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A Review of Selected Tax Expenditures

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This research report updates and expands on a presentation that the tax staffs of the House Research and Fiscal Analysis departments prepared in 2008, at the request of the chair of the Taxes Committee, to provide committee members with background information on tax expenditures. It is intended to serve as a reference guide, compiling information from a variety of sources on selected individual income tax and sales and use tax expenditures.

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Introduction

This research report provides background information on selected tax expenditures in Minnesota. It focuses on individual income tax expenditures and sales and use tax expenditures.

Tax expenditures. The primary purpose of any tax system is to raise revenue to pay for the cost of providing government services. However, governments also commonly use their tax systems for other purposes. One such use is to provide targeted or special tax reductions intended to induce taxpayers to change their behavior or to provide government benefits to certain taxpayers to achieve a public purpose. These tax reductions are often referred to as "tax expenditures," reflecting that they are alternatives to direct expenditure programs to achieving these objectives. The Department of Revenue (DOR) biennially publishes a budget or compendium of Minnesota's tax expenditures under a statutory mandate.[1]

Information provided and organization of the report. This report is designed to provide House members and staff some additional information on selected income and sales tax expenditures beyond that provided in the DOR *Tax Expenditure Budget*. It consists of the following:

- A discussion of the tax expenditure concept and factors that legislators may wish to consider in evaluating whether or not to use tax expenditures versus direct spending to achieve a policy objective.
- A description of the criteria that were used to select the tax expenditures covered in the report.
- The remainder of the body of the report provides the following information for each tax expenditures covered:
  - Describes the tax expenditure
  - Lists the amount of the revenue estimated to be forgone as reported in the DOR *Tax Expenditure Budget* (2012)
  - Describes what House Research staff understands to be the objective or purpose of the tax expenditure
  - Lists commonly known direct spending programs intended to achieve the same or similar objective or purpose to the tax expenditure. **Note:** For a tax expenditure for which we did not know of a related direct spending program or of a program that is generally available across the state, there will be no entry under this heading for the tax expenditure.

[1] Minn. Stat. § 270C.11. The DOR *Tax Expenditure Budget* (*TEB*) describes each expenditure, lists its year of enactment and some other history, and provides an estimate of the benefits (reduced taxes) conferred on beneficiaries of each provision.

  - Provides information on the income distribution (or incidence) of the tax expenditure benefits, as prepared by the Department of Revenue Research Division staff
  - Provides the Suits index for repeal of the expenditure, in comparison with the Suits index for the underlying tax
  - Discusses evidence from published studies by academics or governmental entities on whether the tax expenditure is effective in achieving its purposes or objectives. **Note:** For a tax expenditure for which we either do not know what the objective or purpose was or do not have a basis (e.g., published research or other reliable bases) for providing information on cost effectiveness, there will be no entry under this heading for the tax expenditure.

- Appendices provide information on which other states provide the selected tax expenditures and on calculation of the Suits index, used by the Department of Revenue to measure the progressivity or regressivity of tax provisions.

Background on preparation of the report. This research report updates and expands on a presentation that the tax staffs of the House Research and Fiscal Analysis departments prepared during the 2008 regular legislative session, at the request of the chair of the Taxes Committee, to provide committee members with background information on tax expenditures. Since the presentation was made in 2008, House Research has received and continues to receive requests for copies of the presentation document. This report formalizes and updates that presentation document.

Staff at the Department of Revenue prepared the incidence information included in the report, as well as the information in the 2008 presentation.

The Tax Expenditure Concept

The primary purpose of any tax system (whether federal, state or local) is to raise revenue to pay for the cost of providing government services. However, governments also commonly use their tax systems for other purposes. One such use is to provide special tax reductions intended to induce taxpayers to change their behavior or to provide government benefits to certain taxpayers to achieve a public purpose. Often, the legislature could attempt to achieve these ends through a direct spending program, rather than through a tax-based provision. In the 1960s and 1970s, tax policy experts developed the concept of "tax expenditures" to describe the phenomenon of substituting tax benefits for direct spending. It generally refers to the reductions in revenue collections that result from deviations from a reference or normal tax of the type involved.

Identifying tax expenditures, thus, requires agreeing upon a "**reference or normal tax**"—that is, the features of the tax (whether income, sales, property, and so forth) that would be imposed under generally accepted theory, if the only purpose were to raise revenue. Reductions in revenue collected from this reference or normal tax—for example, exclusions, exemptions, deductions, preferential tax rates, credits, deferrals, and similar—are considered "tax expenditures." Features such as the regular tax rate structure, family size adjustments (e.g., personal and dependent exemptions for an income tax), and exclusions that are considered necessary for practical reasons (e.g., the failure to tax unrealized income) are not typically considered tax expenditures. Since there is not always agreement on the theoretical basis for a tax or the practical limits of tax administration, there may be controversy or disagreement in determining what is and isn't a tax expenditure.

Allocative versus Distributive Features

Another way to distinguish between fundamental or basic tax features and tax expenditures is to focus on whether the purpose of the feature is "distributive" or "allocative" in nature.*

Distributive features are intended to change the distribution of the tax burden primarily for equity or similar reasons—for example, to make the distribution more in line with "ability to pay" or some other concept of fairness. A distributive feature (e.g., progressive rates or standard deduction) is a feature of the reference tax.

By contrast, an allocative feature would divide or allocate resources between private and public goods or among different types of public goods—e.g., encouraging homeownership or reducing pollution. Features that primarily serve allocative functions are more likely tax expenditures than part of the reference tax.

* This distinction is from Richard Musgrave's classic textbook, *Public Finance in Theory and Practice*; its application to tax expenditures is suggested by Daniel N. Shaviro, "Rethinking Tax Expenditures and Fiscal Language," *Tax Law Review* 57, no. 1 (2004).

A key notion underlying the tax expenditure concept is that the government is using tax-based provisions not to raise revenues, but rather to change behavior or to distribute government benefits to individuals or business firms. These are ends or purposes that could (and more typically are) addressed through direct spending programs. The decision to use the tax system is simply a policy choice to use a tax-based mechanism rather than a direct spending program. Using a tax expenditure may have implications both for how well the tax system functions in fulfilling its core purpose of raising revenues and how effective the expenditure is in achieving the desired policy goals. The next section suggests some of the factors that may be relevant in evaluating the advantages and disadvantages of using tax expenditures versus direct spending.

Factors to Consider in Evaluating Whether to Use Tax versus Direct Expenditures

Legislators and other policymakers may wish to consider some of the following factors in deciding whether to use a tax expenditure or a direct spending program to achieve their policy objectives:

- Policy measures
  - Ease of administration
  - Behavioral effects
  - Tax system effects
  - Tax policy principles
  - Interaction with federal tax
  - Constitutional restrictions

- Institutional considerations
  - Durability
  - Viability
  - Legislative process concerns

The discussion of whether to use a tax expenditure or a direct spending program assumes that there is agreement on pursuing a specific or general policy objective and the issue is whether it is best to do that with a tax expenditure or a direct expenditure. Comparison of tax expenditure and direct spending alternatives is more straightforward when considering a new program. In evaluating existing tax expenditures, it is often unclear what a prior legislature's objective was—if indeed it had one—in enacting or modifying a tax expenditure. In some instances, the tax expenditure provision may be attributable to legislative misperceptions about the appropriate theoretical tax base or may simply have followed historical practices used by the federal government or other states when a tax was enacted. This creates challenges in evaluating the effectiveness of some tax expenditures.

Evaluating Tax Expenditures

Tax policy principles are not the primary benchmarks for evaluating tax expenditures. It is sometimes suggested that tax expenditures should be evaluated in the same manner as basic tax features—that is, the extent to which their effects are consistent with the standard tax policy principles of equity, efficiency, simplicity, and so forth.

Our premise is that while it may be appropriate to consider tax policy principles, it is probably inappropriate to consider them exclusively. That's because tax expenditures graft government programs onto the tax system with purposes unrelated to raising revenues. If the policy goal of the program or its means of achieving that goal are inconsistent with or unrelated to one or more tax policy principles, they will be an inappropriate guide for evaluating whether to use a tax or a direct expenditure. The issue is instrumental—what is the best method of delivering or achieving the desired goal—not whether it is a good tax (revenue raising) feature.

As an example, tax expenditures to encourage charitable contributions clearly flunk a test based on pure tax policy criteria. They reduce vertical and horizontal equity, decrease efficiency by requiring higher tax rates, complicate the tax, and so forth. But no one would suggest, given a goal of encouraging charitable contributions, that those are the primary criteria for evaluating whether it is better to use a tax deduction or credit or a direct spending program, such as providing matching contributions.

Policy-based Measures

Ease of administration: Is it easier to administer the program as part of the tax system or as a direct spending program?

Administrative advantages are a frequent justification for using a tax expenditure rather than a direct spending program. For example, it might be cost prohibitive to operate a direct spending program that provides small benefits to a large number of recipients, while if many or all of the recipients are already filing income tax returns, it might be relatively easy to do so as a tax expenditure. In that case there's also a minimal burden on the taxpayers claiming the benefit, since they are already filing an income tax return; with a direct spending program they may instead be required to complete a separate application for the benefit. There is also evidence that the "take-up" of benefits provided administratively through the income tax may be higher than for direct spending programs that require a separate application.[2] But if many of the recipients are not taxpayers or even tax filers, that diminishes the advantage of using a tax expenditure since the administrative cost advantages will be lower. Programs that require or function best with an element of administrative judgment or discretion typically are not good candidates for using tax expenditures to deliver their benefits. To function effectively as a tax expenditure, program parameters must be relatively simple and clear, so that typical taxpayers (or their tax preparers) can correctly apply them to their circumstances.

Some factors to consider:

- Are most recipients or targets of the program already taxpayers or tax filers?
- How complicated are the program parameters—can they be easily self-applied by a taxpayer or preparer or do they require the expertise of a specialist to administer?
- Does it work to deliver the benefit as a lump sum (e.g., a tax refund) once a year or is it important to more regularly provide benefits (e.g., because otherwise the recipient will be financially unable to engage in the desired behavior)?[3]

Behavioral effects: If the goal is to induce changes in behavior, will a tax provision be more effective than a direct spending program in doing so?

A frequent goal of tax expenditures is to change behavior by providing a tax incentive or benefit. As an alternative, a similar incentive or benefit could be delivered through a direct spending program. For example, families paying for college costs can be given a tax credit or provided a grant or scholarship of equal value. If the purpose is primarily to change behavior (to encourage more individuals to attend college), a key issue may be whether a tax credit or grant is more

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[2] For example, there is some evidence that somewhat higher percentages of comparable households claim the federal earned income tax credit than food stamps. See Marsha Blumenthal, Brian Erard, and Chih-Chin Ho, "Participation and Compliance with the Earned Income Tax Credit," *National Tax Journal* 53, no. 2 (2005): 207-08

[3] This may not be relevant if the benefits can be delivered to taxpayers through adjustments in withholding or for sales tax exemptions that provide their benefits when purchases are made. It is a bigger factor for benefits to be delivered to individuals that exceed tax liability, such as refundable credits, or for extraordinary deductions or credits that cannot be automatically reflected in income tax withholding.

effective in achieving that end.

Typically, economic theory has assumed that the form or manner in which a financial incentive (money) is provided does not matter. However, recent research in "behavioral" economics has found that conclusion is not necessarily true; individuals are subject to various cognitive biases that cause them to over or undervalue (on a purely mathematical basis) certain financial mechanisms. For example, individuals assign higher values to potential financial losses than to equivalent gains.

This behavioral insight into the power of "loss aversion" may be relevant to the choice between tax and direct expenditures. Tax concessions allow individuals to "retain" money they already have (i.e., to avoid a loss). In contrast, individuals may perceive receipt of a direct spending benefit as a gain with a lower relative value, even if the dollar amounts are the same. Along these lines, some initial research suggests that loss aversion translates to tax aversion. If these results can be replicated, it may be that individuals, on average, value avoiding paying taxes more highly than receiving an equal financial benefit under a direct spending program. This would suggest (at least under some circumstances) that the state could get more bang-for-the-buck by using a tax expenditure rather than a direct spending program, *all else being equal*. These possibilities need to be validated by additional research in behavioral economics, but could be important to the choice between the two mechanisms.

Effects on the tax system: Does the proposed tax expenditure adversely affect the basic functioning of the revenue/tax system?

Adding tax expenditures inevitably complicates the tax system, reducing understandability and increasing the difficulty of complying with and administering the tax. As more tax expenditures are added, the focus of tax administrators is diverted from collecting revenue to "administering" provisions that have purposes unrelated to raising revenues. For institutional reasons, staff at DOR may be less sympathetic to the objectives of the tax expenditure than staff at an agency that administers similar direct spending programs would be and this may affect how the programs are administered.[4] Increases in the number and complexity of tax expenditures compel taxpayers to spend more time completing their returns and familiarizing themselves with new programs often only to find out that they're ineligible. Sometimes competing tax expenditures for the same purpose (e.g., the multiple federal tax expenditures for higher education costs and retirement saving), require taxpayers to carefully determine which is the best choice for them, which further increases the time spent preparing the return. In addition, the perception that subtractions or credits allow others to avoid paying taxes can erode public confidence in the tax. These negative effects should be balanced against the advantages of using the tax system to deliver the program benefits.

[4] This assumes that the DOR and its staff view their primary mission as administration of the tax system and collection of revenue for the state. If that is true, it seems they will be less invested in ensuring that tax expenditure programs directed at housing, long-term care, higher education, or similar are effective than the staff of state agencies for whom that is their core mission.

Application of tax policy principles: How do tax expenditures intended to further basic tax policy goals fare when evaluated using traditional tax policy principles?

Some tax expenditures are, in fact, intended to promote basic tax policy goals. For example, the sales tax exemption of food for home consumption was likely adopted to reduce the regressivity of the tax. Given such a purpose, it is appropriate to assess to what extent the tax expenditure is successful in furthering the relevant tax policy goal. For example, does the food exemption make the sales tax more equitable or would alternative measures (e.g., a refundable credit) be better targeted or more effective? However, as suggested in the text box on page 5, most tax expenditures are really alternatives to direct spending and likely should not be exclusively evaluated using basic tax policy principles, since they will nearly always violate the principles.

Interaction with federal tax: Does federal tax treatment of the program benefits favor a tax-based or direct spending approach?

Federal income and corporate tax rules can be a factor in choosing between tax expenditures and direct spending programs. Government benefits provided to individuals under direct state and local spending programs, although they constitute economic income to the recipients, are typically exempt from federal income tax under what is often called the general welfare exclusion.[5] By contrast, if state income or property tax reductions are instead provided to individuals who itemize deductions, the federal income tax will implicitly impose a tax on those benefits at the recipient's marginal rate. This occurs because a state income or property tax reduction lowers the individual's itemized deduction for state income or property taxes and increases federal income tax as a result. This effect can siphon off to the federal Treasury between 10 percent and 39.6 percent of the intended benefit, depending upon the recipient's marginal tax rate. A similar effect can also occur (but is less common) with regard to tax expenditures provided to businesses. More commonly, the direct spending benefit will be treated as income to the business, but may not if it qualifies for treatment as a contribution to capital.[6]

Constitutional restrictions: Do commerce clause or other constitutional limits on state tax powers favor using a direct spending program?

Tax and regulatory restrictions on businesses cannot discriminate against or otherwise place an "undue burden" on interstate commerce without risking violating the commerce clause of the United States Constitution. The Supreme Court has been fairly vigilant in ensuring that states do not use their tax codes to favor local business interests over out-of-state businesses. By contrast,

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[5] The general welfare exclusion is not based on a statutory provision, but grew out of Internal Revenue Service practices (starting with the exemption for Social Security benefits) that have been ratified by the courts. *See* Robert W. Wood and Richard C. Morris, "The General Welfare Exclusion," *Tax Notes* (Oct. 10, 2005), 203-09, for a description of the exclusion. Specific statutory exclusions may also apply, such as those for scholarship income. I.R.C. § 117.

[6] I.R.C. § 118.

the Court has been willing to grant states more leeway in their use of direct spending programs.[7] If a proposed tax provision—particularly one favoring in-state business interests—runs the risk of violating the commerce clause, it is possible that a grant or other form of direct spending program will not. This circumstance occurs less frequently for tax expenditures provided to individuals, but can come up in that context as well. For example, it may not be possible to limit a higher education tax credit to in-state schools, but it clearly is constitutional to do so for a direct scholarship or grant-in-aid program.

Constitutional restrictions: Is the policy measure subject to challenge under the First Amendment prohibition of the establishment of religion?

Contrary to the previous section, in one context, constitutional limits may favor using tax, rather than direct, expenditures—when the legislature seeks to provide government benefits to religious organizations, such as religious schools or other organizations. As a general rule, a taxpayer (based only on his or her status as a taxpayer) cannot file a legal challenge to a government program or tax provision in federal court; they don't have legal "standing" to bring a case. However, the U.S. Supreme Court has created a special rule that allows "taxpayer standing" in cases challenging government programs as violating the establishment clause of the First Amendment.[8] In a 2011 case, *Arizona Christian School Tuition Organization v. Winn*, the U.S. Supreme Court held that this special standing rule does not apply to tax expenditures, such as tax credits that assist religious schools.[9] As a result, using tax expenditures for these types of programs may reduce the likelihood that a successful legal challenge can be brought in federal court. However, it is unclear if the Minnesota Supreme Court will follow *Arizona Christian School* in applying its standing rules in enforcing state or federal constitutional restrictions.[10] Thus, a tax expenditure arguably violating the establishment clause of either the federal or Minnesota Constitution may be subject to a taxpayer challenge in Minnesota state courts.

[7] See generally Walter Hellerstein and Dan T. Coenen, "Commerce Clause Restraints on State Business Development Subsidies," *Cornell Law Review* 81 (May 1996), 789-878, for a discussion of the constitutional restrictions that the court has applied to the two types of subsidies in the context of business assistance.

[8] *Flast v. Cohen*, 392 U.S. 83 (1968).

[9] 131 S. Ct. 1436 (2011). It was widely assumed that the *Flast v. Cohen* rule also applied to tax-based assistance (i.e., tax expenditures) and several successful lawsuits were based on this assumption by the parties and the U.S. Supreme Court. This included invalidation of a Minnesota tax credit for private school tuition. *Minnesota Civil Liberties Union v. State*, 224 N.W.2d 344 (1974), *cert. denied* 421 U.S. 988 (1975). This followed from a case in which the U.S. Supreme Court struck down a similar New York state tax credit in which the plaintiff relied on taxpayer standing. *Committee for Public Education and Religious Liberty v. Nyquist*, 413 U.S. 756 (1973).

[10] The Minnesota courts have generally taken a more permissive view of taxpayer standing than the federal courts. See e.g., *McKee v. Likins,* 261 N.W.2d 566 (1977).

Institutional and Process Considerations

The previous section focused on policy-based measures for evaluating the effectiveness of using direct versus tax expenditures. However, legislators and other policymakers are often equally or more concerned with unrelated process or institutional dimensions of choosing between a tax expenditure and a direct spending program—will use of a tax, rather than a direct, expenditure make it easier to pass a program or to garner a larger amount of resources for it over time?

Durability: Tax expenditures are generally thought to receive less regular and rigorous legislative review and, as a result, are more likely to become permanent policy features.

It is widely perceived that tax expenditures are more permanent than direct spending programs. This flows from the common practice of making tax expenditures permanent features of the tax law that remain in place until modified or repealed by a future legislature. By contrast, most direct spending programs have biennial appropriations that the legislature must renew in each budget cycle. This structure generally creates an inertial bias for retaining tax expenditures, as compared with direct spending programs; those familiar with the legislative process recognize that it is easier to "play defense" than offense: that is, to prevent changes in the law from being made, as compared with passing new legislation. However, this state of affairs does not necessarily always follow. A direct spending program could be provided a permanent, open, and standing appropriation that does not require biennial renewal by the legislature.[11] Similarly, a tax expenditure could be set to expire each biennium or after a certain number of years, unless the legislature takes positive action to reenact it.[12]

In any case, proponents of a policy who seek tax expenditure funding often do so because they believe such funding is more likely to continue and be permanent than are direct appropriations for a similarly structured program. Regardless of the features of the tax expenditure (e.g., whether they have sunsets or expiration clauses), this may in part flow from differences in the institutional approaches of the tax-writing legislative committees, which may implicitly assume tax features are permanent, compared with those of finance or appropriation committees, which typically expect to regularly review the funding of all programs within their jurisdictions.

Visibility: Tax expenditures are not counted as explicit governmental spending.

Tax expenditures are not typically counted in the state budget (other than the tax expenditure

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[11] The funding for the property tax refund program, which is not generally considered to be a tax expenditure, is provided through an open and standing appropriation. Minn. Stat. § 290A.23 (permanent open appropriation). The funding level of the property tax refund program has rarely been carefully reviewed or modified by the legislature in recent years. Similarly, the grant alternative to the credit for historic structure rehabilitation has an open and standing appropriation. Minn. Stat. § 290.0681, subd. 7(b). This appropriation is permanent, although the entire program (tax credit and grant) is subject to a sunset clause. Id., subd. 10.

[12] For example, the small business investment (angel) credit sunsets after tax year 2014. Minn. Stat. § 116J.8737, subd. 12.

budget) and are not included in typical national measures of state spending and taxes.[13] These national rankings of state tax and spending amounts are often used to measure the size and business friendliness of states. Legislators who are sensitive to those measures and concerns or who are ideologically opposed to increases in direct or more visible state spending (and the concomitant increases in taxes that result) may favor pursuing their policy goals through tax expenditures, rather than through direct spending programs. This approach is inconsistent with conventional economic theory that equates the two mechanisms, but it seems to be the practical political reality.[14]

Legislative process: Use of tax expenditures can tap other portions of the state budget to provide expanded resources to support a policy.

Proponents of a policy or program may also promote tax expenditures as a source of additional budget resources or a way to tap other legislative supporters for the policy or program. Legislatures typically allocate state budget resources to finance or appropriation committees with jurisdiction over different subject areas. These allocations may be based on incremental increases in previous levels of funding or may be limited by other constraints. Seeking indirect funding through the tax-writing legislative committees may provide a new or supplemental source of funding, since tax-writing committees may have access to more state budget resources than the relevant finance committee. In practice, this allows policy proponents to diversify their funding options and to appeal to a different set of legislative actors.

[13] We are aware of no national comparisons of the level of state and local tax expenditures across states. By contrast, national comparisons of state and local tax and direct spending levels are regularly published (based on data collected by the federal government) by many organizations and are widely cited.

[14] High tax rates that result from tax expenditures, under economic theory, are equally distortive of private market behavior as high tax rates that are attributable to direct spending.

Selection of Tax Expenditures to Review

The report covers only 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. The report does not cover all of the tax expenditures under the two taxes; it excludes tax expenditures from the report based on the following criteria:

- Individual income tax expenditures that would be impractical to modify or reduce for administrative or compliance reasons were excluded. This category largely consists of items that carry over from federal law. Most of these items involve issues of timing, valuation, reporting, and record keeping. For example, tax expenditures for depreciation rules, pension and retirement plan rules, taxation of fringe benefits (which involve significant valuation issues in many cases), and similar provisions are not covered. As a practical matter, changes to these provisions would need to be addressed by Congress. This report also excludes tax expenditures that are mandated by federal law, which the state could not modify or reduce: the subtractions for U.S. bond interest, railroad retirement benefits, on-reservation earnings of American Indians, and active service military pay earned in Minnesota by nonresidents. In addition, a variety of small or more minor tax expenditures that derive from the use of federal taxable income as the starting point for Minnesota's income tax are not discussed.

- Under the sales tax, tax expenditures that predominantly consist of business purchases are excluded based on the premise that the sales tax is intended to be a consumption tax. 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 and only once. Taxing business inputs causes the sales tax to pyramid. (See the box at the right for a description of pyramiding.) Thus, the report does not discuss tax expenditures that primarily apply to intermediate business inputs. Rather, the discussion (and incidence information) focuses on the portion of each tax expenditure that consists of consumer purchases. The approach adopted by the report follows roughly the

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.

recommendations of 2011 *Tax Expenditure Review Report*, rather than the method used in the biennial *Tax Expenditure Budget*.[15] Put another way, this research report follows the view that these "exemptions" from tax are not really tax expenditures, but are consistent with a reference tax base (see discussion on page 91) that treats the sales tax as a consumption tax that should not apply to intermediate business purchases.

- The report also does not cover the sales tax exemptions for purchases by entities, such as governmental units or charities. The effect of repealing these exemptions on incidence is unclear. If the exemptions were repealed, conventional wisdom suggests the sales tax paid by the entities would be shifted to the entities' employees as lower wages or to the users of the entities' services/products in higher prices. Moreover, these exemptions may serve unclear or multiple objectives that are difficult to evaluate. While they likely benefit mainly consumption by individuals of government and nonprofit services, some of them comprise significant elements of business or capital inputs, the outputs of which are taxable. One view is that these purchases should be exempt as intermediate inputs and what should be taxable, in principle, are the services or goods produced or provided by these entities. Following that theory, the report covers tax expenditures for sales made by these entities to purchasers, such as the exemption for admissions to nonprofit arts events and similar.

[15] Contrast Minn. Dept. of Revenue, *Tax Expenditure Review Report: Bringing Tax Expenditures Into the Budget Process* (February 2011), 11-13 (advocating treating the reference tax base for the sales tax as a consumption tax) with Minn. Dept. of Revenue, *State of Minnesota Tax Expenditure Budget Fiscal Years 2012-2015* (February 2012), 103 (treating the reference tax base as sales to the "final user" even if it is for production, not consumption). The *Tax Expenditure Budget* is prepared under a statutory mandate, which contains a definition of tax expenditure. Minn. Stat. § 270C.11, subd. 6. This definition is general and does not resolve questions such as how to treat business inputs under the sales tax. Since enactment of the mandate in the 1980s, DOR has followed the approach of treating sales to final users as the reference sales tax base.

Information Provided

The report provides the following information for each tax expenditure:

- **A brief description of the provision.** In many cases these descriptions borrow liberally from the DOR *Tax Expenditure Budget* (2012) (TEB) or from other House Research Department publications. For federal income tax deductions that flow through to the definition of state taxable income and state income tax subtractions, the description notes if the deduction or subtraction is allowed under both the regular tax and the alternative minimum tax (AMT).[16]

- **The dollar amount of projected revenue lost.** These amounts, unless noted otherwise, are taken from the DOR TEB. Note that TEB estimates for the sales tax include business purchases. By contrast, the data used to prepare the incidence graphs in this publication are limited to information on consumer purchases only (i.e., they do not include estimates of the shifting of business purchases that would be subject to the sales tax if the tax expenditure were repealed).[17]

  It is important to note that the revenue raising potential from repealing multiple tax expenditures is 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 cases, 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 2011-12 (in most cases using the November 2011 Minnesota Management and Budget forecast baseline). Thus, they do not reflect the effects of changes in underlying economic conditions or the law since then.

- **An objective or rationale for the tax expenditure.** These are based on our knowledge of points made by the proponents when the provisions were passed or modified or based on conventional wisdom (e.g., from the literature); they may also include some information on the history of the provision. In many cases, it is simply not 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

[16] The alternative minimum tax or AMT is an alternative tax structure with a broader tax base than the regular income tax. Taxpayers subject to the AMT must pay the additional tax, if the AMT is higher than the regular tax.

[17] The Department of Revenue's *Tax Incidence Study* allocates the tax paid by businesses to households by estimating the amount shifted to consumers, in the form of higher prices, to labor, in the form of lower wages, and to owners of capital, in the form of lower rates of return (page 11 and also Appendix B of *2013 Tax Incidence Study*).

attempted to list these.[18] The legislature may wish to consider tax expenditures and direct expenditures focused on similar purposes together to determine the more cost-effective way to achieve the objectives or to determine the best way to reduce or increase the combined expenditures.

- **Incidence information.** Most sections present a bar graph showing the distribution of the tax expenditure by population decile and the Suits index for the expenditure. The data underlying the graphs and the Suits index measures[19] were prepared by DOR staff in the Research Division, using information they used in preparing the 2011 *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 the distribution of the tax expenditure is regressive—that is, the increased tax from its repeal, as a percentage of income, declines as income increases. Conversely, a positive Suits means that the increased tax from repeal of the expenditure would increase as a percentage of income as income rises. For more information about the Suits index, see Appendix B. 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 increasing 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. 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 increasing 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 while preserving an exemption for business purchases.

- **Evidence on effectiveness in meeting objective.** Where we were aware of published or other studies by neutral observers or analysts (typically academics or government agencies) of the effectiveness of a tax expenditure, this information is reported. 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 selectively for a few tax expenditures.

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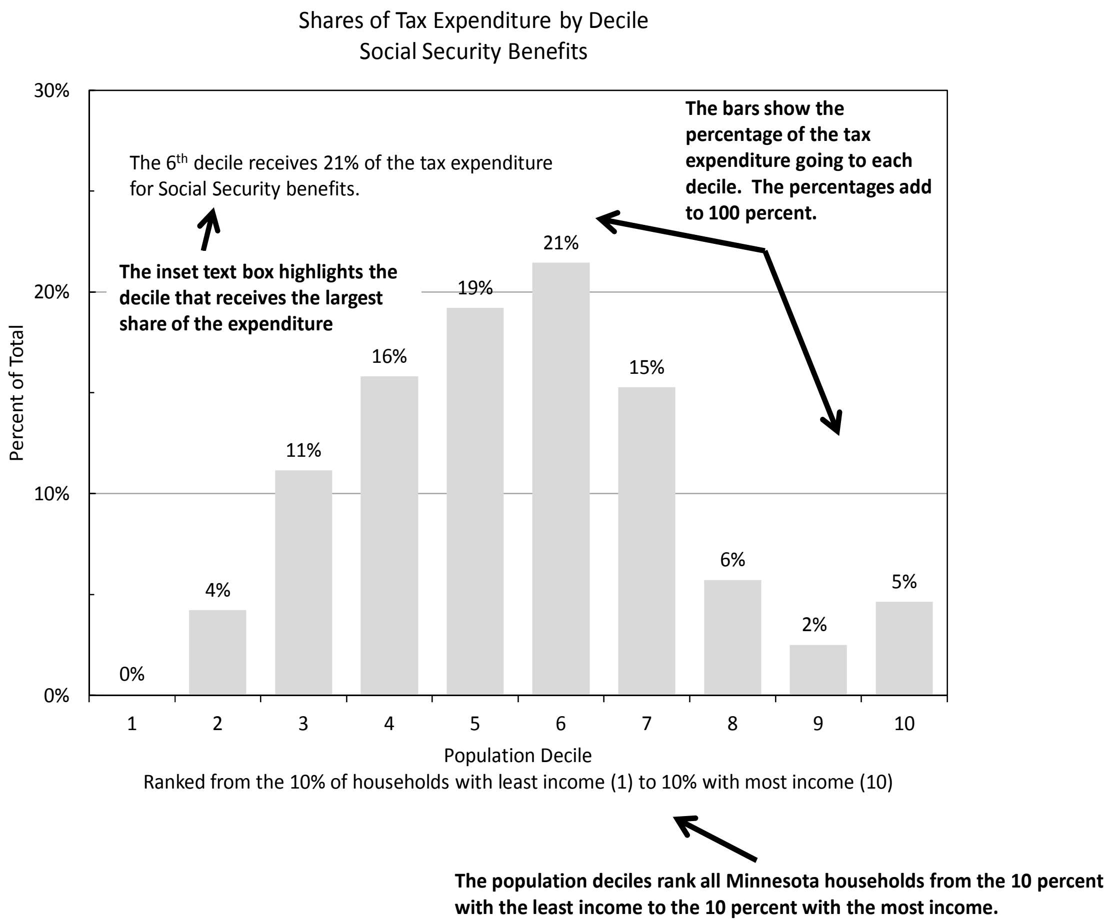
[18] Given our lack of knowledge about direct spending programs, these listings are incomplete. They do not attempt to describe the direct spending programs in any detail.

[19] The Department of Revenue calculated the Suits indexes for this report based on the entire population. The resulting indexes are more accurate than the "population-decile" Suits indexes used in older versions of the *Tax Incidence Study* and in the 2008 version of this presentation.

How to Read the Incidence Graphs

The Department of Revenue (DOR) research staff prepared the incidence information used in the report. The incidence information for each tax expenditure is presented in a bar graph; a sample graph with annotation appears below.



The graphs were prepared using data from DOR's *2011 Minnesota Tax Incidence Study* (2008 tax data). The 2.5 million households in the dataset were ranked from the household with the least income to household with the most income, and, then aggregated into ten population deciles, each containing an equal number of households (about 250,000). Each bar shows the percentage of the tax expenditure received by the households in that decile. The percentages listed above each bar in the graphs sum to 100 percent. Each graph also includes a text box that identifies the decile receiving the largest share of the benefit of the tax expenditure. For example, the sample graph shows that the tenth decile (the 10 percent of households with the highest incomes) received 5 percent of the tax expenditure (the exemption from income tax for Social Security benefits).

DOR ranks households using a broad income measure that includes taxable and nontaxable income reported on individual income tax and property tax refund returns, and also workers' compensation and welfare income obtained from other state agencies. The first decile consists of households with income under about $10,000; the top decile was made up of households with income over about $130,000. Appendix C lists the components of household income and the income breakpoints for all ten population deciles.

Individual Income Tax Expenditures

Overview

Reference tax base: a tax on net income. The *Tax Expenditure Budget* follows the approach that the reference tax base is “income from all sources less expenses that are reasonable and necessary to generate that income.”[20] It is occasionally suggested that the federal income tax is really a hybrid of an income and consumption tax. Given the selection rules set out above for choosing tax expenditures to analyze (i.e., excluding any of the base differences that are appropriate to a consumption style tax, such as the preferences for retirement plans), this is not an issue. As a result, the report follows the same approach as the *Tax Expenditure Budget* and treats the tax as a true income tax.

General description. The Minnesota individual income tax closely follows the federal individual income tax, using federal taxable income as the starting point in computing its tax base. The tax applies a progressive tax rate structure to taxable income, a measure of net income that is adjusted for family size (by allowing deduction of personal and dependent exemption amounts) and is reduced by a variety of deductions. Reliance on the federal income tax has advantages and disadvantages for state policymakers. Using the federal tax base means that taxpayers do much of the calculation necessary to complete their state return when they fill out the federal form, making it relatively easier for taxpayers to comply with and for the state to administer the tax. However, in order to gain those advantages, the state must regularly (usually annually) adopt changes made by Congress to keep in close step with the federal tax.[21] With regard to tax expenditures, the state is in a sense captive to congressional decisions, since many preferences flow through from the federal to the state level. The state can, and often does, disallow tax expenditures provided at the federal level, but doing so makes the state’s tax more complicated for both taxpayers and DOR.

Historical Highlights

Minnesota’s income tax has been directly linked to federal income definitions since 1961, when Minnesota adopted federal adjusted gross income (that is, income before “below-the-line” or personal deductions and exemptions) as the starting point for the state tax calculation. Following federal tax reform in 1986, Minnesota in 1987 restructured its tax to use federal taxable income as the starting tax base, thereby also adopting federal itemized and standard deduction rules, as well as the federal personal and dependent exemptions. Since 1987 the legislature has enacted numerous tax expenditures, both state deductions from taxable income and state credits against tax. The 1990s saw development of a trend in which the income tax has been co-opted as a

[20] Dept. of Revenue, *Tax Expenditure Budget Fiscal Years 2012-2015* (February 2012): 24.

[21] The Minnesota Supreme Court has held that the state constitution does not allow the state to automatically adopt future changes adopted by Congress. *Wallace v. Commissioner of Taxation*, 184 N.W. 2d 588 (Minn. 1971).

mechanism for delivering transfer payments to individuals and payments to individuals and businesses to encourage or reward specified behaviors. In 1990, for example, the legislature enacted a state version of the federal earned income credit, called the working family credit, which acts as a wage supplement to individuals. The working family credit mimics a direct transfer program in that credit amounts in excess of income tax liability are paid as refunds. Another example is the refundable credit for K-12 education expenses, enacted in 1997. The most recent examples of tax expenditures intended to modify behavior with refundable credits are the 2010 enactment of the small business investment credit and historic structure rehabilitation credit.[22]

Individual Income Tax Expenditures Covered

The Minnesota individual income tax includes several categories of tax expenditures listed below that are described in greater detail in the pages that follow:

- Federal full or partial exemptions from adjusted gross income that flow through to Minnesota
  - Social Security benefits
  - interest on Minnesota state and local government bonds
- Federal deductions that reduce taxable income and flow through to Minnesota
  - mortgage interest
  - real estate and other taxes (motor vehicle registration tax)
  - charitable contributions
- State deductions that reduce state taxable income
  - charitable contributions of nonitemizers
  - expenses of living organ donors
  - gain on farm property by insolvent taxpayers
  - K-12 education expenses
  - AmeriCorps education awards
  - elderly or disabled exclusion
  - military pay
  - Job Opportunity Building Zone (JOBZ) income
- Nonrefundable state credits (only available to offset liability)
  - marriage credit
  - long-term care insurance premiums
  - past military service
  - research and development expenses
- Refundable state credits (amounts in excess of liability paid as refunds)
  - JOBZ job creation
  - working family credit
  - child and dependent care
  - K-12 education expenses

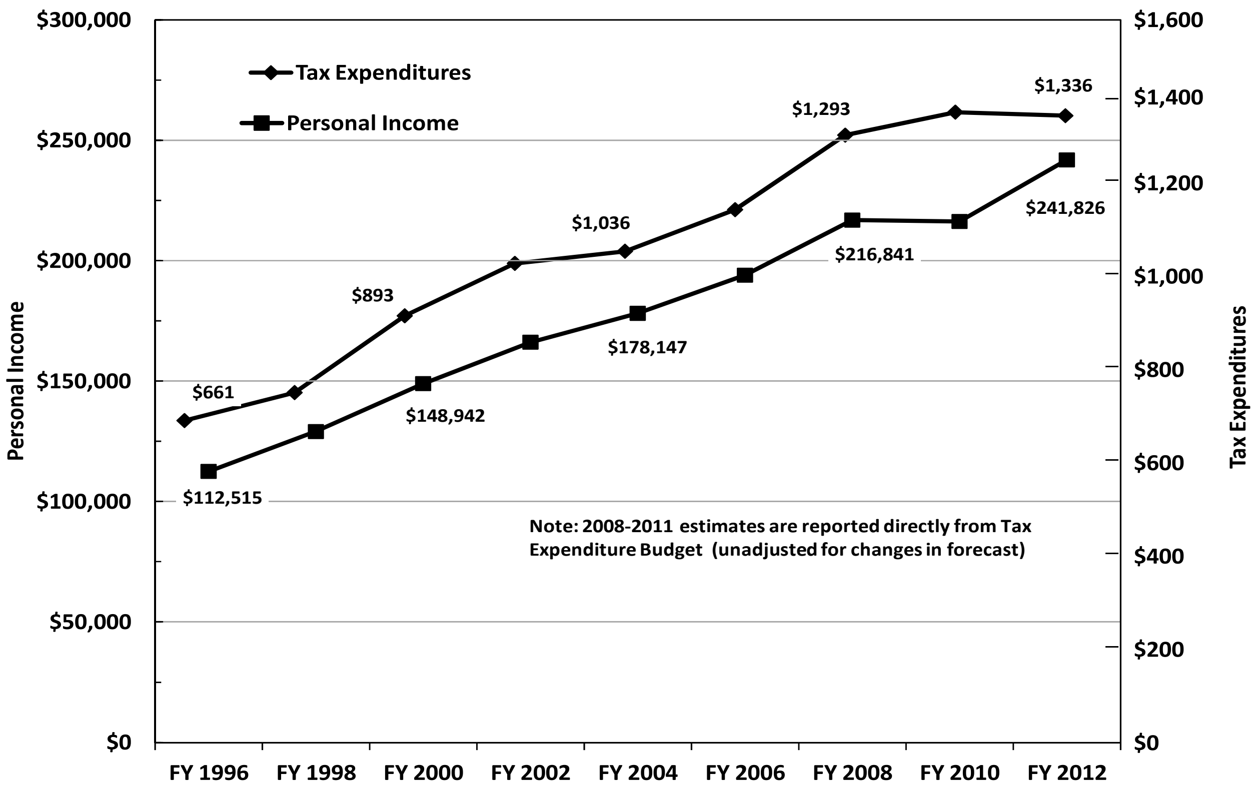
[22] To date, there have not been any individual claims for the historic structure rehabilitation credit.

- military service in a combat zone
- bovine tuberculosis testing
- small business (angel) investment
- historic structure rehabilitation

Growth in the Selected Income Tax Expenditures

The following graph shows the growth of the selected individual income tax expenditures covered in the report relative to the growth of Minnesota personal income from fiscal year 1996 to fiscal year 2012. As the graph shows, personal income and tax expenditures have grown at roughly similar rates over this period.

Dollars of Selected Income Tax Expenditures Compared to Personal Income 1996 to 2012 (millions)

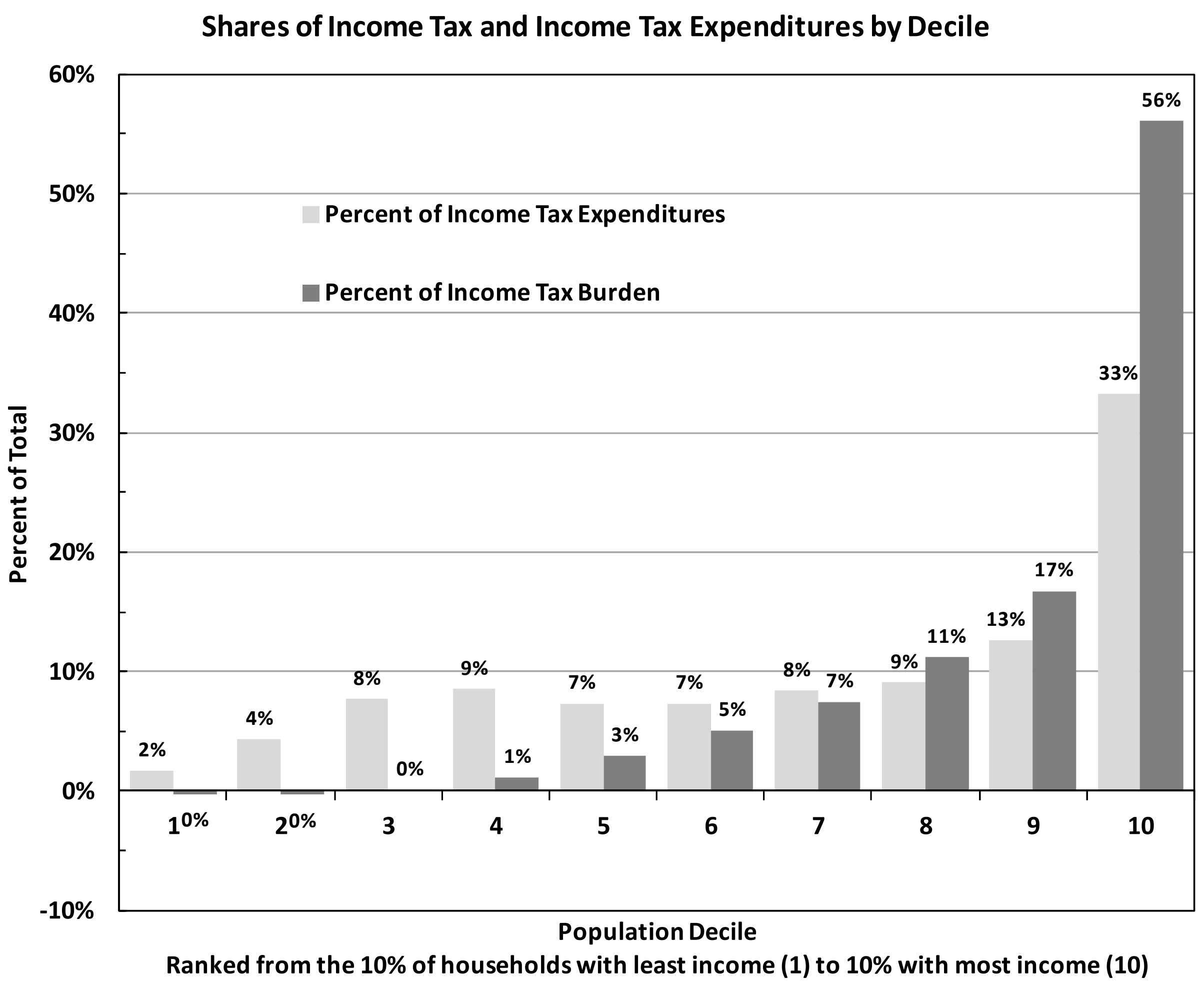


Source: Tax Expenditure Budget data; Minnesota Price of Government

Tax Research Division
MN Department of Revenue
House Fiscal and House Research Departments
February 14, 2013

The Selected Income Tax Expenditures Relative to the Distribution of the Tax

The following graph shows that expenditures are concentrated in the top deciles. For example, the top two deciles (i.e., 20 percent of filers) have 46 percent of tax expenditures. However, the income tax itself is more concentrated at the top of the income distribution than are income tax expenditures. For example, the top decile pays 56 percent of the income tax, but receives 33 percent of income tax expenditures. Put another way, tax expenditures as a percentage of income decline as income rises. In addition, tax expenditures are more concentrated at the bottom of the income distribution than is tax liability. This reflects the allowance of refundable credits, such as the working family and education credits, to households in the bottom deciles.



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

The remainder of this section of the report provides information on the selected individual income tax expenditures.

Social Security Benefits

Description of Provision

Minnesota follows federal law in taxing Social Security benefits. 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 aftertax contributions to Social Security, while the up to 85 percent that may be included in taxable income represents the employer's contributions and transfers, neither of which were taxable to the beneficiary.

In 2009 approximately 858,000 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 2012	FY 2013	FY 2014	FY 2015
$211,800	$220,300	$234,000	$255,100

The tax expenditure for Social Security benefits has increased in nominal terms (unadjusted for inflation) by 33.4 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

Social Security benefits became explicitly exempt from taxation under Treasury Department rulings issued in 1938 and 1941. Larry DeWitt of the Social Security Administration's Historian's Office described the rationale for the rulings as follows:

> Treasury's underlying rationale for not taxing Social Security benefits was that the benefits under the Act could be considered as "gratuities," and since gifts or gratuities were not generally taxable, Social Security benefits were not taxable. It is likely that Treasury took this view owing to the structure of the 1935 Act in which the taxing provisions and the benefit provisions were in separate Titles of the law. Because of this structure, one could argue that the taxes were just a form of revenue-raising, unrelated to the benefits. The benefits themselves could then be seen as a "gratuity" that the federal government paid to certain classes of citizens. Although this was clearly not true in a political and moral sense, it could be construed this way in a legal sense. In the context of public policy, most people would hold the view that the tax contributions created an "earned right" to

> subsequent benefits. Notwithstanding this common view, the Treasury Department ruled that there was no such necessary connection and hence that Social Security benefits were not taxable.[23]

Social Security was enacted in 1935.[24] Taxes were first collected in 1937, and payment of monthly benefits began in 1940.[25] The initial Treasury rulings on taxation of benefits were made before any benefits had been paid. Further, individuals who would begin receiving benefits in 1940 would have paid little if anything in payroll taxes, strengthening the perspective that the benefits were in fact a gratuity. As time went on the exemption may have come to be seen as a way to enhance the value of the benefits, which were initially very modest. Or it may have been viewed as a way to provide a preference to senior citizens, who at the time were, on average, poorer than the rest of the population. The exemption treated Social Security benefits differently from private pension income, in which the amount that exceeds the taxpayer's contributions to the pension is subject to taxation.

In 1983 Congress partially withdrew the total exemption from taxation, providing for up to 50 percent of benefits to be included in taxable income. The rationale for this change was two-fold: to shore up the financing for the Social Security system since revenue raised through taxing benefits goes into the Social Security Trust Funds, and to reverse the early Treasury rulings and treat Social Security benefits more like private pension income.

> When considering the 1983 Amendments, the Report by the House Ways & Means Committee argued as follows: "*Your Committee believes that social security benefits are in the nature of benefits received under other retirement systems, which are subject to taxation to the extent they exceed a worker's after-tax contributions and that taxing a portion of social security benefits will improve tax equity by treating more nearly equally all forms of retirement and other income that are designed to replace lost wages...*[26]

The 50 percent inclusion rate represented the employer share of the payroll tax, which is not taxable to the employee at the time the tax is paid. However, as DeWitt observes, "Even so, this rough-approximation did not really give Social Security benefits the same tax treatment as private pensions—because the real "noncontributed" portion is about 85 percent of the average benefit, not 50 percent."[27]

Further, the 1983 amendments to the Social Security Act maintained the full exemption of benefits for taxpayers with income below $25,000 ($32,000 for married joint taxpayers), which had the effect of retaining preferential treatment of Social Security

[23] DeWitt, *Research Note #12: Taxation of Social Security Benefits* (February 2001).

[24] H.R. 7260, Pub. L. No. 271, 74th Congress.

[25] Social Security Administration, Historian's Office, Historical Background and Development of Social Security.

[26] DeWitt, *Research Note.*

[27] Ibid.

relative to private pension income.

In 1993 Congress increased the share of benefits subject to tax to 85 percent, phased in for taxpayers with incomes over $34,000 ($44,000 for married joint taxpayers). The federal revenues from the 1993 changes were credited to the Medicare trust fund. The House Budget Committee described the rationale for these changes as follows:

> *The committee desires to more closely conform the income tax treatment of Social Security benefits and private pension benefits by increasing the maximum amount of Social Security benefits included in gross income for certain higher-income beneficiaries. Reducing the exclusion for Social Security benefits for these beneficiaries will enhance both the horizontal and vertical equity of the individual income tax system by treating all income in a more similar manner.*[28]

Retaining income thresholds for including first up to 50 percent and, as income increases, up to 85 percent, of benefits in taxable income means that Social Security benefits still receive favorable tax treatment relative to private pensions, except for higher income taxpayers. The 15 percent exclusion was likely intended, as suggested by DeWitt above, to reflect a rough approximation of the employee's after-tax contribution (through payroll or self-employment taxes) to his or her benefits, similar to the tax treatment of private pensions but without going through the actual accounting for each beneficiary. In reality, the effective contribution by beneficiaries varies widely, depending upon earnings history of the beneficiary and spouse, number of dependents, life expectancy, and other factors.[29]

Minnesota conformed to the 1983 and 1993 federal changes both as a way to maintain the simplicity of the Minnesota tax system and to provide revenue and added progressivity.

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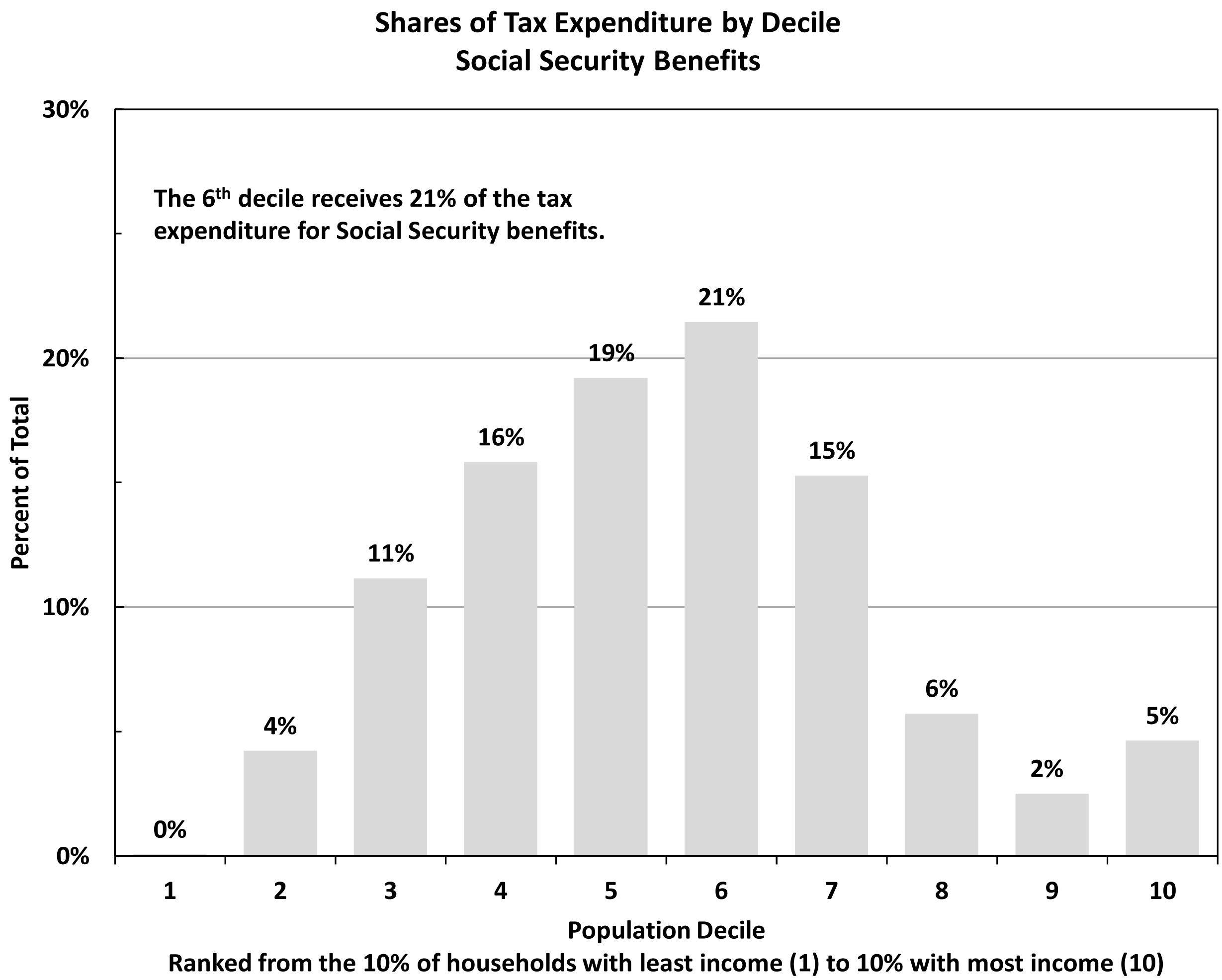
[28] As quoted by DeWitt, ibid.

[29] See e.g., Martin Feldstein and Andrew Samwick, "Social Security Rules and Marginal Tax Rates," *National Tax Journal* 45, no. 1 (March 1992), 1–22, for a discussion of how the return on Social Security taxes varies based on demographic and other characteristics of the participants.

Incidence Information



Source: HITS Model for 2008 and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
December 4, 2012

See the box on page 16 for help in reading this graph.

The Department of Revenue calculated the incidence of the tax expenditure of Social Security benefits using the assumption that 90 percent of all benefits would be taxable, with the remaining 10 percent representing recovery of amounts paid through Social Security taxes. This is generally consistent with the estimates provided in the Department of Revenue's *Tax Expenditure Budget*, and with the method the Joint Committee on Taxation employs in preparing estimates at the federal level.

Suits index for the tax expenditure (if repealed):	-0.606
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for Social Security benefits is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

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. The exemption does provide a substantial economic benefit to low- and middle-income recipients of Social Security benefits, compared with retirees who have other sources of retirement income or other individuals with incomes from other sources.

Interest on Minnesota State and Local Government Bonds

Description of Provision

Interest paid on bonds issued by Minnesota governmental units is exempt from taxation under the federal income tax and flows through to the Minnesota tax. (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 bonds to finance governmental facilities, as well as to qualifying private activity bonds (PABs). PABs include revenue bonds issued for privately owned and used facilities, such as housing and various other facilities permitted under federal law. Interest on state and local bonds is generally exempt under the AMT as well as the regular tax, but interest on some PABs may be subject to taxation under the AMT.

An estimated 80,000 returns benefited from the exemption in tax year 2011.

Projected Tax Expenditure: Interest on Minnesota Bonds
($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$62,500	$62,000	$62,800	$66,000

The tax expenditure for interest on Minnesota state and local government bonds has increased in nominal terms (unadjusted for inflation) by 5.2 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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 in 1933. 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:

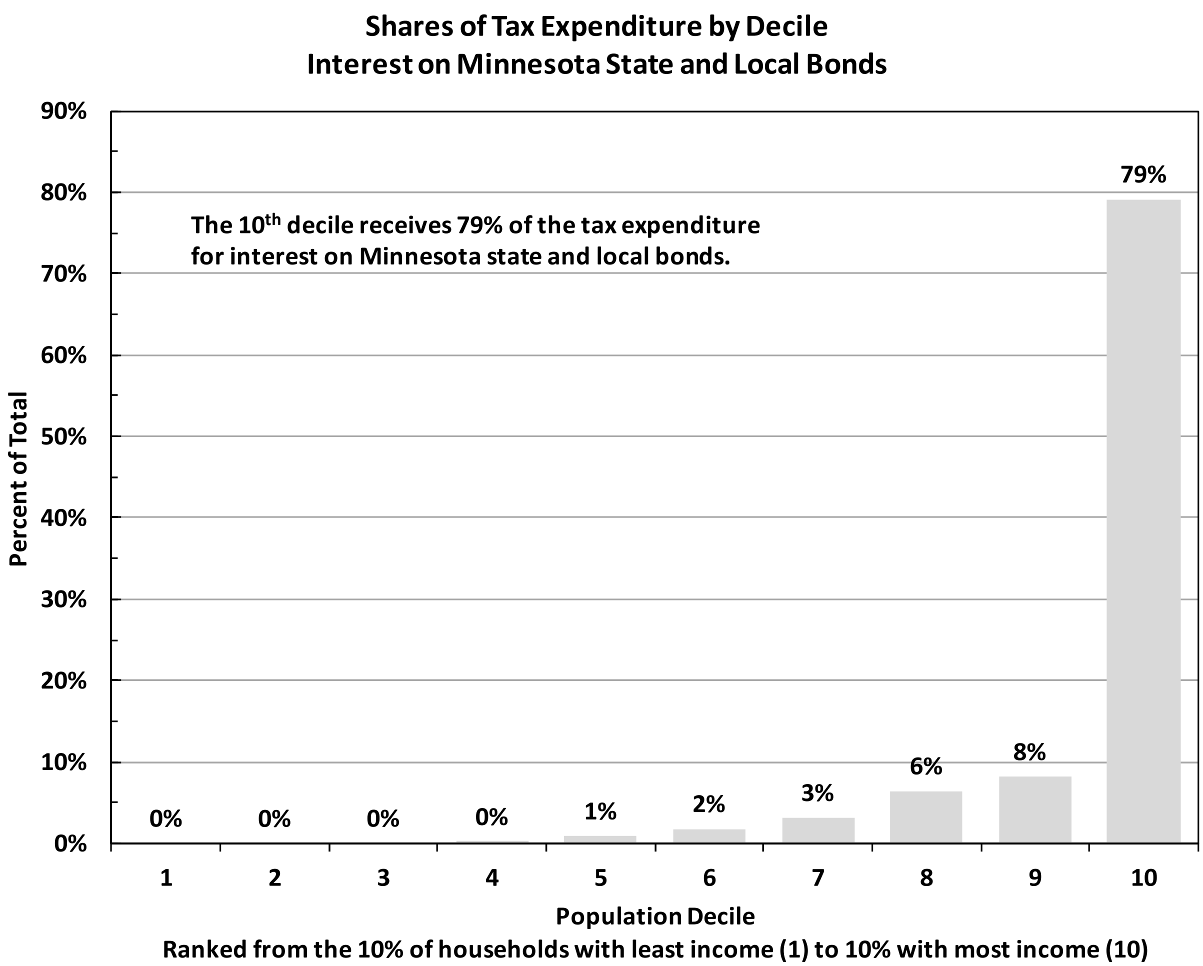
- To lower the borrowing costs for state government
- To provide implicit state aid to local governments through lower interest costs for their debt
- To subsidize specific “private activity” projects (e.g., housing revenue bonds issued by MHFA and local governments and bonds issued for nonprofit organizations’ 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 for the state to pay, in effect, more interest (i.e., the foregone state income taxes on the interest) on its bonds. With regard to interest on local government bonds, the 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 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



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.456
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for exclusion of interest on Minnesota state and local bonds is higher than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) more progressive.

Calculation of the incidence assumes that holders of tax-exempt bonds would simply pay tax on the reported interest. This overstates the amount of the tax benefit to the affected taxpayers. Purchasers of tax-exempt bonds bear an "implicit tax" that reduces the benefit of the exemption to them—that is, they accept lower interest payments, along with the tax exemption. Thus, it is likely that the full tax expenditure does not accrue to holders of tax-exempt bonds; instead, the benefit equals the tax expenditure minus the interest foregone by purchasing Minnesota tax-exempt bonds rather than making a taxable investment. However, for some of the reasons noted below under the discussion of effectiveness, it is widely accepted that despite the implicit tax, most bondholders still benefit from the tax exemption. The net benefit to the bondholders is a function of the tax they would pay on their preferred alternative taxable investment (e.g., tax-exempt interest subject to state tax, fully taxable interest, dividends, capital gains, and so forth).

It is unclear how much investors would shift their portfolios if the Minnesota tax exemption were unavailable. It likely would depend upon how large the implicit tax is. Since the reduction in interest rates that results from the state tax exemption (a measure of the implicit tax) is very small by all accounts, it seems reasonable to conclude that the income distribution of these benefits do not differ much from the reported interest, which is what the graph shows. Put another way, if Minnesota were to repeal the exemption for Minnesota government bonds, many investors would simply diversify their portfolios by purchasing some more non-Minnesota tax-exempt bonds whose interest rates probably do not differ much from those paid on Minnesota bonds. If the federal government were to repeal its exemption for state and local government bonds, the effects likely would differ, because the exemption has a much larger effect on interest rates and because other tax preferred alternative investments are available under the federal tax (e.g., dividends and capital gains).[30]

Evidence on Effectiveness in Meeting Objective

One way to assess the effectiveness of the tax exemption is to compare revenue reductions from the exemption with corresponding reductions in borrowing costs. Studies of the similar federal

[30] See James M. Poterba and Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds," *National Tax Journal* 64, no. 2, pt. 2 (June 2011), 591–614, for a discussion and analysis the federal revenue and incidence effects of repeal of the federal exemption.

income tax exemption for state and local bond interest have found the revenues foregone through the tax exemption exceed interest savings to state and local governments by 10 percent to 40 percent.[31] A few similar studies have been done of state tax exemptions. In general, they find that the revenue foregone by the states exceeds the interest savings by larger percentages than under the federal exemption.[32]

If these analyses are accurate, the state likely could realize budget savings (as high as half of the tax expenditure) by taxing bond interest and paying higher interest on its bonds. With regard to local government bonds, providing state aid payments to local governments to offset their higher borrowing costs would cost the state less, if interest on local bonds were taxed.

The reason for this 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 35 percent federal income tax bracket who itemizes deductions only effectively pays 65 percent of the cost of the state tax after the federal deduction is taken into account. Such an investor will accept a lower interest rate that compensates for only 65 percent of the costs of the exemption, but the state foregoes the full amount of the revenue. Most investors in municipal bonds are higher income individuals who typically itemize deductions.

Some proponents of the exemption dispute these findings and assert that the exemption is a cost-

[31] See, e.g., Joint Committee on Taxation, Present Law and Background Information Relating to State and Local Government Finance (April 25, 2012), 26–34, for a description of the effect of the federal exemption.

[32] See, e.g., Mary E. Loverly and Michael J. Wasylenko, "State Taxation of Interest Income and Municipal Borrowing Costs," *National Tax Journal* 45, no. 1 (1992), 37ff, (finding that the interest reduction equals about one-half of the revenue reduction if all of the bonds were held by residents—the authors specify this as the percentage of the bonds that would need to be held by nonresidents for the state to break even. Id. at 48-59. This results because the state foregoes no tax revenue by exempting the interest from taxation of bonds held by nonresidents); and C. Steven Cole, Pu Liu, and Stanley D. Smith, "The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields, *Journal of Financial and Strategic Decisions* 7, no. 2 (Summer 1994), 67ff (which shows similar results—comparable percentages are 40 to 65).

effective way to reduce state and local borrowing costs. Others assert that a sufficiently large share of Minnesota bonds are held by out-of-state investors to offset its costs.[33] So far no studies have been done to determine if this may be true or if it varies by type of issue. For example, it might be possible that the exemption is cost effective for small issuers, but not for large issuers. This would suggest a strategy for making the exemption more cost effective by excluding bonds of larger issuers—e.g., the state and large cities, counties, and other local units—from qualifying for the exemption.

Recent research in behavioral economics provides another possible justification for state and local bond interest as a cost-effective method for reducing state and local borrowing costs. Contrary to conventional economic theory, some investors may be so averse to paying taxes that they choose tax-exempt investments even when a comparable taxable investment would result in a greater aftertax return. Economists have observed that taxpayers in lower tax brackets purchase more tax-exempt bonds than economic theory suggests that they should. These individuals would realize a higher financial return by buying taxable bonds and paying the tax, but nevertheless purchase (or continue to hold) tax-exempt bonds. Some experimental research has tended to validate this seeming irrational tax aversion.[34] If this is so, the state could harness this tax aversion through the continued use of tax-exempt bonds, although some may question whether this is an inequitable exploitation of the consumer/taxpayers' foibles in doing so.

Proponents also 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 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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[33] This follows the logic of the Loverly and Wasylenko article, cited in note 32.

[34] See, e.g., Abigail B. Sussman and Christopher Y. Olivola, "Axe the Tax: Taxes are Disliked More than Equivalent Costs," *Journal of Marketing Research* 48 (2011): 91-101 ("[W]e found that participants strongly preferred investing in tax-exempt bonds over taxable bonds that were equally profitable—a result that may help explain the puzzling (and suboptimal) tendency for households with low marginal tax brackets to purchase tax-exempt bonds").

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 an estimated 734,000 Minnesota returns in tax year 2011.

Projected Tax Expenditure: Mortgage Interest Deduction
($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$341,600	$335,400	$329,700	$349,700

The tax expenditure for mortgage interest has increased in nominal terms (unadjusted for inflation) by 14.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

Minnesota's income tax has allowed a deduction for mortgage interest since the tax's inception. The original law allowed all interest to be deducted; the restrictions to mortgage interest, along with the dollar limits, were enacted by Minnesota to follow the 1986 federal tax reform. The original purpose or rationale for the interest deduction is unclear. In enacting its tax, Minnesota may simply have been mirroring the federal tax base, which provided a deduction for interest paid. Most proponents of the deduction contend now that it is serves the function of either increasing the rate of homeownership or encouraging improvement or better maintenance of homes, but the original purpose of the deduction under the federal tax was more likely to allow recognition of expenses related to generating income. A Congressional Research Service report states:

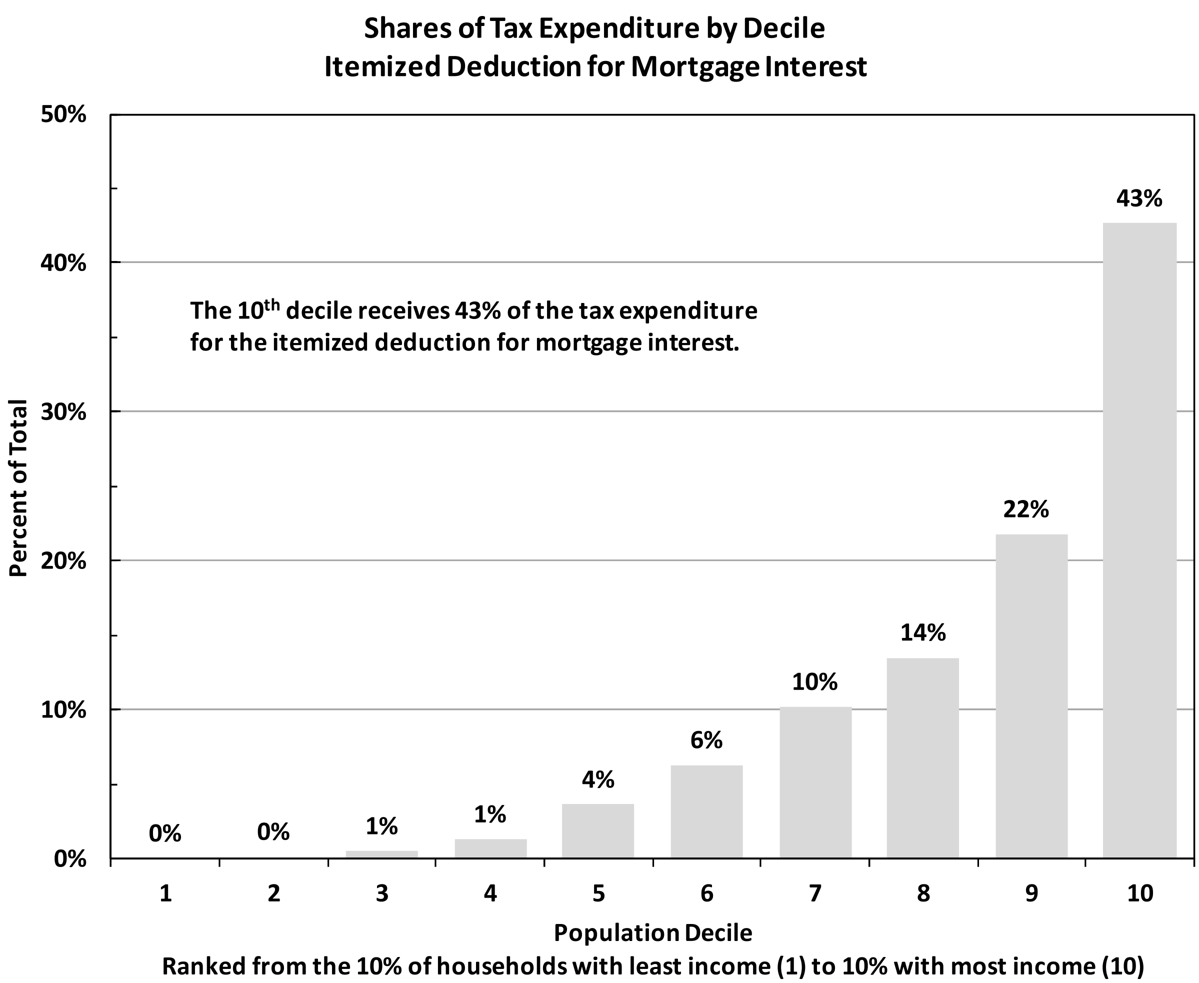
> When laying the framework for the modern federal income tax code in 1913, Congress recognized the importance of allowing for the deduction of expenses incurred in the generation of income, which is consistent with traditional economic theories of income taxation. As a result, all interest payments were made deductible . . . [C]ompared to today, households generally had very little debt on which interest payments were required—credit cards had not yet come into existence, and the mortgage finance industry was in its infancy.[35]

[35] Mark P. Keightley, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, Congressional Research Service (January 18, 2011).

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.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.078
Suits index for the existing income tax:	0.218

Suits index for the overall state and local tax system: -0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for itemized deduction for mortgage interest is less than the Suits index for the individual income tax, repealing the tax expenditure would make the income tax less progressive. However, repeal of the deduction would make the overall tax system more progressive, since the index for repeal is higher than the index for the overall tax system.

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.[36]

Down payment requirements and closing costs combine to prevent renters from becoming homeowners. Further, the barrier to entering the housing market is greater for lower-income households. The deduction does little or nothing to help with those costs. As the Congressional Research Service observes regarding the mortgage interest and property tax deductions in combination: "While the deductions lower the annual cost of homeownership, they do not provide any upfront benefit that can assist in completing a home purchase."[37]

[36] Edward L. Glaser and Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, Harvard Institute of Economic Research, Discussion Paper 1979 (October 2002).

[37] Mark P. Keightley, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, Congressional Research Service (January 18, 2011).

Itemized Deductions for Real Estate and Other Taxes

Description of Provisions

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. Real estate taxes are not deductible in calculating the Minnesota AMT.

The deduction for real estate taxes benefited an estimated 785,000 returns in tax year 2011. The deduction for other taxes benefited an estimated 609,000 returns in tax year 2011.

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

FY 2012	FY 2013	FY 2014	FY 2015
$160,000	$167,000	$169,700	$179,700

The tax expenditure for real estate taxes has increased in nominal terms (unadjusted for inflation) by 64.4 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

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

FY 2012	FY 2013	FY 2014	FY 2015
$16,100	$16,500	$16,900	$17,900

The tax expenditure for other taxes has increased in nominal terms (unadjusted for inflation) by 91.7 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.[38]

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 to 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 Minnesota deduction is unclear. It may simply be a case of Minnesota

[38] The sharp increase from FY 2002 to FY 2012 in the tax expenditure for other taxes paid stems in part from law changes resulting in an increase in motor vehicle registration taxes. In 2000, Governor Ventura proposed and the legislature enacted a maximum vehicle registration tax of $189 for the first renewal, and $99 for each subsequent renewal (Laws 2000, chapter 490, article 7, section 1). In 2008, the maximum renewal amounts were repealed (Laws 2008, chapter 152, article 3, section 1).

opting to follow the federal practice in allowing taxes (other than the state income itself) to be deducted. When the federal income tax was enacted, almost all state and local taxes were deductible. A 2010 Congressional Research Service report suggests "A major rationale [for the federal deduction] was that tax payments reduce disposable income in a mandatory way and thus should be deducted when determining a taxpayer's ability to pay the federal income tax."[39] Since the 1913 enactment of the federal tax and the 1933 enactment of the Minnesota tax, the deductibility of state and local taxes (other than those that constitute business expenses related to the production of income) has been significantly cut back. For example, Minnesota's deduction is now limited to property taxes that are based on value. Excise and sales taxes are no longer deductible. This clearly suggests that the compulsory nature of state and local taxes is no longer the basis for allowing a deduction.

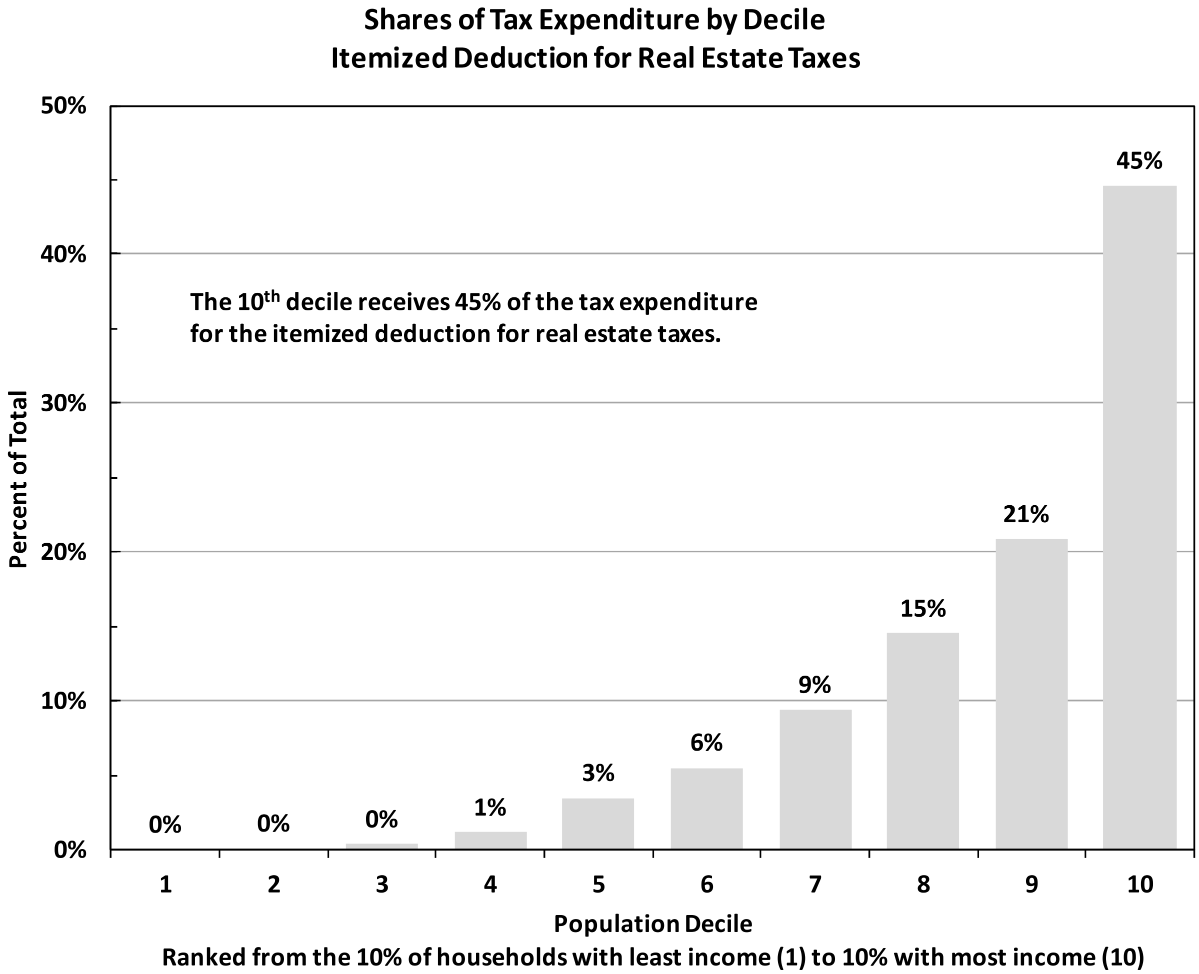
Economists and tax analysts now generally view the federal deduction as a way of providing implicit aid to state and local governments. The notion is that some of these services may provide spillover benefits (benefits that go to individuals who are not residents of the local government or to those who 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. Critics of the deduction argue that local property taxes also fund many services with private benefits. If these services were provided through other mechanisms (e.g., by the private market or through user fees), the costs would not be deductible. The deduction, thus, encourages consumption of these services via property tax funding—e.g., provision of municipally funded garbage, recreational, or other similar services. None of these rationales support the deduction of motor vehicle registration taxes, which are generally considered to be user fees since they are dedicated to paying highway and road costs.

Related Direct Spending Programs

Minnesota provides substantial 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.

[39] Congressional Research Service, *Tax Expenditures Compendium of Background Materials on Individual Provisions* (December 2010): 342-43.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

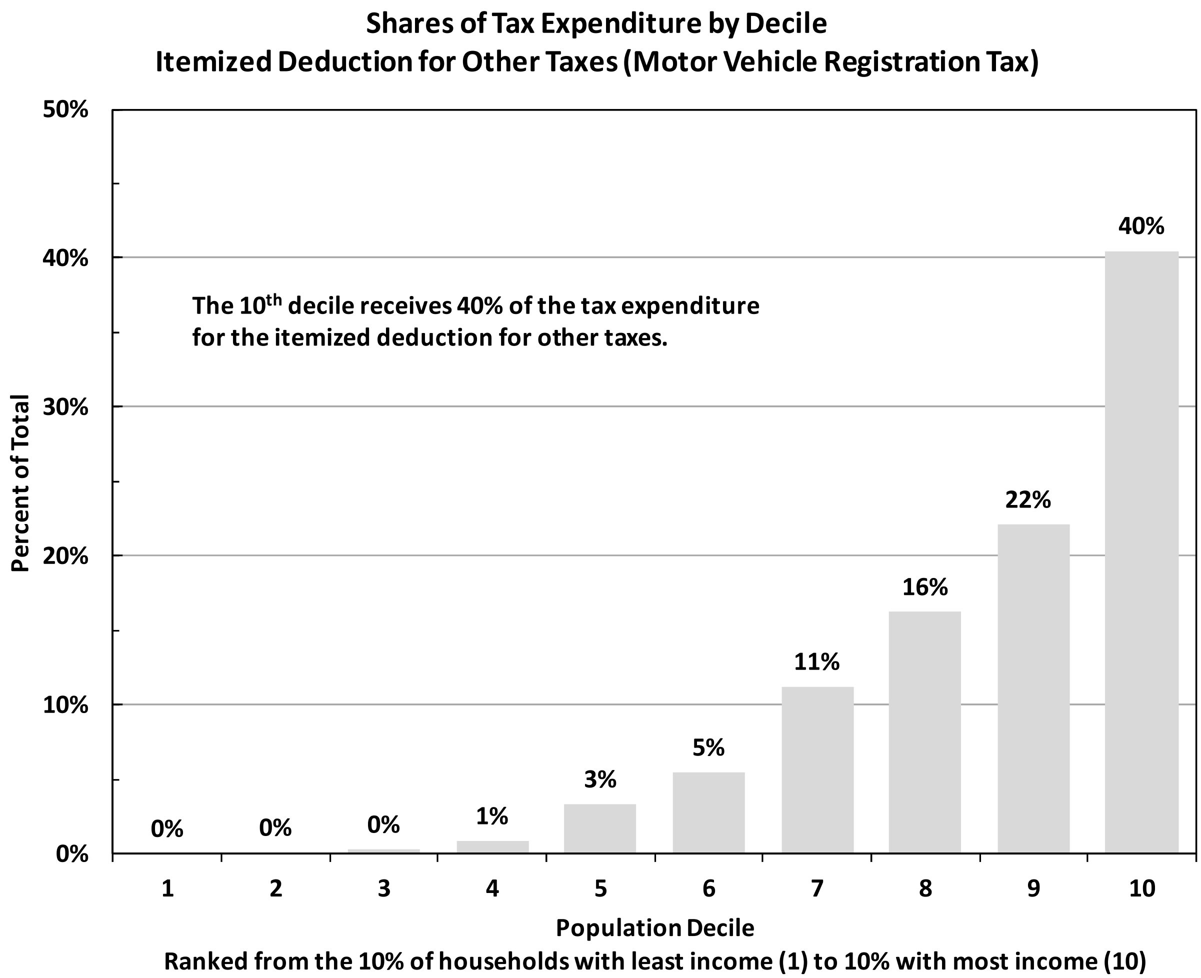
Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.099
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for itemized deduction for real estate taxes is less than the Suits index for the individual income tax, repealing the tax expenditure would make the income tax less progressive. However, repeal of the deduction would make the overall tax system more progressive, since the index for repeal is higher than index for the overall tax system.



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.099
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for itemized deduction for other taxes (motor vehicle registration tax) is less than the Suits index for the individual income tax, repealing the tax expenditure would make the income tax less progressive. However, repeal of the deduction would make the overall tax system more progressive, since the index for repeal is higher than index for the overall tax system.

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 nondeductible 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 9.85 percent of the taxes) and is inversely related to an income-based measure of need—i.e., individuals with higher incomes typically receive more relief and lower income individuals less.

Charitable Contribution Deduction

Description of Provision

Minnesota follows federal law in allowing contributions to governments and nonprofit 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 percent 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 charitable contribution deduction is allowed under both the regular tax and the AMT.

The deduction reduced taxes on about 709,000 Minnesota returns in tax year 2011.

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

FY 2012	FY 2013	FY 2014	FY 2015
$173,500	$178,400	$183,600	$194,000

The tax expenditure for charitable contributions increased in nominal terms (unadjusted for inflation) by 7.6 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

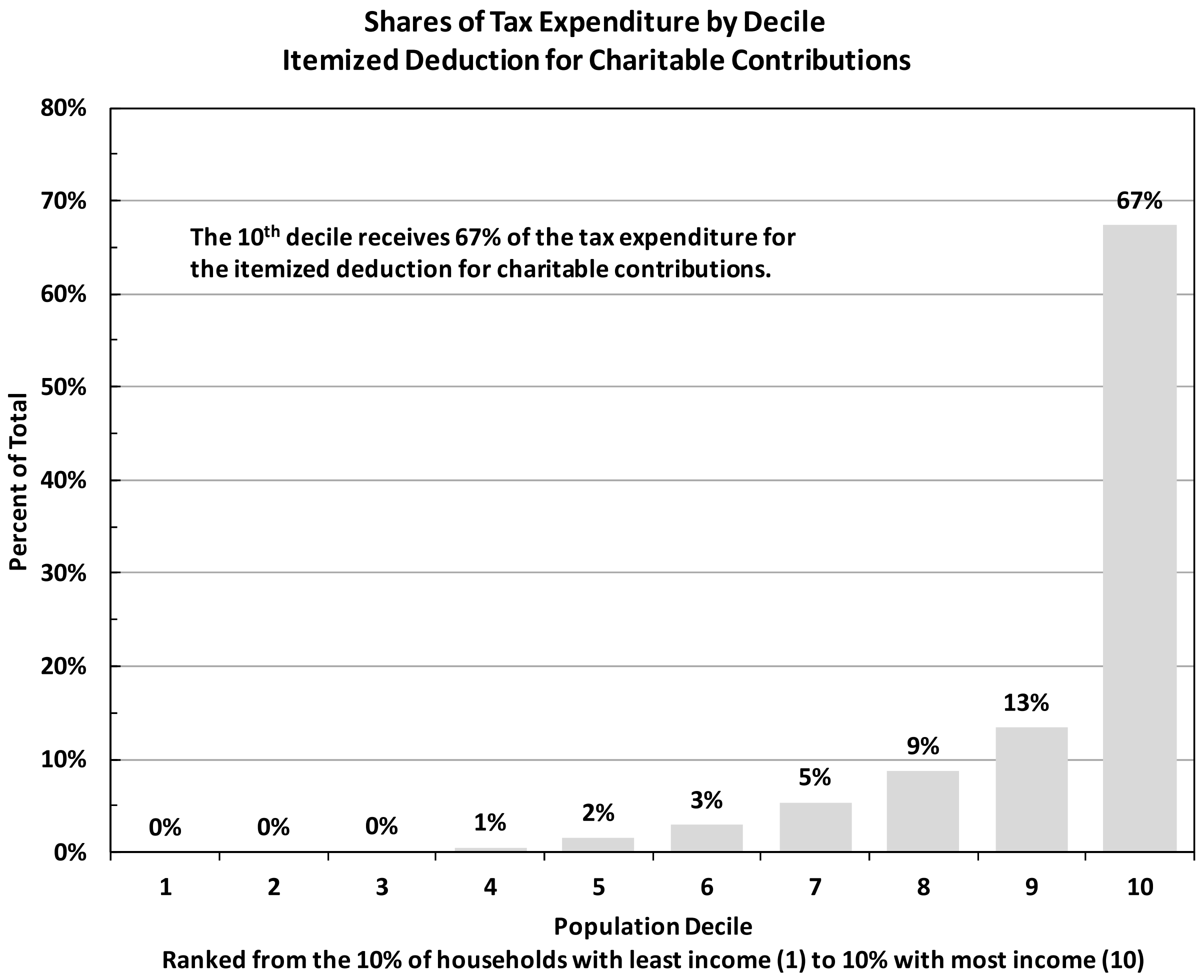
The charitable contribution deduction has been a feature of the Minnesota tax since its inception. The generally accepted purpose of the deduction is to encourage taxpayers to make charitable contributions.[40] The federal deduction was initially put in place out of congressional concern that the high-income tax rates used to finance World War I would reduce charitable contributions.[41] The concern was that the lower incomes resulting from higher income taxes would cause donors to contribute less to charity. Congress attempted to counter this by lowering the price of making a contribution, since the deduction results in a contribution reducing tax by an amount equal to the marginal rate times the contribution. The assumption was that the reduction in the price or cost of making contributions would induce taxpayers to maintain giving at prior levels. When federal income tax rates were lowered during the 1920s, the deduction remained in place. When Minnesota enacted its income tax in 1933, it followed the federal practice of allowing deduction of charitable contributions. The current perspective on the

[40] An alternative theory supporting the deduction is that it is base defining and not a tax expenditure. Under this theory, contributions are not personal consumption, but rather are like the taxpayer not having the income at all. William D. Andrews, "Personal Deductions in an Ideal Income Tax," *Harvard Law Review* 86, no. 2 (1972), 344–75, is perhaps the classic statement of this view of the deduction. This research report, like the state's tax expenditure budget, assumes that deduction is a tax expenditure with a purpose of increasing the amount of charitable contributions.

[41] Evelyn Brody and Joseph J. Cordes, "Tax Treatment of Nonprofit Organizations: A Two-Edged Sword?" in Boris, Elizabeth, and C. Eugene Steuerle (eds.), *Nonprofits and Government* (Washington, D.C.: Urban Institute Press, 2006): 141-181.

purpose of the deduction 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, and that contributions generally provide social goods. It is occasionally suggested that a goal is to lessen the burdens of government by stimulating charitable giving.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.304
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the itemized deduction for charitable contributions is higher than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) more progressive.

Evidence on Effectiveness in Meeting Objective

Extensive studies of the effects of the federal charitable contribution deduction have been made. These studies generally have found 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.

From a policy perspective, the key question relates to the price elasticity of contribution behavior. Economists measure responses to changes in prices as elasticities (how much does the quantity purchased change when price rises or falls). As noted, the deduction reduces the "price" of making a contribution, so theory suggests contributions will increase. A key policy question could be whether donors increase their giving by an amount equivalent to the cost to the government of allowing the deduction. A price elasticity of -1 (or lower)[42] means that each dollar of revenue foregone through the deduction results in at least an additional dollar of revenue contributed to charities. If the price elasticity is that low or lower, legislators and policymakers can conclude that they could not increase the resources for charities (or governmental entities performing the same functions) by directly appropriating money for that purpose. However, even if giving is not that responsive to the deduction, some may prefer an incentive that allows individuals to make private choices regarding which charitable activities to fund, rather than a direct grant program.

Although the studies generally agree that the amount of contributions increases as price decreases (e.g., with allowance of a deduction), there isn't a consensus on the magnitude. A recent review of studies attempting to determine the price elasticity of giving, many spanning the time period of major federal income tax rate reductions in the 1980s, show various elasticities ranging from 0 to -1.26.[43] The authors conclude that the one study with an elasticity lower than -1 was "likely overstated" and settled on a center elasticity of -0.5.[44] If that is correct, a dollar of government subsidy (through allowance of a deduction or credit) results in only 50 cents of additional giving. This suggests that it may be more effective for the government to make grants

[42] Price elasticities are negative numbers (or zero for a commodity that is inelastic), but are often expressed as absolute values or positive numbers.

[43] Jane G. Gravelle and Donald J. Marples, *Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options*, Congressional Research Service (March 18, 2010): 26-29.

[44] One explanation for low responsiveness may simply be that taxpayers do not correctly perceive the extent to which they would personally benefit from the charitable contribution deduction. In the behavioral economics literature, this would be referred to as "low salience"—taxpayers perceive the subsidy as being smaller than it really is. One study suggests that is the case with the charitable contribution deduction. Jacob Goldin and Yair Listokin, "Tax Expenditure Salience" available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2097836 (survey finding taxpayers "systematically underestimate the size of the subsidy associated with the [itemized deduction for charitable contributions.]")

directly to charities rather than allowing a deduction.[45] Others who have reviewed the literature are less convinced that a -1 price elasticity is not plausible, especially for high-income taxpayers.[46]

A recent study, not covered by literature review, found elasticities of -1.6 (cross-section data) or -1.4 (panel data), lending support to the idea that the deduction may be cost effective, particularly for high-income individuals.[47]

It has been widely recognized that the charitable contribution deduction has compliance issues, particularly for contributions of property (rather than cash). Many of these compliance issues center on whether the taxpayers are claiming appropriate values for the contributed property. With a variety of special exceptions, the law generally requires use of the property's fair market value to determine the amount of the deduction.[48] However, unless there is a public market for the property (e.g., publicly traded securities or commodities), this value will be uncertain and the potential for misstatement (typically overstatement) of the value will be high. Congress has attempted to address some of these issues by imposing special rules for contributions of property, including special process rules (requiring appraisals and so forth) or limiting the value to the proceeds realized by the charity (e.g., for certain motor vehicles or intellectual property). However, it is unclear how effective these rules are. A recent Treasury Inspector General report found that about 60 percent of the individual returns with noncash contributions that it sampled had not complied with the process requirements and that the I.R.S. had not implemented adequate controls to identify taxpayers' noncompliance.[49] The report, however, notes that the I.R.S. has undertaken or completed "at least eight compliance initiatives" on noncash charitable

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[45] This option has been suggested as a replacement for the federal deduction and is discussed briefly by the staff of the Joint Committee on Taxation. *Present Law and Background Relating to the Federal Tax Treatment of Charitable Contribution* (February 11, 2013): 54. The United Kingdom has a matching grant program to stimulate contributions, rather than a tax-based incentive.

[46] John A. List, "The Market for Charitable Giving," *Journal of Economic Perspectives* 25, no. 2 (Spring 2011): 157-80. After reviewing some of the same literature as Gravel and Marples, List concludes:

> Combining the totality of the evidence with the results on price elasticities from the field experiments discussed below, I am left with the thought that there is a fair amount of evidence, although not universal agreement, that charitable giving is at least unitary price elastic [i.e., -1] if not price elastic, especially amongst the high-income classes. (172)

See also Joint Committee on Taxation, *Present Law*, 33-35, for a discussion of the literature on economic effects of the tax price and quantity of giving.

[47] Jon Bakija, "Tax Policy and Philanthropy: A Primer on the Empirical Evidence for the U.S. and its Implication," *Social Research* 80, no. 2 (2013): (forthcoming).

[48] Conceptually, it should be the value of the property to the recipient charity or governmental entity, if the purpose of the deduction is to deliver value to the recipient. This may not equal the objective fair market value of the property, if the charity does not have a good use for the property and has to incur costs to hold or dispose of it. These issues are discussed in detail in Roger Colinvaux, "Charitable Contributions of Property: A Broken System Reimagined," *Harvard Journal of Legislation* 50 (2013).

[49] Treasury Inspector General for Tax Administration, *Many Taxpayers are Still Not Complying with Noncash Charitable Contribution Reporting Requirements* (December 20, 2012).

contributions.[50] This suggests both that noncompliance may be high (at least in the I.R.S's view) and that the deduction imposes significant tax administrative costs.

[50] Treasury Inspector, 8.

Subtraction for Charitable Contributions by Nonitemizers

Description of Provision

Taxpayers who do not itemize deductions are allowed to subtract 50 percent 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. The subtraction for nonitemizers is allowed both under the regular tax and under the AMT.

An estimated 173,000 returns benefited from this provision in tax year 2011.

Projected Tax Expenditure: Nonitemizer Subtraction for Charitable Contributions ($ thousands)

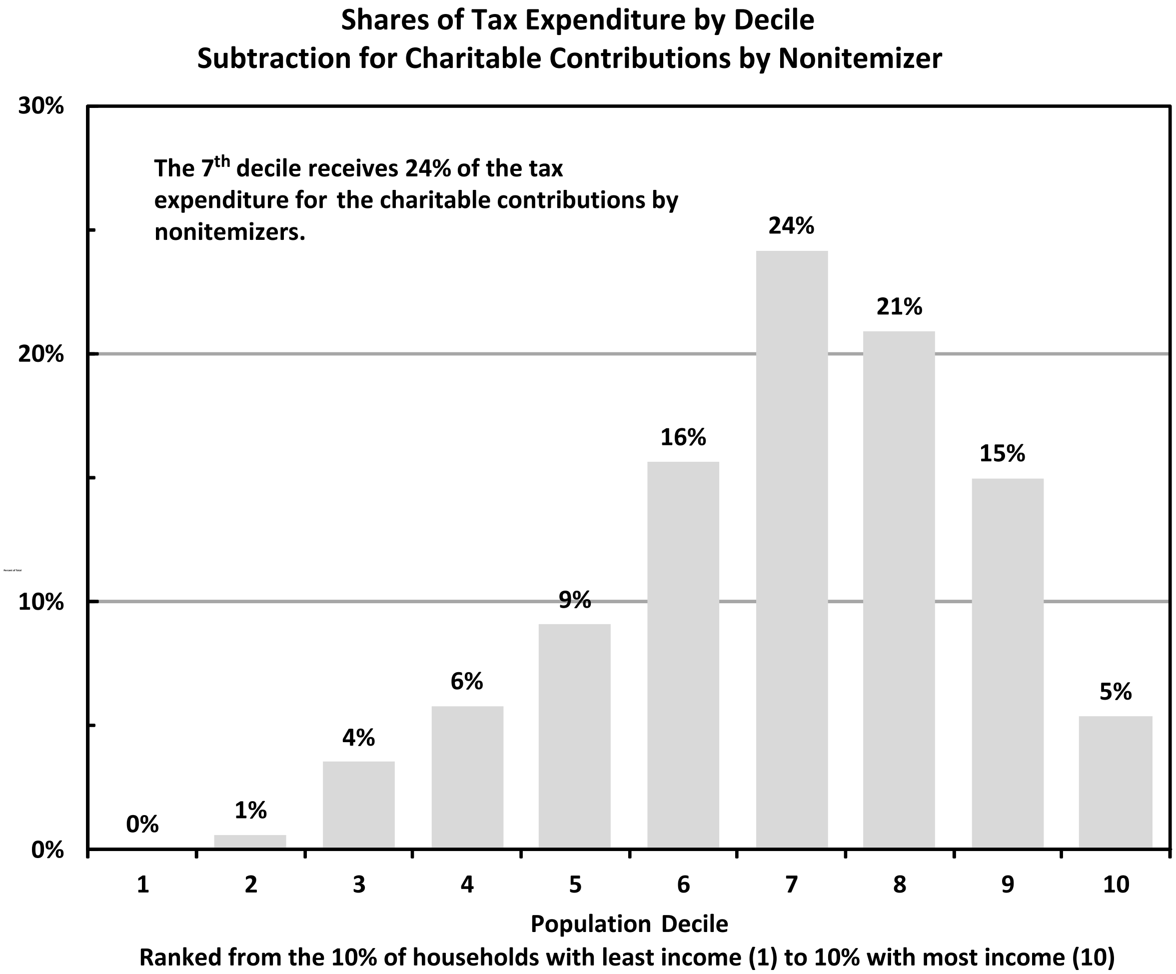
FY 2012	FY 2013	FY 2014	FY 2015
$7,500	$7,600	$8,000	$8,500

The tax expenditure for charitable contributions made by nonitemizers has increased in nominal terms (unadjusted for inflation) by 87.5 percent from FY 2002 to FY2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

This provision was enacted in 1999. It is intended to equalize the treatment of itemizers and nonitemizers and to encourage more individuals to make charitable contributions. 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.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.394
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the subtraction of charitable contributions by nonitemizers is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

Evidence on Effectiveness in Meeting Objective

The subtraction does not fully equalize the tax benefits of making charitable contributions by nonitemizers and itemizers. In most instances, it allows a smaller benefit to nonitemizers, because they are allowed to subtract only one-half of contributions. In other instances, it allows a larger benefit to nonitemizers, because individuals who itemize, but who would derive a larger benefit from the nonitemizer 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 are a cost-effective way to increase contributions.

Expenses of Living Organ Donation Subtraction

Description of Provision

Donors of all or part of their liver, pancreas, kidney, intestine, lung, or bone marrow are allowed a subtraction from federal taxable income of expenses for travel and lodging related to the donation and for lost wages, net of sick pay, resulting from the donation. The maximum subtraction is the lesser of the actual expenses or $10,000 for each organ donation. The maximum tax benefit for a filer in the top income tax bracket is $785. The subtraction applies to organ donations made by the taxpayer and also by the taxpayer's dependent(s), and is allowed under the AMT and the regular tax.

About 100 Minnesota returns benefited from this provision in tax year 2010.

Projected Tax Expenditure: Organ Donor Subtraction ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
Less than $50	Less than $50	Less than $50	Less than $50

Objective or Rationale

This subtraction was enacted in 2005. The rationale for it is not clear, but based on testimony by supporters of the subtraction when it was adopted, possible rationales include the following:

- To encourage organ donations and, thereby, to help alleviate the shortage of transplantable organs
- To provide tax benefits for expenses related to organ donation similar to those allowed for charitable contributions
- To provide public recognition of the societal benefits of the organ donation

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

- **Effectiveness in encouraging organ donation.** Whether the subtraction is effective in increasing the number of organ donations is an empirical question. Three published empirical studies have researched the effectiveness of state tax deductions, including the Minnesota subtraction, in encouraging organ donation. Each of the studies used similar methodologies, using regression analysis to analyze the variations in donation rates across states with and without tax deductions over time, and controlling for other relevant factors that may affect donation rates. None of these studies found that the state tax deduction had a statistically significant effect on organ donation.[51]

Based on these studies, it is reasonable to conclude that the deduction does not increase organ donations.[52] The authors suggest various explanations for this ineffectiveness:

- Potential donors may be unaware of the tax benefits.
- The benefits are too small relative to the costs.[53]
- Financial incentives may not be important because most donations are made by family members.[54]
- Grant programs that cover these costs may have affected the statistical measures.

Minnesota could modify its subtraction in various ways to attempt to overcome its ineffectiveness. If one assumes that the dollar amount is too small to have the desired incentive effect, the subtraction could be converted to a credit and made more generous. Alternately, the legislature could convert the tax expenditure to a direct spending program that reimburses a higher percentage of expenses than the subtraction effectively does. Such a program could be administered by Minnesota transplant hospitals and funded by the departments of human services or health. It may be reasonable to expect that a direct spending program would be better publicized and have more usage, since transplant hospitals would likely be more effective in communicating its availability to family members of the potential recipients, the primary group that make live donations. A direct spending program could also provide benefits or incentives to nonresidents and others with no Minnesota tax liability for whom the subtraction provides no benefits or incentive to donate.

- **Tax benefits comparable to charitable contributions.** The subtraction provides tax benefits that are roughly comparable to the treatment of charitable contributions. Certain aspects of the subtraction are more generous than the treatment of charitable contributions—donors need not itemize deductions to qualify, costs are fully deductible (nonitemizers only qualify to deduct one-half of charitable contributions over $500), and foregone income (lost wages) are allowed as a deduction, which is not permitted under

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[51] Nicola Lacetera, Mario Macis, and Sarah S. Stith, "Removing Financial Barriers to Organ and Bone Marrow Donation: The Effect of Leave and Tax Legislation in the U.S." NBER Working Paper No. 18299 (August 2012); Atheendar S. Venkataramani, Erika G.Martin, Anitha Vijayan, and Jason R. Wellen, "The Impact of Tax Policies on Living Organ Donation in the United States," *American Journal of Transplantation* 12, no. 8 (August 2012): 2133-2140; Alison J. Wellington and Edward A Sayre, "An Evaluation of Financial Incentive Policies for Organ Donations in the United States," *Contemporary Economic Policy* 29, no. 1 (January 2011): 1-13.

[52] Lacetera et al., "Removing Barriers," concludes that there is small effect on bone marrow donations.

[53] Lacetera et al., favor this explanation since it is consistent with their finding of an effect on bone marrow donations, where donor costs are lower.

[54] Lacetera et al., specifically analyzed this question and found "only weak evidence for the hypothesis that nonbiologically related donors are more sensitive to the financial disincentive to donation."

the charitable contribution deduction. Other aspects are less generous than the treatment of charitable contributions—for example, the $10,000 maximum limit.

- **Public recognition.** The subtraction may have been motivated more by the desire to provide a token recognition of the costs and sacrifices that donors incur, rather than to provide an incentive for changing behavior. This goal 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. The relatively small number of individuals that use the subtraction suggests that administrative costs for a direct payment program would be reasonable, although likely higher than for the subtraction, which has minimal administrative costs.

Disposition of Farm Property Subtraction

Description of Provision

Minnesota's income tax allows a subtraction from federal taxable income 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.

Fewer than 50 returns benefited from this subtraction in tax year 2010.

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

FY 2012	FY 2013	FY 2014	FY 2015
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 reenacted 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 the use of federal taxable income). However, the federal exclusion is limited to discharge or cancellation of indebtedness income, while the Minnesota subtraction also extends to capital or other gain realized on the sale or exchange of farm property by insolvent taxpayers.

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.

Subtraction for K-12 Education Expenses

Description of Provision

Minnesota's income tax allows a subtraction for K-12 education-related expenses. Qualifying expenses include the following:

- 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. The subtraction is not allowed under the AMT.

An estimated 222,000 returns benefited from this provision in tax year 2011.

Projected Tax Expenditure: K-12 Education Expense Subtraction ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$18,200	$18,300	$18,600	$19,000

The tax expenditure for K-12 education expenses has increased in nominal terms (unadjusted for inflation) by 9.0 percent from FY 2002 to FY2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

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 amount of the deduction was increased in 1976, 1981, and 1998. One argument in favor of the 1976 and 1981 expansions was that tax assistance to parents sending their children to nonpublic schools would alleviate overcrowding in public schools, and help nonpublic schools remain in operation.[55]

Related Direct Spending Programs

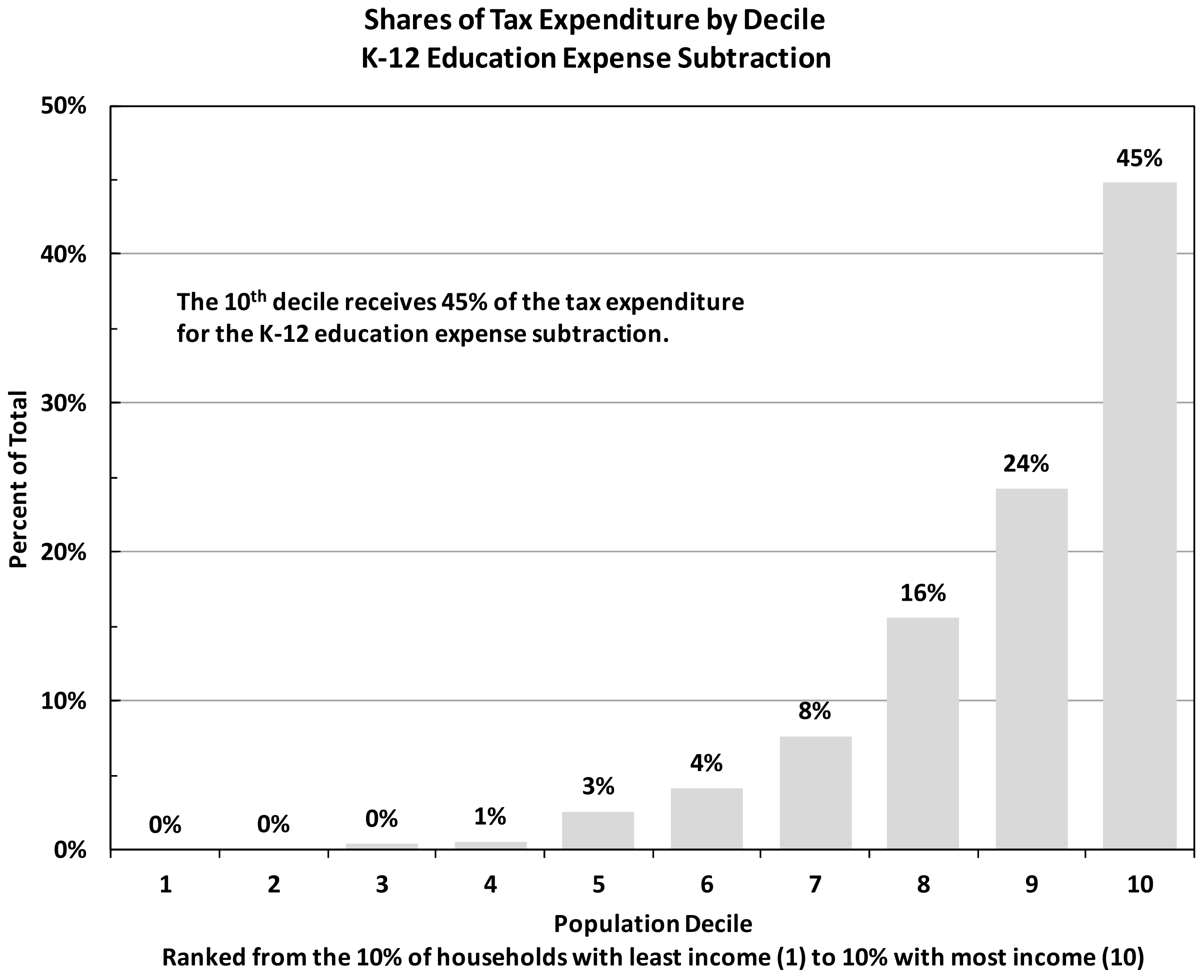
The state provides funding for public education. In addition, public school districts are required to provide nonpublic school pupils with textbooks, individualized instructional materials, and standardized tests, all of which must be secular in nature. A district must also provide the same health services it provides to public school students to nonpublic school students. Nonpublic secondary students must be offered guidance and counseling services by public secondary schools.[56] The appropriation for these items equaled $14.4 million in FY 2011. Districts must also provide equal transportation to nonpublic school students.[57] The appropriation for nonpublic school student transportation aid equaled $19.4 million in FY 2011. 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 education appropriations and not easily separated.

[55] Betty Malen Anderson, "Politics of Persistence: The legislative process resulting in Minnesota's tuition tax concession statutes for elementary-secondary education," University of Minnesota PhD thesis, 1983.

[56] Minn. Stat. §§ 123B.40 to 123B.48.

[57] Minn. Stat. §§ 123B.84 to 123B.86.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.064
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for K-12 education expense subtraction is less than the Suits index for the individual income tax, repealing the tax expenditure would make the income tax less progressive. However, repeal of the subtraction would make the overall tax system more progressive, since the index for repeal is higher than index for the overall tax system.

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 (i.e., taxpayers claiming the subtraction pay lower state income taxes, which reduces their state income tax deduction, and in turn increases their federal tax liability, with the amount of the offset depending on the taxpayer's federal tax bracket). 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 to traditional public education, and with enrollment levels at public schools below their historic high points, it also seems unlikely that the subtraction plays a significant role in preventing crowding in public schools.

AmeriCorps Education Awards Subtraction

Description of Provision

Minnesota's income tax allows a subtraction for amounts received as national service education awards from the National Service Trust for service in an approved AmeriCorps National Service Program. The subtraction is not allowed under the AMT.

About 600 returns benefited from this provision in tax year 2010.

Projected Tax Expenditure: AmeriCorps Subtraction ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$100	$100	$100	$100

Objective or Rationale

This subtraction was initially enacted in 1997 for benefits under the Minnesota Youth Works program. It was repealed in 2005 and reenacted 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 of the efforts and economic sacrifices of individuals who served in these programs (e.g., similar to the preferential tax treatment for military pay).

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 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 or he is in. The subtraction will have no value to a 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. However, since AmeriCorps is a federal program, there could be high administrative costs to administering a direct spending program rather than an income tax subtraction. The state may not have access to information on program participants, who would then have to apply for benefits, and it's not obvious which state agency would be best suited to administer payment of stipends.

Elderly or Disabled Exclusion

Description of Provision

Persons who are age 65 or over or totally disabled may claim a subtraction from federal taxable income, 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. The amounts are shown in the table.

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

The exclusion is not allowed under the AMT.

An estimated 6,800 returns benefited from this provision in tax year 2011.

Projected Tax Expenditure: Elderly Exclusion ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$800	$700	$700	$600

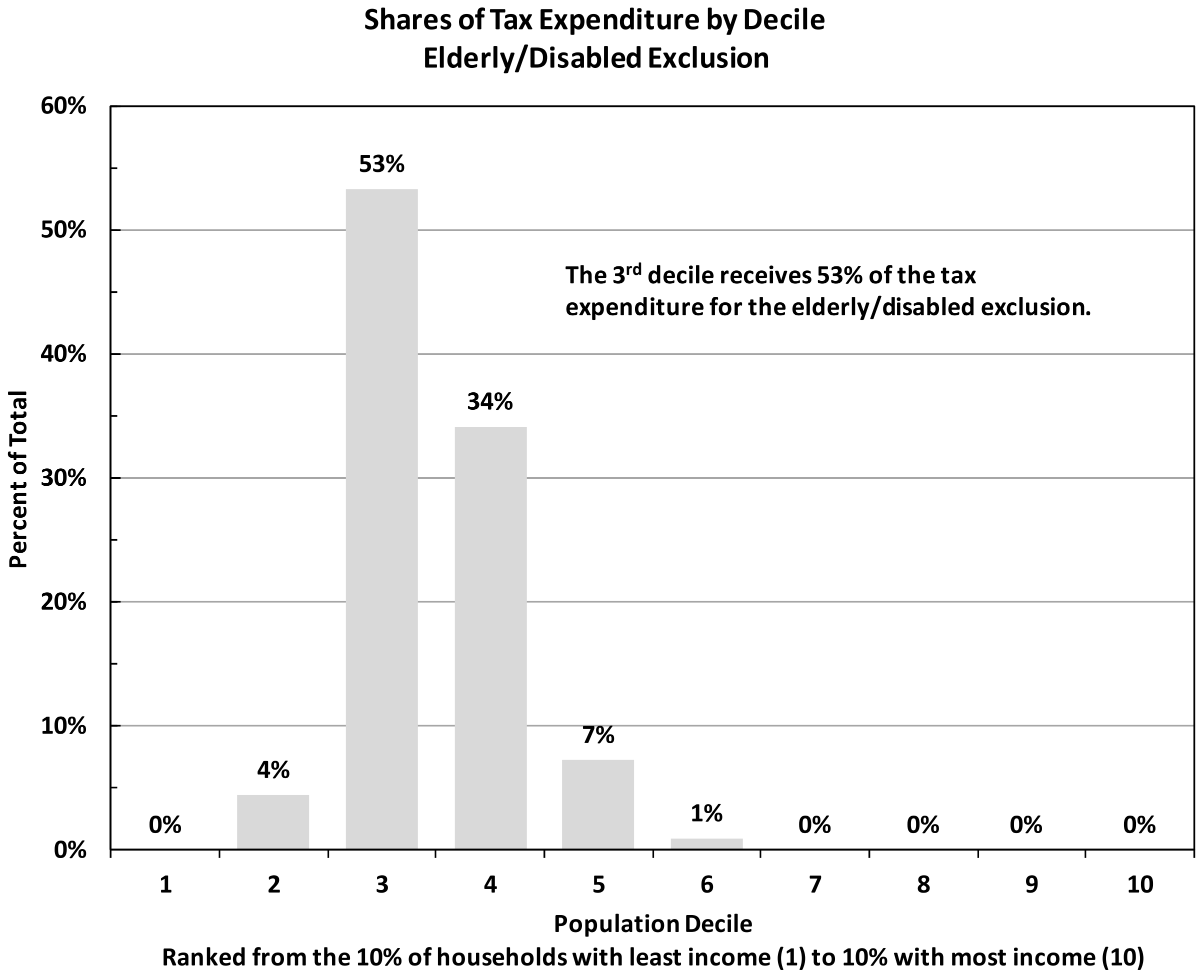
The tax expenditure for income of the elderly and disabled has decreased in nominal terms (unadjusted for inflation) by 61.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

The number estimated to claim this subtraction has fallen from 11,000 in tax year 2003 to 6,800 in tax year 2011.

Objective or Rationale

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. The subtraction benefits low-income taxpayers who have more of their income from taxable sources such as pensions and interest than from sources such as Social Security, which is nontaxable to low-income taxpayers. 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.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.606
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for elderly/disabled exclusion is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

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 much larger exclusion would be necessary to make a material difference. The combined exemptions for Social Security and veterans' benefits reduce state taxes by more than $211 million (FY 2012), while the elderly exclusion reduces tax liability by less than $1 million per year. In a more direct comparison, the exemption for Social Security benefits provides a tax benefit of roughly $200 on average across all income levels, while the elderly exclusion provides an average tax benefit of just over $100. 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. 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.

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. The subtractions are allowed under the regular tax and the AMT.

An estimated 10,000 returns per year claim the subtraction for active service by members of the full-time military, and an estimated 14,000 claim the subtraction for in-state National Guard and reserve active service.

Projected Tax Expenditure: Subtractions for Military Pay ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$13,000	$13,500	$14,100	$14,900

The tax expenditure for military pay has increase in nominal terms (unadjusted for inflation) by 196 percent 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 2012, when it was expanded to allow subtraction for active service pay of members of the full-time military as well as members of the National guard and reserves, as well drill and summer camp pay. This 196 percent increase compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

The subtraction in current law was 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 exemptions.

Incidence Information

Not available

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, 2001 attacks.

Job Opportunity Building Zone (JOBZ) 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; and
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 12 years, 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, and by five years for certain glass and wind turbine manufacturing projects. The subtraction is allowed under both the regular tax and the AMT.

About 2,000 returns benefited from this provision in tax year 2010.

Projected Tax Expenditure: JOBZ subtraction ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$2,700	$2,700	$3,000	$3,300

The tax expenditure for net income in a JOBZ zone has increased in nominal terms (unadjusted for inflation) by 170 percent from FY 2006, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2012, compared with an 24.1 percent nominal increase in personal income over the same time period.

Objective or Rationale

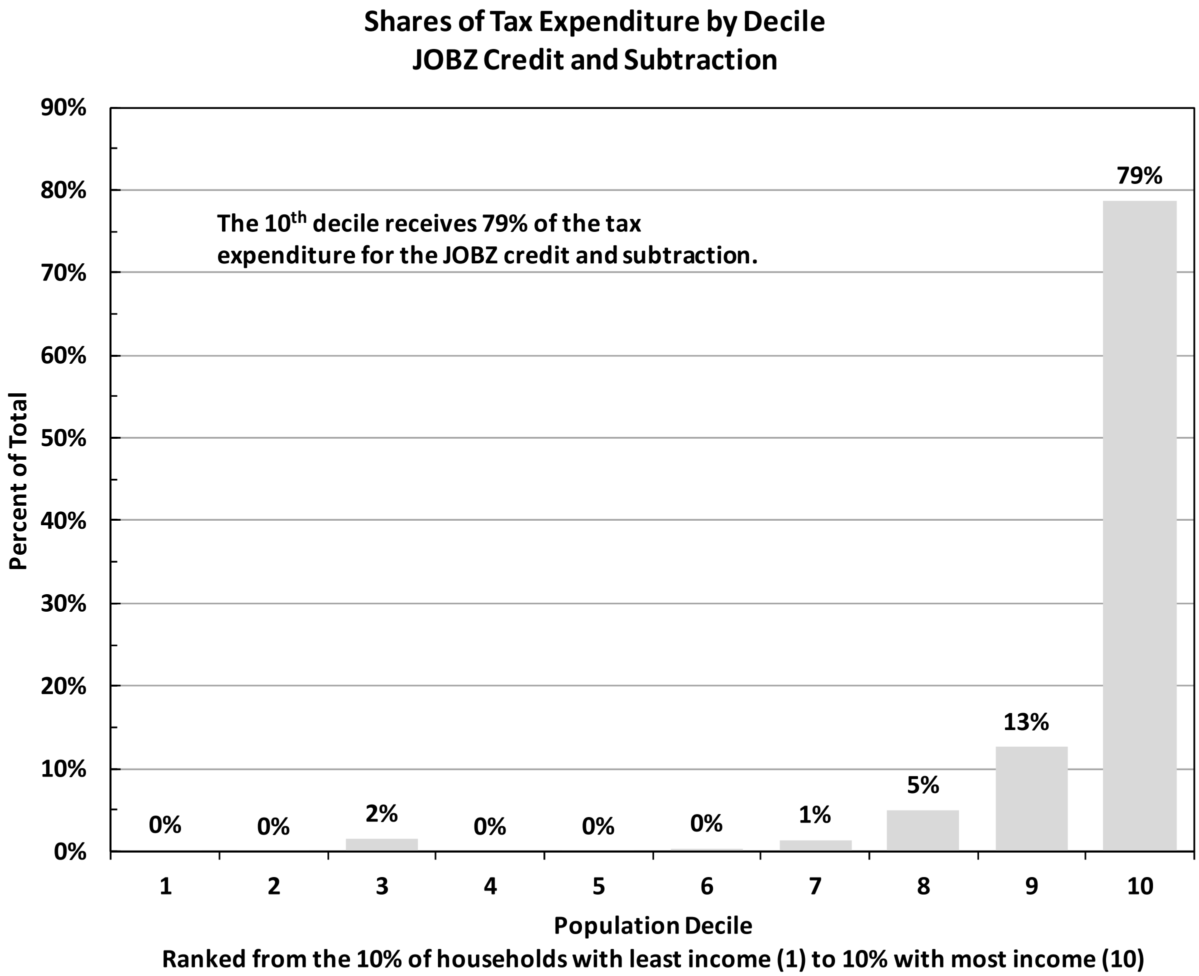
This subtraction was enacted in 2003. The impetus for this provision is driven by an economic theory that suggests that lower taxes and less regulation will increase jobs and incomes in the zone by attracting capital, labor, and economic activity.

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.

Incidence Information

The incidence graph combines the JOBZ subtraction and the JOBZ credit.



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.624
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the JOBZ credit and subtraction is higher than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) more progressive.

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." [58]

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

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 398,000 returns claimed the credit for tax year 2010.

Projected Tax Expenditure: Marriage Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$62,200	$64,500	$67,200	$70,300

The tax expenditure for the marriage credit has increased in nominal terms (unadjusted for inflation) by 8.0 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

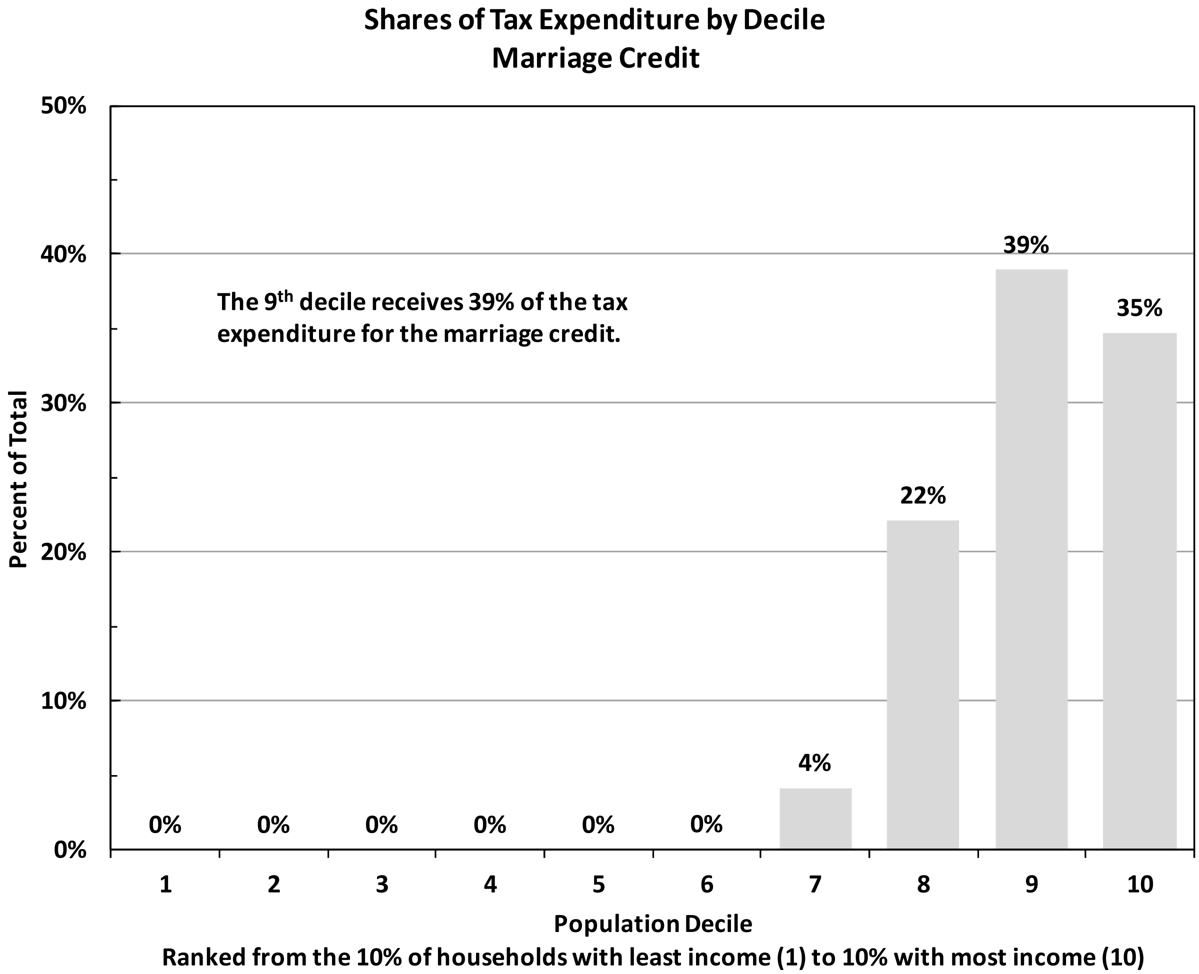
Objective or Rationale

The credit was enacted in 1999 to help offset the marriage penalty in the state income tax rate and bracket system, and due to differences in the standard deduction amount allowed for married couples and single filers. 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 or her own income.

The penalty in the rates and brackets results from the following:

- the use of combined income for a married couple to calculate their tax
- the progressive rate structure

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	0.059
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the marriage credit is less than the Suits index for the individual income tax, repealing the tax expenditure would make the income tax less progressive. However, repeal of the credit would make the overall tax system more progressive, since the index for repeal is higher than index for the overall tax system.

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 carry over 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.

Credit for Long-Term Care Insurance Premiums

Description of Provision

The credit equals 25 percent of long-term care (LTC) insurance premiums paid to the extent the premiums were not deducted as an itemized deduction for medical expenses. 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 2010, the credit was claimed by approximately 60,000 returns.

Projected Tax Expenditure: Long-term Care Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$8,200	$8,400	$8,500	$8,700

The tax expenditure for the long-term care credit has increased in nominal terms (unadjusted for inflation) by 82.2 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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.[59]

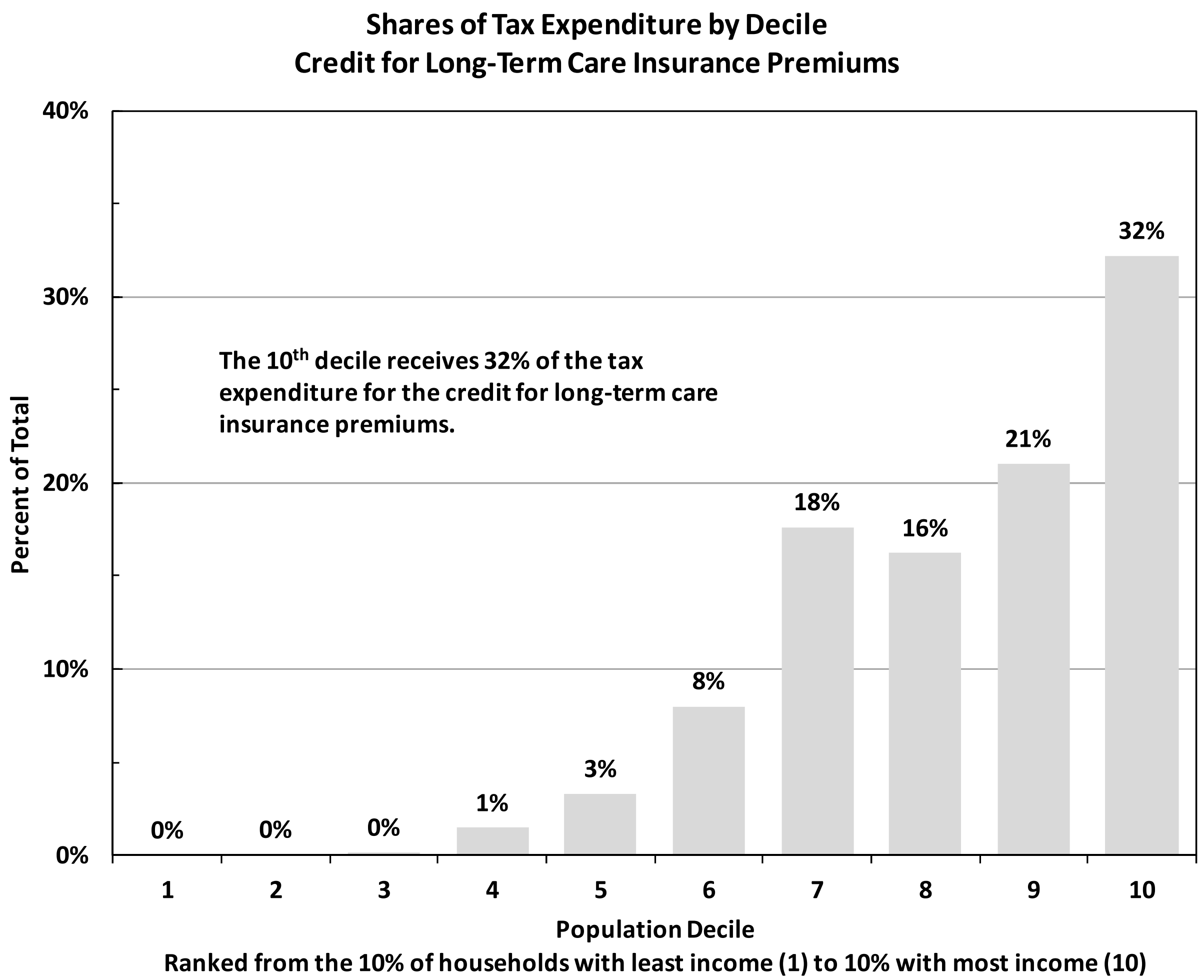
Related Direct Spending Programs

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 spenddown requirements. Participation in the partnership program requires purchasing more comprehensive LTC insurance than is required under the tax credit. For example, the partnership program requires benefits that include inflation protection, whereas the 2000 Legislature repealed the similar requirement under the tax

[59] Adverse selection, in this context, refers to the risk that buyers of LTC have superior knowledge of their risk of utilizing LTC than the insurers do. If this is so, the insurance market will not function efficiently. For example, purchasers with unobservable risks are more likely to purchase LTC insurance, causing insurers to charge premiums that are higher than normal risk individuals are willing to pay.

credit, because it considered the resulting higher premiums to create too great a barrier to the purchase of LTC insurance.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.081
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the long-term care credit is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

Evidence on Effectiveness in Meeting Objective

Since the LTC credit was enacted in 1997, a number of studies have been done of LTC insurance and the use of tax incentives to encourage its purchase. Many of these studies are summarized in Jeffrey R. Brown and Amy Finkelstein, "The Private Market for Long-Term Care Insurance in the U.S.: A Review of the Evidence."[60] 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. The studies find varying sensitivities or elasticities (see the section on the charitable contribution deduction for a discussion of elasticity on page 41) 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:

- Charles Courtemanche and Daifeng He, "Tax Incentives and the Decision to Purchase Long-Term Care Insurance" found that the federal itemized deduction for LTC insurance increased the take-up rate of LTC insurance for eligible individuals by 3.3 percentage points.[61] 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.

- Gopi Shah Goda, "The Impact of State Tax Subsidies for Private Long-Term Care Insurance On Coverage and Medicaid Expenditures" provides results showing that tax incentives for LTC had a significant impact on the purchase of private LTC, when other factors were controlled for, increasing the probability that coverage is purchased by 28 percent.[62] However, the author observes, "The most striking fact is that the response to tax incentives is significantly larger among individuals with high income and a large amount of assets. The estimated coefficients change in sign and are not statistically significant for the low income and low asset samples." The former group (high-income and high-asset individuals), of course, is less likely to access Medicaid to pay for LTC, while the latter are much more likely to do so. This undercuts the effectiveness of tax incentives to offset the cost of LTC. The study explicitly simulated the effect of tax incentives on Medicaid spending and found that $1 in tax expenditures could produce $0.84 in Medicaid savings ($0.51 in federal savings and $0.33 in state savings).

- Anne Theisen Cramer and Gail Jensen, "Why Don't People Buy Long-Term Care Insurance?" found price was a "small but significant factor in the decision to purchase

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[60] *Journal of Risk Insurance* 70, no. 1 (2009): 45-29.

[61] *Journal of Public Economics* (forthcoming).

[62] *Journal of Public Economics* 95, issue 7-8 (August 2011): 744-57.

LTC insurance."[63] (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.

- David Nixon, "State Programs to Encourage Long-Term Care Insurance" found no statistically significant relationship between the availability of state tax incentives and purchases of LTC insurance.[64]

These empirical results are consistent with intuition and with related findings 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 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.[65] 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 income range—not the poorest or richest—are the best market for LTC.[66] 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.

- 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.

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[63] *Journal of Gerontology* 61B, no. 4 (2006): S185-S193.

[64] University of Hawaii Policy Paper #001 (November 2006).

[65] Jeffrey R. Brown and Amy Finkelstein, "Why is the Market for Long-Term Care Insurance So Small?" *Journal of Public Economics* 91, no. 10 (2007): 1967-91 (finding a 51 percent load).

[66] Cramer and Jensen, "Why Don't People," note 63.

- 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. The large benefits under Medicaid combined with the requirement to spend down one's income and assets to qualify may simply overpower the incentive effects of tax reductions. As the authors of one study observe:

> 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.[67]

[67] Jeffrey R. Brown and Amy Finkelstein, "The Interaction of Public and Private Insurance: Medicaid and the Long Term Care Insurance Market," *American Economic Review* 98, no. 3 (June 2008): 1083-1102.

Credit for Past Military Service

Description of Provision

Minnesota allows a $750 nonrefundable income tax credit for individuals who have separated from the military and had at least 20 years of military service or have a 100 percent service-related disability. The credit begins to phase out when adjusted gross income reaches $30,000 and is not available to individuals with income over $37,500.

About 1,600 individuals claimed the credit in 2010.

Projected Tax Expenditure: Credit for Past Military Service ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$1,000	$1,000	$1,000	$1,000

Objective or Rationale

Conference committee discussions at the time the credit was enacted suggest the purpose was most likely to recognize significant military service by Minnesota veterans.

Related Direct Spending Programs

The credit functions like a supplement to military retirement pay for qualifying lower-income veterans. Because military retirement is administered by the federal government, not the state, it's more practical for the state to administer the payments through the income tax system.

Incidence Information

Not available.

Evidence on Effectiveness in Meeting Objective

When the credit was enacted, the Department of Revenue estimated that about 14,000 returns would claim the credit. While data from the federal Department of Defense provides information on the number of retirees receiving various levels of retirement pay, data on military retiree income from sources other than military pensions is scant. Actual usage of fewer than 2,000 returns per year suggests that either there are fewer low-income retirees than estimated, or a large number of retirees have failed to claim the credit. To the extent that the original estimate overstated the eligible population, then the credit has succeeded at providing a pension supplement to lower income military retirees. To the extent that eligible individuals have failed to learn of the credit and claim it, then the tax system has not succeeded at supplementing the income of these individuals.

Research and Development Credit

Description of Provision

Minnesota allows a refundable credit for individuals who are partners in a partnership or shareholders in an S corporation for spending on research and development performed within Minnesota. The credit is based on and relies on the similar federal credit for many of its definitions and rules. The credit equals 10 percent of the first $2 million of qualified expenditures and 2.5 percent of qualified expenditures over $2 million. Qualified expenditures are measured as the excess over a base amount, but cannot exceed 50 percent of current-year expenditures. The base amount is equal to a percentage (not to exceed 16 percent) of the business's Minnesota gross receipts. That percentage is based on the percentage that the business's qualified research expenses were of its Minnesota gross receipts at some point in the past (1984-1986 for most firms). The credit for many businesses is determined based on the 50 percent limit, rather than the increase over the base amount.

The credit was enacted in 1981 as a nonrefundable credit and applied to both individual income taxpayers and C corporations. In 1987 as part of a major tax reform and simplification, the credit was limited to C corporations. In 2010, the credit was once again extended to filers under the individual income tax and was made refundable. In 2013, the refundability of the credit was repealed, but a unitary business was allowed to allocate the credit among any of its entities.

About 1,000 individuals claimed the credit in tax year 2010.

Projected Tax Expenditure: Research and Development Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$8,000	$8,000	$8,000	$8,000

Objective or Rationale

The credit is intended to encourage research spending in Minnesota and to provide the associated advantages of that spending (more jobs and economic activity in the state). An often-cited purpose of the similar federal credit is to encourage private research generally, since it is widely considered that private research has significant social benefits (spillover benefits that go to other businesses and individuals). Some estimates suggest that these spillovers exceed the amount of the private benefits. It seems reasonable to infer that the state credit has a similar purpose, since it was enacted immediately after Congress adopted the federal credit.

Incidence information

Not available

Evidence on Effectiveness in Meeting Objective

When enacted, the Department of Revenue estimated that extending the credit to individual returns would reduce revenues by about $1 million per year. The estimate was based on allocation of federal tax expenditure estimates to Minnesota. Higher actual claims may suggest increased research spending in Minnesota since enactment of the credit, but could also mean that existing levels of research spending at the time of enactment were higher than nationwide estimates would imply or that the refundable feature of the Minnesota credit were not fully taken into account.

Studies of the federal credit have generally concluded that it is cost effective in stimulating increases in research that equal or exceed the cost of the credit. This evidence is largely from research done using data from the 1980s.[68] It is unclear to what extent this relationship still holds and whether it holds for the portion of the credit that is available to unincorporated businesses that qualify for the credit under the individual income tax. The refundable feature of the Minnesota tax differs from the federal rules and its effects have not been studied.

There are fewer studies of the effects of state research credits, but they tend to be consistent with finding the incentives to be effective. One study concludes that the state credits are effective in stimulating more private research expenditures in the state.[69] Another study by Daniel J. Wilson, an economist with the San Francisco Federal Reserve Bank, reaches the same conclusion, finding a strong effect of state credits.[70] Perhaps, more important, Wilson finds that almost all of this effect is the result of luring activity away from other states. This suggests that states may need to adopt research credits as a defensive measure, to prevent states with credits from diverting private research operations away from their states. Moreover, the generosity of their credits need to be roughly comparable to other states, because of what the author characterizes as "nearly costless geographic mobility in R&D activity." It is unclear whether the distinction between C corporations and pass-through entities is important in this regard, however.

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[68] Congressional Research Service, *Tax Expenditures Compendium of Background Material on Individual Provisions* (December 2010): 94-95.

[69] Yonghong Wu, "The Effects of State R&D Tax Credits in Stimulating Private R&D Expenditure: A Cross-state Empirical Analysis," *Journal of Policy Analysis and Management* 24, no. 4 (2005): 785-802.

[70] Daniel J. Wilson, "Beggar Thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of the R&D Tax Credits," *The Review of Economics and Statistics* 91, no. 2 (2009): 431-36.

Job Opportunity Building Zone (JOBZ) 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 2011, the adjusted amounts were $35,650 and $118,830.

The jobs credit was claimed on 813 returns in tax year 2010.

Projected Tax Expenditure: JOBZ Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$700	$700	$700	$700

The tax expenditure for the JOBZ credit has increased in nominal terms (unadjusted for inflation) by 400 percent from FY 2006, its first reporting after enactment in the *Tax Expenditure Budget*, to FY 2012, compared with 24.1 percent nominal increase in personal income over the same time period. However, following full implementation of the JOBZ program, the tax expenditure amounts for the credit have been flat or declining. The credit is scheduled to expire after tax year 2016, when the duration of most JOBZ designations also end. The law allows the credit and other JOBZ benefits to continue beyond 2016 for qualifying businesses in a few zones (qualifying ethanol plants, qualifying high-technology glass and wind turbine businesses in high unemployment counties, and businesses in automotive recovery zones).

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 (page 61)

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.[71] See also the discussion under the Job Opportunity Building Zone Income Subtraction.

[71] Dagney Faulk, "Do State Economic Development Incentives Create Jobs? An Analysis of State Employment Tax Credits," *National Tax Journal* 55, no. 2 (2002): 263-80.

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 330,000 returns for tax year 2010.

Projected Tax Expenditure: Working Family credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$201,100	$186,700	$188,600	$190,500

The tax expenditure for the working family credit has increased in nominal terms (unadjusted for inflation) by 95.8 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

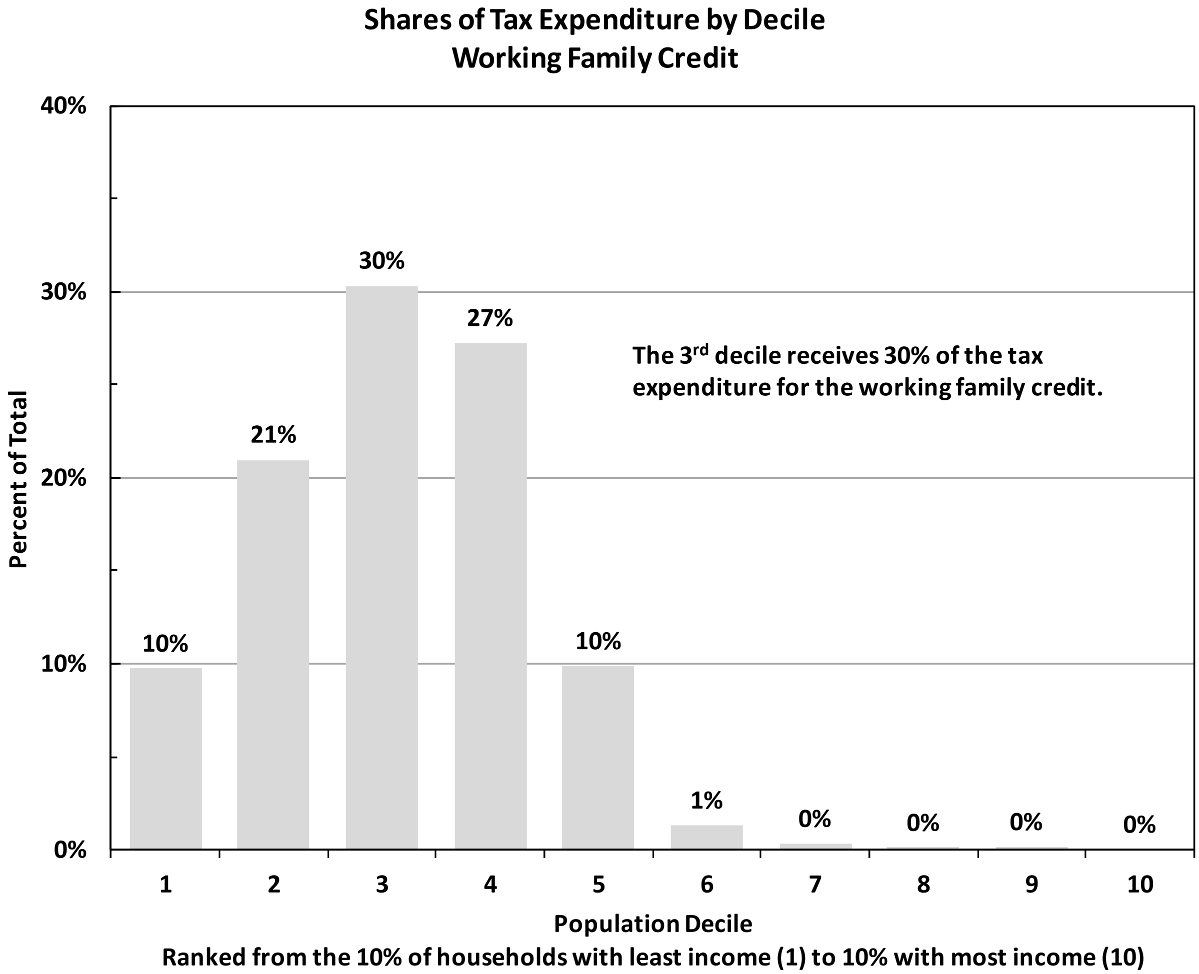
Objective or Rationale

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 (SNAP), housing assistance under various programs, and income assistance under Minnesota Family Investment Program.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.895
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the working family credit is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

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.[72] The credit also results in single parents who have one child and are 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.

[72] Nina Manzi and Joel Michael, House Research Department, *The Federal Earned Income Tax Credit and the Minnesota Working Family Credit* (March 2013), 19-23, available at: http://www.house.leg.state.mn.us/hrd/pubs/feicwfc.pdf.

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 phaseout. The maximum Minnesota credit is $720 for one dependent and $1,400 for two or more. For tax year 2013, the Minnesota credit begins to phase out when income reaches $24,860 and is not available to families with incomes over $38,510. A Minnesota family can receive the maximum credit, even if the family has little or no income tax liability. The provision is tied to the federal credit; the decrease in the projected expenditure from fiscal year 2013 to fiscal year 2014 is due to the expiration of more generous federal provisions after tax year 2012. The federal and state provisions are more fully described in a House Research publication.[73]

This credit was claimed on approximately 36,500 returns filed for tax year 2010.

Projected Tax Expenditure: Child and Dependent Care Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$14,000	$14,000	$11,700	$11,700

The tax expenditure for the child and dependent care credit has increased in nominal terms (unadjusted for inflation) by 12.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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 2013, the

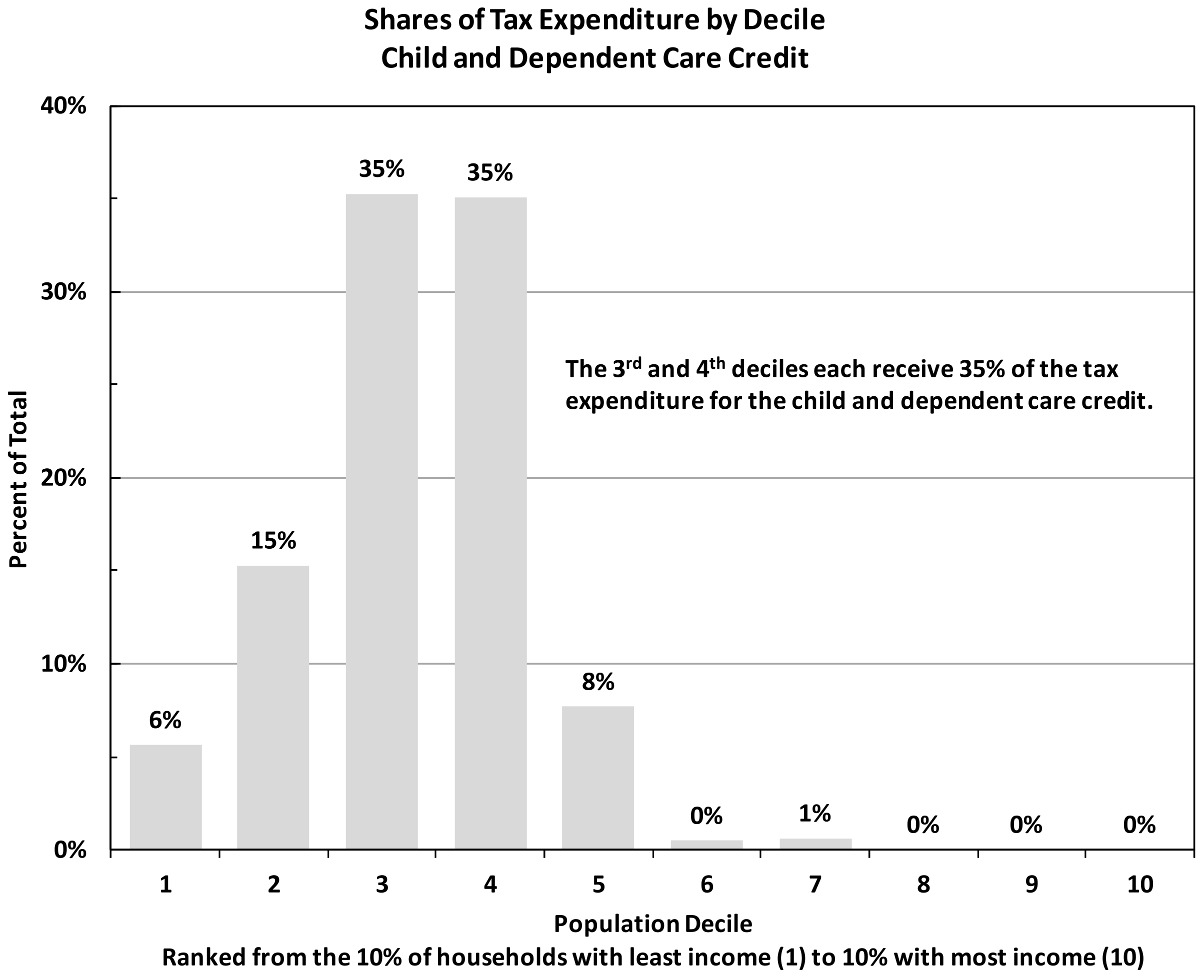
[73] Nina Manzi, House Research Department, *The Minnesota and Federal Dependent Care Tax Credits* (August 2012), available at: http://www.house.leg.state.mn.us/hrd/pubs/depcare.pdf.

appropriation for BSFCC was about $85.4 million ($45.9 million federal, $36.8 million state, and the rest county). In addition, federal and state funding provides for MFIP child care assistance; the projected amounts for FY 2013 are $74.3 million federal and $32.0 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 tax year 2013, the credit is available for incomes up to $38,510. The table shows the maximum incomes for BSFCC and MFIP child care by family size for 2013.

Maximum Income

Family size	MFIP child care	BSFCC (when entering program)
1	$8,964	$20,915
2	$15,984	$27,350
3	$21,048	$33,786

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.888
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the credit for child and dependent care is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

Evidence on Effectiveness in Meeting Objective

We are aware of no studies of the effectiveness of the Minnesota dependent care credits in encouraging work, if that is the rationale for the credit. Empirical studies of the federal credit, which is not refundable and is available to middle and upper income taxpayers, and of direct spending child care subsidy programs similar to Minnesota's basic sliding fee program (BSF) have been done. These studies generally find that reductions in the cost of child care—whether through tax credits or payment of direct subsidies—increase the labor supply (the decision to work) of mothers of young children. One study of the federal dependent care tax credit simulated the effect of making the federal credit refundable (i.e., implementing a policy similar to the Minnesota credit).[74] The response was very small—less than a 1 percent increase in the number of hours worked. By contrast, increasing the subsidy rate (from 30 percent to 80 percent) was estimated to increase hours worked by 24 percent.

More studies have been done of direct spending child care programs, particularly following enactment of the federal welfare changes in the 1990s that mandated work and helped fund state child care subsidies. These studies vary significantly in their findings as to how responsive the labor supply of parents is to reductions in the price of child care that result from the subsidies. The elasticities range from -0.05 to -0.50.[75] (See the discussion of elasticities under the deduction for charitable contributions on page 41.) We're unaware of any study that analyzes whether tax credits have differential effects compared with direct spending program subsidies. The simulations in one study[76] suggest that the higher percentage subsidies under the BSF program are likely to have a larger effect on the decision to work than the lower rate Minnesota tax credit, albeit at a much higher state budget cost.

The average amount of expenses claimed on the credit is about $2,000. Because these low-income taxpayers must wait until the following year to receive their credit as a refund (about two-thirds 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 to 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

[74] Susan L. Averett, H. Elizabeth Peters, and Donald M. Waldman, "Tax Credits, Labor Supply, and Child Care," *Review of Economics and Statistics* 79, no. 1 (February 1997): 125-135.

[75] Chris M. Herbst, "The Labor Supply Effects of Child Care Costs and Wages in the Presence of Subsidies and the Earned Income Tax Credit," *Review of Economics of the Household* 8 (2010): 199-230 (0.05), and U.S. General Accounting Office, *Child Care: Child care subsidies increase the likelihood that low-income mothers will work*, Report No. HEHS-95.20 (1994) (-0.50).

[76] Averett et al., "Tax Credits, Labor Supply."

federal tax.[77] If that is the goal of the Minnesota credit, it does add a progressive element to the tax.

[77] Amy E. Dunbar, "Child Care Expenses: The Child Care Credit," *The Encyclopedia of Taxation & Tax Policy* (2nd ed. 2005): 66-69.

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 phaseout. 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 phaseout 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 57,000 returns claimed the credit in 2010.

Projected Tax Expenditure: K-12 Education Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$14,600	$14,400 $14,	300 $13,900	

The tax expenditure for the K-12 education credit has decreased in nominal terms (unadjusted for inflation) by 33.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

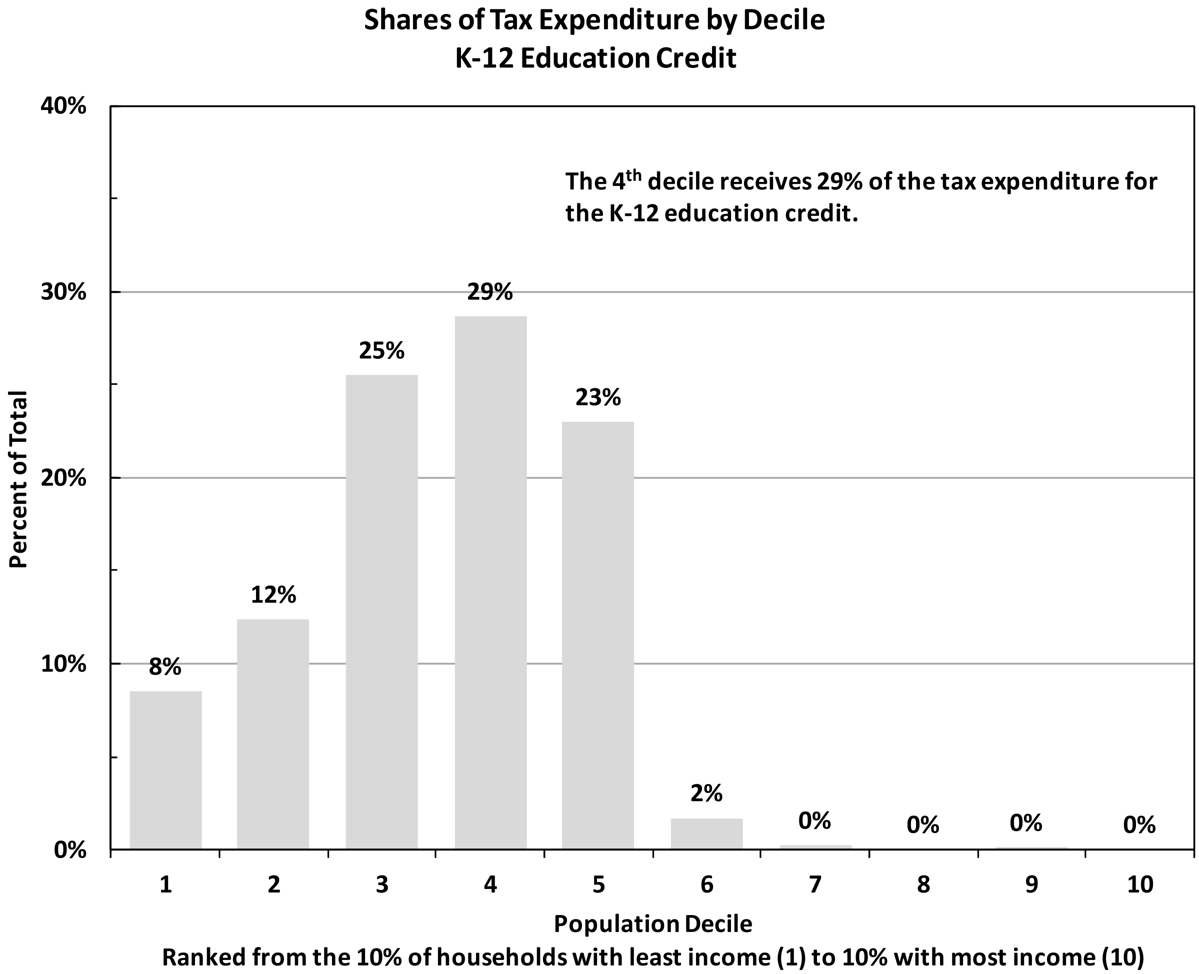
Objective or Rationale

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.

Incidence Information



Source: HITS Model for 2008,
and Tax Incidence Study database

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.869
Suits index for the existing income tax:	0.218
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for K-12 education credit is less than the Suits index for the individual income tax (and for the overall state and local tax system), repealing the tax expenditure would make the income tax (and the overall tax system) less progressive.

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 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.

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, 2001.

An estimated 2,500 individuals claim the credit annually.

Projected Tax Expenditure: Credit for Combat Zone Service ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$1,900	$1,900	$1,900	$1,900

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.

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.

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; testing has not been mandated since 2010, but the credit would be available should testing be required in the future.

The credit benefits an unknown number of returns per year.

Projected Tax Expenditure: Bovine Tuberculosis Testing Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
minimal	$0	$0	$0

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.

Small Business (Angel) Investment Credit

Description of Provision

Minnesota allows qualified investors in certified small businesses to claim a refundable income tax credit equal to 25 percent of their investments up to a maximum of $125,000 ($250,000 for married joint filers). The maximum overall amount of credits available per year is capped at $11 million for tax year 2010, and $12 million per year for tax years 2011 through 2014. A business must meet certain qualifications related to location, size, and line of business, to be certified. To qualify for the credit, individuals must either be accredited investors under Securities and Exchange Commission (SEC) Regulation D or must certify that they will only invest in an offering that is exempt from registration under state law. Individuals must make a minimum investment of $10,000 to qualify for a credit. The credit sunsets following tax year 2014.

The credit was claimed by 267 returns in tax year 2010.

Projected Tax Expenditure: Small Business Investment Credit ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$16,200	$12,000	$12,000	$12,000

Objective or Rationale

The purpose of the credit is to encourage investment in early stage Minnesota businesses engaged in specified activities (manufacturing, technology, research and development, or developing new products or processes). The credit is intended to fill the gap between when a startup business receives funding from its founders and their family members, and when it becomes large enough to attract interest and investment from venture capital investors.

Incidence Information

Not available

Evidence on Effectiveness in Meeting Objective

The relevant question is whether the credit induces additional investments in startup/early stage businesses that would not otherwise have been made (i.e., if the credit were not available). Enactment of similar credits in Wisconsin, effective in 2004, was not followed by noticeable increases in startup/early stage investments. It's not clear if effects of the credits can be separated from larger trends in the economy. However, the annual caps on Wisconsin's credits were much higher than under the Minnesota credit, both in the absolute dollar amounts allowed and in the ratio of the cap to the pre-existing investment market. The lower the cap relative to the existing market, the greater the chance that credits will be awarded to individuals who would have invested absent the credit.[78]

A program evaluation of Minnesota's credit is due in January 2014, prior to the credit's sunset, and should provide additional insight into the credit's effectiveness at encouraging investment in early stage businesses.

[78] *Tax Incentives and Venture Capital Financing in Minnesota,* presentation to House Taxes Committee, House Research Department, February 9, 2010.

Sales and Use Tax Expenditures

Overview

Reference tax base: a consumption tax. Economists and tax theorists generally consider that a sales tax[79] should be, in principle, a tax on consumption. That is, the tax should apply to all final sales that are used for personal consumption. But the tax should not apply to capital inputs, intermediate sales, or purchases or uses that are part of the production or selling process. Taxing business inputs results in uneven taxation, depending upon how integrated the production process is. These issues are discussed briefly at the beginning of this research report under the description of the tax expenditures covered and "pyramiding" of the sales tax. (See page 12.[80]) The *Tax Expenditure Budget* takes the view that reference tax base is "gross receipts from the sale of tangible personal property or services to the final user. Included in the tax base are products that are sold digitally as well as in tangible form."[81] This approach deviates from the ideal tax, as described above, since it focuses on whether the purchase was made by "the final user," not whether the purchase was for consumption versus production. It treats purchases for resale or of items that will be directly incorporated into products that will be resold, as not appropriately subject to tax, but that all other final sales should be taxed. The report follows the view that the reference tax base consists of final sales and purchases for consumption. As a result, it does not treat exemptions for business inputs—such as capital equipment used to produce goods—as tax expenditures.

Historical Highlights

When the sales tax was enacted in 1967, it deviated from the consumption tax principle in two important ways that both made it both narrower and broader than an ideal sales tax. First, it was primarily envisioned as a tax on tangible goods. Services and "intangibles" (e.g., purchases of investment products, copyrights, trade names, and similar) generally were not subject to tax.[82]

[79] The Minnesota sales tax includes, as all other state sales tax do, a complementary use tax that applies to purchases or sales made outside of Minnesota that are used in Minnesota. Internet or mail order purchases by Minnesota residents from retailers outside of the Minnesota are a typical example where the use, rather than the sales, tax would apply. Throughout the report references to "sales tax" also should be considered to include the use tax effects.

[80] See William F. Fox and LeAnn Luna, "How Broad Should State Sales Taxes Be? A Review of the Empirical Literature," *State Tax Notes* (September 4, 2006): 639, 642-644, for a more thorough discussion of these issues. The authors observe, "Economists almost uniformly oppose taxes on business-to-business transactions because of how they think imposition of the tax on business purchases will influence business behavior." The concerns are that businesses vertically integrate, relocate, or otherwise act to avoid the tax.

[81] Department of Revenue, *Tax Expenditure Budget for Fiscal Years 2012-15* (February 2012): 103.

[82] Of course, what are now referred to as "digital" goods—music downloads, software transferred over the Internet, and so forth—did not exist in 1967. The only nontangible items taxed under the original law were four

Thus, a large portion of consumption (services) was not subject to taxation. Second, the tax did not adequately distinguish between purchases of intermediate goods and services that were for production, not consumption. Purchases for resale were exempt, as were raw materials or other items used in manufacturing goods for sale, but otherwise business inputs were taxable. As a result, the tax was inappropriately broad, resulting in pyramiding of the tax. In addition, the tax provided general exemptions for governments and charitable organizations and for items that may have been deemed a "necessity" such as food, drugs, and clothing.

Many of the existing sales tax exemptions are a product of the sales tax's history, since most of these original features of the tax have remained unchanged. Over time a number of services were added to the sales tax base, including cable and satellite television, building and car cleaning, laundry and dry cleaning, security services, and pet boarding. In 2013, the legislature subjected many digital goods to taxation. However, most services and intangibles remain exempt. The legislature, starting in the 1980s, began to systematically expand the exemptions for business inputs to include capital equipment of manufacturers and some other types of businesses and the certain inputs for some of the newly taxable services.[83] However, these changes only modestly reduced the amount of business inputs that are taxable. In sum, the tax remains largely a creature of its history with three crucial features that are all relevant and create challenges for analysis its tax expenditures:

- It is largely a tax on goods; most services remain untaxed.
- Many business inputs are taxable. These items comprise a substantial portion of the tax base, approximately 41 percent according to Department of Revenue estimates.[84]
- Exemptions are provided for necessities, apparently to improve the equity or fairness of tax.

Difficulties in Analyzing Sales Tax Expenditures

This history and structure presents several major challenges for analysis of sales tax expenditures.[85]

services: (1) admissions and charges to places of amusement and sporting events, (2) lodging, (3) electricity, and (4) telephone service.

[83] The 2013 Legislature undertook a new direction, reversing this trend by repealing one of these exemptions (the sales tax exemption for capital equipment of telecommunications companies) and by extending the tax to some business services that are intermediate inputs and under an ideal sales tax would not be taxed.

[84] Department of Revenue, *2013 Minnesota Tax Incidence Study* (March 1, 2013): 9.

[85] John L. Mikesell, "The Normal State Sales Tax: The Vision Revealed in State Tax Expenditure Budgets," *State Tax Notes* (April 7, 2003): 91-95, discusses the confusion and variation in the treatment of sales tax in state tax expenditure budgets.

- **Exemption of services and intangibles is an accident of history, not a conscious policy choice to achieve an objective.** With regard to the exclusion of services and intangibles from the tax base, it seems apparent that the legislature considered this to be a structural feature of the tax; that was the way nearly all of the other state sales taxes were structured. (Minnesota was one of the last states to enact a sales tax.) The legislature likely did not intend to accomplish any particular alternative (nonrevenue) goal in structuring the tax in that way. Thus, it is practically impossible to evaluate whether these exemptions (tax expenditures) are achieving some goal or make policy sense as a way to achieve such an objective. They can best be characterized as an accident of sales tax history. As a result, this research report does not attempt to analyze or discuss how effective they are in achieving a policy objective or spending-type program goal.

- **Taxation of business inputs results in large negative tax expenditures.** Business inputs, which should not be part of a sales tax intended to be a consumption tax, comprise over 40 percent of the tax base and essentially are a negative tax expenditure. Although not used in most state tax expenditure budgets, the federal tax expenditure budgets (both the versions prepared by the executive and legislative branches) now recognize negative tax expenditures. Negative tax expenditures are generally "provisions that provide treatment less favorable than normal * * * tax law and are not related directly to progressivity[.]"[86] Taxation of business inputs would seem to fit into the similar category of negative tax expenditures for a sales tax. As such, their taxation creates policy problems for the sales tax (uneven taxation of different types of consumption, favoring some businesses over others, discouraging investment, and so forth) that merit attention, as much as positive tax expenditures. However, the form of the analysis in this research report does not lend itself to addressing these issues and the report only addresses the more traditional positive tax expenditures.

- **The exemption of necessities is intended to make the tax more equitable.** Exemption of some necessities is a nearly universal feature of state sales taxes. For example, few states tax food for home consumption and even fewer tax prescription drugs.[87] These exemptions likely are intended to improve the equity of the tax; that is, they serve a distributive function (determining how to distribute the cost of government to the private sector or how to raise revenue), rather than an allocative function (changing the mix of goods provided by the government[88]). As such, they could easily be considered a basic feature of the tax, features intended to add progressivity to the tax,

[86] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017* (February 2013): 3. See also John L. Mikesell, "A State Tax Expenditure Framework To Improve Fiscal Discipline," *State Tax Notes* (November 8, 2010), 411-418, for a view that state tax expenditure budgets should address the issue of negative tax expenditures (415).

[87] See the table in Appendix A.

[88] Put another way, they are not intended to increase the amount of the exempt items purchased. That would be the case with a true tax expenditures, such as a credit for purchasing long-term care insurance, which is intended to encourage taxpayers to buy insurance. The exemptions are intended to relieve the burden of the tax that falls on poorer individuals.

to make it fairer or more equitable.[89] However, the standard view is that they are tax expenditures. Thus, the research report treats the exemption of necessities in the usual manner, as tax expenditures. The appropriate way to analyze them, though, would be using traditional tax policy criteria, since they appear to be roughly basic tax features and not intended to satisfy some alternative goal. A standard alternative technique for increasing the progressivity (or reducing the regressivity) of a sales tax is through a low-income credit or refund program. The advantages and disadvantages of the two approaches—a refund or credit versus exemptions—is discussed once in the next section of the overview and not under each exemption.

- **Certain exemptions may be partially an attempt to reduce the administrative burden of the tax.** As stated on page 3, exclusions considered necessary for practical reasons are generally not considered tax expenditures. A clear example of this would be the de minimis exemption for nonbusiness purchases subject to the use tax.[90] An individual may make up to $770 in annual purchases for personal consumption from out-of-state vendors without incurring the complementary use tax. The administrative costs for individuals and the state if a person had to pay the use tax on souvenirs brought home from their family vacation would probably far exceed the amount of tax that would be collected. However, other exemptions, such as the exemption for sales made by nonprofit youth groups, may have a policy goal beyond reducing administrative costs and are included in this discussion.

Reducing Regressivity: Low-income Credits versus Exemptions

Many of the sales tax's exemptions (tax expenditures under the common definition) appear to be intended to make the tax fairer or more progressive by not taxing necessities, such as food, drugs, clothing, and home heating fuels. An alternative approach to increasing progressivity would be to expand the tax base to some or all of the exempt items while providing a credit or refund program for lower income households.[91] Several states—particularly those that impose their sales taxes on food—provide credit or refund programs. They can be administered as part of the state's individual income tax as a refundable credit or as a separate, standalone program. Minnesota could administer a low-income credit or refund either under its income tax or its separate property tax refund (PTR) program.[92] Conceptually, a refundable sales tax credit could

[89] John L. Mikesell, "The Normal State Sales Tax: The Vision Revealed in State Tax Expenditure Budgets," *State Tax Notes* (April 7, 2003), 92, makes this point.

[90] A seller with no physical presence in the state is usually not required to collect the sales tax on a purchase; however, the Minnesota purchaser is required to submit a use tax equal to the unpaid sales tax for untaxed but taxable items brought in and used in the state.

[91] This option could be combined with a reduction in the rate to hold revenues constant—that is, some of the additional revenue from the base expansion would be used to finance the credit and the rest could be used to reduce the tax rate.

[92] Typically, these refundable credit programs are not dependent upon the actual purchases of food or other necessities covered, but are calculated based on the average amounts purchased by individuals or families with about

be designed in a manner similar to the PTR and could be integrated into the PTR calculations.[93] However, data from DOR indicate that a much larger percentage of low-income households file income tax returns, than PTR claims.[94] This suggests that administrative and participation considerations may favor a credit administered under the income tax, rather than the PTR.

The comparative advantages and disadvantages of the two approaches to reducing sales tax regressivity have been widely discussed and analyzed in the literature.[95] The following discussion draws on and summarizes that literature. It parallels a similar discussion in the 1986 report of the Minnesota Tax Study Commission.[96]

- **Vertical equity.** A low-income credit is more cost effective in increasing progressivity or vertical equity than exemptions. An exemption provides benefits to everyone across the income distribution, while a credit or refund can be targeted only to those with lower incomes. Since middle and upper income households spend more, exemptions provide them with large absolute dollar amounts of benefits. (The benefits are smaller percentages of their incomes, of course.) It's unnecessary to exempt purchases by middle and upper income households to reduce regressivity. Overall, a credit or refund would allow larger reductions in regressivity with a tax that either yields more revenue or has a lower rate.

- **Revenue stability.** Exempting necessities makes revenues from the tax less stable by focusing the tax base more on consumer durables and other discretionary purchases that fluctuate more with economic cycles than purchases of food, home heating fuels, or other necessities do. A broader base with a credit or refund minimizes this effect.

- **Neutrality.** Exemptions distort market decisions more than a credit. For example, they favor individuals who prefer to consume luxury versions of the necessities (e.g., buying lobster and filet mignon, designer clothes, or owning large homes that cost large sums to heat) versus those who prefer to spend their discretionary income on taxable items (e.g., taxable entertainment, furniture, electronics, and so forth).

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the same income. This eliminates the need to save receipts or otherwise show how much one has actually purchased.

[93] This could be done operationally by adding an imputed measure of the sales tax burden for a household, based on its size and income, to its qualifying property tax or rent constituting property tax. The threshold rates and credit/refund percentages would need to be adjusted appropriately to reflect the expectation that households can pay more of their income in combined sales and property tax than the current PTR expects them to pay in property tax alone.

[94] For households in the bottom three population deciles, 66 percent file income tax returns, while only 35 percent file PTR claims. This is information from the 2010 DOR tax incidence data base.

[95] See, e.g., John F. Due and John L. Mikesell, *Sales Tax* (2nd ed. 1995): 75-88; Steven Gold, "Simplifying the Sales Tax: Credits or Exemptions?" in *Sales Taxation Critical Issues in Policy and Administration* (William F. Fox, ed. 1992): 157-68; Bradford Case and Robert D. Ebel, "Using State Consumer Tax Credits for Achieving Equity," *National Tax Journal* 42, no. 3 (1989): 323-37.

[96] *Final Report of the Minnesota Tax Study Commission* vol. 1 (1986): 153-165.

- **Administration and compliance.** The effects of the two approaches on administrative and compliance costs are ambiguous. On the one hand, exemptions create line drawing issues—distinguishing between prepared food (taxable meals) and groceries, exempt clothing and taxable sporting goods, and so on. Administering these detailed rules raises costs for both DOR and retail businesses and inevitably results in some noncompliance, much inadvertent. On the other hand, a refund or credit requires a separate administrative infrastructure—accepting applications, processing and paying refunds, and so forth. This is expensive for both DOR and taxpayers. Many individuals will hire tax preparers to prepare and file their claims, diluting the benefits to the targeted recipients. Moreover, experience shows that without extensive outreach and publication efforts (and perhaps even with it), participation in a refund program will be low, failing to fully achieve its objective of decreased regressivity. For example, many eligible households fail to apply to Minnesota's PTR benefits.[97]

- **Timing and certainty.** Exemptions provide certain and immediate relief. By contrast, a credit or refund is delayed until the taxpayer applies and receives payment, well after the purchases have been made. This presents cash flow challenges for low-income families. Also, a percentage of eligible taxpayers, as noted above, will fail to apply.

- **Understandability and acceptability.** Exemptions are widely understood and are popular with the public. The trend of states over the last two decades to exempt food and repeal credits reflects this dynamic. By contrast, the typical individual does not know what a low-income credit is, and is even less likely to understand the concept of eligibility thresholds and credit percentages (or copays).

In conclusion, a variety of considerations support both approaches. Standard tax policy criteria support the credit or refund approach, but political acceptability factors clearly favor the approach of exempting necessities.

Sales and Use Tax Expenditures Covered

The Minnesota sales and use tax includes three basic categories of tax expenditures, exemptions for goods, for services, and by type of seller. The tax expenditures listed below are described in greater detail in the pages that follow.

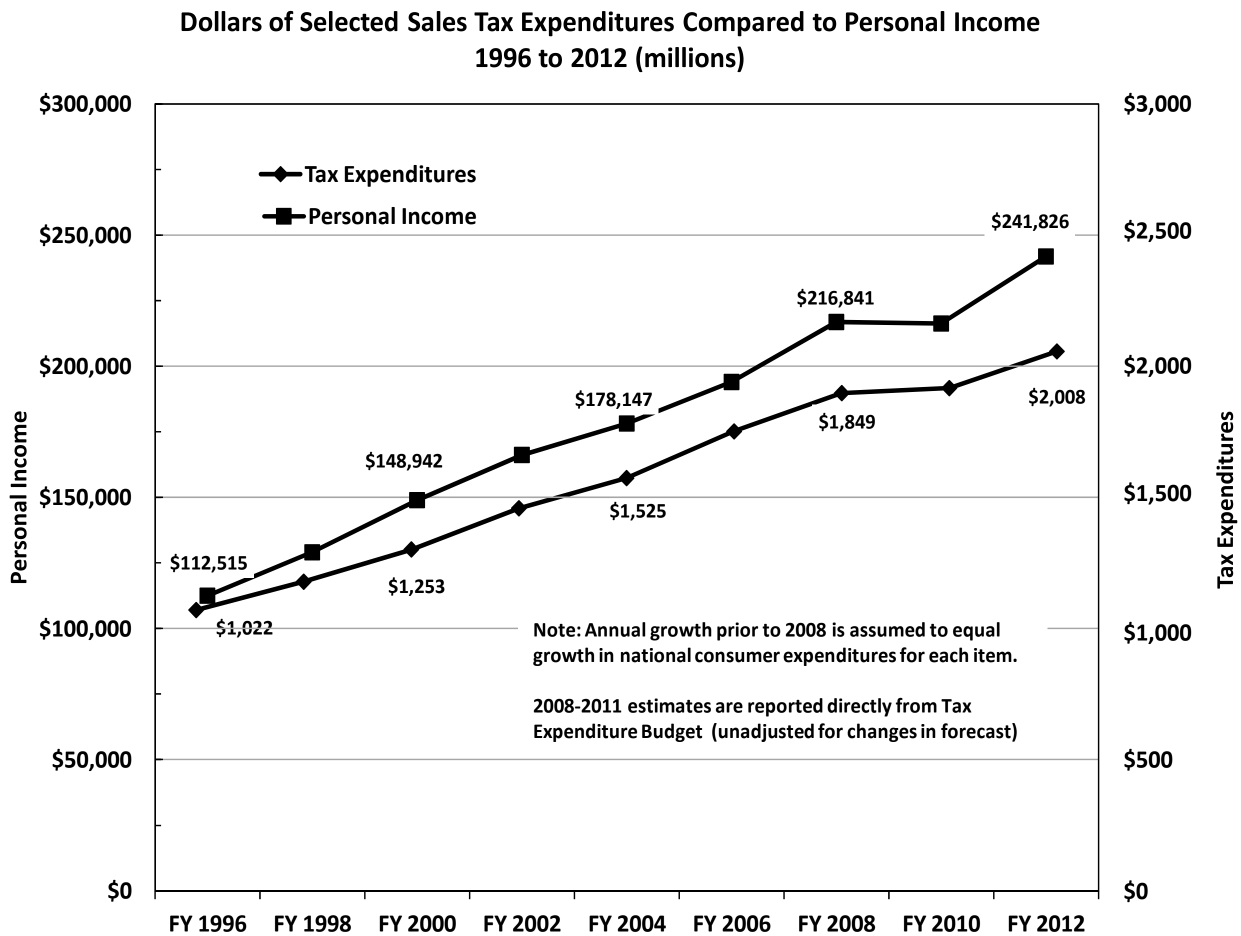
- Exemptions for purchases of goods or tangible personal property
  - clothing and wearing apparel
  - groceries
  - home heating fuel
  - publications
  - drugs, medicines, and medical devices

[97] DOR estimates that only about 60 percent of the households who are eligible actually claim their property tax refunds. It seems reasonable that an expanded program that includes a sales tax refund will face similar participation rates.

    - residential water and sewer (service)
    - digital goods (hybrid between good or service)
    - caskets and burial vaults
- Exemptions of services
    - funeral and cremation services
    - motor vehicle repair services
    - household goods repair services
    - personal services
    - legal services
    - accounting services
- Sales made by specific types of entities
    - admissions to arts events
    - fundraising events for nonprofits
    - institutional meals
    - isolated and occasional sales
    - YMCA, YWCA, and JCC memberships

Growth in the Selected Sales Tax Expenditures

The graph on the following page shows the growth in the selected sales tax expenditures over the last 20 years, relative to the growth in personal income. The selected sales tax expenditures are limited to those for which incidence information is included in the report. 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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House Research Dept.
House Fiscal Affairs Dept.
February 14, 2013

Distribution of the Selected Tax Expenditures Relative to the Tax

The chart on the following page plots the relative portions that the sales tax base and selected sales tax expenditures as a percent of household income by population decile. It shows that the selected sales tax expenditures are significantly less regressively distributed than the existing tax base. Put another way, if the tax base were expanded to include the selected tax expenditures, the overall tax would become more regressive.

Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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This graph only includes the combined incidence of the selected sales and use tax expenditures in this report for which we have individual incidence analyses; it does not include the incidence of digital goods, caskets and burial vaults, or the entity-based exemptions.

The remainder of this section provides information on the selected sales and use tax expenditures.

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 outerwear, 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 2012	FY 2013	FY 2014	FY 2015
$312,100	$322,800	$331,100	$341,500

Expenditures on clothing and wearing apparel have decreased in nominal terms (unadjusted for inflation) by 11.4 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

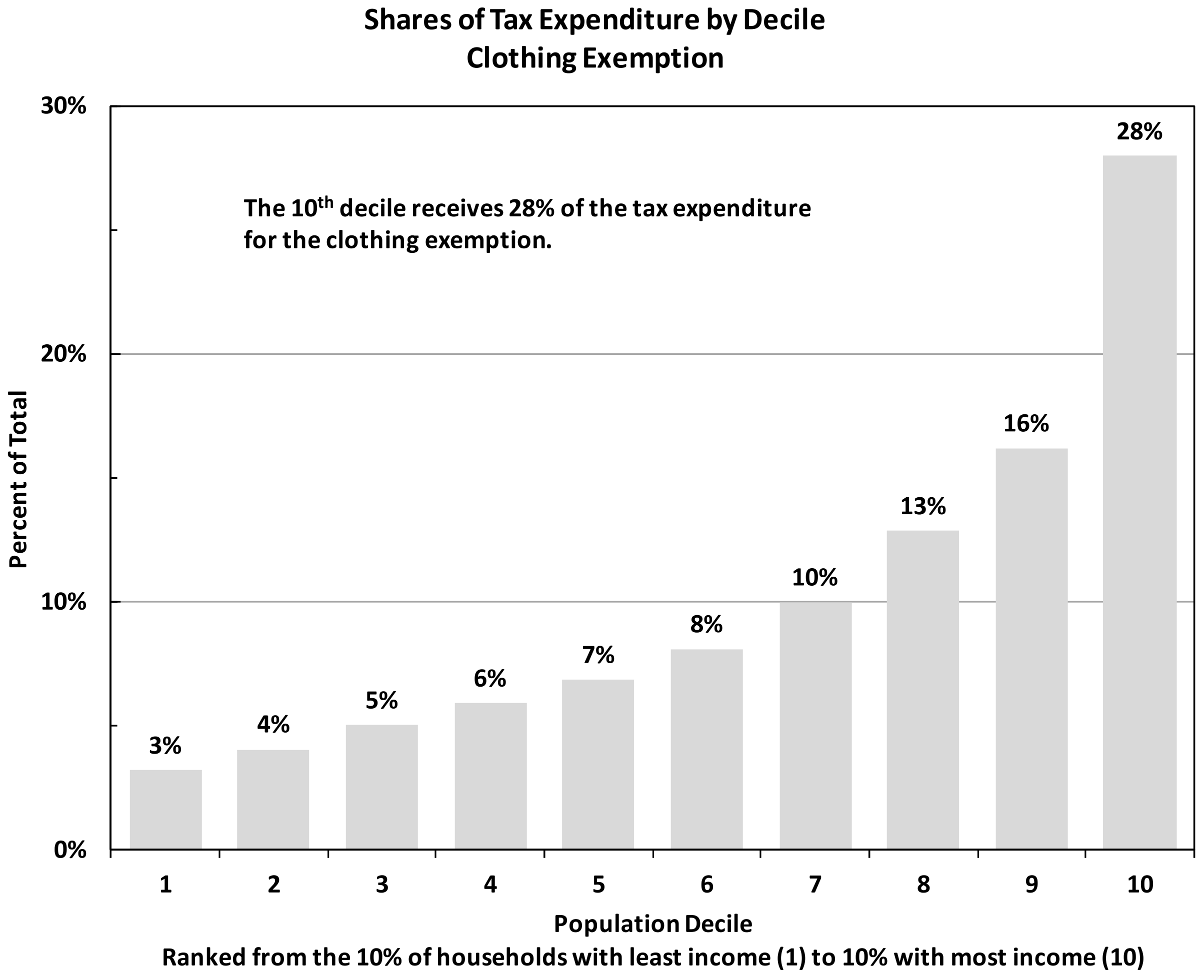
Objective or Rationale

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 necessity to reduce the regressivity of the tax. The definition was changed slightly to conform to SSUTA requirements.

Repeal of this exemption would decrease administrative complexity since it would no longer be necessary to differentiate between taxable clothing, such as athletic and safety apparel, and nontaxable clothing.

Very few state sales taxes exempt clothing purchases. See Appendix A for details.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.215
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the clothing exemption is higher than the Suits index for the sales and use tax, repealing the tax expenditure would make the sales and use tax less regressive. However, repeal of the exemption would make the overall tax system more regressive, since the index for repeal is less than index for the overall tax system.

Evidence on Effectiveness in Meeting Objective

If the purpose of the exemption is to reduce regressivity, the exemption does not serve this goal well. As reflect in the Suits indexes shown in the graph, the distribution of clothing purchases is slightly less regressive than the existing sales tax base. Revenues from repeal of the tax expenditure could be used to decrease the sales tax rate, which would provide a slight reduction in the overall regressivity of the sales tax. An alternative would be to use part of the increased revenue to pay for a refundable low-income tax credit based on family size. This would provide assistance that is better targeted to low-income households, while collecting the tax from middle and upper income households and would allow holding the regressivity of the overall tax system constant, while repealing the exemption to raise revenues.[98]

[98] Extending the sales tax to clothing would slightly decrease the regressivity of the sales tax. But if the change is used to raise revenues, by increasing the overall reliance on sales tax revenues (a regressive source, as compared to income and other progressive sources) it would increase the overall regressivity of Minnesota's state and local taxes. As shown in the graph, the Suits index for the sales tax including clothing purchases is -0.215. By contrast, the overall tax system for 2010 had a significantly less regressive Suits index of -0.060.

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.

The original exemption applied to virtually all food sold in a grocery store. 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.

Projected Tax Expenditure: Groceries ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$681,700	$705,300	$723,400	$746,100

Expenditures on groceries have increased in nominal terms (unadjusted for inflation) by 62.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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 of the exemption is not clear but it is widely assumed to be intended as an exemption for a necessity and to reduce the regressivity of the tax.

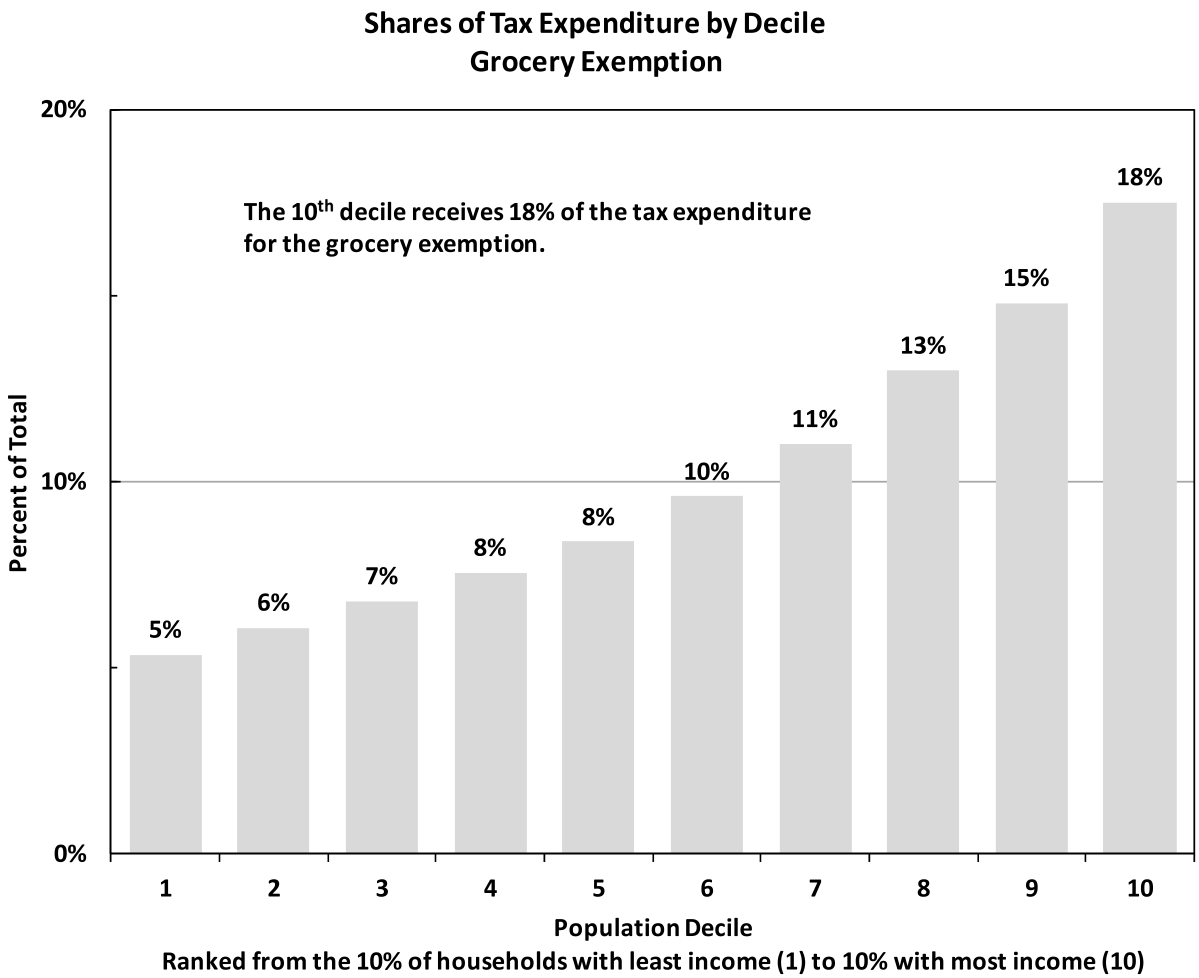
Only a few states tax groceries; two of these states (Kansas and Idaho in 2011[99]) mitigate the regressivity of taxing groceries by providing low-income refunds or credits. The details are in Appendix A.

Related Direct Spending Programs

The Food Stamp (Supplemental Nutrition Assistance Program) and Women, Infants, and Children (WIC) programs, funded by the federal government, and the state-funded Minnesota Food Assistance program provide food support for low-income families and individuals.

[99] The 2012 Kansas Legislature repealed the Kansas food credit, effective on January 1, 2013. See the Kansas Department of Revenue Notice 12-13 (7/9/2012), available at: http://rvpolicy.kdor.ks.gov/Pilots/Ntrntpil/IPILv1x0.NSF/23d6cf461dc0d3f58625656e005c41cd/91e1b17a810a93d886257a36004a9ce3?OpenDocument.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.349
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the grocery exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Evidence on Effectiveness in Meeting Objective

Exempting grocery purchases, as shown in the graph, does reduce the regressivity of the tax, but much of the current exemption goes to middle- and high-income households for luxury, as well as basic foodstuffs. In addition, taxing prepared food under the theory that it is not a "necessary" expenditure distorts consumer behavior and, as others have noted, ignores the fact that many taxable meals and prepared foods are often necessities for workers, the elderly, and the homeless. Part of the revenues resulting in a repeal of this exemption could be used to fund a refundable low-income tax credit based on family size, similar to the credits in other states. This would provide assistance that is better targeted to low-income households, while collecting the tax from middle and upper income households and eliminating some of the distortion in consumer behavior.

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. This also exempts purchases during those months of natural gas and electricity used for other purposes (e.g., clothes drying, cooking, lighting, and so forth).

Projected Tax Expenditure: Home Heating Fuels ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$130,500	$135,900	$140,000	$142,200

Expenditures on home heating fuel have increased in nominal terms (unadjusted for inflation) by 72.2 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

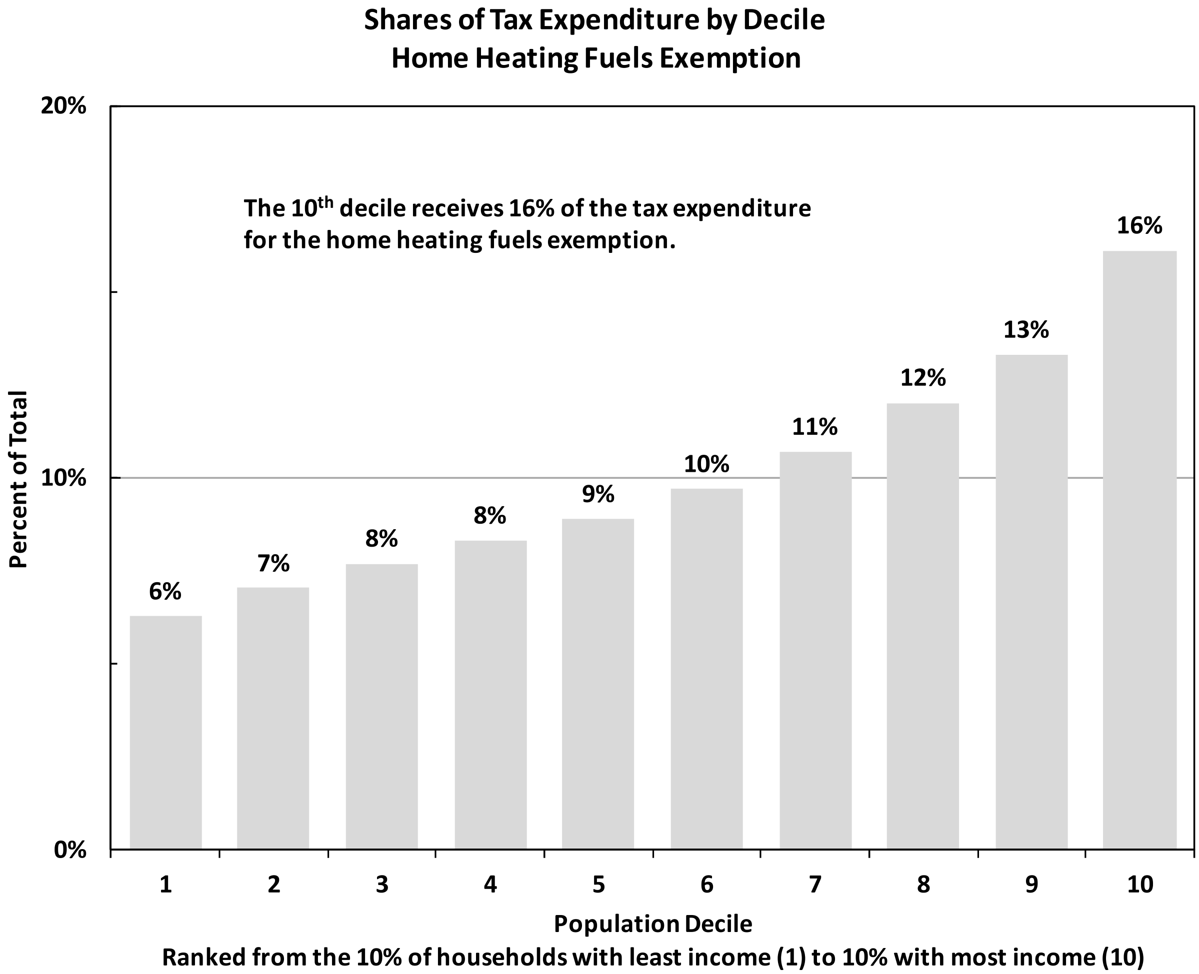
Objective or Rationale

This exemption was enacted in 1978 and was expanded to include hot water heating in 1984. The exemption was enacted as an exemption for a necessity to reduce the regressivity of tax. As indicated by the Suits index, a tax on home heating fuels is much more regressive than the current sales 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.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.414
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the home heating fuels exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Evidence on Effectiveness in Meeting Objective

Exempting home heating fuels from taxation does reduce the regressivity of tax. But 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. Additionally, a portion of the increased revenue could be used to provide assistance to low-income households for energy conservation measures such as energy efficient furnaces and increased home weatherization. A side effect of the current exemption is that it discourages conservation by slightly reducing the price of energy (compared with other types of consumption that are subject to sales tax).

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 and subscription magazines, and to advertising circulars. Beginning in 1983 magazines and periodicals sold over the counter were excluded from this exemption.

Projected Tax Expenditure: Publications ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$57,700	$58,300	$58,900	$59,600

Expenditures on publications have increased in nominal terms (unadjusted for inflation) by 30.3 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

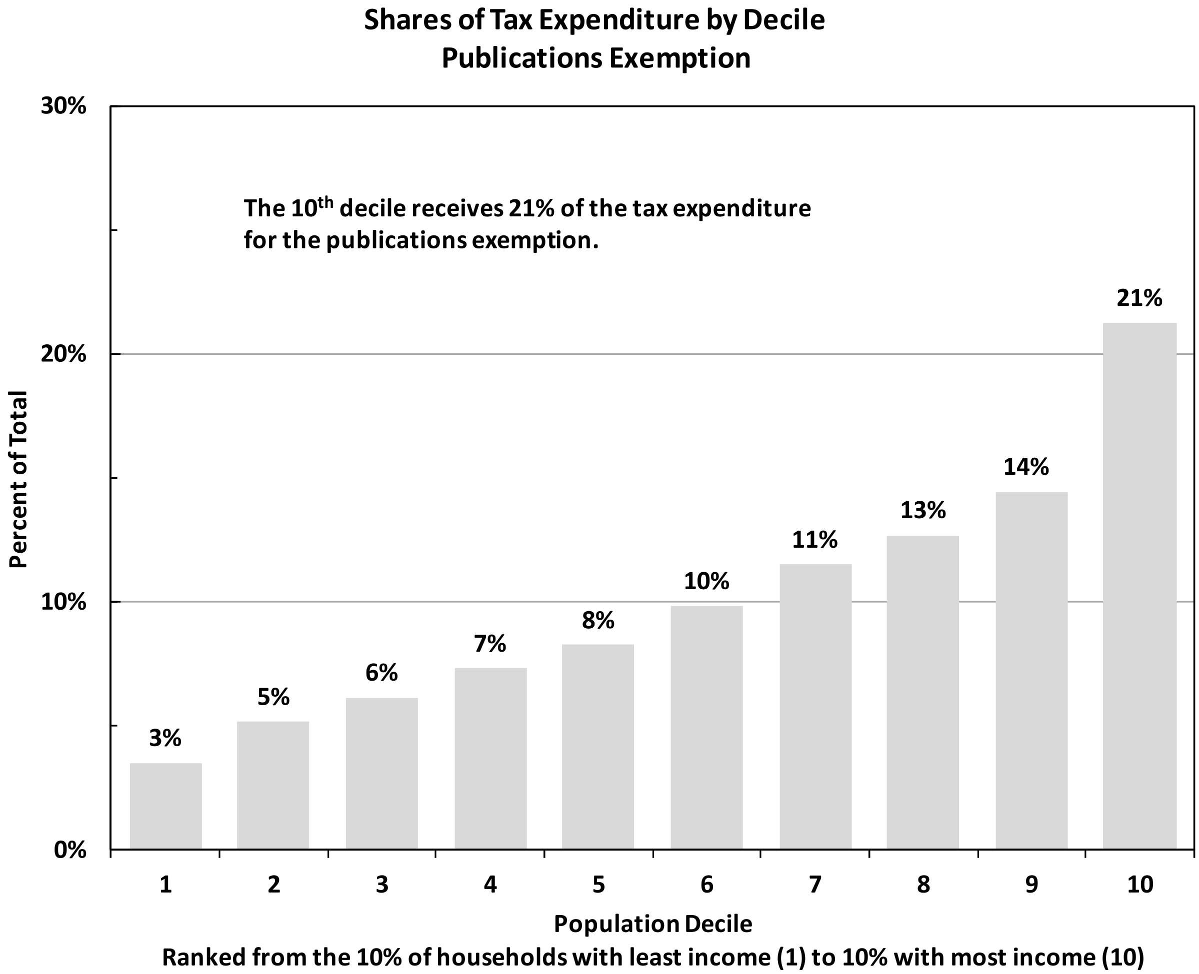
Objective or Rationale

This exemption was enacted as part of the original tax in 1967. 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 based on the view that the sales tax is 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." The rationale for the exemption of sales of print publications to consumers—e.g., the price an individual pays for a newspaper—is not clear. It may have been intended to encourage dissemination of the news and other public information through the print media or it may have been an attempt to treat the paid, print media in the same way as "free" media that rely exclusively on advertising revenues to cover their operations (broadcast radio and television back in 1967). When legislative efforts have been made to repeal the exemption, supporters of the exemption (mainly the newspaper industry) have used both of those rationales to justify the exemption.

Related Direct Spending Programs

If the rationale for the exemption is to encourage dissemination of news and other public information, the state grants to support public television and radio could be considered a related direct spending program.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.317
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the publications exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Evidence on Effectiveness in Meeting Objective

Given the plethora of alternative free and low-cost information sources, it is hard to show that the sales tax exemption of newspapers has a significant impact on dissemination of news and other public information. The change in the news and magazine industry from paper to electronic media adds to the complexity of taxing publications (see the digital goods discussion). Taxing magazines sold over the counter while exempting magazine subscriptions and digital magazines raises efficiency issues since it distorts consumer behavior, favoring subscription and digital purchases compared with over-the-counter purchases.

Exemption of Drugs, Medicines, and Medical Devices

Description of Provision

Drugs, medicine, insulin, medical oxygen for human use, durable medical equipment for home use, kidney dialysis equipment, mobility-enhancing equipment and prosthetic devices, and prescription eyeglasses are exempt from sales and use tax. This exemption was 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, in response to SSUTA definitions that require all over-the-counter medicines to be treated equally, the exemption was extended once again to all nonprescription drugs. In 2008, the exemption for durable medical equipment was expanded to include all kidney dialysis equipment and associated repair and replacement parts. The 2013 Legislature expanded this exemption to include otherwise taxable medical items purchased through Medicare and Medicaid beginning July 1, 2013.

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

	FY 2012	FY 2013	FY 2014	FY 2015
Drugs and medicine	$316,000	$326,900	$335,300	$345,800
Medical devices	$8,300	$8,600	$8,900	$9,200
Prescription eyeglasses	$38,900	$40,300	$41,300	$42,600
Medicare and Medicaid purchases	—	—	$370	$420

Expenditures on prescription drugs, nonprescription drugs, and eyewear have increased in nominal terms (unadjusted for inflation) by 63.5 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

Many items exempted under this provision (e.g., legend drugs or drugs requiring prescriptions) 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 (nonprescription) medication, most of the durable medical equipment for home use, and residential and motor vehicle mobility enhancing equipment. The rationale of the original exemption likely was that these goods are a necessity and the exemption reduces the regressivity of the tax. It is not clear that the rationale holds up well for all parts of the exemption, particular for prescription eyeglasses.

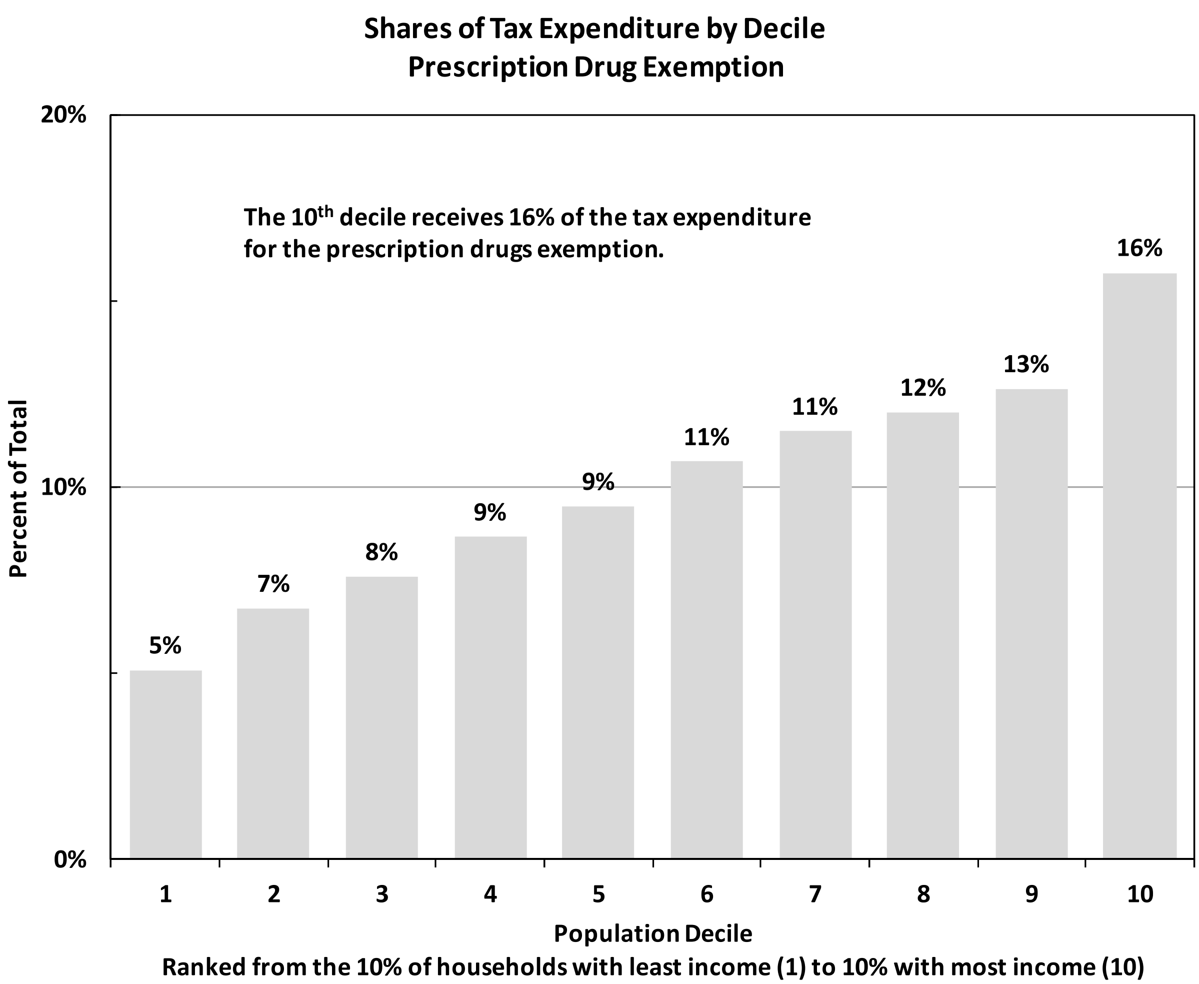
The 2013 session law included a purpose statement for the expansion of the exemption to Medicare and Medicaid purchases. The rationale given was to simplify tax administration and provide relief for sellers unable to collect the sales tax under those programs, which do not adjust their reimbursement rates to account for imposition of the sales tax.

Exempting the items subject to the health care provider tax avoids some tax pyramiding that would otherwise occur. No states tax prescription drugs, but most states impose the sales tax on over-the-counter drugs. See Appendix A for details.

Related Direct Spending Programs

The state and federal governments and counties provide these items to qualifying low-income families and individuals in the state through the federal medical assistance (Medical Assistance or MA) and the state MinnesotaCare programs. The federal government provides assistance to seniors under the Medicare program and will provide assistance to low- and middle-income individuals to pay for coverage purchased through exchanges under the Affordable Care Act, starting in 2014. Qualifying military veterans, regardless of income, also receive assistance for these purchases through the Veteran Assistance medical programs.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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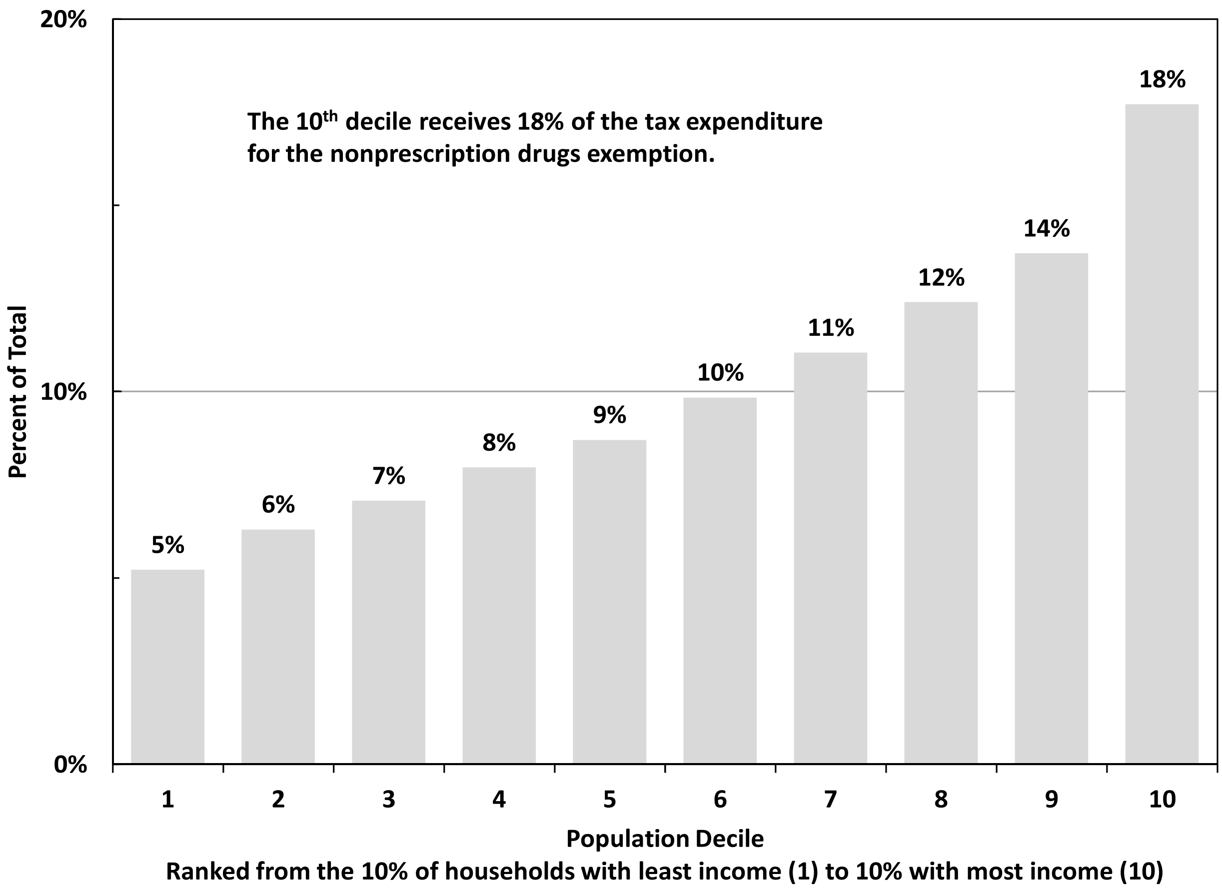
See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.416
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for prescription drugs is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Shares of Tax Expenditure by Decile
Nonprescription Drug Exemption



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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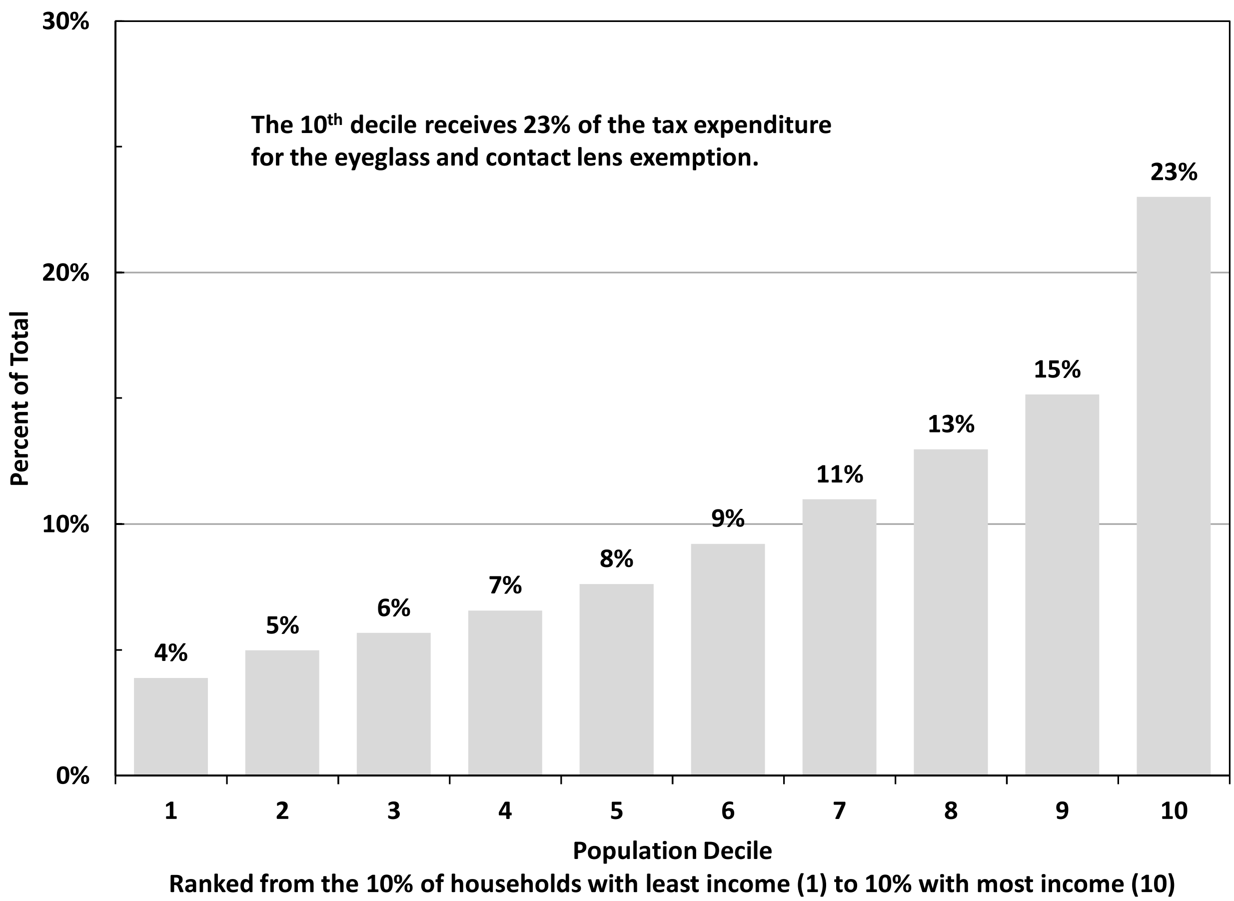
See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.381
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the nonprescription drug exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Shares of Tax Expenditure by Decile
Eyeglass and Contact Lens Exemption



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

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See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.290
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the eyeglass and contact lens exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Evidence on Effectiveness in Meeting Objective

As indicated by the Suits index for all portions of this tax exemption, this exemption does make the sales tax less regressive. However, like the sales tax on food and clothing, a substantial portion (60 percent to 70 percent depending on the item) of the exemption benefits the top five population deciles. The additional revenue gained by taxing these purchases in the middle and upper income households could be used to both expand low-income assistance through existing federal and state health programs while also lowering the overall sales tax rate.

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 2012	FY 2013	FY 2014	FY 2015
Residential Water	$19,100	$20,100	$20,900	$21,800
All Sewer	$48,200	$50,100	$52,100	$54,200

Expenditures on residential water and sewer have increased in nominal terms (unadjusted for inflation) by 48.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

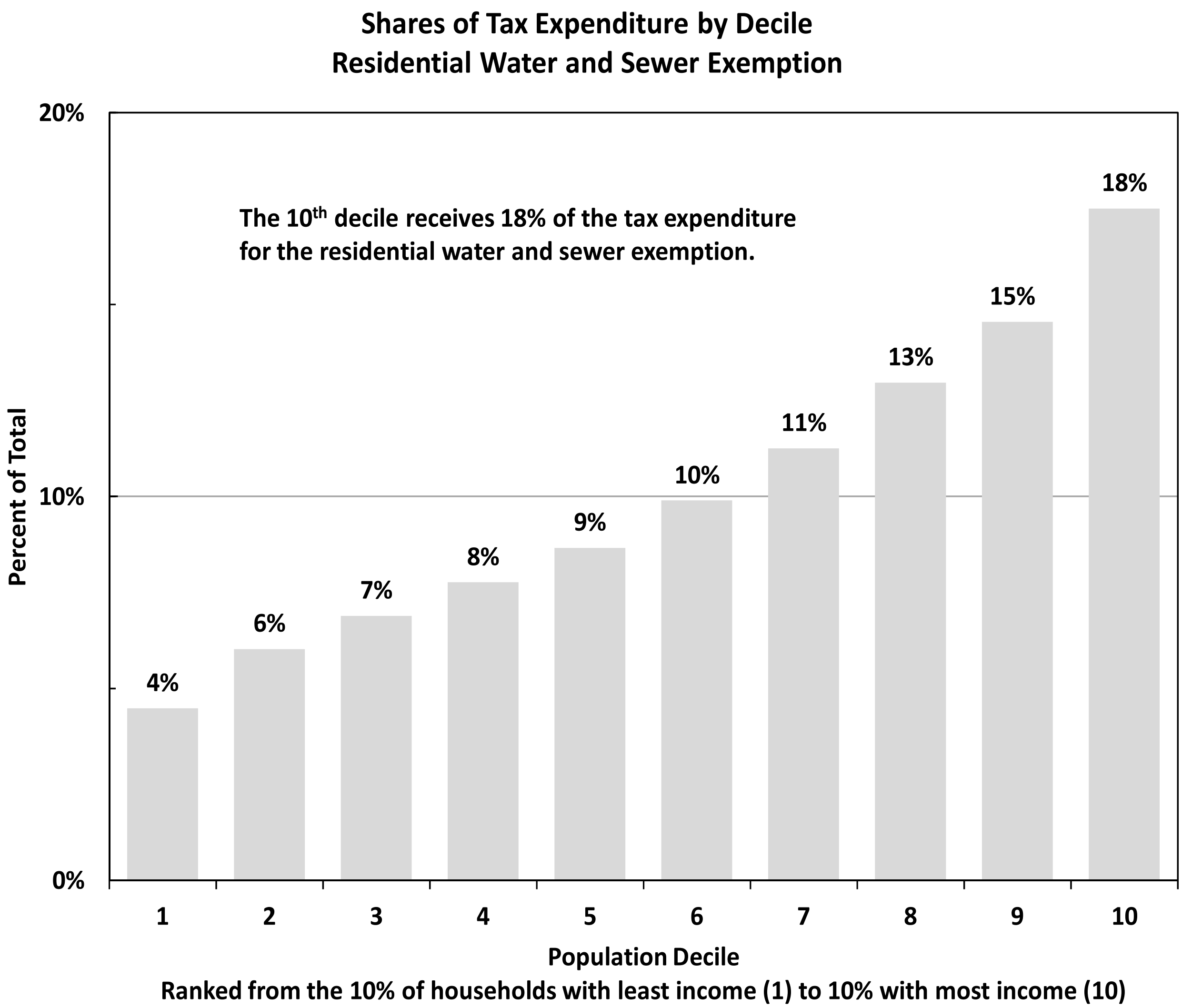
Objective or Rationale

The exemption for water was enacted in 1978. The rationale for this exemption is that it is considered a necessity. The sales tax has never applied to sewer services. It is likely that this exemption resulted from the fact that the original sales tax focused on goods not services, rather than to any policy objective. If the tax had applied to services, the legislature might still have exempted sewer service from taxation, considering residential sewer services as a necessity and business sewer services as a business input.

Related Direct Spending Programs

Several state government programs operate to assist local governments in their financing wastewater treatment and water supply systems to their communities, including loans made under the Clean Water Revolving Fund, loans and grants made by the Public Facilities Authority, and the small communities wastewater treatment program.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.374
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the residential water and sewer exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Evidence on Effectiveness in Meeting Objective

Imposing the sales tax on residential water and sewer services would make the current sales tax base more regressive. A side effect of the current exemption is that it discourages conservation by slightly reducing the price of water, compared with consumption that is subject to sales tax.

Digital Goods

Description of Provision

Digital goods are items delivered in electronic form that are also available in tangible form. Examples include music, books, videos, computer software, electronic games, greeting cards, and artwork. With the exemption of prewritten computer software, all of these items are taxable when sold in a physical form but exempt when downloaded or accessed electronically over the Internet. During the 2013 session, the law was changed to begin taxing a number of digital goods beginning July 1, 2013. The digital goods that are now taxed are e-books, audiovisual works, music, and interactive online computer games.

Projected Tax Expenditure: Digital Goods ($ thousands)

FY 2012	FY 2013	FY 2014[100]	FY 2015[100]
$5,300	$5,800	$2,590	$2,630

Objective or Rationale

Generally the sales tax base consists of *tangible* goods and selected services; digital goods are neither. They also did not exist when the sales tax was enacted in 1967; therefore, the sales tax law made no provision for taxing these goods. The transfer of prewritten computer software was addressed in 1983 when the law was amended to include it as tangible personal property "whether contained on tape, discs, cards, or other devices." The base expansion in the 2013 session law did not include certain digital goods such as digital artwork, which are more likely an input to business advertising rather than for private consumption.

Related Direct Spending Programs

State and local government support of public libraries help ensure some access to certain digital goods (i.e., downloadable audio works and ebooks) to all individuals.

Incidence Information

Not available

[100] The FY 2014 and 2015 expenditures are equal to the revenue loss from the 2012 tax expenditure report, minus the revenue estimated to be generated from the base expansion to certain digital goods in the 2013 omnibus tax bill. These numbers are overstated since they include not only the expenditure loss from the remaining exempt digital goods but also the amount of uncollectable tax on the now taxable goods.

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 2012	FY 2013	FY 2013	FY 2014
$4,600	$4,500	$4,400	$4,300

Expenditures on caskets and burial vaults have decreased by 22 percent in nominal terms (unadjusted for inflation) from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

This exemption was enacted as part of the original 1967 sales tax. (Cremation and funeral services are also exempt. These exemptions are artifacts of the failure of the initial sales tax to tax most services. The exemption for caskets and burial vaults could be justified as serving a goal of treating all of these related goods and services, some of which are substitutes for each other, equally.) The rationale for the exemption is unclear; it was likely considered a necessity or politically inexpedient to tax because of the context.

Related Direct Spending Programs

Under various state laws[101] counties are required to provide for the cost of burial, including caskets, for persons receiving public assistance, unknown persons, and bodies of indigent unclaimed persons. Burial, rather than cremation, is required if that is the deceased or next of kin's known preference or faith tradition. The purpose of this requirement is primarily for public health reasons.

Incidence Information

Not available

[101] See Minn. Stat. §§ 256.935, 261.035, and 390.21.

Funeral Services

Description of Provision

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

Projected Tax Expenditure: Funeral Services ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$28,600	$30,100	$31,500	$33,200

Expenditures on funeral or cremation services have increased in nominal terms (unadjusted for inflation) by 88.8 percent from FY 2002 to FY 2012, compared with a 49.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

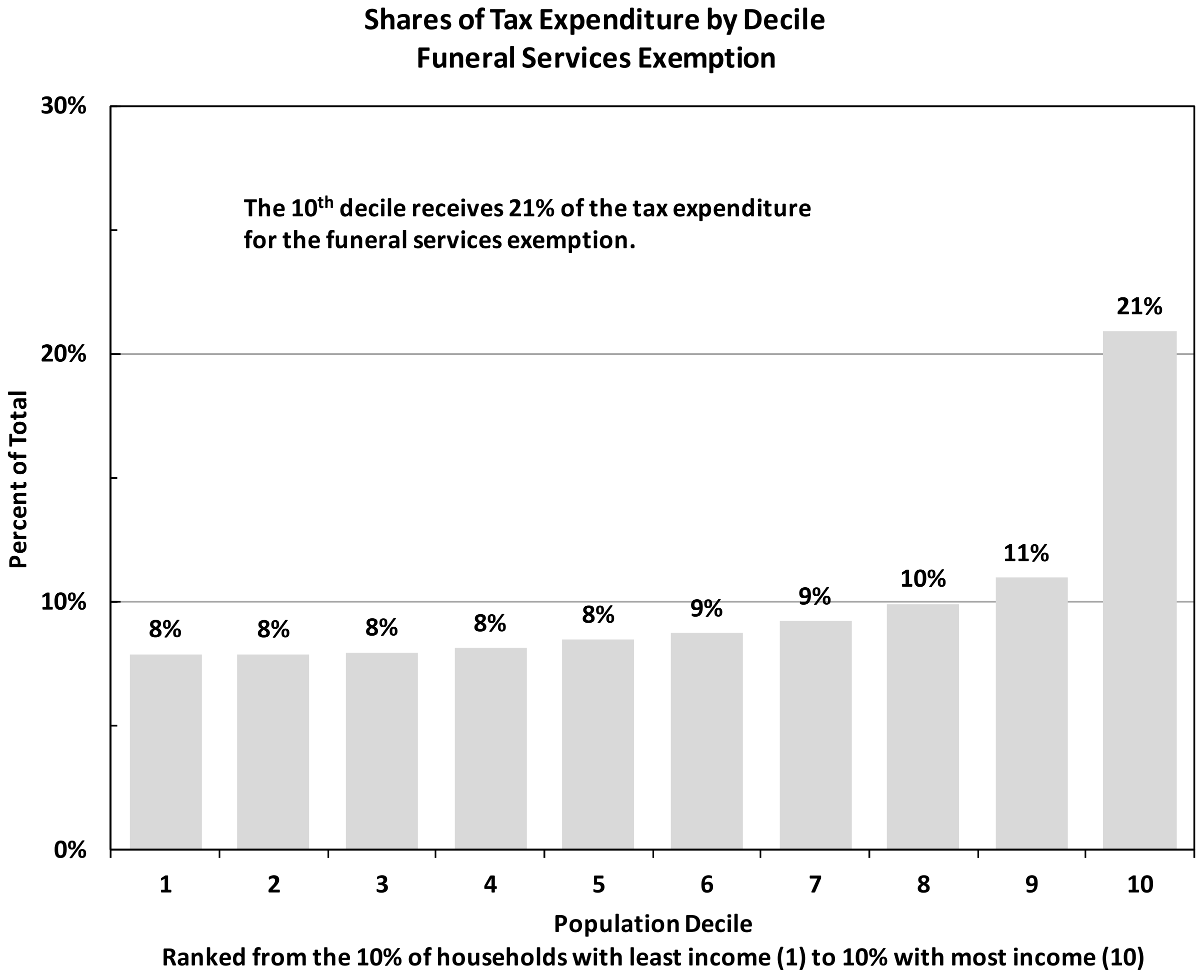
The sales tax has never applied to funeral or cremation services. It was likely that funeral services were not taxed because they were services. However, if the tax had been applied to most services, these services may have still been exempted as a necessity or because of the negative political implications of "taxing death," similar to the rationale for the exemption on caskets and burial vaults.

Related Direct Spending Programs

Under various state laws[102] counties are required to provide for the cost of burial, including caskets, for persons receiving public assistance, unknown persons, and bodies of indigent unclaimed persons. Burial, rather than cremation, is required if that is the deceased or next of kin's known preference or faith tradition. The purpose of this requirement is primarily for public health reasons.

[102] See Minn. Stat. §§ 256.935, 261.035, and 390.21.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.366
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the funeral services exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Motor Vehicle Repair Services

Description of Provision

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

Projected Tax Expenditure: Consumer-only Motor Vehicle Repair and Maintenance Services ($ thousands)

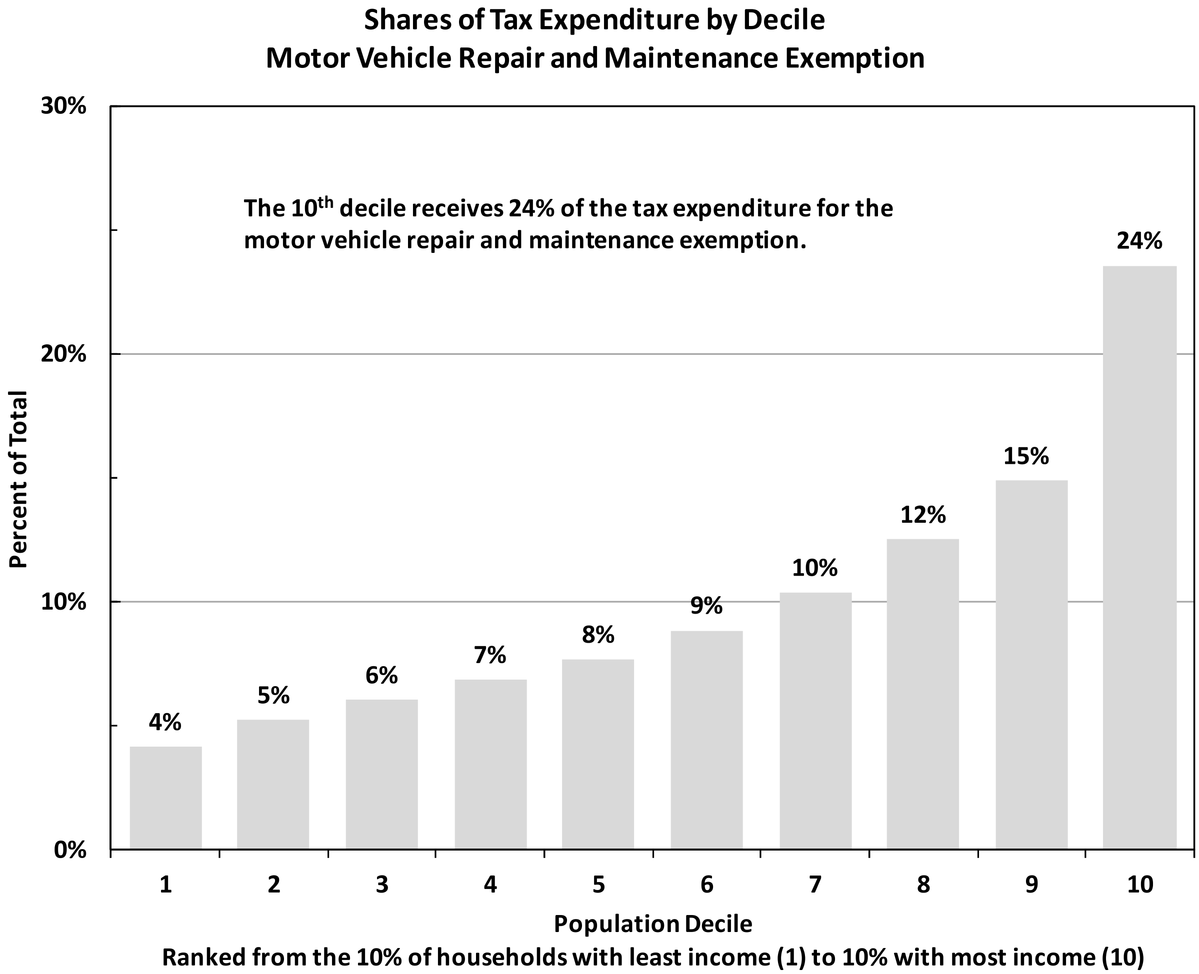
FY 2012	FY 2013	FY 2014	FY 2015
$130,900	$135,400	$138,800	$143,000

Expenditures on motor vehicle repair have increased in nominal terms (unadjusted for inflation) by 19.1 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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. Taxing this service would slightly increase the regressivity of the tax, as indicated by the Suits indexes. Although most car repairs are purchased by consumers, significant amounts are purchased by businesses (approximately 21 percent, based on DOR estimates). 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.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.288
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the motor vehicle repair and maintenance exemption is less than the Suits index for the sales and use tax (and for the overall state and local tax system), repealing the tax expenditure would make the sales and use tax (and the overall tax system) more regressive.

Household Goods Repair Services

Description of Provision

Household goods repair services, such as furniture and appliance repair services, are not taxed.

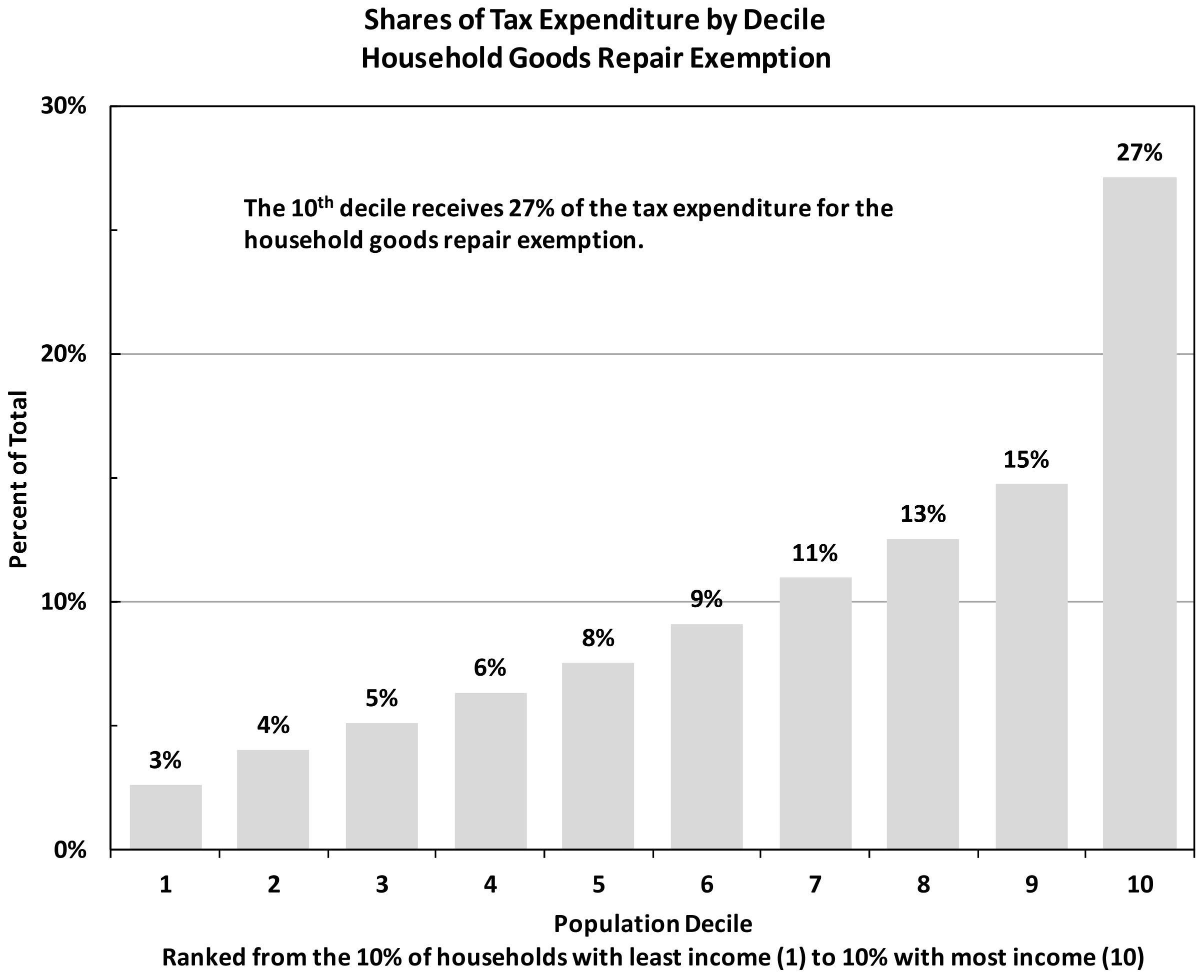
Projected Tax Expenditure: Household Goods Repair Services ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$18,200	$19,000	$19,600	$20,400

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. The incidence of taxation of these service is very similar to the existing sales tax base with essentially identical Suits indexes for both.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.228
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the household goods repair exemption is essentially the same as the Suits index for the sales and use tax, repealing the tax expenditure would not change the distribution of the sales tax. However, repeal of the exemption would make the overall tax system more regressive, since the index for repeal is less than index for the overall tax system.

Personal Services

Description of Provision

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

Projected Tax Expenditure: Personal Services ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$97,400	$102,500	$107,100	$112,800

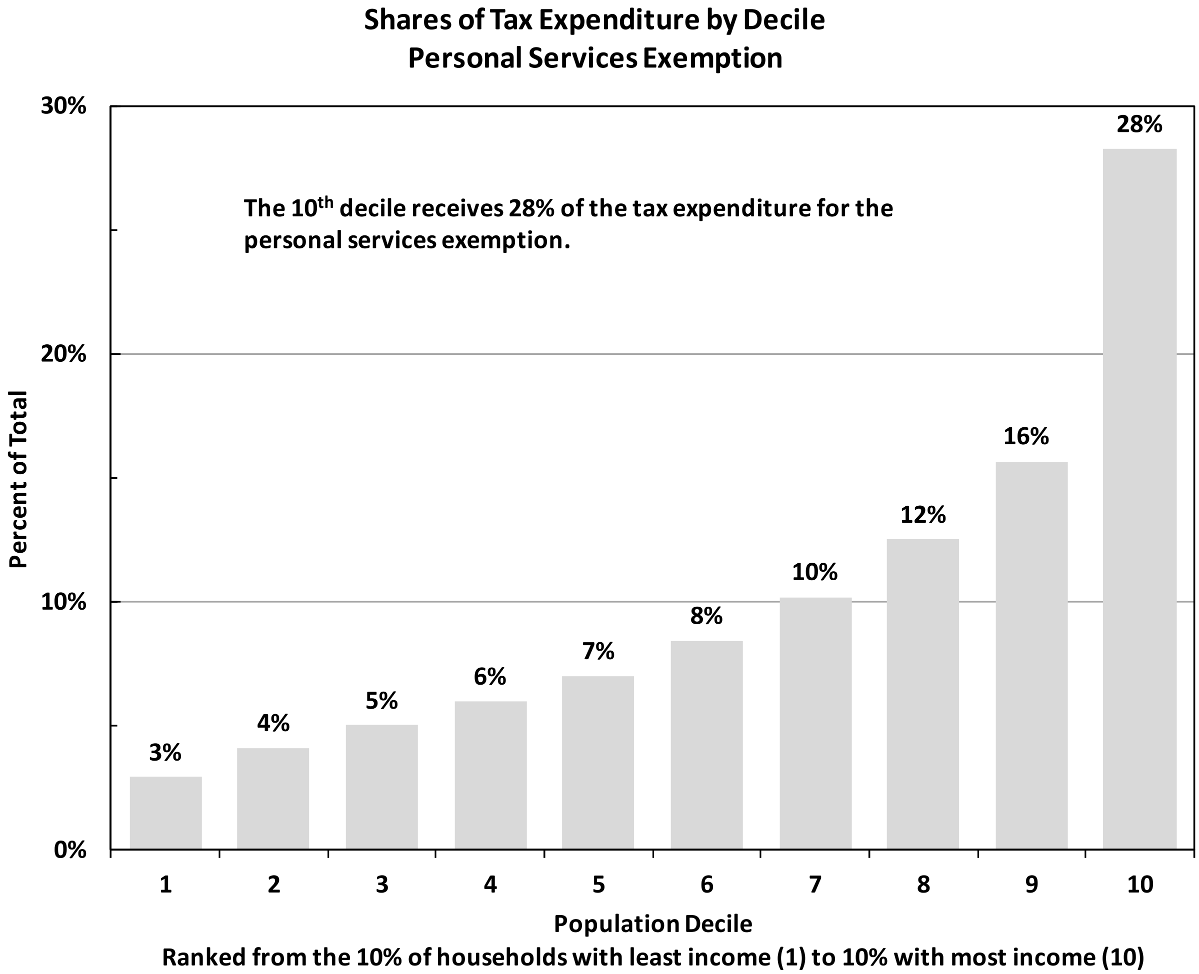
Expenditures on personal services have increased in nominal terms (unadjusted for inflation) by 217.9 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period. The incidence of taxing these services would be significantly less regressive than the existing sales tax base. Consumption of 44 percent of the services is concentrated in the two top income deciles.

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.

The incidence of these purchases, as evidenced by the Suits indexes, are less regressive than the existing sales tax base.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.136
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the personal services exemption is higher than the Suits index for the sales and use tax, repealing the tax expenditure would make the sales and use tax less regressive. However, repeal of the exemption would make the overall tax system more regressive, since the index for repeal is less than index for the overall tax system.

Legal Services

Description of Provision

Legal services for individuals (consumer purchases) and businesses are not subject to sales tax.

Projected Tax Expenditure: Consumer Purchases of Legal Services ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2014
$97,900	$103,000	$107,600	$113,300

There is no separate expenditure data for consumer legal services for FY 2002. However, expenditures on both consumer and business legal services have increased in nominal terms (unadjusted for inflation) by 76.4 percent from FY 2002 to FY 2012, compared with a 44.9 percent 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 (approximately 71 percent based on DOR estimates). Taxing consumer legal services, while exempting business purchases, would present some administrative and compliance issues. Some legal services purchased by small businesses (e.g., estate and financial planning and liability protection) serve both functions and it would not be clear how to appropriately tax them.

Related Direct Spending Programs

A number of state programs provide reduced or no-cost legal services to low-income individuals. Public defender services,[103] including public defense corporation grants, provide services in the criminal justice system, and representation in child protection proceedings for a child age 10 and over.[104] Legal services for civil actions are provided to low-income individuals through the qualified legal services programs (i.e., Legal Aid).[105]

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[103] Minn. Stat. ch. 611. The public defender corporation grants are in § 611.216.

[104] Minn. Stat. § 260C.163, subd. 3.

[105] Minn. Stat. § 480.24 et seq.

Incidence Information

Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.141
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the legal services exemption is higher than the Suits index for the sales and use tax, repealing the tax expenditure would make the sales and use tax less regressive. However, repeal of the exemption would make the overall tax system more regressive, since the index for repeal is less than index for the overall tax system.

Accounting Services

Description of Provision

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

Projected Tax Expenditure: Consumer Purchases of Accounting Services ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$27,800	$29,300	$30,600	$32,200

There is no separate expenditure data for consumer legal services for FY 2002. However, expenditures on both consumer and business accounting services have increased in nominal terms (unadjusted for inflation) by 133.1 percent from FY 2002 to FY 2012, compared with a 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

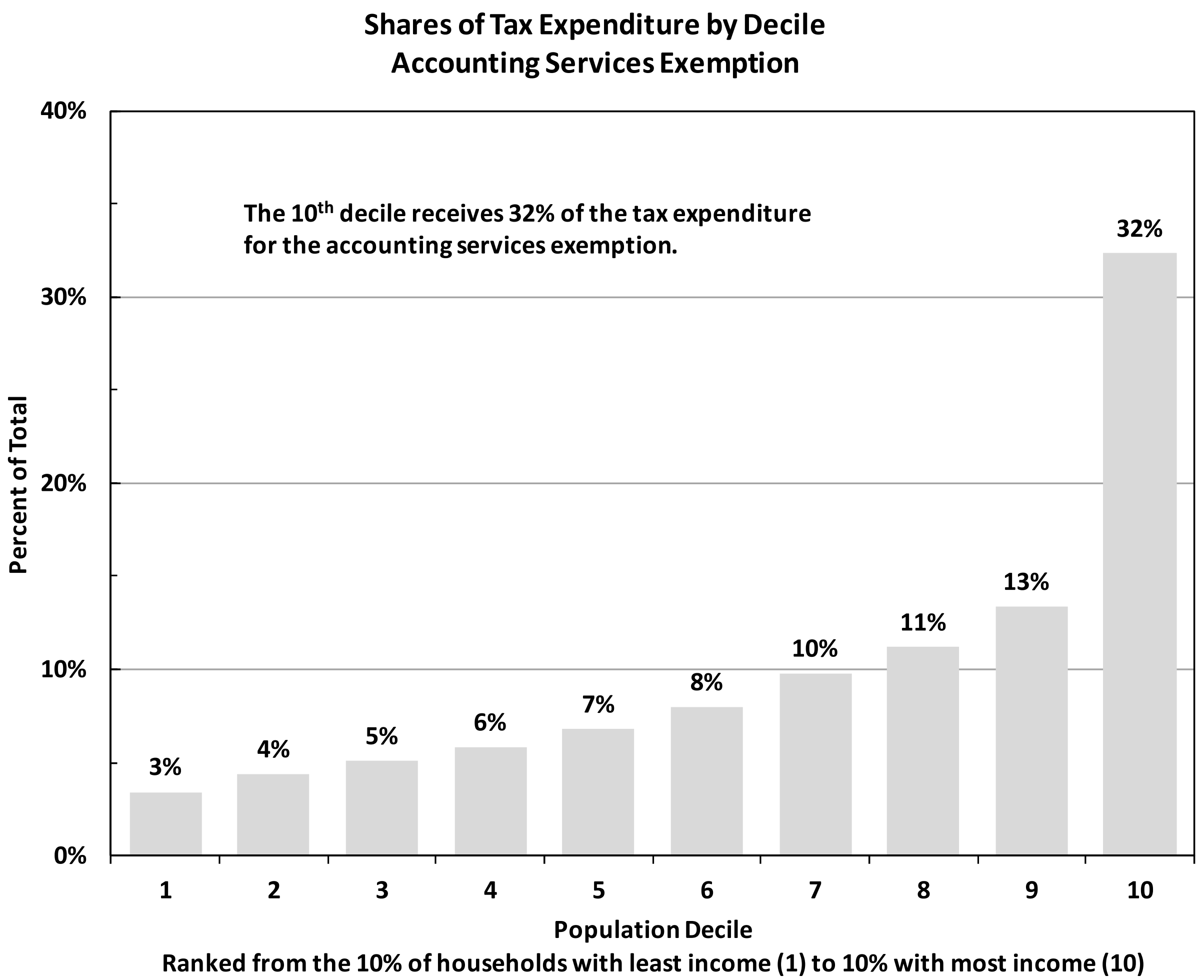
The sales tax has never applied to accounting services; the original sales tax applied to very few services. It is likely that these services were not taxed because they were services, rather than to achieve a policy objective. Accounting services purchased by businesses are intermediate business inputs 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 (approximately 87 percent based on DOR estimates). Taxing consumer accounting services, while exempting business purchases, would present some administrative and compliance issues. Some legal services purchased by small businesses (e.g., income tax preparation and financial planning) serve both functions and it would not be clear how to appropriately tax them.

Related Direct Spending Programs

The state provides grants[106] to fund volunteer accounting and tax preparation services for low-income, elderly, and disadvantaged Minnesota residents to help them file federal and state income tax returns and Minnesota property tax refund claims and to provide personal representation before the Department of Revenue and Internal Revenue Service.

[106] These grants were originally financed with separate or special biennial appropriations but are now funded under the Department of Revenue's base budget, starting with Laws 2005, First Special Session, chapter 3, article 11, section 9.

Incidence Information



Source: 2008 Tax Incidence Study database, based on detail from Consumer Expenditure Survey

Tax Research Division
MN Department of Revenue
November 28, 2012

See the box on page 16 for help in reading this graph.

Suits index for the tax expenditure (if repealed):	-0.166
Suits index for the existing sales and use tax:	-0.229
Suits index for the overall state and local tax system:	-0.060

Note: Suits index values can range from -1 to +1. Negative values indicate a regressive distribution; 0, a proportional distribution; and positive values a progressive distribution. For more information see Appendix B.

Because the Suits index for repeal of the tax expenditure for the accounting services exemption is higher than the Suits index for the sales and use tax, repealing the tax expenditure would make the sales and use tax less regressive. However, repeal of the exemption would make the overall tax system more regressive, since the index for repeal is less than the index for the overall tax system.

Exemption for Admissions to Arts Events

Description of Provision

Tickets and admissions to cultural and artistic events hosted by certain nonprofit organizations are exempt if the proceeds, after reasonable expenses, are used to provide Minnesotans with opportunities to participate in the creation, performance, or appreciation of the arts. Qualifying hosting organizations include:

- nonprofit arts organizations that receive at least 5 percent of their annual budgets from voluntary donations;
- municipal boards that promote arts and cultural events; and
- public and private nonprofit colleges and universities for events in facilities owned by the educational institutions.

When the exemption was enacted in 1980, it covered only events hosted by nonprofit arts organizations. It was expanded to events sponsored by municipal boards in 1992, to events at the University of Minnesota in 2002, and to events sponsored by other higher education institutions in 2005. The requirements that (1) a certain percent of a nonprofit arts organization's budget come from donations and (2) that the proceeds must be used to provide arts experiences for citizens of the state were also added in 2005.

Projected Tax Expenditure: Admission to Arts Events ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$5,200	$5,300	$5,400	$5,600

The estimated tax expenditures for admissions to arts events has decreased in nominal terms (unadjusted for inflation) by 8.8 percent from FY 2002 to FY 2012, compared with an 44.9 percent nominal increase in personal income over the same time period. This decrease is partially due to the 2005 law changes, which narrowed the types of organizations and events that qualify for the exemption. The expenditure on admissions to arts events has actually increased by 23.8 percent from FY 2006 to FY 2012, after the law change.

Incidence Information

Not available

Objective or Rationale

The objective or rationale for this exemption is unclear. Two possible rationales for it may be the following:

- Public arts performances by nonprofit organizations provide a public good that benefits members of the public beyond those attending performances. By subsidizing these organizations, whether through incentives for charitable contributions or by allowing them to retain more of their income by not taxing their admissions, the government helps secure these public benefits.

- The exemption is intended to enable more low-income individuals to attend arts performances. To qualify, these organizations must provide free or reduced price attendance opportunities for lower income persons in order to maintain their tax-exempt status; the exemption allows them to provide more attendance opportunities for the same cost.

Related Direct Spending Programs

The state provides direct grants for arts and cultural events through the State Arts Board and dedication of a portion of the legacy sales tax to the arts. Grants are probably most useful when trying to ensure a certain level of spending on arts such as public sculpture or large outdoor arts events where it is hard to limit enjoyment to persons paying an admission fee. In those instances there is both a clearer public goods aspect to the arts and less ability to charge direct beneficiaries. Most accounts suggest that as a result of passage of the legacy constitutional amendment, Minnesota has one of the highest amounts of per capita state government direct spending on arts in the nation.

Incidence Information

Not available

Evidence on Effectiveness in Meeting Objective

If the goal is to subsidize cultural and artistic events that would otherwise not be adequately funded, the exemption provides a subsidy with minimal state administrative costs. However, the subsidy does not distinguish between arts events that are sufficiently popular to be self supporting and those that are too expensive to finance through admissions alone. The subsidy is proportional to ticket sales for all qualifying arts and cultural events, regardless of the need for a subsidy. A reasonable inference is that more successful arts organizations (measured by the demand for admissions to their events) are bigger beneficiaries of the exemption. This may be desirable, if the goal is to assist organizations with the greatest public support or prospects for success. However, it is unclear how well that correlates with either the public goods aspects of nonprofit arts events or the goal of expanding access.

If the goal is to enable more low-income people to attend cultural and arts events, the exemption may also help meet that goal. A customer buying an admission ticket makes the purchasing decision based on total price; therefore the exemption probably has little impact on the price charged (including the sales tax) or the number of tickets sold. If the organization charges the same ticket price as it would without the exemption, the amount that would have been remitted to the state as tax revenue may be used to fund free or reduced price tickets. However, it is unclear how effective the law’s requirement that the proceeds be used for expanded arts “opportunities” is in ensuring access by low-income individuals to events. The terms of the requirement are ambiguous and do not directly require the proceeds to be used to subsidize tickets for the low-income patrons. Alternatively, a direct subsidy could be given to the organizations to fund free tickets. That approach would have higher administrative costs, but would be more likely to ensure that more of the benefit goes to low-income attendees.

Exemption for Fundraising Events for Nonprofits

Description of Provision

The main sales tax exemption for fundraising sales by the following nonprofit organizations includes sales under the following circumstances:

- Fundraising sales that do not exceed $10,000 annually by an educational or social organization serving primarily persons 18 years old or younger or a senior citizen group.

- Fundraising events by nonprofits where the proceeds go exclusively for charitable, religious, or educational purposes. Bingo and other gambling activities do not qualify, and the organization may not conduct fundraising for more than 24 days per year.

The exemption was enacted in 1985 and was last changed in 2001.

Projected Tax Expenditure: Fundraising Sales by Certain Nonprofits ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$15,000	$15,500	$15,900	$16,100

The law also provides for a few other minor fundraising sales tax exemptions—admissions to charitable golf tournaments and candy sales by youth groups. However, these tax expenditures are minimal and we have no estimate for their cost.

The estimated tax expenditures on fundraising sales by nonprofits have increased in nominal terms (unadjusted for inflation) by 100 percent from FY 2002 to FY 2012, compared with an 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

The fundraising sales tax exemptions appear to be based on two basic rationales, minimizing administrative and compliance costs and helping to support the charitable functions of groups doing fundraising:

- The $10,000 annual fundraising exemption for youth and senior citizen groups is clearly an attempt to balance the high administrative and compliance costs against the relatively small amount of money that would be collected from each group if every scouting troop, school booster club, senior social group, or similar group were required to calculate, collect, and remit sales taxes. The goal of this portion of the exemption is not to provide a subsidy to all youth and senior groups since any group raising more than $10,000 in annual sales is required to collect and remit tax on *all* of its taxable sales, even if the group is providing the same youth and senior services as smaller groups.

- The exemption for fundraising events where the proceeds are used exclusively for charitable, religious, or educational purposes also helps to minimize compliance and administrative costs, while providing a subsidy to these nonprofits either directly by increasing the net profit on each sale or indirectly by providing an incentive for increased purchasing from these organizations since the costs of goods and taxable services sold by the nonprofit has a price advantage equal to the combined state and local sales tax rate. The limit to no more than 24 days per year of fundraising events was likely intended to minimize the extent to which these fundraising activities compete with for-profit businesses that make similar sales.

Incidence Information

Not available

Evidence of Effectiveness in Meeting Objective

The $10,000 exemption seems well designed to prevent both small organizations and the Department of Revenue from incurring administrative and compliance costs that are disproportionate to the revenue at stake. However, the $10,000 dollar amount was set in 1985 and has not been adjusted for inflation. (Adjusting it for inflation would increase the limit to over $21,000 in 2013 dollars.) As a result, it may now be too low. However, many organizations that no longer qualify under the $10,000 limit may still qualify for the exemption as a result of the alternative provision because they limit their events to 24 or fewer days per year and use the proceeds for the required charitable purposes.

The alternative (24-day event-limited) exemption provides a modest benefit to organizations conducting fundraising that is proportional to the organization's success in selling taxable items. If the organization charges the same total price for goods as it would if it charged sales tax, the net profit the organization receives is higher than if sales tax was paid, giving the organization more money to spend on its mission. If the organization charges the same nominal price for the good as private vendors that have to charge sales tax, there is an incentive for consumers to buy from the nonprofit rather than a commercial seller. The increased number of sales also results in more revenue for the nonprofit to spend on its mission.

Exemption for Institutional Meals

Description of Provision

Although most prepared food is subject to sales tax, the following prepared meals are exempt:

- meals and drinks served to patients, residents, and inmates of hospitals, nursing homes, and correctional facilities and similar institutions
- meals served at all elementary, middle, and secondary schools
- meals served to students under a board contract at all colleges and universities
- congregate dining, meals on wheels, and similar programs serving senior citizens and the disabled

This exemption was included when the original law was enacted in 1967. It has been modified several times over the years but the largest change occurred in 2002, when the exemption for meals sold by colleges and universities was limited to those included in a boarding contract and vending machine sales at all schools became taxable.

Projected Tax Expenditure: Institutional Meals ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$43,000	$44,400	$45,600	$47,100

The estimated tax expenditures on institutional meals have increased in nominal terms (unadjusted for inflation) by only 4.4 percent from FY 2002 to FY 2012, compared with an 44.9 percent nominal increase in personal income over the same time period. This small increase is partially due to the 2002 law changes. The expenditure on institutional meals has increased by 6.2 percent from FY 2004 to FY 2012, after the law change.

Objective or Rationale

The objective or rationale for the exemption of institutional meals is unclear. A variety of rationales can be hypothesized for different portions of the exemption. A major rationale is likely to reduce administrative and compliance costs related to the difficulties with correctly estimating the price to which the sales tax would apply. Meals in schools and programs serving the elderly and disabled are often charged on a sliding fee scale and vary depending on the recipient. In many college cafeterias, the portion of room and board fees that is actually spent on the prepared cafeteria food depends on the eating habits of the student.

It may help to consider that food is a component of the entire service being provided. Under that viewpoint, these meals should be exempt because they are a business input. The actual service provided (e.g., medical care or incarceration) may or may not be exempt under another provision of the sales tax law. Finally, the exemption may be viewed as a way to support the services (e.g., education, long-term care services, and so forth) that are provided by the relevant institutions. Many of these services or institutions are directly or indirectly funded by state government through education aid, higher education appropriations and grants, medical assistance, appropriations for corrections programs, and so forth. The exemption may support these services by reducing costs to the institutions and/or their clients.

Incidence Information

Not available

Related Direct Spending Programs

The state directly and indirectly pays for many of the services provided by these institutions, including through education aid and Medical Assistance for long-term care and hospital patients. The free and reduced lunch program, funded federally, helps fund meals for low-income school children.

Evidence on Effectiveness in Meeting Objective

If the exemption is primarily intended to minimize compliance and administrative costs, while helping to support programs that are heavily financed by the state and federal governments, it likely achieves those objectives.

Exemption for Isolated and Occasional Sales

Description of Provision

The sales tax exemption for isolated and occasional sales was included in the original 1967 sale tax law; however, the provisions that apply to business sales have been modified several times over the years.

Isolated and occasional sales made by individuals not engaged in the business of selling have always been exempt. An individual hosting a garage sale once a year or selling a used vacuum cleaner on eBay is an isolated and occasional sale; having a table at a monthly swap meet or maintaining an inventory of goods to sell online is not.

Isolated and occasional sales by businesses of property used in a trade or business are exempt if they meet one of the following criteria:

- it is a farm auction sale
- sale of substantially all the assets of a business
- the sales do not exceed $1,000 in a 12-month period
- the transaction meets standards in certain Internal Revenue Code sections related to specific business events such as liquidations and involuntary conversions

Prior to 1991 the exemption for isolated and occasional sales by a business was broader. In 1991, the business exemptions for isolated sales by businesses narrowed to include only transactions that met the Internal Revenue Code requirements. The other criteria were reinstated in 1992.

Projected Tax Expenditure: Isolated and Occasional Sales ($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$40,300	$41,400	$42,700	$44,100

The estimated tax expenditures on isolated and occasional sales have increased in nominal terms (unadjusted for inflation) by 32.1 percent from FY 2002 to FY 2012, compared with an 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

Clearly the exemption for nonbusiness-related isolated and occasional sales is an attempt to balance the high administration and collection costs both for the state and individuals against the relatively small amount of money that would be collected in sales tax on these sales. This is also the rationale for the exemption on isolated sales of a trade or business that do not exceed $1,000 annually; the cost of the administration probably exceeds the tax that would be collected.

The rationale for the sales tax exemption for the other portion of the isolated and occasional sales of property used in a trade or business is likely to minimize the taxation of business inputs. As stated in the sales tax overview, good policy dictates that business inputs should be excluded from the sales tax base when possible.

Incidence Information

Not available

Evidence of Effectiveness in Meeting Objective

If the purpose of the exemption is to reduce the compliance and administrative costs of the tax, it seems likely to achieve that objective by relieving small or sporadic sellers from the cost of complying and DOR from enforcing and administering the tax.

Exemption for YMCA, YWCA, and JCC Memberships

Description of Provision

Onetime initiation fees and periodic dues for the "Ys" were exempted from the sales tax in 1987 when the sales tax was first imposed on memberships to clubs providing sports and athletic facilities. The exemption was extended to the Jewish Community Centers of Greater Minneapolis and St. Paul in 1996. Separate charges for using the sports and athletic facilities of these institutions remain taxable.

Projected Tax Expenditure: YMCA, YWCA, and JCC Memberships
($ thousands)

FY 2012	FY 2013	FY 2014	FY 2015
$5,000	$5,300	$5,500	$5,800

The estimated tax expenditures on YMCA, YWCA, and JCC memberships have increased in nominal terms (unadjusted for inflation) by 127.3 percent from FY 2002 to FY 2012, compared with an 44.9 percent nominal increase in personal income over the same time period.

Objective or Rationale

The rationale for the exemption for these membership fees and dues is probably similar to the rationale for the exemption on admissions to arts events—to provide a subsidy to these nonprofits to help fund free and low-cost memberships to lower income households. The additional revenue results either directly from increasing the net profit from each membership or indirectly by increasing the number of people joining these clubs, rather than for-profit athletic clubs since the costs of membership to these nonprofit clubs has a price advantage equal to the combined state and local sales tax rate.

Incidence Information

Not available

Evidence on Effectiveness in Meeting Objective

If the goal is to enable more low-income people to join health clubs, the exemption may help meet that goal. However, the law does not require that the additional revenue from the exemption be used to provide memberships to low-income individuals and families. Alternatively, a direct subsidy could be given to the organizations to fund free or reduced price memberships. That approach would have higher administrative costs, but would be more likely to ensure that more of the benefit goes to low-income persons.

Appendix A
How Minnesota's Tax Expenditures Compare with Other States

This appendix contains two tables that provide summary comparisons of Minnesota's major individual income tax expenditures (Table A-1) and sales and use tax expenditures (Table A-2) with those in place in the other states.

These comparisons are intended to help legislators assess how common or "popular" Minnesota's tax expenditures are with those typically in other states' tax structures. This may provide some measure of "political acceptability" or how difficult it would be to eliminate these tax expenditures (or convert them to direct spending programs). If a tax expenditure is widely in use in other states, that may suggest that it will be politically difficult to repeal or restructure the similar provision in Minnesota. It probably should not be taken as much, if any, evidence of the policy advisability or sensibility of the tax expenditure, though. As should be clear from discussion in the report, some tax expenditures reflect historical quirks or following federal or other state structures, rather than carefully considered decisions that use of the tax system is the optimal way to achieve specific nontax policy objectives.

Table A-1
National Comparison of State Individual Income Tax Expenditures

State	Social Security benefits	In-state municipal bond interest	Mortgage interest	Real estate taxes	Charitable contributions	Organ donors	Elderly exclusion	Military pay – active duty	K-12 expenses	Long-term care
Alabama	Exempt	Exempt	Yes	Yes	Yes	No	No	Federal	No	Deduct
Alaska	No income tax									
Arizona	Exempt	Exempt	Yes	Yes	Yes	No	+2	Exempt	Credits	Federal
Arkansas	Exempt	Exempt	Yes	Yes	Yes	Yes	+2	$9,000	No	Federal
California	Exempt	Exempt	Yes	Yes	Yes	No	+2	Federal	No	Federal
Colorado	Partial exemption	Exempt	Yes	Yes	Yes	No	No	Federal	No	Credit
Connecticut	Partial exemption	Exempt	No	Credit	No	No	No	Federal	No	No
Delaware	Exempt	Exempt	Yes	Yes	Yes	No	Exclude	Federal	No	Federal
Florida	No income tax									
Georgia	Exempt	Exempt	Yes	Yes	Yes	Yes	No	Federal	Credit	Federal
Hawaii	Exempt	Exempt	Yes	Yes	Yes	No	+2	$5,881 R	No	Federal
Idaho	Exempt	Exempt	Yes	Yes	Yes	Credit	No	OoS	No	Deduct
Illinois	Exempt	Taxable	No	Credit	No	No	+0.5	Exempt	Credit	No
Indiana	Exempt	Exempt	No	Yes	No	No	+2	$5,000	Credit	Deduct
Iowa	Partial exemption	Taxable	Yes	Yes	Yes	Yes	+0.5	Exempt	Credit	Federal
Kansas	Partial exemption	Exempt	Yes	Yes	Yes	No	No	*	No	Federal
Kentucky	Exempt	Exempt	Yes	Yes	Yes	No	+2	Exempt	No	Deduct
Louisiana	Exempt	Exempt	Yes	Yes	Yes	Credit	+1	OoS $	Deduct	Federal
Maine	Exempt	Exempt	Yes	Yes	Yes	No	Credit	Federal	No	Deduct
Maryland	Exempt	Exempt	Yes	Yes	Yes	No	+1	*	No	Credit
Massachusetts	Exempt	Exempt	No	No	No	No	+-0.16	Federal	No	No
Michigan	Exempt	Exempt	No	Credit	No	No	+0.65	Exempt	No	No
Minnesota	Same as federal	Exempt	Yes	Yes	Yes	Yes	Exclude	Exempt	Credit	Credit
Mississippi	Exempt	Exempt	Yes	Yes	Yes	No	+0.25	$15,000 R	No	Credit
Missouri	Partial exemption	Exempt	Yes	Yes	Yes	No	+1.05	CZ only	No	Deduct
Montana	Partial exemption	Exempt	Yes	Yes	Yes	No	+1	Exempt	No	Deduct
Nebraska	Same as federal	Exempt	Yes	Yes	Yes	No	Credit	Federal	No	Federal
Nevada	No income tax									
New Hampshire	Income tax on investment income only									
New Jersey	Exempt	Exempt	No	Yes	No	No	+1	Federal	No	No
New Mexico	Same as federal	Exempt	Yes	Yes	Yes	Yes	Exclude	Exempt	No	Federal
New York	Exempt	Exempt	Yes	Yes	Yes	Yes	No	Federal	No	Credit
North Carolina	Exempt	Exempt	Yes	Yes	Yes	No	No	Federal	No	Credit
North Dakota	Same as federal	Exempt	Yes	Yes	Yes	Yes	No	Federal+R	No	Credit
Ohio	Exempt	Exempt	No	No	No	Yes	No	Federal+OoS	No	Deduct
Oklahoma	Exempt	Exempt	Yes	Yes	Yes	Yes	+1	Exempt	No	Federal
Oregon	Exempt	Exempt	Yes	Yes	Yes	No	Credit	OoS+$6,000R	No	Credit
Pennsylvania	Exempt	Exempt	No	No	No	No	No	OoS	Credit	No
Rhode Island	Same as federal	Exempt	No	No	No	Yes	No	Federal	Credit	No
South Carolina	Exempt	Exempt	Yes	No	Yes	No	Exclude	*	No	No
South Dakota	No income tax									
Tennessee	Income tax on investment income only									
Texas	No income tax									
Utah	Same as federal	Exempt	Yes	Yes	Yes	Credit	No	Federal	No	No
Vermont	Same as federal	Exempt	Yes	Yes	Yes	No	Credit	OoS+*	No	No
Virginia	Exempt	Exempt	Yes	Yes	Yes	Yes	+0.86	$15,000	No	Credit
Washington	No income tax									
West Virginia	Same as federal	Exempt	No	No	No	No	Exclude	R*	No	Deduct
Wisconsin	Exempt	Taxable	Credit	No	Credit	Yes	+0.36	R	No	Deduct
Wyoming	No income tax									

Sources: Rich Olin, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (July 2012) (generally tax year 2011), supplemented by information from House Research publications and information for state government websites.

Notes:

Social Security benefits: No state taxes more benefits than those subject to the federal income tax; states listed with "partial exemptions" tax a smaller amount of benefits than provided under the federal tax, but do not exempt all benefits from taxation.

In-state municipal bond interest: States listed as "taxable" all exempt some bond interest on selected types of bonds, but have a general rule of taxability. Indiana also exempts out-of-state bond interest; Utah exempts out-of-state bond interest, if the other state exempts interest on Utah bonds.

Elderly exclusion: This column is limited to states that provide an exemption or exclusion based on age of the taxpayer or spouse—similar to Minnesota's elderly exclusion—or allow an extra exemption or personal credit amount for the elderly or disabled. It does not include states that allow partial or full exemptions for pension income of various types (governmental, military, and all), which are common provisions in many states. States that allow an additional exemption for the elderly (ages vary) are listed as "+1"; "+.05" if the added amount is one-half the regular exemption or credit, and so on; states, like Minnesota, that have an exclusion are listed as "Exclude."

Military pay: All states with an income tax conform to the federal exemption for combat zone pay; listing is "CZ only" if state only exempts combat zone pay. If state follows the federal rules (exempting combat zone pay and quarters allowances), entry is "Federal." If all active duty pay is exempt, entry is "Exempt"; if exemption is limited to a fixed amount, the dollar amount is listed. In some states exemption of fixed dollar amounts is subject to an income test. If state exempts military pay for those stationed outside the state, entry is "OoS" and "OoS$" if a dollar limit applies. If state exempts active duty pay of National Guard and reserves, entry is "R." If state exempts a particular type of pay, entry is "*" (certain bonuses and loan assistance in Kansas; up to $15,000 for service outside the United States if total pay is less than $30,000 in Maryland; National Guard and reserve training pay in South Carolina; first $6,000 of National Guard and reserve training pay in Vermont; National Guard and reserve active duty pay under presidential orders in West Virginia).

K-12 expenses: "Credit" entry may refer to credit for K-12 tuition or expenses paid (similar to the Minnesota credit) or for contributions to organizations providing scholarships (states uses different terminology or acronyms for these organizations including among others STOC, SGO, and SSO), which several states have. For more detailed information on states with credit programs, see House Research, *Income Tax Deductions and Credits for Public and Nonpublic Education in Minnesota* (September 2011): 18-34. For states with both credits and deductions (e.g., Indiana and Minnesota), only credit is entered in the table.

Long-term care: States listed as "deduct" allow full deduction for long-term care insurance premiums; states listed as "federal" follow federal itemized deduction rules (allowing deduction of certain long-term care insurance premiums if medical expense exceed the required percentages of adjusted gross income); "credit" states allow tax credit, but may also follow federal itemized deduction rules, as Minnesota does. Some states allow larger deductions than federal, but not unlimited (e.g., Kansas allows $1,000 more than federal law). The table lists these states as federal unless the deduction is unlimited. Details on parameters of long-term insurance credits are available in House Research, *Long-term Care Insurance Income Tax Credit* (September 2013). Georgia, Iowa, Missouri, Montana, New Mexico, and North Dakota allow tax credits or deductions for caregivers who provide long-term care to elderly or disabled relatives or dependents. The Montana credit also applies to LTCI premiums paid on behalf of an elderly family member. Nebraska has a credit for contributions to a long-term care savings plan, and Connecticut exempts interest on Home Care Option Program accounts.

Table A-2
National Comparison of State Sales and Use Tax Expenditures

State	Sales Tax Rate (%)	Clothing	Groceries	Home Heating Oil	Prescription Drugs	Over-the-counter Drugs	Newspapers	Residential Water	Caskets	Repair Services
Alabama	4	Taxable[107]	Taxable	Taxable	Exempt	Taxable	Taxable[108]	Exempt	Taxable	Exempt
Alaska	No sales tax									
Arizona	6.6	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	2.7%	Taxable	Exempt
Arkansas	6	Taxable[107]	1.5%	Taxable	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable
California	7.5	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
Colorado	2.9	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
Connecticut	6.35	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable
Delaware	No sales tax									
Florida	6	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable[109]	Exempt	Taxable	Exempt
Georgia	4	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Exempt
Hawaii	4	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable
Idaho	6	Taxable	Taxable	Exempt	Exempt	Taxable	Taxable if > $.11/copy	Exempt	Exempt	Exempt
Illinois	6.25	Taxable	1%	Taxable	1%	1%	Exempt	Exempt	Taxable	Exempt
Indiana	7	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
Iowa	6	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Kansas	6.3	Taxable	Taxable	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Kentucky	6	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Taxable	Exempt
Louisiana	4	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable
Maine	5	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt
Maryland	6	Taxable[107]	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt
Massachusetts	6.25	Exempt <$175	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt
Michigan	6	Taxable	Exempt	4%	Exempt	Taxable	Taxable	Exempt	Taxable	Exempt
Minnesota	6.875	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt
Mississippi	7	Taxable[107]	Taxable	Exempt[110]	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable
Missouri	4.225	Taxable[107]	1.225%	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Exempt
Montana	No sales tax									
Nebraska	5.5	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable[111]
Nevada	6.85	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
New Hampshire	No sales tax									
New Jersey	7	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
New Mexico	5.125	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
New York	4	Exempt <$110	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
North Carolina	4.75	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable[112]	Exempt	Exempt <$1500	Exempt
North Dakota	5	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
Ohio	5.5	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable[113]
Oklahoma	4.5	Taxable[107]	Taxable	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
Oregon	No sales tax									
Pennsylvania	6	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
Rhode Island	7	Exempt <$250	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt
South Carolina	6	Taxable[107]	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt
South Dakota	4	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable

[107] These states offer a sales tax holiday on clothing, usually for back-to-school shopping in late July or early August. Oklahoma’s sales tax exemption covers all goods sold.

[108] Electronic transmission of newspapers exempt.

[109] Mail subscriptions exempt; home delivery subject to tax.

[110] Mississippi excludes heating oils from sales taxes but levies a per-gallon excise tax.

[111] Motor vehicle repairs are exempt.

[112] Exempts newspapers sold through street vendors, vending machines, and news carriers making door-to-door deliveries.

[113] Exempts repairs of property, which is exempt from sales tax. Exempts public utility repairs.

State	Sales Tax Rate (%)	Clothing	Groceries	Home Heating Oil	Prescription Drugs	Over-the-counter Drugs	Newspapers	Residential Water	Caskets	Repair Services
Tennessee	7	Taxable[107]	5.25%	Exempt	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable
Texas	6.25	Taxable[107]	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable[114]
Utah	5.95	Taxable	1.75%	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable
Vermont	6	Exempt	Exempt	Taxable[115]	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable[116]
Virginia	5.0	Taxable[107]	2.5%	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt
Washington	6.5	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	5.029%	Taxable	Taxable
West Virginia	6	Taxable	1%	Taxable	Exempt	Taxable	Taxable[112]	Exempt	Taxable	Taxable[117]
Wisconsin	5	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable
Wyoming	4	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable[118]	Taxable	Taxable

[114] Aircraft, commercial vessels, and motor vehicles exempt.

[115] Subject to Vermont's fuel gross receipts tax.

[116] Motor vehicle repair, maintenance, and restoration services are not taxable. The repair and maintenance of computer programs is not taxable.

[117] Repairs to farm equipment and aircraft are exempt.

[118] Municipal utilities providing services within city boundaries are exempt.

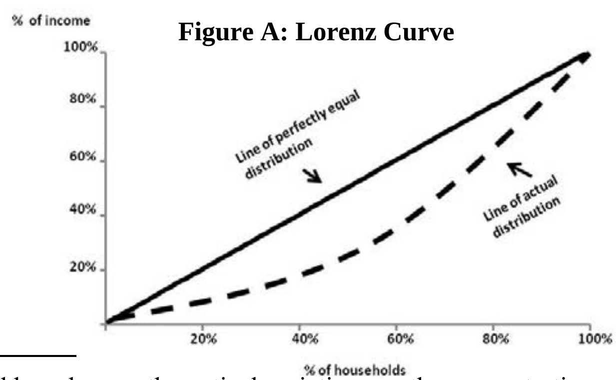
Appendix B
The Suits Index

This report uses the Suits index to compare the progressivity/regressivity of various tax expenditures. The Suits index is one of several numerical indexes that economists use to measure the distribution of taxes.[119] The Suits index is one of the most widely used of these indexes and is used by the Department of Revenue in the *Minnesota Tax Incidence Study*. The Suits index is a numerical value or score that measures progressivity; index values range from -1 (most regressive) to +1 (most progressive).

The Suits index was developed by Daniel Suits in 1970.[120] Suits described the index as having been "inspired by and related to" the Gini ratio, or coefficient, which in turn is based on the Lorenz curve, proposed by economist Max O. Lorenz in 1905 as a method for comparing the distribution of wealth in a society at different points in time.[121] This appendix provides an overview of the Lorenz curve, the Gini coefficient, and finally the Suits index.

The **Lorenz curve** plots the cumulative percentage of households in a population along one axis, and the cumulative percentage of income or wealth along the other.[122] In a perfectly equal distribution, the result would be a straight, 45-degree line as shown in Figure A, in which the first 10 percent of the households possessed 10 percent of the income, the first 20 percent possessed 20 percent of the income, and so on.

Figure A: Lorenz Curve



[119] These indexes are all based on mathematical variations on the concentration curve (e.g., Lorenz curve and Gini index). Donald W. Kiefer, "Distributional Tax Progressivity Indexes," *National Tax Journal* 37, no. 4 (1984), 497-513, describes eight of these indexes and their properties.

[120] Daniel Suits, "Measurement of Tax Progressivity," *American Economics Review* (September 1977): 747-52. A very similar measure with nearly identical properties was proposed by Khetan and Poddar. C. P. Khetan and S. N. Poddar, "Measurement of Income Tax Progression in a Growing Economy: The Canadian Experience," *Canadian Journal of Economics* 9 (1976): 613-629.

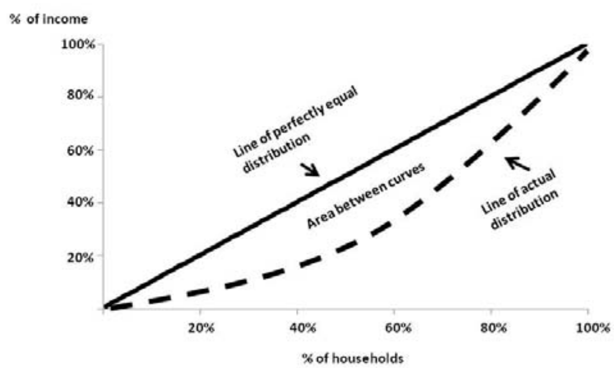
[121] M. O. Lorenz, "Methods of Measuring the Concentration of Wealth," *American Statistical Association* (June 1905).

[122] Lorenz's paper put the percentage of households on the vertical (Y) axis and of wealth on the horizontal (X) axis, so that a line showing an unequal distribution of wealth skewed toward higher income households would bow up above the 45-degree line. Today households are typically plotted on the X axis and wealth on the Y axis, so that an unequal distribution skewed toward higher income households bends down below the 45-degree line. The graphs in the appendix follow the current practice.

For most income distributions, the lower-end shares of the population have disproportionately low shares of the income, while the higher-end shares have disproportionately high shares of the income, resulting in something like the dashed line in Figure A. Lorenz's insight was that one could plot the actual distribution at multiple points in time, and by comparing the two lines, determine if the distribution of wealth had grown more or less unequal over time.

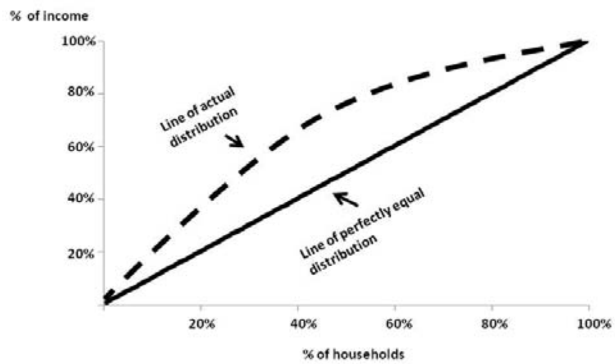
Lorenz did not propose comparing the curves in a quantifiable manner, but rather visually inspecting them to determine changes in the distribution of income or wealth over time. A method for comparing different curves numerically came from the Italian statistician Corrado Gini, who proposed measuring the area between the 45-degree line and the line of actual distribution as a way to quantify inequality or to assign it a specific numerical value. The resulting **Gini coefficient or ratio** makes it convenient to compare two or more distributions.

Figure B: Gini Index for a Regressive Distribution



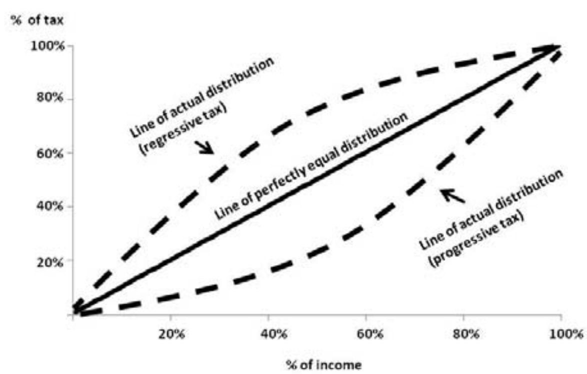
Assuming that the graph shows a unit square, then the area under the 45-degree line equals 0.5, and the Gini coefficient equals 0.5 minus the area between the line of actual distribution and the X axis. In a proportional distribution, the line of actual distribution will be the 45-degree line, and the Gini coefficient equals 0, or 0.5 minus 0.5. In a regressive distribution, the Gini coefficient will be greater than zero, since the area between the line of actual distribution and the X axis is less than the area between the line of equal distribution and the X axis (in this case, the Gini coefficient equals the area *between* the line of equal distribution and the line of actual distribution. In a progressive distribution as shown in Figure C, the Gini coefficient will be less than zero, since the area between the line of actual distribution and the X axis will be greater than the area between the 45-degree line and the X axis.

Figure C: Gini Coefficient for a Progressive Distribution



The **Suits index** applies the Lorenz curve and Gini coefficient concepts to taxes. While the graphs underlying the Lorenz curve and Gini coefficient plot the distribution of income or wealth in comparison to the distribution of households, the graphical representation of the Suits income compares the distribution of a tax (or a tax expenditure), on the Y axis, to the distribution of income, on the X axis. The resulting index compares the distribution of income to the distribution of the tax itself across the population. As with the Gini coefficient, a proportional tax (or tax expenditure) results in a Suits index of zero; a progressive tax in a positive Suits index, and a regressive tax in a negative Suits index.

Figure D: Suits Index



The Suits index, in measuring the distribution of taxes (or tax expenditures) across income, rather than across households, is more useful in comparing the progressivity of tax expenditures in the same time period than it is in comparing the progressivity of taxes or tax expenditures across time. The index relies not only on the distribution of taxes, but also on the distribution of income. As a result, an increase or decrease in the value of the index from one year to the next may reflect a change in the distribution of the tax expenditure being measured, a change in the underlying income distribution, or, more likely, a combination of the two.[123] Thus, year-to-year changes in Suits indexes should not be interpreted as implying that tax policy changed the distribution of taxes or tax expenditures. The changes may simply reflect changes in the income distribution, unrelated to tax policy.[124]

Staff at the Research Division of the Department of Revenue prepared the Suits indexes for the tax expenditures presented in this report. They calculated the indexes using the database for the *2011 Tax Incidence Study*. The calculations rely on the tax expenditure benefits claimed by Minnesota households ranked from least to greatest income, using software rather than a graphical measurement to calculate the area under the line of actual distribution for each expenditure and compare it with the area under the line of equal distribution.

[123] Kiefer, "Distributional Tax Progressivity," provides an in-depth analysis of the strengths and weaknesses of the various distributional indexes.

[124] Other distributional indexes that hold constant the effects of changes in the income distribution are better suited to this task. This can be done by measuring (again using the Gini coefficient) the extent to which the tax system changes the income distribution (redistributes income). Several indexes do this in different ways (e.g., by measuring percentage or absolute changes).

Appendix C
Household Income and Population Deciles

The *2011 Minnesota Tax Incidence Study* (2008 tax data) includes the following items in household income:

- wages
- taxable and nontaxable interest
- taxable dividends
- business income
- capital gains and other gains
- taxable and nontaxable IRA distributions
- taxable and nontaxable pension and annuity income
- taxable unemployment benefits
- taxable and nontaxable Social Security benefits
- other taxable income reported on the individual income tax return (including alimony received)
- public assistance cash payments
- workers' compensation
- other nontaxable income reported on property tax refund

Household income is reduced by the following:

- taxable refunds of state taxes
- half of self-employment tax
- penalty on early withdrawal of savings
- alimony paid

Before calculating the breakpoints for population deciles, DOR aggregates returns into household; each household includes income reported by the taxpayer, taxpayer's spouse, and any dependents claimed for income tax purposes. The table below shows the household incomes of each of the ten population deciles as reported in the *2011 Minnesota Tax Incidence Study*, which uses 2008 tax data. DOR allocated tax expenditures to these population deciles, as presented in the graphs throughout this report.