Tax Expenditures and Tax Expenditure Evaluation

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PRINCIPLES OF SOUND TAX POLICY

- **SIMPLICITY:** Tax codes should be easy for taxpayers to comply with and for governments to administer and enforce.
- **TRANSPARENCY:** Tax policies should clearly and plainly define what taxpayers must pay and when they must pay it. Hiding tax burdens in complex structures should be avoided. Additionally, any changes to the tax code should be made with careful consideration, input, and open hearings.
- **NEUTRALITY:** Taxes should neither encourage nor discourage personal or business decisions. The purpose of taxes is to raise needed revenue, not to favor or punish specific industries, activities, and products. Minimizing tax preferences broadens the tax base, so that the government can raise sufficient revenue with lower rates.
- **STABILITY:** Taxpayers deserve consistency and predictability in the tax code. Governments should avoid enacting temporary tax laws, including tax holidays, amnesties, and retroactive changes, and strive to establish stable revenue sources.

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WHAT ARE TAX EXPENDITURES?

Tax Expenditure: "A tax provision that provides a gross or taxable income definition, deduction, exemption, credit, or rate for certain persons, types of income, transactions, or property that results in reduced tax revenue."

- *2020 Tax Profile & Expenditure Report*; §39-21-302, C.R.S.

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COMMON TYPES OF TAX EXPENDITURES

- **EXEMPTIONS**: Indirectly reduce tax revenue by specifying certain items that are not included in the tax base, oftentimes based on category, class, or status.
  - Exemptions are, by definition, not subject to taxation in the first place.
- **DEDUCTIONS**: Indirectly reduce tax revenue by reducing taxable income when certain conditions are met.
  - Oftentimes used to offset expenses incurred by a taxpayer.
- **CREDITS**: Directly reduce tax liability dollar-for-dollar.
  - Can be nonrefundable or refundable.

STRUCTURAL EXPENDITURES

- Structural expenditures do one or more of the following:
  - Establish the basic elements of a tax provision
  - Avoid duplication of a tax
  - Promote administrative efficiency
  - Clarify the definition of the types of transactions or individuals who are subject to a tax
  - Ensure that taxes are evenly applied
- Examples:
  - Net operating loss deduction
  - Credit for income taxes paid to other states
  - Sales tax exemptions for business inputs

PREFERENTIAL EXPENDITURES

- Preferential expenditures are usually designed do one or more of the following:
  - Incentivize certain behaviors/ activities
  - Assist certain industries
  - Stimulate certain types of economic activity

- Examples:
  - Child care contribution credit
  - Colorado Works Program credit
  - Innovative trucks credit
  - Certified auction group license fee credit
  - Sales tax exemption for food purchased for home consumption

WHY IS TAX EXPENDITURE EVALUATION IMPORTANT?

- Tax expenditures are not subject to the annual budget and appropriations process, but, like appropriated expenditures, they reduce the amount of revenue that is available for other purposes.

- During the appropriations process, the state determines how to spend the revenue that is being collected, but tax expenditures reduce the amount of revenue that is collected in the first place.

HOW EFFECTIVE ARE TAX INCENTIVES?

- The consensus among most economists is that many tax incentives merely subsidize economic activities that would have occurred anyway.

- Ultimately, a broad-based, low-rate, competitive tax code is much better equipped to attract business investment and promote long-term economic growth.

HOW EFFECTIVE ARE TAX INCENTIVES?

"Tax credit programs are more properly viewed as tax subsidies than as 'incentives' to induce investment behavior. If the purpose of tax incentive programs is to influence investment behavior, state policymakers should consider abandoning these programs in favor of more equitable approaches such as across-the-board reductions in corporate income tax rates, which benefit all corporations equally."

– David S.T. Matkin, "Designing Accountable and Effective Economic Development Tax Incentives" (2010)

EVALUATING PREFERENTIAL TAX EXPENDITURES

- What is the purpose of this incentive?
- Is there a way to measure results?
- Does this expenditure incentivize long-term investments or short-term gaming of the tax code?
- Could the tax code be more competitive through rate or structural reform instead of this expenditure?

Questions?

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