



PERSPECTIVE

Better Questions about Tax Preferences

BY JUSTIN MARLOWE



In FY 2020, the State of Arizona collected \$19.9 billion in total state tax revenue. That same year it granted hundreds of credits, exemptions, deductions, and other “tax preferences.” According to the Arizona Department of Revenue, those tax preferences reduced the total tax liability for Arizona individuals and businesses by \$20.3 billion. In other words, Arizona did not collect more revenue than it did collect.

Arizona is not an outlier. Moreover, there’s plenty of reason to believe that the size and scope of tax preferences will only expand as states and localities work to compete in the post-COVID-19 economy. At the surface, this seems like a tremendous challenge for state and local finance professionals. But in fact, it’s an opportunity to answer some new and compelling questions.

Tax preferences have received unprecedented recent attention among policymakers, journalists, researchers, and regulators. All that attention has so far produced two big outcomes. One is much more visibility into who receives tax preferences. In fact, according to the Institute on Taxation and Economic Policy’s catalog of state “tax expenditure” reports, virtually every state now publishes some inventory of tax preferences and their revenue impact. GASB Statement No. 77, Tax Abatement Disclosures, was also a big step toward better visibility into what tax preferences “cost” in foregone revenue. Because of these and other efforts, we now know more than ever about when and where tax preferences happen.

The other big outcome is much more attention to the “benefit” side. If tax preferences are like any other

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policy or program, then they should produce measurable benefits like jobs created or retained, growth in homeownership, business investment in plant and equipment, and so forth. With that logic in mind, policymakers around the country have turned to legislative auditors, third-party evaluators, and other analysts to look for those measurable benefits. There's considerable debate as to whether this is the right approach, but there's no debate about its growing popularity. According to the Pew Charitable Trusts, in just the last 15 years a total of 28 states have established a process for evaluating the effectiveness of some or all of their tax preferences. Several localities have launched analogous efforts.

This "benefit-cost" approach has shown much promise. But unfortunately, it also suffers from a major drawback: Many tax preferences don't produce these types of measurable benefits. For instance, most states and localities do not require wholesalers to collect sales taxes on goods sold to retailers. This is because sales taxes are supposed to be paid by consumers, not by the intermediaries who bring products to market. That preference is not designed to encourage wholesalers to expand their operations, but to ensure that they don't pay a tax they're not supposed to pay.

The same is true for goods and services that have never been taxed. State and local codes evolved from piecemeal collections of laws in the 18th and 19th centuries to become the comprehensive tomes they are today. During that evolution, the most efficient and transparent way to codify long-standing exemptions was to write them into the new tax code as tax preferences. That's why many states exempt items like farm

machinery and livestock feed through tax preferences, even though those items have never been subject to state taxes.

Most states and localities exclude these "structural" or "technical" adjustments from their regular tax preference evaluations. But that's not to suggest they're unimportant. In fact, they're ubiquitous. For instance, consider a recent report from the Washington State Department of Revenue. It showed that preferences designed to "prevent double taxation" and to memorialize items "excluded from the original tax base" account for more than 48 percent of that state's nearly 700 preferences. Add in preferences for non-profits and governments, and preferences intended to directly subsidize rural economies, and one can argue that only about \$5 billion of the state's \$25 billion in annual tax preferences are designed to deliverable measurable outcomes.

At best, this means a large share of state and local tax preferences escapes careful scrutiny. At worst, it means we're guilty of measuring what can be measured, rather than measuring what ought to be measured. We shouldn't avoid careful analysis of structural tax preferences just because their benefits are difficult to measure. To keep from avoiding them, we need to think about them a bit differently.

First and foremost, we need to broaden the focus to include fairness and efficiency. In many cases this means the measurable absence of something, rather than measurable changes in behavior. Is there evidence that a tax preference removes a uniquely challenging barrier to doing business? Do businesses that have left a jurisdiction point to the absence

of tax preferences as a reason for their departure? These are difficult questions to answer, but they're not necessarily more difficult than the "but for" analysis that's now common in tax preference evaluation.

Second, we need to consider some additional measurable outcomes. Most tax preference evaluations focus on specific revenue impacts and specific outcomes at specific moments in time. Virtually none put the costs and benefits of preferences in the larger context of "total cost of doing business." Tax preferences might be small relative to other costs like labor or materials, but they make a tremendous difference at the margin. Without careful attention to how a preference changes the larger business landscape, though, it's difficult to know if it delivers any value to taxpayers.

Oddly enough, today's tax preference evaluation methods also tend to overlook who actually pays taxes. There's no doubt that tax preferences shift the burden across different tax sources and, in turn, across taxpayers. But with no indication of when and how those shifts happen, it's difficult to know how structural preferences restructure the tax burden writ large.

Third, we need to think much more carefully about what is "structural." The line between wholesalers and retailers is blurring. So is the line between information products and information services, between content creators and content consumers, and between one state or country and another. These boundaries may or may not be the right way to think about who consumes goods and services, and who should be taxed as a result.

Fortunately, today's state and local public finance professionals are more prepared than ever to ask and help answer these new questions about tax preferences. ■

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