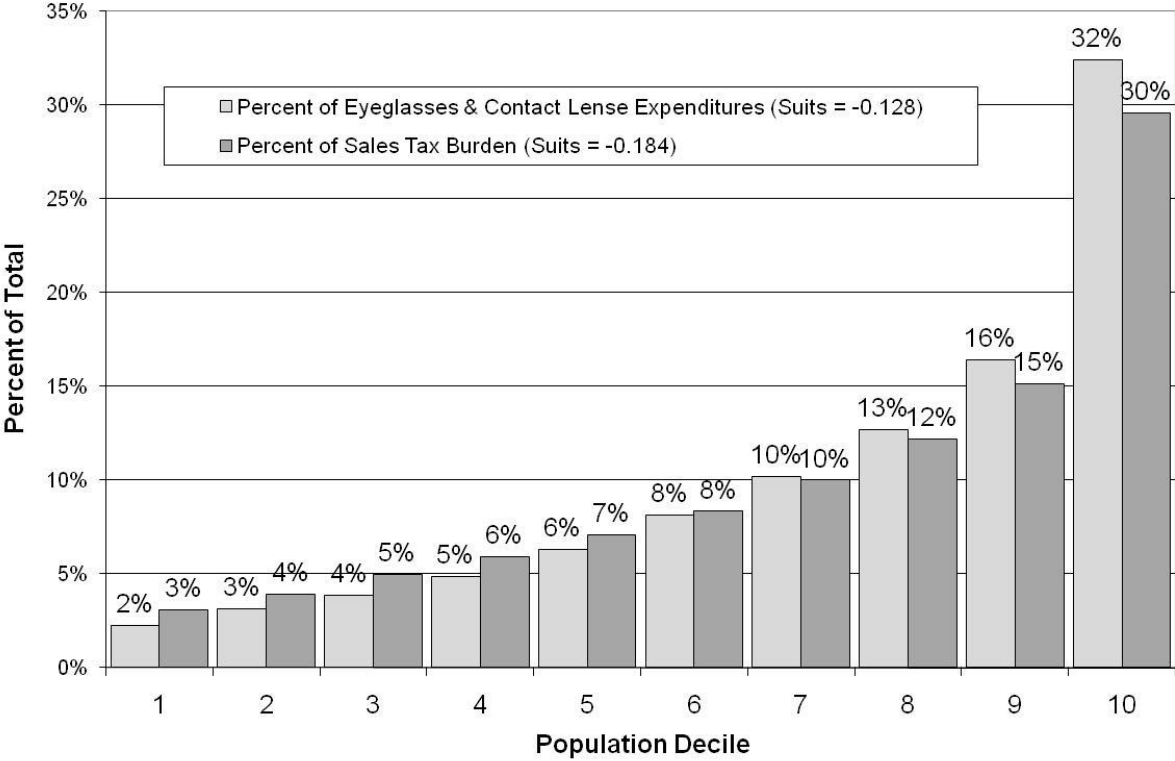


Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

**Shares of Eyeglass & Contact Lens Expenditures  
and Sales Tax by Population Decile**



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
MN Department of Revenue  
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# Review of Tax Expenditures

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## Residential Water and Sewer Exemptions

### Description of Provision

Water for residential use is exempt. Sewer services for all users are exempt. The tax expenditure data for sewer services includes business as well as residential services; the combined incidence data is based on consumer purchases only.

#### Projected Tax Expenditure: Residential Water and Sewer Exemption (\$ thousands)

	FY 2008	FY 2009	FY 2010	FY 2011
<b>Residential Water</b>	\$9,600	\$10,000	\$10,400	\$10,900
<b>All Sewer</b>	\$31,100	\$33,200	\$34,400	\$35,600

Expenditures on residential water and sewer have increased in nominal terms (unadjusted for inflation) by 188.1% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

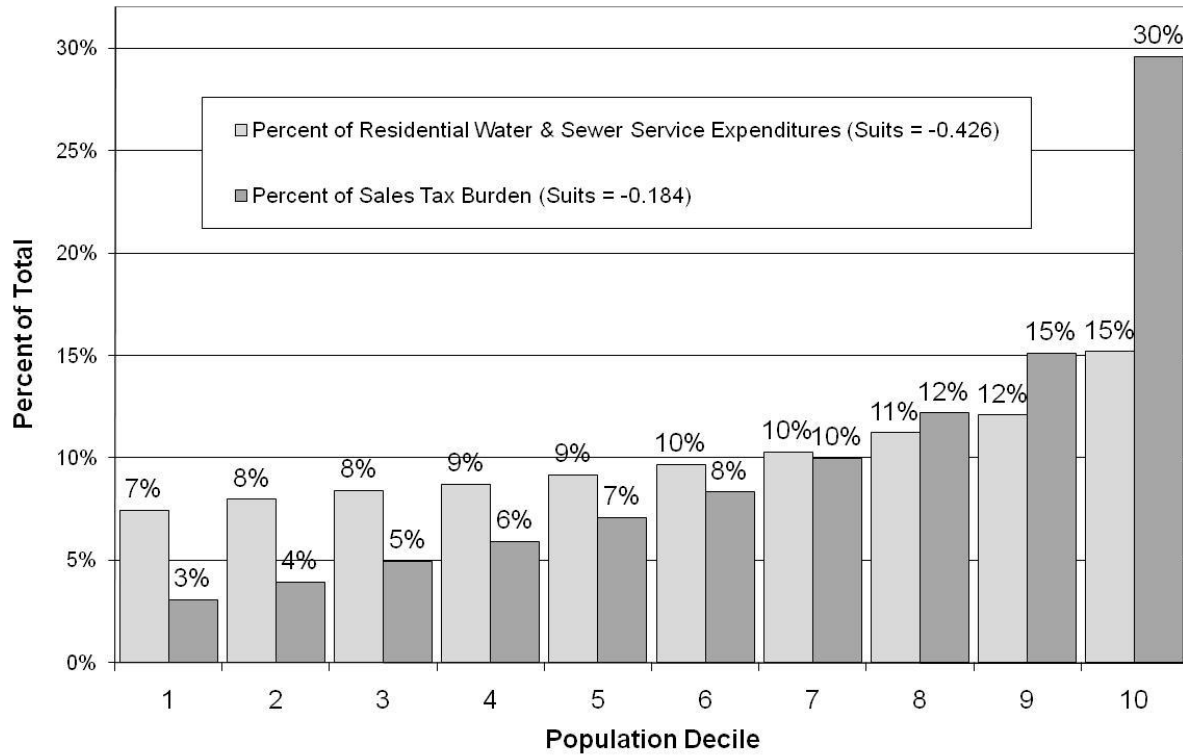
### Objective or Rationale

The exemption for water was enacted in 1978. The rationale for this exemption is that it is considered a basic necessity. The sales tax has never applied to sewer services. It is likely that this exemption is due to that, rather than to any policy objective. If the tax had applied to services, the legislature might have exempt residential sewer service from taxation.

# Review of Tax Expenditures

## Incidence Information

### Shares of Residential Water & Sewer Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
MN Department of Revenue  
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# Review of Tax Expenditures

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## Caskets and Burial Vaults Exemption

### Description of Provision

Caskets and burial vaults for human burials are exempt from sales and use tax.

### Projected Tax Expenditure: Caskets and Burial Vaults (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$4,900	\$4,900	\$4,900	\$4,900

### Objective or Rationale

This exemption was enacted as part of the original 1967 sales tax. (Cremation services are also exempt.) The rationale for the exemption is unclear; it was likely considered a necessity.

### Incidence Information

Not available

# Review of Tax Expenditures

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## Funeral Services

### Description of Provision

The sales tax does not apply to funeral or cremation services.

#### Projected Tax Expenditure: Funeral Services (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$18,400	\$19,100	\$19,900	\$20,700

Expenditures on funeral services have increased in nominal terms (unadjusted for inflation) by 84.1% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

### Objective or Rationale

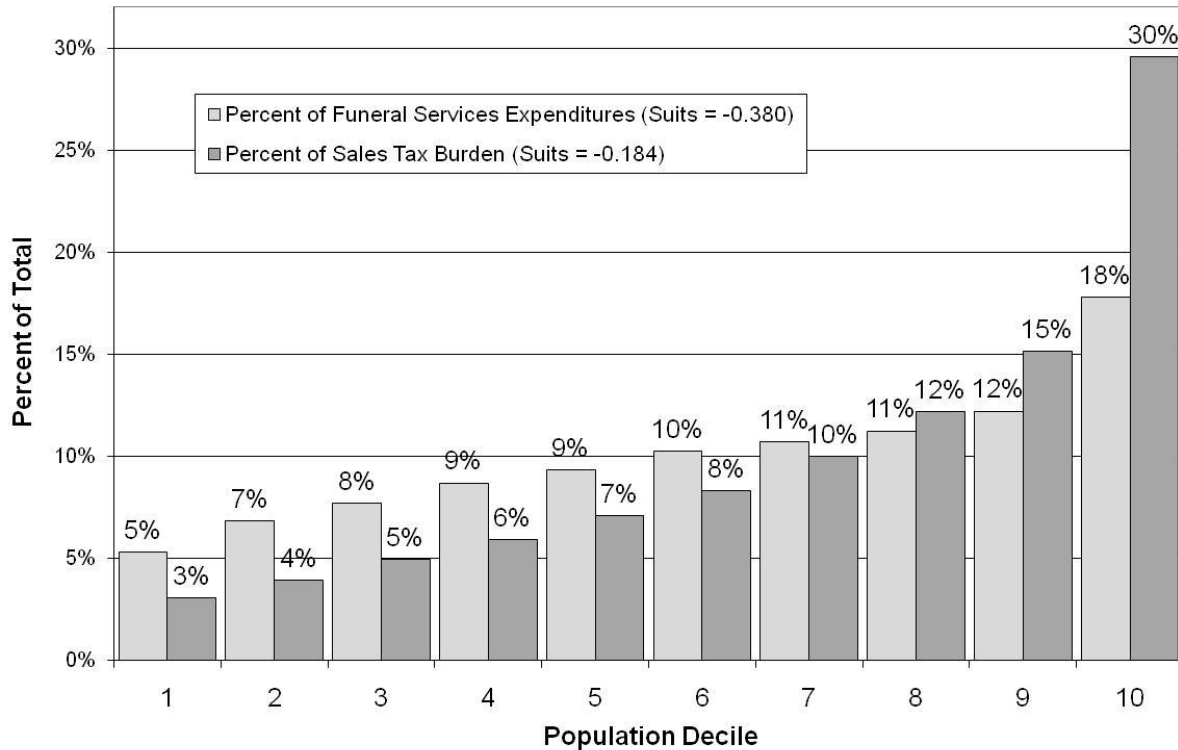
The sales tax has never applied to funeral or cremation services. It was likely that that funeral services were not taxed because they were services, but if the tax had been applied to most services, these services may have been exempted on the same theory that caskets and burial vaults were.



# Review of Tax Expenditures

## Incidence Information

### Shares of Funeral Services Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
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March 16, 2009

# Review of Tax Expenditures

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## Motor Vehicle Repair Services

### Description of Provision

The sales tax does not apply to automotive repair and maintenance services.

#### Projected Tax Expenditure: Motor Vehicle Repair and Maintenance Services (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$155,800	\$160,300	\$165,500	\$170,600

Expenditures on motor vehicle repair have increased in nominal terms (unadjusted for inflation) by 171.8% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

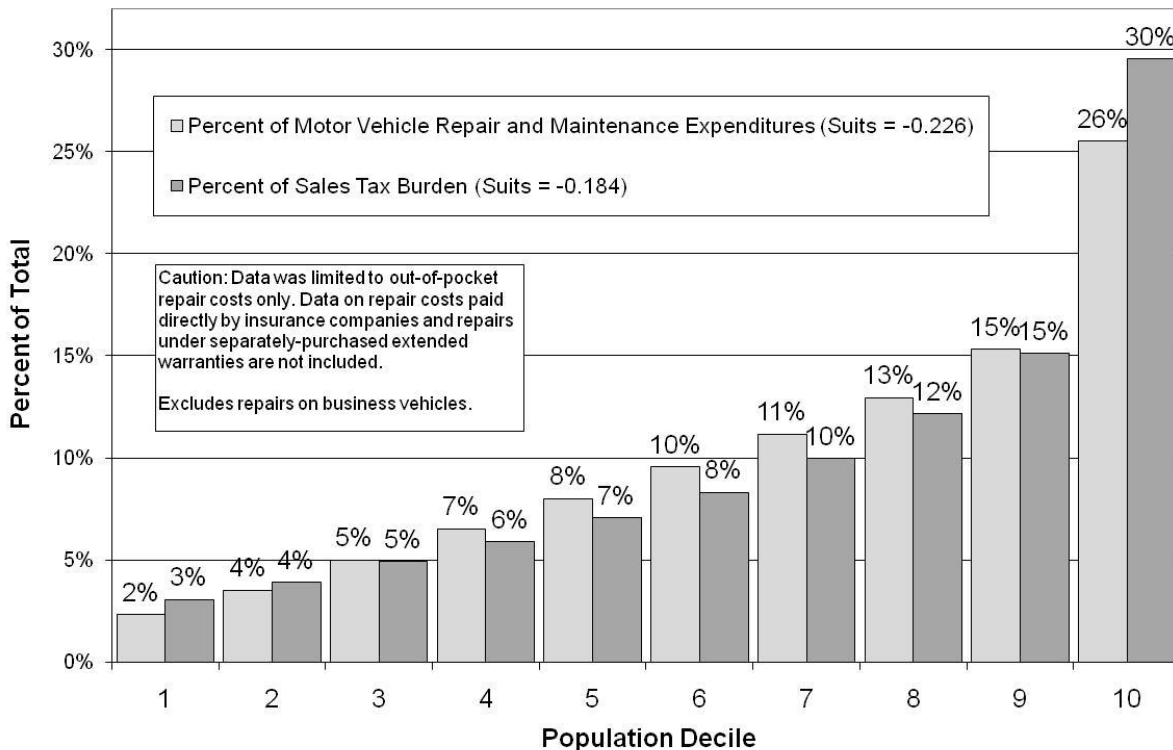
### Objective or Rationale

The sales tax has never applied to automotive repair and maintenance services. It is likely that auto repair and maintenance services were not taxed because they were services, rather than to achieve a policy objective. In recent years some have argued that taxing car repair services would fall more heavily on the poor and the exemption reduces tax regressivity. Although most car repairs are purchased by consumers there is a significant amount purchased by businesses as well. Car repair purchased by businesses are intermediate business inputs that conventional tax policy holds should not be subject to a consumption tax to avoid the distortions that result from “pyramiding.” In addition, a substantial amount of car repairs are paid through warranties that are included in the original price of the vehicle. Since the price of the car is subject to the motor vehicle sales tax, imposing the tax on the amounts paid (by car manufacturers) would result in taxing the price paid for these repairs twice.

# Review of Tax Expenditures

## Incidence Information

**Shares of Motor Vehicle Repair and Maintenance Expenditures and Sales Tax by Population Decile**



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
MN Department of Revenue  
March 16, 2009

# Review of Tax Expenditures

## Household Goods Repair Services

### Description of Provision

Household goods repair services such as basement waterproofing services and floor refinishing services are not taxed.

#### Projected Tax Expenditure: Household Goods Repair Services (\$ thousands)

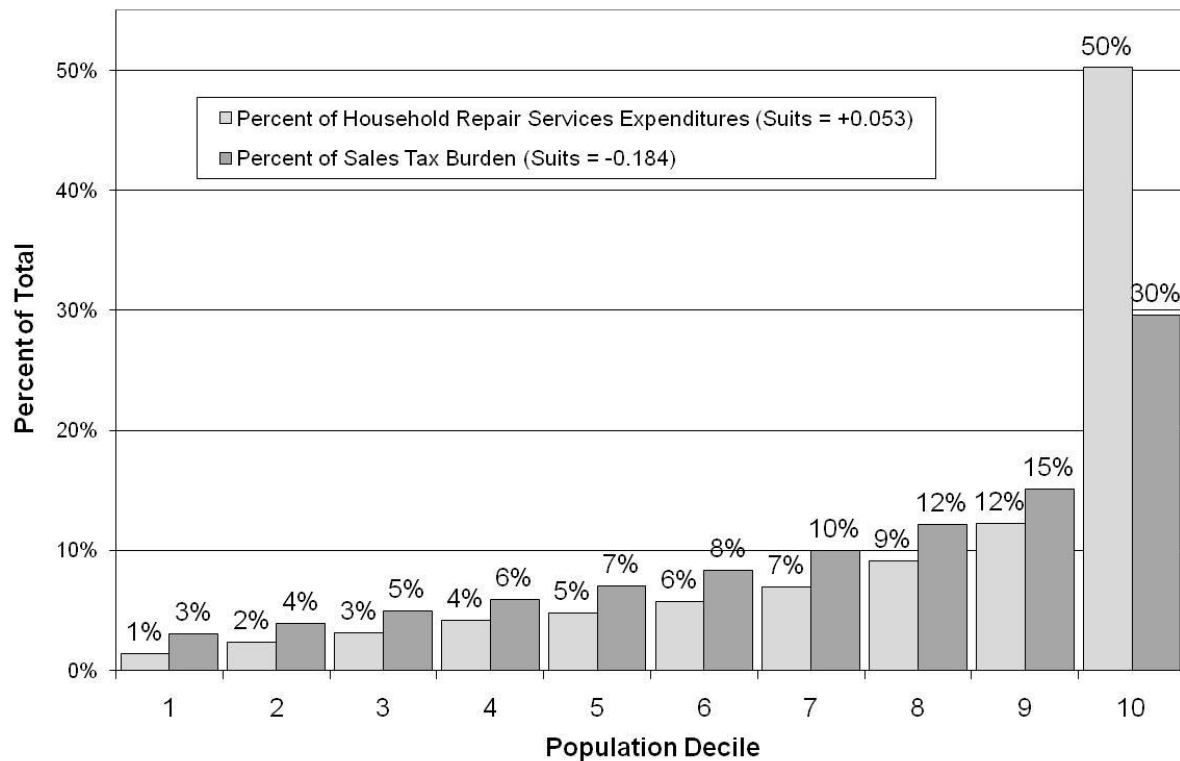
FY 2008	FY 2009	FY 2010	FY 2011
\$33,700	\$34,800	\$36,100	\$37,300

### Objective or Rationale

The sales tax has never applied to household goods repair services. It is likely that these services were not taxed because they were services, rather than to achieve a policy objective.

### Incidence Information

#### Shares of Household Goods Repair Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division  
MN Department of Revenue  
March 16, 2009

# Review of Tax Expenditures

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## Personal Services

### Description of Provision

Personal services such as hair care, hair removal, nail care, and tattoo piercing services are not taxed.

#### Projected Tax Expenditure: Personal Services (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$81,200	\$84,400	\$88,000	\$91,400

Expenditures on personal services have increased in nominal terms (unadjusted for inflation) by 161.3% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

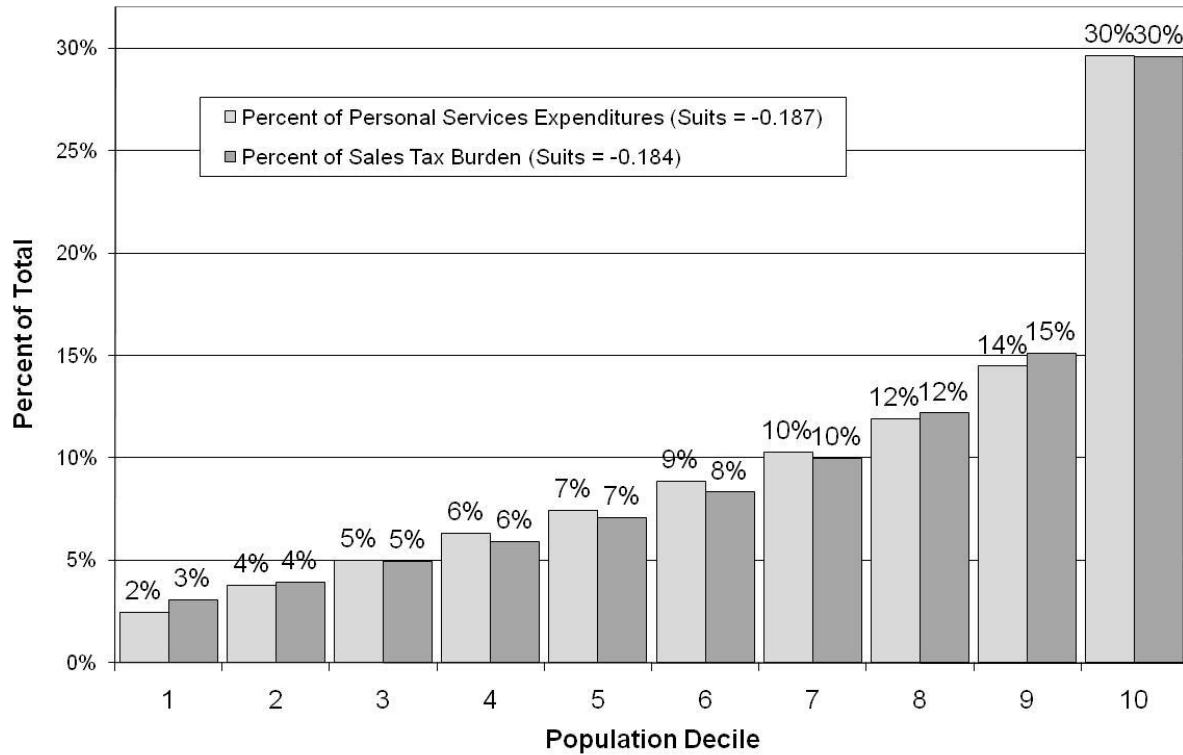
### Objective or Rationale

The sales tax has never applied to personal services. It is likely that these services were not taxed because they were services, rather than to achieve a policy objective.

# Review of Tax Expenditures

## Incidence Information

### Shares of Personal Services Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

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## Legal Services

### Description of Provision

Legal services for individuals and businesses are not subject to sales tax.

#### Projected Tax Expenditure: Legal Services (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$279,900	\$290,300	\$302,300	\$314,000

Expenditures on legal services have increased in nominal terms (unadjusted for inflation) by 159.8% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

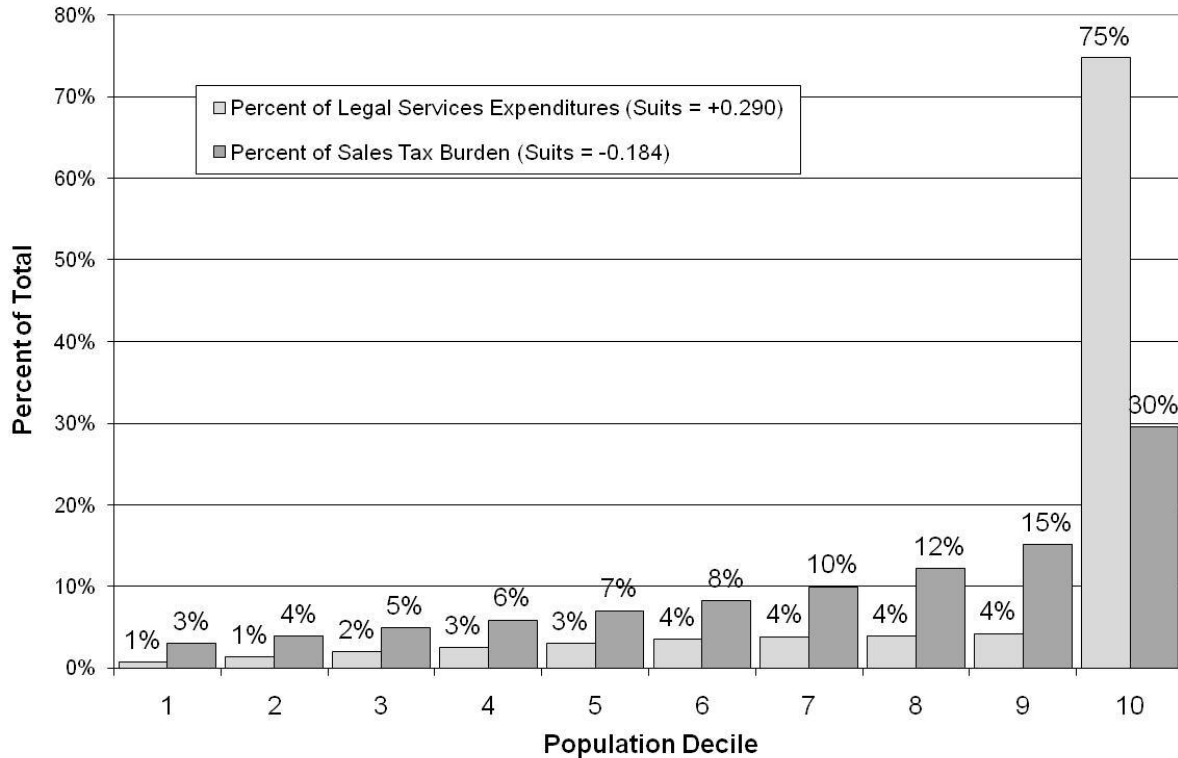
### Objective or Rationale

The sales tax has never applied to legal services. It is likely that these services were not taxed because they were services, rather than to achieve a policy objective. Legal services purchased by businesses are intermediate business inputs that conventional tax policy holds should not be subject to a consumption tax to avoid the distortions that result from “pyramiding.” Most legal services are purchased by businesses, although a significant portion is not.

# Review of Tax Expenditures

## Incidence Information

### Shares of Consumer Legal Services Expenditures and Sales Tax by Population Decile



Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

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## Accounting Services

### Description of Provision

Accounting services for individuals and businesses are not subject to sales tax.

#### Projected Tax Expenditure: Accounting Services (\$ thousands)

FY 2008	FY 2009	FY 2010	FY 2011
\$153,800	\$159,300	\$165,900	\$172,200

Expenditures on accounting services have increased in nominal terms (unadjusted for inflation) by 128.5% from FY 1990 to FY 2008, compared with an 158.8% nominal increase in personal income over the same time period.

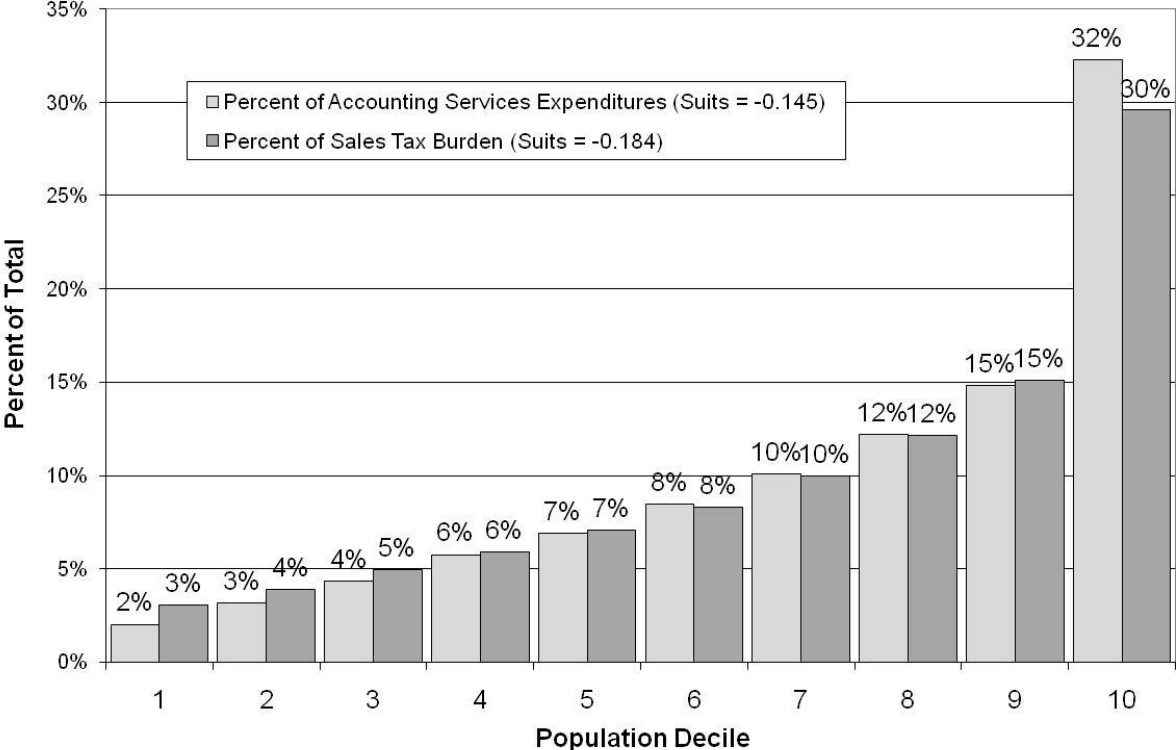
### Objective or Rationale

The sales tax has never applied to accounting services; the original sales tax applied to very few services. It is likely that these services were not taxed because they were services, rather than to achieve a policy objective. Accounting services purchased by businesses are intermediate business inputs that conventional tax policy holds should not be subject to a consumption tax to avoid the distortions that result from "pyramiding." Most accounting services are purchased by businesses.

# Review of Tax Expenditures

**Incidence Information**

**Shares of Household Expenditures on Accounting Services  
and Sales Tax by Population Decile**



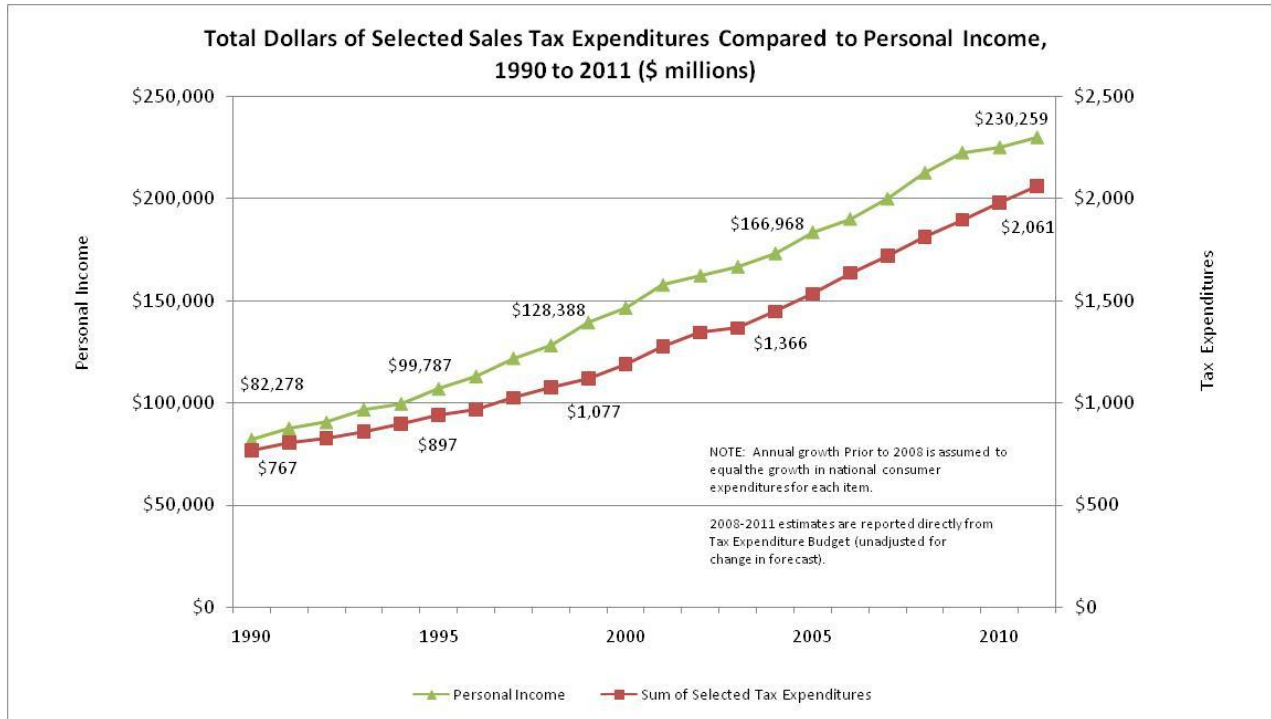
Source: Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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# Review of Tax Expenditures

## Growth in the Selected Sales Tax Expenditures

The graph shows the growth in the selected sales tax expenditures over the last 20 years, relative to the growth in personal income. The graph reveals that these tax expenditures (as is the case with the sales tax base itself) have been growing at a slightly slower rate than personal income.



Source: Tax Expenditure Budget data; Minnesota Price of Government

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