STATE INCOME TAX EXPENDITURES

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In this brief, we consider both personal and business income tax expenditures at the state level. We use California, Massachusetts, Minnesota, and the District of Columbia as examples. We separate tax expenditures into those that occur because of conformity with federal tax provisions and those that result from state-specific tax policies. We find that the former category accounts for between 70 and 85 percent of the total cost of combined individual and business income tax expenditures. We also find that except for certain economic development and income security provisions common to many states, state-specific tax expenditures vary considerably by state.

INTRODUCTION

Tax expenditures refer to forgone revenues from special provisions in the tax code such as exclusions, deductions, deferrals, credits, and preferential tax rates that benefit specific activities or groups of taxpayers. Both the Office of Tax Analysis in the US Treasury Department and the Congressional Joint Committee on Taxation (JCT) publish annual lists of federal tax expenditures.[1] Even at the federal level, however, opinions vary on what is considered part of the normal tax structure or an administrative necessity rather than a "special" provision. These differences are wider at the state level because of different tax laws and interpretations of the reference or normal tax structure, making tax expenditures difficult to compare across states.

Tax expenditure reporting is not uniform across state governments. According to the National Conference of State Legislatures,[2] most states furnish regular tax expenditure budgets for the public and legislators, but many do not justify how they differentiate between "normal" and "special" tax provisions. Furthermore, while it is considered best practice not only to report on tax expenditures frequently but also to include information for each provision about the rationale,

[1] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023" JCX-55-19, December 18, 2019; US Department of the Treasury, Office of Tax Analysis, "Tax Expenditures: FY 2021" October 7, 2019.

[2] National Conference on State Legislatures, "Tax Expenditure Budgets and Reports: Best Practices," January 2017.

desired outcome, category of taxpayers who benefit, and metrics for rigorous effectiveness evaluation, most states fail to meet these standards.

To provide a snapshot of tax expenditures at the state level, we consider tax expenditures in California, the District of Columbia, Massachusetts, and Minnesota.[3] The District of Columbia and Minnesota have been recognized for their comprehensive and informative reporting;[4] we selected the other two states for their relatively detailed and well-structured reporting, and to capture a variety of ways state taxes conform to federal laws. Even within these four case studies, reporting on specific tax expenditures varies.[5]

We consider only tax expenditures that apply to individual and corporate income taxes. At the state and local level, significant special exclusions, deductions, deferrals, credits, and preferential tax rates also apply to sales and property taxes. For example, tax expenditures in sales taxes equaled 27 percent of all reported fiscal year (FY) 2020 tax expenditures in California and 32 percent in Massachusetts.[6]

Tax expenditures in all four jurisdictions are costly. The estimated sums of individual and corporate income tax expenditures for FY 2020 equal 51 percent of total individual and corporate income tax revenues in California, 54 percent in the District of Columbia, 56 percent in Massachusetts, and 61 percent in Minnesota.[7] In comparison, the sum of estimated federal individual and corporate income tax expenditures equals over 70 percent of total federal individual and corporate income tax revenues in FY 2020.

CONFORMITY AND FEDERAL LINKAGES

State tax codes are closely connected to the federal tax code because many states link directly to federal definitions of income. Forty-one states and the District of Columbia have a broad-based individual income tax, and most of them—including California, the District of Columbia, and Minnesota—start with federal adjusted gross income (FAGI) as their income base.[8] Taxpayers in Massachusetts start with gross income and subtract many of the same adjustments as on their federal income tax return, but they can also subtract some state-specific deductions. Unless they have provisions adding back certain items, states that conform with FAGI automatically incorporate all major federal exclusions, exemptions, and adjustments to gross income, such as exclusions of employer contributions for health insurance and to retirement plans, and deductions for contributions to IRAs and student loan interest.

Very few states start with federal taxable income (FTI) as their base. These states carry over exclusions and deductions from FAGI into their income tax base, but they also include other federal deductions that determine FTI, such as either the federal standard or itemized deductions and the federal deduction for qualified business income. Before 2018, federal taxpayers could also deduct a personal exemption amount ($4,150 in 2017) for themselves and each of their

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[3] California Tax Expenditure Report 2018–19. Department of Finance; District of Columbia Tax Expenditure Report. Office of Revenue Analysis (September 2018); Commonwealth of Massachusetts Tax Expenditure Budget Fiscal Year 2020. Executive Office for Administration and Finance (January 2019); and State of Minnesota Tax Expenditure Budget Fiscal Years 2018-2021. Minnesota Department of Revenue, Tax Research Division (February 2018).

[4] Michael Leachman, Dylan Grundman, and Nicholas Johnson. May 2011. "Promoting State Budget Accountability Through Tax Expenditure Reporting," Washington, DC: Center on Budget and Policy Priorities.

[5] For example, Minnesota included the exclusion of Medicare benefits as its third largest income tax expenditure for FY 2020, but this provision was not included in the tax expenditure reports for the other three states or in tax expenditures listed by Federal agencies.

[6] Neither California nor Massachusetts counts sales tax exemptions for sales of services and sales or leases of real property as a tax expenditure. The share of tax expenditures attributable to sales taxes would be much higher if they included these exemptions.

[7] California only reports tax expenditures with an annual cost of at least $5 million.

[8] Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not have an individual income tax. New Hampshire and Tennessee tax only interest and dividend income.

dependents when determining FTI. The 2017 Tax Cuts and Jobs Act (TCJA) temporarily eliminated all federal personal exemptions (through 2025). In May 2019, Minnesota switched its starting point from FTI to FAGI so that state law rather than federal law determines dependent exemptions and standard or itemized deductions.[9]

The remaining states with broad-based income taxes start with their own calculation of the income tax base, but regardless of the exact starting point, all states with a broad-based income tax generally adhere closely to the components of FAGI and thus carry over many of the exemptions and deductions from the federal level.

Even when conformity is not explicit, states often follow the federal lead regarding certain tax provisions, such as itemized deductions and tax credits. For example, many states allow the same itemized deductions (generally except for state and local income taxes) as federal law. And more than half the states, including California, Massachusetts, and Minnesota, as well as the District of Columbia, have their own version of the federal earned income tax credit (EITC).

For corporate income taxes, all but 4 of the 44 states with their own corporate income tax start with either FTI or net FTI as their corporate tax base (net FTI subtracts net operating losses and special deductions from FTI). The District of Columbia starts with federal gross income for its corporate income tax, and Alabama, Arkansas, Mississippi, and Pennsylvania do not use a federal starting point for their corporate income tax.[10]

The type of conformity matters. States that conform to the Internal Revenue Code (IRC) on a "rolling" basis link automatically to updates in federal law. State that conform on a "static" basis link to federal law as it was on a certain date. California, Massachusetts, and Minnesota all have static conformity with a fixed date preceding the TCJA, although Massachusetts conforms to certain IRC provisions on a rolling basis. Thus, except for certain provisions in Massachusetts, recent changes in federal law did not automatically pass through to those states.[11] The District of Columbia conforms to the IRC on a rolling basis.

TAX EXPENDITURES FROM FEDERAL CONFORMITY

Because of close conformity with federal law, the list of major state tax expenditures closely resembles the list of major federal tax expenditures.[12] Tax expenditures from federal conformity account for most of the cost of total state individual and business income tax expenditures: 85 percent in California and Minnesota, and 72 percent in the District of Columbia and Massachusetts. As at the federal level, for which JCT and the Office of Tax Analysis identified about 200 separate tax expenditures, the top ten most costly tax expenditures account for a significant portion of the total cost.

Heading the list of the major state tax expenditures arising from federal conformity are the exclusions for employer contributions to employee retirement and health insurance plans. Employer contributions to qualified retirement or pension plans and the investment income earned on plan balances are generally excluded from employees' taxable income until the benefits are paid out. The net value of the tax deferral (the revenue loss from excluding contributions and investment income minus the revenue collected from taxing retirement benefits) is counted as a tax expenditure. Similarly, the value of tax deferral for contributions to traditional individual retirement accounts and self-employment retirement plans is also a significant state-level tax expenditure.

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[9] Minnesota House Research, H.F.5. Omnibus Tax Bill, May 24, 2019.

[10] Six states (Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming) do not have a corporate income tax. Nevada, Ohio, Texas, and Washington instead levy a tax on gross business receipts. Delaware has a gross receipts tax in addition to a tax on corporate income.

[11] As discussed later in this brief, Minnesota subsequently amended its tax law to conform to some of the TCJA changes.

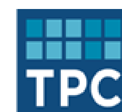
[12] See Sammartino and Toder (2019a, 2019b).

Employer contributions to health insurance plans, which provide benefits for sickness or injury, are also generally excluded from employees' taxable income. Unlike employer contributions for retirement plans, there is no limit on the amount of deductible employer contributions to health plans.

TABLE 1

Top 10 Federal-Conformity Income Tax Expenditures by State

Millions of dollars, fiscal year 2020



Tax provision	California		District of Columbia		Massachusetts		Minnesota	
	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount
Net exemption of employer contributions and earnings of private pension plans	(1)	$10,000	(2)	$144	(1)	$1,945	(1)	$1,562
Exemption of employer contributions for health insurance premiums and medical care	(2)	$8,000	(1)	$186	(2)	$1,278	(2)	$1,507
Exemption of social security and railroad retirement benefits[(a)]	(3)	$4,300	(7)	$52	(3)	$1,077	(3)	$409
Deduction for mortgage interest on owner-occupied residences	(4)	$4,100	(4)	$90	-	NA	(6)	$271
Exclusion of capital gains on sale of principal residences	(5)	$3,900	(6)	$53	(5)	$543	(8)	$227
Deduction for charitable contributions[(b)]	(6)	$3,500	(5)	$83	-	$32	(5)	$279
Nontaxation of capital gains at death	(7)	$2,800	(9)	$37	(4)	$955	(9)	$221
Deduction for state and local real estate and personal property taxes	(8)	$2,360	-	$27	-	NA	-	$189
Exclusions for individual retirement accounts and self-employed retirement plans	(9)	$1,700	(3)	$107	(7)	$301	(4)	$341
Exclusion of benefits provided under cafeteria plans	(10)	$1,600	(10)	$35	-	NR	(7)	$270
Exclusion of interest on state and local government bonds	-	NR	(8)	$44	-	$52	-	$45
Accelerated depreciation of equipment, buildings, and rental housing	-	NR	-	$18	(6)	$365	-	$63
Exclusion of investment income on life insurance and annuity contracts	-	$1,050	-	$5	(8)	$250	(10)	$213
Exemption of public assistance or welfare benefits	-	NR	-	$1	(9)	$199	-	$28
Net operating loss carry-forward	-	NR	-	NR	(10)	$169	-	NR

Sources: California Department of Finance, "Tax Expenditure Report 2018-19," June 2018; District of Columbia Office of Revenue Analysis, "Tax Expenditure Report 2017," September 2018; Massachusetts Executive Office for Administration and Finance, "Tax Expenditure Budget Fiscal Year 2020," January 2019; Minnesota Department of Revenue, "Tax Expenditure Budget Fiscal Years 2018-2021," February 2018; Authors' analysis.
Notes: Values include both personal income and corporation income tax expenditures.
NA - not allowed; NR - not reported in the tax expenditure report.
(a) Includes additional state-level exclusions or subtractions, in addition to the partial exclusion under federal law.
(b) Massachusetts allows a charitable deduction under the corporate income tax but not the personal income tax.

Social Security benefits are partially or fully excluded from FAGI for taxpayers whose income falls below certain thresholds. California, the District of Columbia, Massachusetts, and most other states go one step further and exclude all Social Security benefits regardless of income. Minnesota includes the portion of Social Security benefits that are taxable at the federal level in state taxable income but, like some other states that tax Social Security benefits, allows an additional exemption. The values reported in table 1 for the exemption of Social Security benefits include both the

federal and the additional state exemption. The District of Columbia and Minnesota report the two parts of this tax expenditure separately, while California and Massachusetts show only the combined tax expenditure.[13]

The major federally derived state tax expenditures also include deductions for home mortgage interest, charitable contributions, and state and local real estate taxes. Taxpayers who itemize can claim these deductions on their federal return. Currently, only about 11 percent of federal taxpayers claim itemized deductions rather than taking the standard deduction. California, the District of Columbia, and Minnesota generally allow the same itemized deductions as on federal returns (again, except for the deduction of state and local income taxes). Massachusetts does not allow individual income tax deductions for home mortgage interest, charitable contributions, or state and local taxes but allows corporations to deduct charitable contributions.

Some states allow taxpayers to claim itemized deductions on their state returns only if they claim them on their federal return. California and Minnesota allow taxpayers to claim itemized deductions on their state income tax return whether they itemize or claim the standard deduction on their federal return; the District of Columbia requires taxpayers to make the same election on both their state and federal returns.

The TCJA eliminated some federal itemized deductions, modified others, and capped the annual deduction for state and local taxes at $10,000. Because California and Minnesota conformed with the IRC as it was before the TCJA, these changes did not apply to itemized deductions in those states. California enacted legislation to conform with certain provisions of TCJA but not with those affecting itemized deductions.[14] Minnesota modified its tax law to accept some of the federal changes to itemized deductions, including the $10,000 limit on the deduction for state and local taxes paid.[15] The District of Columbia conforms to the IRC on a rolling basis, so it eliminated the same deductions as federal law, but it decoupled from federal law regarding the cap on the deduction for state and local taxes, allowing taxpayers to claim the full amount of their real estate taxes if they itemize on their District of Columbia tax return.

Other major tax expenditures at the state level include some of the federal preferences for capital gains, including the exclusion for capital gains transferred at death and the exclusion for capital gains on the sale of principal residences. Capital gains on assets transferred at death escape taxation because the cost basis for inherited assets is deemed to be the asset's value when the owner dies (commonly referred to as step-up in basis). Taxpayers who sell a principal residence can exclude up to $250,000 of capital gains ($500,000 for married couples) for federal income tax purposes if they meet certain ownership and use requirements.

A federal tax preference that generally does not carry over to the states is the reduced tax rate that applies to long-term capital gains and qualified dividends. California, the District of Columbia, and Minnesota all tax long-term capital gains at the same rate as other income. Massachusetts taxes long-term capital gains at the same rate as other income but has a higher rate on short-term capital gains (assets held one year or less) and long-term gains on collectibles.

STATE-SPECIFIC TAX EXPENDITURES

On top of federally linked tax expenditures, states have considerable freedom to implement their own tax expenditures to encourage certain taxpayer behavior; subsidize business costs for certain industries; or meet public goals, such as subsidizing health care, education, housing, and income security. We list the major state-specific tax expenditures for

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[13] Minnesota also includes the tax exclusion for Medicare benefits in its tax expenditure report. Because none of the other jurisdictions include it as a tax expenditure and neither the Office of Tax Analysis or JCT include it at the federal level, we omit it here.

[14] See the State of California, Franchise Tax Board, "Analysis of Amended Bill: Loophole Closure and Small Business and Working Families Tax Relief Act of 2019 (AB 217), June 13, 2019, https://www.ftb.ca.gov/tax-pros/law/legislation/2019-2020/AB217-061319.pdf.

[15] Minnesota House Research, H.F.5. Omnibus Tax Bill, May 24, 2019.

the four jurisdictions below, assigning them to different budget functions. Most are categorized as either economic development or income security, the latter comprising special provisions to assist low-income households. Our third category, social policy, includes provisions intended to help specific groups, but which are not limited to low-income members of those groups.

We exclude from the tables tax expenditures based on the apportionment of income for business taxes and the foreign-source income of multinational corporations because states do not use similar methods of estimating these tax expenditures and no obviously correct baseline rules exist. All four jurisdictions require combined income reporting by businesses. Businesses must include all domestic income, which is then allocated to each state for tax purposes based upon a state's apportionment formula. In the past, states typically used a three-factor formula that gave equal weight to the share of a business's total assets, employment, and sales in the state. In recent years, however, many states moved to a formula that double- or triple-weights sales or that uses sales as the single factor. California, the District of Columbia, and Minnesota all use a single-factor sales formula. Massachusetts uses a three-factor formula with double-weighted sales (except for manufacturing companies, qualifying defense contractors, and qualifying financial service providers, which can use a single-factor sales formula). Minnesota and Massachusetts report the difference between using their current formula and an equally weighted three-factor formula as a tax expenditure. The other jurisdictions do not report the difference as a tax expenditure.

Nearly all states require businesses to include only domestic income in combined reporting, offering multinational corporations a "water's edge" election that allows them to exclude income earned abroad. California, The District of Columbia, Massachusetts, and Minnesota all follow this practice. California reports the water's edge election as a tax expenditure as does the District of Columbia, which reports a tax expenditure for the exclusion of active income of controlled foreign corporations. The other two states do not report a tax expenditure for their corporate income tax treatment of foreign-source income.

A comparison of the 10 most costly state-specific tax expenditures shows the variety across the states as well as some common features. One common provision is the EITC. The EITC primarily benefits low- and moderate-income working families with children, offering a federal credit of up to $6,557 for a family with three qualifying children in 2019. The credit phases in with earnings and phases out as income rises above a threshold. The federal credit is fully refundable, meaning that if the credit exceeds a taxpayer's income tax liability, they will receive the difference as a payment from the Internal Revenue Service. Most states determine their credit amounts as a percentage of the federal credit (except Minnesota, which calculates its credit, called the Working Family Credit, as a percentage of income). The EITC is refundable in all four jurisdictions, and most of its budgetary cost comes from the portion that exceeds income tax liability. For FY 2020, state EITC tax expenditures were the largest state-specific tax expenditure in the District of Columbia ($79 million) and Minnesota ($270 million) and the fourth largest in California ($370 million) and Massachusetts ($280 million). The District of Columbia offers a more expansive credit than most states, providing a credit to taxpayers without qualifying children and across an expanded range of income eligibility beyond the federal limits.[16]

Tax expenditures for housing, including subsidies for both renters and low-income homeowners, are also common across states. California provides a nonrefundable renters' credit of $60 ($120 for joint filers) to renters with income below specific thresholds; this provision will cost an estimated $140 million in FY 2020 and is the costliest state-specific tax expenditure after the top 10 listed in table 2. Similarly, Massachusetts allows taxpayers to deduct half of their rent paid for their principal residence up to $3,000 a year; this provision also will cost an estimated $140 million in FY 2020. The District of Columbia and Massachusetts have property tax "circuit breakers," which provide a refundable income

[16] See "State Earned Income Tax Credits," Urban Institute, accessed December 16, 2019, https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/state-earned-income-tax-credits.

tax credit to offset a portion of property tax payments for low-income homeowners and renters. The credit in Massachusetts is only available to seniors.

TABLE 2

Top 10 California-Specific Income Tax Expenditures

Millions of dollars, fiscal year 2020

Tax provision	Functional area	Amount
Research and development credit	Economic development	$1,700
Dependent exemption in excess of personal exemption credit	Social policy	$1,600
Tax preferences for head-of-household and qualifying widow(er) filing status	Social policy	$1,300
Earned income tax credit	Income security	$370
Incentives for enterprise zones and similar areas	Economic development	$320
Tax preferences for subchapter S corporations	Economic development	$260
Film credit	Economic development	$176
Exclusion of unemployment insurance benefits	Income security	$170
Tax-exempt status for qualifying nonprofit and charitable corporations	Social policy	$160
California Competes credit	Economic development	$150

Sources: California Department of Finance, "Tax Expenditure Report 2018-19," June 2018; Authors' analysis.
Notes: Values include both personal and corporation income tax expenditures. Table does not include federal-conformity tax expenditures or corporate income tax state apportionment and international income provisions.

All four jurisdictions have significant tax expenditures intended to foster economic development (Francis 2016). The largest of these are research credits, which have an estimated revenue cost of $1.7 billion in California, $284 million in Massachusetts, and $77 million in Minnesota in FY 2020. The credit in each state is available for qualified research expenditures that exceed a base amount and is nonrefundable, but it can be carried forward if not fully used in the current year.

TABLE 3

Top 10 District of Columbia-Specific Income Tax Expenditures

Millions of dollars, fiscal year 2020

Tax provision	Functional area	Amount
Earned income tax credit	Income security	$79
Incentives for qualified high-technology companies	Economic development	$33
State subtraction of social security and railroad retirement benefits	Social policy	$31
Property tax circuit-breaker	Housing	$22
Exemption of tax on capital gain from the sale or exchange of a qualified high-technology company investment	Economic development	$13
Child and dependent care credit	Social policy	$13
Subtraction of DC and federal government survivor benefits	Income security	$4
Subtraction for health insurance premiums paid for a same-sex spouse or domestic partner	Health	$3
Investment funds exemption from unincorporated business franchise tax	Tax policy	$2
State subtraction for college savings plan contributions	Education	$2

Sources: District of Columbia Office of Revenue Analysis, "Tax Expenditure Report 2017," September 2018; Authors' analysis.

Notes: Values include both personal and corporation income tax expenditures. Table does not include federal-conformity tax expenditures or corporate income tax state apportionment and international income provisions.

The District of Columbia does not have a research credit, but it does have business tax incentives to attract and retain high-technology businesses. It provides qualified high-technology companies a five-year exemption from business franchise taxes and a reduced rate thereafter. Qualified high-technology companies also receive other tax preferences, including employment credits and a credit for employing and retraining disadvantaged workers. The combined tax expenditure for these tax preferences is $33 million in FY 2020. The District of Columbia's Office of Revenue Analysis notes that evaluating the effectiveness of these incentives is difficult because they are not available only for new investments, and that the incentives pose some financial risk for revenues because of inadequate dollar or time limits and the absence of provisions to claw back benefits for companies that leave the District (Office of Revenue Analysis 2018).

TABLE 4

Top 10 Massachusetts-Specific Income Tax Expenditures

Millions of dollars, fiscal year 2020

Tax provision	Functional area	Amount
Exemption of distributions from certain contributory pension and annuity plans	Social policy	$395
State deduction for employee social security and railroad retirement payments	Social policy	$326
Research credit	Economic development	$284
Earned income credit	Income security	$280
Rent deduction	Housing	$140
Deduction for dependents under age 12	Social policy	$128
Exclusion for small business corporations	Economic development	$123
Low income housing credit	Housing	$106
Refundable state tax credit against property taxes for seniors ("circuit breaker")	Housing	$89
Film (or motion picture) credit	Economic development	$80

Sources: Massachusetts Executive Office for Administration and Finance, "Tax Expenditure Budget Fiscal Year 2020," January 2019; Authors' analysis.
Notes: Values include both personal and corporation income tax expenditures. Table does not include federal-conformity tax expenditures or corporate income tax state apportionment and international income provisions.

Other state economic development incentives include the "California Competes" credit and Massachusetts's "Economic Development Incentive Program credit," which are designed to attract businesses and maintain business growth in each state. For FY 2020, these will cost an estimated $150 million and $30 million, respectively. Both states have additional specific provisions targeted by industry or geography. For example, Massachusetts has tax incentives for individuals and businesses in the "Life Sciences" industry, which are expected to cost $18 million in FY 2020.

Tax incentives for film production are economic development provisions that vary in usage and design across states.[17] California and Massachusetts have income tax credits for qualifying corporations or individuals with film or TV production expenses. For FY 2020, California's credits will cost an estimated $176 million; Massachusetts's credits will cost an estimated $80 million. The credits are intended to promote net new job creation and other economic benefits,

[17] "State Film Production Incentives and Programs," National Conference of State Legislatures, February 5, 2018, http://www.ncsl.org/research/fiscal-policy/state-film-production-incentives-and-programs.aspx.

but the evidence of those outcomes is mixed. According to the California's Legislative Analyst's Office, the costs have outweighed the benefits, and their research finds that the net number of film industry jobs is not strongly affected by tax incentives.[18] The District of Columbia has similar incentives (the District of Columbia Film, Television and Entertainment Rebate Fund), but it is funded by annual appropriations and not through tax expenditures. Similarly, Minnesota's “Snowbate” program was not a tax credit but offered filmmakers a cash rebate of 25 percent of their production costs.

TABLE 5

Top 10 Minnesota-Specific Income Tax Expenditures

Millions of dollars, fiscal year 2020

Tax provision	Functional area	Amount
Working family credit	Income security	$270
Marriage credit	Social policy	$97
Dividend received deduction	Tax policy	$86
Research and development credit	Economic development	$77
State subtraction of social security income	Social policy	$65
Historic structure rehabilitation credit	Social policy	$39
Child and dependent care credit	Social policy	$35
Student loan credit	Education	$29
Subtraction for military pension and retirement pay	Veterans' benefits	$25
Subtraction for K-12 education expenses	Education	$18

Sources: Minnesota Department of Revenue, "Tax Expenditure Budget Fiscal Years 2018-2021," February 2018; Authors' analysis.

Notes: Values include both personal and corporation income tax expenditures. Table does not include federal-conformity tax expenditures or corporate income tax state apportionment and international income provisions.

STATE TAX EXPENDITURE REPORTING

Tax expenditure reporting by state varies because each state has its own tax system, its own set of federal conformity rules, and its own definitions on what counts as a “special” provision. For example, California considers the head-of-

[18] Brian Weatherford, “An Update on California's Film Tax Credit Programs,” California Legislative Analyst's Office blog, July 22, 2019.

household and qualifying widow/widower filing statuses as tax expenditures because they create forgone revenue from lower tax rates and larger exemptions. Other states consider filing status an integral part of the basic income tax base structure rather than a tax expenditure. All states can improve their reporting by providing an up-front overview of their income tax base, listing all relevant provisions they consider as part of the "normal tax system" and not as tax expenditures.

Reporting across states varies in regularity as well as detail. For example, Iowa reports on tax expenditures every five years; Washington reports every four years; Alabama reports every year; and Kentucky and Oregon (both biennial-budget states) report every biennium, with the former reporting prior to biennial budget sessions and the latter reporting with the governor's budget. Given the amount of forgone revenue and the range of policy goals that tax expenditures can target, states should evaluate and report on tax expenditures annually or biennially.

Most tax expenditures receive less scrutiny than direct spending programs, but economic development provisions are a notable exception. In recent years, many states have started to pay special attention to evaluating their economic development tax incentives.[19] According to research by the Pew Charitable Trusts, states such as Minnesota are leading the way both by setting a strategic plan for periodic evaluation of these provisions and by using measures of their impact to inform policy choices. These impacts include how well the tax incentives influence business behavior, their economic trade-offs and indirect effects, whether their objectives match their outcomes, whether they are administered efficiently, and whether they are constrained by adequate fiscal protections (Goodman and Boender 2019; Pew Charitable Trusts 2017).

The review of tax expenditures is improving with time, although insights gained from evaluations of some tax expenditures may not be universally applicable to all others. In addition to reports that describe tax expenditure provisions, their statutory authority or origins, and their revenue effects, states would also benefit from evaluating tax expenditures on four additional metrics:

1. The objective or purpose of the tax provision
2. The number and characteristics of taxpayers benefitting from the provisions (such as the distribution by income or industry)
3. The provision's direct and indirect outcomes (such as net new jobs or economic activity)
4. Recommendations for improved oversight or accountability measures

The District of Columbia's tax expenditure report covers some of these additional metrics, such as the purpose and beneficiaries of tax expenditure provisions (Office of Revenue Analysis 2018). Since 2018, Colorado's Office of the State Auditor has released exemplary evaluations of both small and large tax provisions, detailing their purpose, performance measures, economic costs and benefits, comparisons with similar provisions, data constraints, and future policy considerations.[20]

CONCLUSION

Income tax expenditures are a significant form of fiscal intervention by both the federal government and states, but they are easy to overlook because they are administered through the tax code. Income tax expenditures equal 50 to 60

[19] See "State Tax Incentive Evaluations Database," National Conference of State Legislatures, October 24, 2018. See also, Connecticut Department of Economic and Community Development (2018) and State of Connecticut Auditors of Public Accounts (2018).

[20] See "2019 Tax Expenditure Evaluation Reports," Colorado Office of the State Auditor, accessed December 16, 2019, and Pew Charitable Trusts (2018).

percent of total individual and corporate income tax revenues in California, the District of Columbia, Massachusetts, and Minnesota. A large share of state tax expenditures results from states' conformity with federal definitions of income and tax rules, but state-specific special exclusions, deductions, deferrals, credits, and preferential tax rates also are costly.

Tax expenditures depend on each state's own tax system, and they can be designed to achieve beneficial societal goals such as economic development, affordable housing, and income security for the residents of that state. If ill-considered or poorly designed, however, they can fail to advance these goals and instead simply provide unwarranted special benefits to certain industries or individuals. Given the discretion states hold over both federally derived and state-specific tax expenditures, states should report on their tax expenditures regularly and carefully evaluate and monitor each provision.

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