1-8-2002

# Informational Hearing on Review of Tax Expenditures

Assembly Committee on Revenue and Taxation

# Assembly Committee on Revenue and Taxation

# Informational Hearing on Review of Tax Expenditures

January 8, 2002



**Members:**

Ellen M. Corbett
Chair

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Vice Chair

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Eileen Roush
Senior Consultant

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STAFF
KIMBERLY MITCHELL BOTT
CHIEF CONSULTANT
EILEEN A ROUSH
SENIOR CONSULTANT
IRENE FRAUSTO
COMMITTEE SECRETARY
STATE CAPITOL
P.O. BOX 942849
SACRAMENTO, CA 94249-0114
(916) 319-2098

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
ELLEN M. CORBETT, CHAIR
EIGHTEENTH ASSEMBLY DISTRICT

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ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
ELLEN M. CORBETT, CHAIR
EIGHTEENTH ASSEMBLY DISTRICT

# REVIEW OF TAX EXPENDITURES

## Summary Report for the Informational Hearing

Tuesday, January 8, 2002
State Capitol, Room 126
Sacramento, California

## INTRODUCTION

On Tuesday, January 8, 2002, the Assembly Committee on Revenue and Taxation held an informational hearing to review tax expenditures. The hearing was held in Room 126 of the State Capitol in Sacramento, California from approximately 10:00 a.m. until approximately 12:30 p.m. Approximately thirty people attended the hearing.

Eight of the committee's members heard testimony from 17 witnesses. Members who participated in the hearing included:

Assemblymember Ellen M. Corbett, Committee Chair
Assemblymember Tom Harman, Committee Vice-Chair
Assemblymember Elaine Alquist
Assemblymember Dion Aroner
Assemblymember Paul Koretz
Assemblymember Barbara S. Matthews
Assemblymember Helen Thomson
Assemblymember Mark Wyland

This final report contains the committee staff's summary of the testimony offered and conclusions reached during the hearing. The report also reprints the background paper written by staff before the hearing (refer to blue pages) and reproduces written testimony and documents submitted by the witnesses (refer to yellow pages).

## THE WITNESSES

Mr. Mark Ibele, Fiscal and Policy Analyst, Legislative Analyst's Office*

Mr. Dave Vasche, Director, Economics, Taxation, & Fiscal Forecasting, Legislative Analyst's Office*

Mr. Dave Hayes, Manager, Research & Statistics, State Board of Equalization

Mr. Phil Spilberg, Director, Economic & Statistical Research Bureau, Franchise Tax Board

Mr. Bruce Smith, Principal Economist, Department of Finance*

Ms. Pat Leary, Legislative Representative, California State Association of Counties

Mr. Michael Coleman, Chief Consultant, League of California Cities

Mr. Lenny Goldberg, California Tax Reform Association

Mr. Fred Main, Sr. VP & General Counsel, California Chamber of Commerce

Mr. Tom Rankin, President, California Labor Federation, AFL-CIO

Mr. Gerry Meral, Planning and Conservation League

Mr. Chris Micheli, Carpenter, Snodgrass & Associates*

Ms. Jean Ross, Executive Director, California Budget Project*

Mr. Ray Rossi, Director, External Affairs, Intel Corporation*

Mr. Greg Turner, General Counsel/Legislative Director, California Taxpayers Association

* Written materials presented by the individual is contain in the yellow pages at the end of this report.

**Information Presented**

The hearing was presented in two segments: 1) an introduction to tax expenditures provided by representatives of the Legislative Analyst's Office, the Franchise Tax Board, Board of Equalization, Department of Finance, and California State Association of Counties; and 2) a discussion of whether tax expenditures work provided by nine invited witnesses representing business, public interest groups, taxpayer rights groups, local government, and the environment.

Testimony presented during the introductory segment of the hearing closely paralleled information contained in the background paper. Witnesses discussed the number and types of existing tax expenditures and the ways in which the taxing agencies and the Department of Finance prepare tax expenditure cost estimates. Local government also discussed the way in which state-enacted tax expenditures can be economically disadvantageous to local governments. A significant amount of testimony focused on the observation that information required to pragmatically estimate the economic impact of existing or proposed new tax expenditures is often unavailable to the agencies responsible for estimating these impacts. Witnesses also commented on the trade-offs between the cost of data collection (to both the reporting party and the receiving agency alike) and the value of the information obtained.

The second segment of the hearing consisted of a panel discussion regarding the yardstick that most accurately measures the effectiveness of a tax expenditure. Panel members were selected to represent a broad spectrum of viewpoints and included individuals representing organized labor, business, the environment, local government, public interest groups, and taxpayer advocate groups. As anticipated and disclosed in the background paper, many of the panelists suggested the need for periodic review of tax expenditures and elimination of underutilized or ineffective items. However, no consensus emerged among the panelists as to the appropriate standard for evaluating tax expenditures. Specific information shared with the Committee by the panelists is reproduced in the yellow pages of this report.

Following the conclusion of the invited witnesses' testimony, Ms. Corbett asked the panelists to discuss the most appropriate way to measure the effectiveness of a specific tax expenditure, the manufacture's investment credit (MIC). Proponents of the MIC asserted that the evaluation was self-executing because the credit would continue only if an enumerated benefit (specifically the number of new jobs created in California) surpassed a stated threshold. Opponents suggested that the MIC sometimes rewarded action that would have been taken in the absence of the credit.

**Public Comment**

Mr. Roland Boucher, Tax Reform 2000, testified that the cost of various tax expenditures was not accurately estimated by the taxing agencies. He suggested that tax expenditures should be used to simply tax reporting by individuals. A copy of the information Mr. Boucher presented at the hearing is contained in the yellow pages at the end of this report.

David R. Doerr, California Taxpayers' Association, affirmed the testimony presented by Mr. Boucher and emphasized that any savings resulting from eliminating tax expenditures should be passed on to Californians through a broad-based tax rate reduction.

## SUMMARY AND RECOMMENDATIONS

In anticipation of the testimony presented, and the conclusion that additional information is required to evaluate the effectiveness of specific tax expenditures, Ms. Corbett requested in December, 2001 that the LAO review and determine the information needed to review three specific tax expenditures. Attached is a copy of the letter requesting review of information needed to determine the economic effectiveness of the following measures: credit for research expenses (R&D credit); credit for manufacturing and research property (MIC); and the employers' credit for employees within enterprise zones (hiring credit). The LAO is to respond with preliminary findings no later than June 30, 2002. The due date for the final report will be determined following discussions regarding the preliminary report.

MEMBERS
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ELAINE ALQUIST
DION ARONER
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MARK WYLAND

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**ASSEMBLY COMMITTEE ON REVENUE AND TAXATION**
**ELLEN M. CORBETT, CHAIR**
EIGHTEENTH ASSEMBLY DISTRICT

December 21, 2001

Elizabeth G. Hill, Legislative Analyst
Legislative Analyst's Office
925 L Street, Suite 1000
Sacramento, CA 95814

Dear Ms. Hill:

As chair of the Assembly Committee on Revenue and Taxation, I see numerous bills that provide tax incentives for specific activities. As the bills are presented, proponents testify that the proposed incentive will result in direct economic benefits to the State. Opponents often argue that the measure does not produce the stated benefits, and that the State's funds could be better used.

The economic effectiveness of an enacted tax incentive frequently is difficult to ascertain. Some tax incentive measures pass without a clear directive for subsequent evaluation; other measures contain a directive for review that, in practice, does not reflect the actual economic impact. To enhance the Legislature's ability to consider the merit of specific measures, or to consider alternative measures

In light of California's current fiscal condition, I would like to review the effectiveness of certain tax incentives to compare their respective values to the state with the continuing cost in terms of revenue loss.

This represents a formal request for your staff to analyze and evaluate the dynamic effects of three specific tax expenditures. To the extent that data are available, I ask that you prepare an analysis of the following tax expenditures: credit for research expenses (R&D credit); credit for manufacturing and research property (MIC); and the employers' credit for employees within enterprise zones (hiring credit).

In order to utilize the information provided, I ask for your preliminary findings no later than June 30, 2002. The due date for the final report can be established following discussion of the preliminary findings.

If you or your staff have questions or comments about this request, please feel free to contact and work with the Committee staff. Thanks in advance for your efforts and cooperation.

Sincerely,

/s/

ELLEN M. CORBETT
Chair

cc: Mr. Dave Vasche, Legislative Analyst
Mr. Mark Ibele, Legislative Analyst

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ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
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# REVIEW OF TAX EXPENDITURES

## Background Paper for the Informational Hearing

Tuesday, January 8, 2002
State Capitol, Room 126
Sacramento, California

Assembly
California Legislature

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# INFORMATIONAL HEARING ON

# REVIEW OF TAX EXPENDITURES

# BACKGROUND PAPER

**Tuesday, January 8, 2002**
**10:00 a.m. – 1:00 p.m.**
**State Capitol Room 126**
**Sacramento, California**

## INTRODUCTION TO THE HEARING

Each year, state legislators introduce hundreds of bills that impact the Revenue and Taxation Code. Some of these bills incentivize taxpayer behavior; others offer more equitable tax treatment to certain taxpayers than they are afforded under existing law. Still other bills are intended to stimulate one or more sectors of the economy; conform state tax law to federal tax law; or ease tax law administration. Despite their differences, virtually all of these measures can be categorized as tax expenditures.

With this hearing, the Assembly Revenue and Taxation Committee examines tax expenditures. We will begin by introducing the topic -- defining the term, summarizing the different types of tax expenditures that exist, reviewing how many exist, and learning how various state agencies calculate their fiscal impacts. Local government representatives will also describe how state tax expenditures can impact cities and counties. During the second half of the hearing, we will solicit testimony from a wide variety of interested parties regarding the criteria that each suggests using to evaluate whether a given tax expenditure is effective. This testimony is expected to provoke considerable debate, because although virtually no one questions the importance of evaluating existing and proposed new tax expenditures, different groups hold different views about the appropriate bases for the evaluations.

The background information that follows in the remainder of this paper is intended to set the context for testimony that will be offered by the invited witnesses. Because the predominant focus of this hearing involves the evaluation of tax expenditures, this paper will address that area first. Following this discussion will be more general statements regarding tax expenditures; i.e., definition, classification, comparison with budget expenditures, measurement issues, etc.

## EVALUATING TAX EXPENDITURES

The sheer number of tax expenditures that are currently part of California's Revenue and Taxation Code and the approximate aggregate value of revenue foregone by the state due to these expenditures provides ample justification for a close evaluation of these expenditures. An evaluation is also supported by the age of some of the state's existing expenditures.[1]

The number and magnitude of existing tax expenditures strongly suggest the need for close study of proposed *new* tax expenditures. Particularly in a year where the state expects a large budget shortfall, any proposal to reduce the amount of revenue available to the state warrants close inspection.

Yet, while few if any would disagree about the merits of evaluating existing and proposed new tax expenditures, there is considerable debate over what criteria should be used to make such an evaluation. When framing the debate, it is useful to define nomenclature. Three common types of evaluation include the following:

- Utilization: Utilization reflects the extent to which an expenditure is used by those to whom it is made available. In the case of a tax expenditure, information regarding utilization would involve how many taxpayers claim the credit, deduction, exemption, or exclusion; the aggregate value of all claims; and a distributional analysis of the claims (e.g., the annual incomes of individual claimants, the annual gross receipts of business claimants, the industry sector to which business claimants belong; the geographical distribution of claimants; etc.).

  Tax agencies are in the best position to report to the Legislature regarding utilization of a given tax expenditure because of their access to taxpayer data. Enacting legislation generally needs to require taxpayers to report the information necessary for evaluation in order to ensure a more comprehensive analysis. However, resulting revisions to tax forms to collect such additional information has a cost that legislators must consider when deciding whether to require the additional information to be reported.

- Effectiveness: As the testimony of the invited witnesses is expected to show, the term effectiveness means different things to different people. To a business, the effectiveness of a tax expenditure may be measured by the number of new jobs it creates, the amount of new investment it generates, or an increase in profit realized.

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[1] Although a tax expenditure generally is enacted with the vote of a simple majority, a 2/3rds vote is required to repeal an existing tax expenditure. As noted in the Department of Finance's (DOF's) Tax Expenditure Report in Appendix A, most of those that have been repealed have done so automatically because of the existence of sunset dates. Legislative action has seldom been taken to repeal a tax expenditure without a sunset date.

To a labor group, effectiveness may relate to the quality of the jobs that are created (e.g., their wage and benefit levels). To an environmental group, effectiveness may relate to whether open space land is preserved or anti-sprawl land use decisions are incentivized. Public interest groups may grade a tax expenditure on whether it redistributes income from wealthier to poorer Californians or improves the quality of public education. To the general consumer, effectiveness may relate to an increase in "dollars in the pocket."

The task of measuring effectiveness begins with determining what the word "effective" means. Yet, it does not end there. Once one decides what is meant by "effectiveness", one must attempt to measure it. Tools for measuring effectiveness include information regarding utilization and available studies regarding specific outcomes believed to be correlated in some way with a given expenditure. However, in an economy as large as California's and among a population as diverse as California's, it is important to distinguish between correlation and causation. An increase in the number of jobs in a particular industry or a particular geographic area that occurs shortly after a tax expenditure is enacted represents a correlation; the job increase does not prove that tax expenditure caused the jobs to be created.

Often, even correlations will not be apparent. California's trillion dollar economy makes it extremely difficult to discern the specific impact of tax law changes, even when they are very large. The impacts of smaller tax expenditures can be nearly impossible to discern.

These measurement challenges are compounded by the dimension of time. Sometimes a tax expenditure may take several years for its impact to be seen. For that reason, an effectiveness study undertaken too early may reach a conclusion far different from a study undertaken after the impact of the expenditure is felt.

The challenges noted above do not suggest that effectiveness evaluations should not be performed. Rather, a discussion of the challenges is intended to point out how difficult, time-consuming, and labor-intensive effectiveness evaluations can be to perform properly. Requiring that effectiveness evaluations be performed for every existing and proposed new tax expenditure has a cost that legislators must consider when deciding the merits of requiring these studies to be done.

- Efficiency: Efficiency involves assessing value gained for each dollar of expenditure. A simple example illustrates the difference between effectiveness and efficiency. A tax expenditure that creates 100 new jobs may be effective. However, if the state foregoes $200,000 in revenue for each new job created, the tax expenditure may not be as efficient as another use of the same funds. This example also illustrates that efficiency is determined by comparing expenditures to each other; efficiency of a specific expenditure cannot be determined in a vacuum.

  It is precisely because an efficiency evaluation requires the analysis of more than one alternative that efficiency evaluations are the most time consuming and labor-intensive evaluations of the three discussed in this paper. As was noted regarding utilization and effectiveness evaluations, the depth and intensity of the effort required to perform a credible efficiency evaluation suggests a significant cost. Before requiring an efficiency evaluation, the legislature must determine an appropriate trade off between the cost to perform the study and the importance of the information that will be gained.

## THE DEFINITION OF "TAX EXPENDITURE"

"Tax expenditures" were defined under the Congressional Budget and Impoundment Control Act of 1974 (the federal budget act) as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." According to the Joint Committee on Taxation of the United States Congress, federal tax expenditures include any reduction in income tax liability that results from special tax provisions or regulations that provide tax benefits to particular taxpayers.

California's budget act does not define the term "tax expenditure." However, the California Department of Finance (DOF) has defined tax expenditures as provisions of tax law that result in the collection of fewer tax revenues than would be collected under the basic tax structure. The definition used by DOF is sufficiently broad to include several provisions of California's Revenue and Taxation Code, such as income and franchise tax credits and deductions, sales and use tax and property tax exemptions, and income and franchise tax gross income exclusions. However, DOF's definition does exclude several broad categories of California's tax laws. For example,

- Inclusions or Exclusions of Basic Tax Structure. Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling *tangible personal property* at retail. According to its basic definition, California's sales tax does not apply to sales or leases of real property or sales of services. Therefore, these exemptions are not considered tax expenditures; rather, they are elements of the basic tax structure.

- Rate Reductions. Across-the-board tax rate reductions do not represent tax expenditures. Rate changes would only represent tax expenditures if a particular set of rates was very narrowly targeted to specific taxpayers.

- Rate Structures. Progressive or regressive rate structures do not constitute tax expenditures. For example, the basic structure of California's personal income tax is progressive. Applying different tax rates to different income groups is a basic characteristic of the tax and does not represent a tax expenditure.

- Federally Mandated Items. Exemptions or exclusions required by federal law or the federal Constitution are not tax expenditures.

- Penalties, Interest, and Other Timing Items. Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted to specific taxpayers.

The Legislative Analyst's Office (LAO) defines tax expenditures more broadly than DOF. Although the inconsistency in definition often yields different estimates of the total number of tax expenditure programs, the distinction is generally overlooked as tax policy debates typically focus on the merit of specific tax law provisions.

## CLASSIFICATION

Tax expenditures come in many different sizes and shapes and can be classified in many different ways (e.g., according to type of tax, revenue impact, length of enactment, purpose, etc.). Persons undertaking tax expenditure evaluations often find it helpful to classify tax expenditures according their purposes, because an evaluation commonly focuses on whether a particular tax expenditure is meeting its original purpose. The following is an example of a classification scheme that uses purpose as the basis for the classification:

- Equity. Equity measures remove perceived inequities in existing tax law. For example, AB 1198 (Matthews, 2001) exempted liquefied petroleum gas pumped into external storage tanks for residential use from sales and use tax. The exemption was an equity measure, because it placed rural homeowners who use propane stored in on-site tanks on equal sales tax footing with urban homeowners whose gas is delivered through gas lines, which is exempt from sales tax. The sales tax exemption of AB 1198 was enacted as part of the budget trailer bill, AB 426 (Cardoza, Chapter 156, Statutes of 2001).

- Incentive. Targeted tax reductions are intended to incentivize certain taxpayer behavior; i.e., to encourage taxpayers to take an action previously unplanned or to accelerate/delay an action already planned. These tax expenditures may involve any combination of exemptions, credits, deductions, or exclusions.

- Stimulative. A category of tax reductions that can overlap with incentive measures, stimulative tax reductions are intended to increase the amount of profitable economic activity conducted within a particular geographic region or within a particular economic sector (such as high-technology or manufacturing). Like incentive measures, stimulative measures can involve any combination of exemptions, credits, deductions, or exclusions.

- Relief. Measures that provide either broad-based or targeted tax relief are generally intended to help a certain sector of the economy or a population group. Relief measures sometimes overlap with equity measures and typically include rate reductions or exemptions.

- Conformity. These measures conform state tax law to federal tax law. They are intended to reduce tax law complexity, reduce taxpayer compliance costs, and ease tax law administration.

- Administrative. Administrative measures are intended to reduce administrative costs by easing tax law administration.

## TAX EXPENDITURES VERSUS BUDGET EXPENDITURES

The term "tax expenditure" is somewhat of a misnomer. Rather than representing an *expenditure* of money, a tax expenditure works in reverse – it stops the *collection* of a certain amount of revenue. Revenue that is not collected cannot be expended.

There are several differences between tax expenditures and budget expenditures, particularly in California. Some of the more significant differences are as follows:

- Budget expenditures require a 2/3rds vote for enactment and generally require a 2/3rds vote for repeal[2]. Tax expenditures typically require a simple majority vote for enactment and a 2/3rds vote for repeal.

- Budget expenditures are typically reviewed once per year as part of the annual budget process. Once enacted, tax expenditures are seldom reviewed unless required as part of the enacting legislation.[3]

- The size of a budget expenditure is usually capped at a certain level and requires a 2/3rds vote of the legislature to be increased. The amount of revenue that is foregone through the adoption of a tax expenditure is usually uncapped.

Although tax expenditures and budget expenditures are fundamentally different from each other, there are a few similarities. Tax expenditures are most similar to those direct spending programs that have no spending limits and that are available as entitlements to those who meet the statutory criteria established for the programs.

## MEASURING THE FISCAL IMPACT OF TAX EXPENDITURES

### Theory

Economists generally recognize three different types of economic impacts when they estimate the quantitative effect of any particular tax law change on state and local

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[2] One exception to this general rule is the Governor's line-item veto authority, which requires only a stroke of the Governor's blue pencil rather than a vote of the Legislature to remove a tax expenditure that has been authorized by the Legislature.

[3] The three common types of evaluation (utilization, effectiveness, and efficiency) discussed above apply equally to budget expenditures and tax expenditures.

government revenues. The three types of impacts that are generally recognized include static, direct effect, and dynamic. Revenue estimates that quantify these impacts are called static revenue estimates, direct effect revenue estimates, and dynamic revenue estimates, respectively. A brief explanation of each type of impact and the assumptions that would be used to estimate the revenue impact of each impact follow:

- A static impact is the most short-term in nature and represents the immediate economic effect of any given change in the tax law. A static revenue estimate prepared for a sales tax exemption would equal the sales tax rate multiplied by the dollar value of total sales of the exempted item. Similarly, a static revenue estimate prepared for an increase in the cigarette tax rate would equal the incremental increase in the tax rate per pack of cigarettes multiplied by total packs of cigarettes sold.

- A direct effect revenue estimate takes direct economic effects into account by incorporating the initial ripple effects of a tax law change on the economy. Because they reflect secondary behavioral responses, direct effect estimates are longer-term in nature than static revenue estimates. Following the examples above, a direct effect estimate prepared for a sales tax exemption would reflect changes in consumer purchasing habits resulting from the exemption. The estimate would equal the sales tax rate multiplied by the dollar value of total sales expected to result after the exemption is enacted. Similarly, a direct effect estimate prepared for an increase in the cigarette tax rate would take a decline in cigarette consumption into account. The estimate might also consider the possibility that some taxpayers will switch from cigarettes to other forms of taxable tobacco that will generate different amounts of revenue.

- A dynamic revenue estimate takes all of the ripple effects of a tax law change into account. It represents the long-term impact of the tax law change on the economy and estimates how the economy will be changed once it returns to equilibrium, approximately five to eight years after a tax law change is enacted. Following the examples above, a dynamic revenue estimate prepared for a sales tax exemption would examine the question of how many new jobs and how much new investment was created as a result of increased sales of the product covered by the exemption. A dynamic revenue estimate prepared for an increase in the cigarette tax rate would examine the increase in productivity and decrease in health care costs likely to result from a decline in cigarette consumption. It would also account for the number of jobs likely to be lost due to a decline in cigarette sales.

**Practice**

When a law affecting the Revenue and Taxation Code is introduced, the applicable tax agency estimates the fiscal impact of the proposal. The Board of Equalization (BOE) estimates the fiscal impact of changes affecting the tax laws it administers (Sales and Use Tax Law, Property Tax Law, and a myriad of special taxes and fees including the cigarette and other tobacco products tax, fuel taxes, alcoholic beverage taxes, and others). The Franchise Tax Board (FTB) estimates the fiscal impact of changes affecting the

Personal Income Tax and Corporation Tax Laws. Both of these agencies generally prepare static estimates. However, when reliable information is available that allows the preparation of a direct effect estimate, the agencies will prepare direct effect estimates. In all cases, the tax agencies document the assumptions they use when developing their estimates.

The ability of both tax agencies to develop their revenue estimates is directly related to the amount and type of information available to them. Tax laws vary in the extent to which they contain special reporting requirements to provide the information necessary to evaluate the tax expenditure.

There is a trade-off involved in requiring more information to be reported on California's tax forms. On one hand, increasing the amount of information required to be reported has the potential to improve the tax agencies' abilities to estimate the revenue impacts of proposed tax law changes. However, requiring taxpayers to report more information increases both taxpayer compliance costs and tax agencies' administrative costs to revise instruction booklets, input the reported information, and evaluate it. To enhance the usefulness of the information to evaluate the actual effectiveness of a tax expenditure, the direction to provide, collect, and review the requisite information should be part of the enacting legislation.

In 1994, SB 1837 (Campbell, Chapter 383, Statutes of 1994) was enacted in order to improve the state's ability to predict the responsiveness of tax revenues to changes in the tax code. That measure required both the LAO and DOF to perform dynamic revenue analyses of proposals that were estimated to have a fiscal impact of $10 million or more using static revenue estimating techniques. The LAO was required to perform its analyses on proposed changes to the annual budget that involved changes in state tax law; DOF was required to perform its analyses on all other proposed changes to state tax law. In order to comply with SB 1837's legislative directive, DOF built a computable general equilibrium model of California's economy.

DOF's model predicts the long-term impact of proposed changes in state tax law. The model approximates the California economy by relying on hundreds of equations that predict the response of producers and consumers within an integrated economy. First-order responses produce second- and third-order responses, which ripple through the modeled economy until a new equilibrium is reached. The model generates three types of economic impacts: revenue feedback (discussed below), changes in private non-residential investment (reported in millions of dollars), and changes in employment (reported in number of jobs).

Feedback effects represent the amount by which the stimulative effects of a tax expenditure ripple through the economy to offset some of the revenue loss predicted using static revenue estimating techniques. For example, when DOF uses its model to simulate a large, broad-based, state corporation tax reduction, the model returns an 18 to 20 percent feedback effect. In round numbers, this means that a proposed tax law change that is estimated to reduce Corporation tax revenues by $100 million will reduce tax revenues by between $80 million and $82 million when the stimulative effects of the tax reduction are considered; the remaining $18 million to $20 million will be recovered through the stimulative effects of the rate reduction. The DOF model predicts that a broad-based sales and use tax rate reduction will generate a feedback effect of between eight and ten percent (i.e., a sales and use tax rate reduction estimated using static techniques to reduce revenue by $100 million will cost the state between $90 million and $92 million; the remaining $8 million to $10 million will be recovered through the stimulative effects of the rate reduction). Finally, DOF's model predicts a three percent feedback rate for broad-based personal income tax rate cuts. The feedback effects of targeted rate cuts differs somewhat from feedback effects calculated for broad-based cuts but are usually of a similar order of magnitude.

## LIST OF TAX EXPENDITURES

As noted earlier, the number of existing tax expenditures depends on the definition of tax expenditure that is used. Both the LAO and DOF produce tax expenditure reports in which they list existing tax expenditures and their estimated revenue impacts. DOF's report, required to be produced annually, is a relatively slim volume included in Appendix A. The LAO's tax expenditure report is published less frequently but is more comprehensive. The last comprehensive tax expenditure report produced by the LAO is dated February 1999. Its length prevents its inclusion in an Appendix to this background paper. However, an updated listing of existing tax expenditures and their estimated revenue impacts that was prepared by the LAO for this Committee hearing is included in Appendix B.

## AGGREGATE VALUE OF TAX EXPENDITURES

People are often tempted to add each of the individual revenue impacts listed in either the DOF or the LAO documents and conclude that the sum represents the aggregate amount of revenue foregone by the state. However, a sum generated in this way would be misleading. Because of interactions between different tax expenditures and prohibitions against so-called double-dipping (i.e., claiming more than one tax benefit for undertaking a single action), the cumulative amount of revenue foregone by the state is likely to be somewhat less than the sum of each individual provision.

However, summing the cost of individual tax expenditures does yield an order-of-magnitude approximation of the magnitude of revenue foregone by the state. Using both the DOF and LAO reports, the aggregate value of state tax expenditures is in the range of tens of billions of dollars annually.

## THE IMPACT OF TAX EXPENDITURES ON LOCAL GOVERNMENTS

When performing revenue estimates, state agencies often focus on the impact of a tax expenditure on the state. However, many tax expenditures also have significant local impacts. Revenue impacts are the most common type of impact, particularly when the state enacts a sales and use tax exemption. Because the sales and use tax is both a state and local source of tax revenue, a state decision to enact a sales and use tax exemption often results in a loss of local government revenue. By statute, local governments are protected from the loss of revenue resulting from a sales and use tax exemption enacted by the state.[4] However, legislation authorizing sales and use tax exemptions could include language that eliminates the reimbursement requirement.

State-enacted property tax exemptions can also have local revenue impacts. Again, local governments are protected by statute from the net loss of revenues resulting from property tax exemptions enacted by the state.[5] Again, in a similar manner to the sales tax exemption reimbursement discussed above, legislation authorizing property tax exemptions could include language that eliminates the reimbursement requirement. Eliminating the reimbursement requirement means that cities, counties, special districts, and redevelopment agencies lose property tax revenue when the state enacts a property tax exemption. The state's school funding obligations require state backfill of any loss of property tax revenue by school districts.

Other examples of local impacts resulting from state-enacted tax expenditures include those relating to local economic development, changes in local land use patterns, and changes in the amount of open space.

[4] Revenue and Taxation Code section 2230 requires the state to reimburse local agencies for their net loss of revenues resulting from sales tax exemptions enacted by the state.
[5] Revenue and Taxation Code Section 2229 requires the state to reimburse local agencies for their net loss of revenues resulting from property tax exemptions enacted by the state

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Vasche, Jon and Hoang Nguyen, "The Treatment of Feedback Effects in Revenue Impact Analyses", Tax Notes, October 31, 1994, pp. 599-618.

# APPENDIX A

California Department of
Finance

2001-2002

Tax Expenditure Report

# Tax Expenditure Report

## 2001-02

DEPARTMENT OF FINANCE

CALIFORNIA

PREPARED BY
THE DEPARTMENT OF FINANCE

## Introduction

The Department of Finance (Department) has been required to provide a tax expenditure report to the Legislature since 1971. Chapter 1762, Statutes of 1971, required that a biennial report be submitted to the Legislature. Chapter 268, Statutes of 1984, increased the reporting frequency from once every two years to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

This report fulfills the Department's statutory requirement pursuant to Government Code Section 13305.

## Definitions

There is no absolute rule for defining tax expenditures, and the concept of a "tax expenditure" can be defined in several different ways. For the purposes of this report, the Department has chosen to define a tax expenditure as any special provision in the tax law that results in the collection of fewer tax revenues than would be collected under the basic tax structure. This report is also intended to identify only tax expenditures with large revenue impacts in order to focus attention on those areas of the tax structure with major fiscal significance.

Although broad, this definition does exclude several provisions of the tax law from classification as tax expenditures.

- Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. According to its basic definition, California's sales tax does not apply to sales or leases of real property, sales of services, wholesale transactions, or sales of securities and insurance. These exemptions are therefore not considered tax expenditures. They are elements of the basic tax structure.

- Across-the-board tax rate reductions do not represent tax expenditures. Tax expenditures resulting from changes in the rate structure only exist if different sets of rates are applied to a similar base.

- Progressive rate structures do not constitute tax expenditures. The basic structure of California's income tax is progressive. For that reason, application of different tax rates to different income levels is a basic characteristic of the tax and does not represent a tax expenditure.

- Exemptions or exclusions required by the U.S. Constitution or federal laws are not considered tax expenditures.

- Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted.

However, the definition of "tax expenditure" is subject to debate, and there is no single rule for determining what constitutes an element of the basic tax structure or defining how costly an expenditure must be for inclusion. For these reasons, this report may exclude items that are included in other tax expenditure reports and vice versa.

## *Why Adopt Tax Expenditures*

Tax expenditures may be classified into the following four broad groups:

- Those which conform California tax law to federal provisions.

- Those intended to remove perceived inequities in the basic tax structure.

- Those intended to ease tax administration.

- Those which grant targeted tax reductions through exemptions, credits, deductions, or exclusions.

There are several differences between tax expenditures and direct expenditures (those authorized through the budget process). First, tax expenditures are reviewed less frequently than direct expenditures once they are in place. This can offer taxpayers more certainty than if tax expenditures were subject to annual review, but can also result in tax expenditures remaining in the tax code long after outliving usefulness.

In general, there is also no control over the amount of foregone revenue that results from a tax expenditure once that provision has become part of the tax code. Finally, the vote requirements for tax expenditures and direct expenditures are different. Tax expenditures that are adopted legislatively (except those adopted as urgency measures) require approval by a simple majority of both houses of the Legislature. A two-thirds vote is required for budgetary appropriations.

## *Recent Changes in Tax Expenditures*

Tables one and two provide an overview of recent changes in tax expenditure programs. Table one lists the tax expenditures that are either repealed or sunset. Table two lists the tax expenditures enacted since 1990. This report omits programs with an annual cost of under $5 million in an effort to focus on tax expenditures of fiscal significance.

## *Revenue Estimates*

The estimates listed in this report are intended as a general indication of revenue losses from tax expenditure programs. These estimates represent full fiscal year revenue impacts. Thus, if a tax expenditure is enacted part way through a fiscal year, the revenue impact cited is that which resulted during the first *full* year in which the expenditure was effective.

Tables three and four list the major revenue losses estimated to result from the principal tax expenditures for which estimates can reasonably be developed. Both tables have been limited to tax expenditures of $10 million or more. Examples of excluded expenditures are personal income tax credits for political contributions, the elderly, and the military, and sales tax exemptions for master records and tapes and for bullion.

In general, revenue estimates for the Personal Income Tax and Bank and Corporation Tax Laws are easier to quantify than those for the Sales and Use Tax Law. Personal income and bank and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law contain little specific information regarding items purchased from individual retailers. For this reason, independent data sources must be used when estimating the revenue impacts of various sales tax expenditure programs, and the precision of these estimates can be lower than those for the Personal Income and Bank and Corporation Tax Laws.

In addition, certain estimates under *all* of the tax laws for which tax expenditure costs are cited can be subject to significant margins of error due to data limitations. Other factors complicating this report's estimates include the effects of tax law interactions and taxpayer reactions to changes in tax law. Therefore, while Tables three and four display the total value of the major identified expenditures within each major tax, these figures are best viewed as illustrative only. The fiscal impact of individual tax expenditures cannot be summed to generate the total fiscal impact of all tax expenditures due to the complicating factors of tax law interactions and taxpayer behavioral responses.

## *State Revenue Losses*

### PERSONAL INCOME TAX

The personal income tax law includes the vast majority of all tax expenditure programs approved to date. It is estimated that special income tax provisions account for over $18 billion in annual tax expenditures.

### Sales and Use Tax

The sales and use tax law contains identifiable State tax expenditures worth over $1.1 billion annually. Examples of these include custom computer programs, printed advertising, and motion picture leases.

### Bank and Corporation Tax

Tax expenditures in the bank and corporation category amount to $4.0 billion annually. Examples of these expenditures include provisions for S-corporations, research and development, carryover of net operating losses, water's edge election, and the manufacturers' investment credit.

### Other State Taxes

Remaining tax laws are estimated to contain tax expenditure programs valued at slightly above $270 million. Much of this revenue loss results from motor vehicle fuel tax and insurance tax expenditures.

## *Local Revenue Losses*

Table four lists revenue losses from the principal exemptions or preferential provisions of property tax law. Property taxes are local taxes, and the legislative exemptions or preferential provisions do not constitute State tax expenditures. Nonetheless, they impact State finances because local tax exemptions reduce property tax allocations to schools. Under current school finance law, the State is generally required to provide the difference in funding between local property tax allocations and school districts' revenue limits. Consequently, each dollar of property tax revenue foregone by schools results in an additional dollar of State funding through the school apportionment process. Passage of Proposition 98 in November 1988 further impacts state school financing by establishing minimum funding levels for public schools and community colleges, based on both property taxes and State funding. In addition, some property tax exemptions result in State subventions to local governments other than school entities in order to make up some or all of their revenue losses.

Local government revenue losses from identifiable property tax exemptions are estimated at approximately $200 million, while losses from sales tax expenditures are estimated at slightly over $660 million.

## *Unidentifiable Revenue Loss Areas*

It is not always possible to quantify the revenue loss of a particular tax expenditure. Fortunately, in most instances, those tax expenditures whose revenue impact cannot be estimated represent unique situations and probably do not result in significant revenue losses. Some examples of tax expenditures for which revenue losses cannot be quantified include sales tax exemptions for livestock and for meals furnished by institutions, and property tax exemptions for intangibles and air carrier ground time.

## Table One

### State Tax Expenditures Eliminated Since 1990 with a Value of $5 Million or More—Dollars in Millions

| Year | Chapter | Description | First Full Year Savings |
|---|---|---|---|
| **1990** | | **None** | |
| **1991** | | **Personal Income Tax** | |
| | 117 | Reduced itemized deductions for high income taxpayers | $248 |
| | | **Sales and Use Tax**[1] | |
| | 85 | Common carrier fuel (aircraft)[2] | 106 |
| | 85 | Newspapers | 57 |
| | 85 | Non-subscription periodicals[3] | 30 |
| **1992** | | **Personal Income Tax** | |
| | SS | Child care credit provisions expired December 31, 1992 | 106 |
| **1993** | | **None** | |
| **1994** | | **None** | |
| **1995** | | **Personal Income Tax** | |
| | SS | Ridesharing expenses credit expired December 31, 1995 | 13 |
| **1996** | | **None** | |
| **1997** | | **Personal Income Tax** | |
| | SS | Los Angeles Revitalization Zone incentives expired December 31, 1997 | 51 |
| | | **Bank and Corporation Tax** | |
| | SS | Los Angeles Revitalization Zone incentives expired December 31, 1997 | 67 |

SS=Sunset

1 Chapter 85, Statutes of 1991, also repealed the exemptions for candy, snack foods, and bottled water. However, these exemptions were reinstated in November 1992 by Proposition 163.

2 Chapter 905, Statutes of 1992, reinstated the exemption for watercraft common carrier fuel and reinstated a partial exemption for aircraft common carrier fuel used on international flights.

3 reinstated the exemption for subscription periodicals.

# TABLE TWO

## STATE TAX EXPENDITURES SINCE 1990 WITH A VALUE OF $5 MILLION OR MORE—DOLLARS IN MILLIONS

| YEAR ENACTED | CHAPTER | DESCRIPTION | FIRST FULL YEAR COST |
|---|---|---|---|
| 1990 | | **Personal Income Tax** | |
| | 1347 | Stay-at-home parent credit | $25 |
| | | **Bank and Corporation Tax** | |
| | 1513 | Increased compliance penalties | 5 |
| 1991 | | **Personal Income Tax** | |
| | 117 | Extension of net operating loss (NOL) carryover[1] | 45 |
| | | **Bank and Corporation Tax** | |
| | 117 | Extension of net operating loss (NOL) carryover[1] | 164 |
| | 117 | Extension of research and development credit | 64 |
| | | **Sales and Use Tax** | |
| | 461 | Newspapers and periodicals distributed free of charge | 20 |
| 1992 | | **Personal Income Tax and Bank and Corporation Tax** | |
| | 17 | Establishment of revitalization zone for LA riot area | 7 |
| | | **Sales and Use Tax** | |
| | 903 | Subscription periodicals | 10 |
| | 905 | Watercraft common carrier fuel | 21 |
| 1993 | | **Personal Income Tax** | |
| | 874 | Limited partnerships investment source rule | 10 |
| | 881 | Manufacturers' investment credit | 32 |
| | 881 | Small business stock exclusion | 26 |
| | | **Bank and Corporation Tax** | |
| | 881 | Manufacturers' investment credit | 365 |
| | 1121 | Expanded credit union income exemption | 13 |
| | | **Sales and Use Tax** | |
| | 881 | Manufacturing equipment for start-up firms | 10 |
| | 887 | Intangible rights | Unknown |
| 1994 | | **Bank and Corporation Tax** | |
| | 748 | Extended and limited the employer child care credit | 5 |
| 1995 | | None | |
| 1996 | | **Personal Income Tax** | |
| | 954 | Long-term care deduction | 9 |
| | 954 | Medical savings accounts | 8 |
| | 954 | Increased spousal IRAs | 8 |
| | 954 | Educational assistance exclusion | 7 |
| | | **Bank and Corporation Tax** | |
| | 953 | Expanded Enterprise Zone program | 10 |
| | 954 | Expanded research and development tax credit | 22 |
| | 954 | Reduced minimum franchise tax for new businesses | 8 |
| | | **Insurance Tax** | |
| | 967 | Coverage provided through California Earthquake Authority | 30 |

[1] The use of net operating loss (NOL) carryovers was suspended for the 1991 and 1992 tax years, and the 1993, repealed the sunset date.

## STATE TAX EXPENDITURES SINCE 1990 WITH A VALUE OF $5 MILLION OR MORE—DOLLARS IN MILLIONS

| YEAR ENACTED | CHAPTER | DESCRIPTION | FIRST FULL YEAR COST |
|---|---|---|---|
| 1997 | | **Personal Income Tax** | |
| | 612 | Expanded exclusion of capital gains on the sale of principal residences | $105 |
| | 612 | Expanded IRA provisions including the Roth IRA and education IRA | 31 |
| | | **Bank and Corporation Tax** | |
| | 613 | Expanded research and development tax credit | 46 |
| 1998 | | **Personal Income Tax** | |
| | 322 | Nonrefundable renters' credit | 141 |
| | 322 | Student loan interest deduction | 15 |
| | 322 | Expanded home office deduction | 8 |
| | 323 | Increased health insurance deduction for self-employed | 12 |
| | 323 | Permanent extension of employer child care credits | 11 |
| | | **Bank and Corporation Tax** | |
| | 322 | Joint Strike Fighter credit | 61 |
| | 323 | Increased alternative incremental research and development credit | 18 |
| | 323 | Reduced minimum franchise tax for first two years for new, small businesses | 11 |
| | 323 | Expanded the manufacturers' investment credit to computer programming and software activities | 7 |
| 1998 | | **Sales and Use Tax** | |
| | 323 | Expanded and extended exemption for property used in space flights | 8 |
| | 323 | Partial exemption for property used in teleproduction or postproduction | 8 |
| | 323 | Exemption for non-annual plants | 7 |
| 1999 | | **Personal Income Tax** | |
| | 117 | Increased health insurance deduction for self-employed taxpayers | 19 |
| | | **Bank and Corporation Tax** | |
| | 64 | Minimum franchise tax exemption for first two years for new corporations | 58 |
| | 77 | Increased research and development credit | 7 |
| 2000 | | **Personal Income Tax** | |
| | 75 | Teacher retention credit | 188 |
| | 107 | Long-term care credit | 38 |
| | 107 | Graduate student exclusion | 10 |
| | 113 | Credit for land donation | 5 |
| | 114 | Refundable child care credit | 189 |
| | | **Bank and Corporation Tax** | |
| | 107 | Increased research and development tax credit | 33 |
| | 107 | Increased net operating loss carryover | 5 |
| | 113 | Credit for land donation | 5 |
| 2000 | | **Sales and Use Tax** | |
| | 107 | Rural investment exemption | 5 |
| | 599 | Deduction for worthless acounts | At least 6 |

# TABLE THREE

## MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF $10 MILLION OR MORE, 2001-02—DOLLARS IN MILLIONS

| PERSONAL INCOME TAX | FULL YEAR COST |
|---|---|
| Home mortgage interest deduction | $3,200 |
| Exclusion of pension contributions and earnings | 3,200 |
| Exclusion of employer contributions to health plans | 2,700 |
| Exclusion of Social Security benefits | 1,200 |
| Charitable contributions deduction | 1,200 |
| Exclusion of capital gains at death | 1,000 |
| Exclusion of investment income on life insurance and annuity contracts | 900 |
| Real estate and other taxes deduction | 885 |
| Employee business and miscellaneous expenses deduction | 800 |
| Exclusion of capital gains on sale of principal residence | 600 |
| Exclusion of benefits provided under cafeteria plans | 360 |
| Contributions to self-employed retirement plans | 350 |
| Exclusion of miscellaneous fringe benefits | 300 |
| Exclusion of compensation for injuries or sickness | 210 |
| Household and dependent credit | 190 |
| Teacher retention credit | 190 |
| Medical and dental expenses deduction | 135 |
| Exemption for senior citizens | 110 |
| Renters' credit | 100 |
| Deduction of health insurance paid by self-employed | 85 |
| Exclusion of employer contributions to life insurance | 84 |
| Carryover of net operating losses | 79 |
| Contributions to IRAs | 71 |
| Exclusion of State lottery winnings | 51 |
| Exclusion of unemployment insurance benefits | 49 |
| Exclusion of scholarship/fellowship income | 49 |
| Exclusion for small business stock | 43 |
| Manufacturers' investment credit | 41 |
| Long-term care caregiver credit | 38 |
| Education IRA | 37 |
| Exclusion of meals and lodgings furnished by non-military employer | 30 |
| Research and development credit | 25 |
| Enterprise Zone hiring and sales tax credits | 25 |
| Exclusion of employer-provided child care | 23 |
| Exclusion of foster care payment | 19 |
| Student interest deduction | 17 |
| Moving expenses deduction | 16 |
| Medical Savings Accounts deduction | 11 |
| Limited partnerships investment source rule | 10 |
| Exclusion for graduate education | 10 |
| Subchapter S-corporations[1] | -370 |
| **Total** | **$18,073** |

[1] The gain represents the net result after allowing for the pass-through of net business gains and losses to shareholders, as well as the impact of business source income to nonresident shareholders.

# Table Three



## Major Identifiable State Tax Expenditures of $10 Million or More, 2001-02—Dollars in Millions

| Sales and Use Tax[1] | Full Year Cost |
|---|---|
| Vessels and aircraft[2] | $300 to $600 |
| Cargo and returnable containers[2] | 100 to 500 |
| Custom computer programs | 174 |
| Partial exemption for vending machine sales | 50 |
| Motion picture production services | 28 |
| Leases of motion pictures | 20 |
| Watercraft common carrier fuel | 11 |
| Printed advertising[3]c | 10 to 50 |
| Newspapers and periodicals distributed free of charge[3] | 10 to 50 |
| Student meals[3] | 10 to 50 |
| Subscription periodicals | 10 |
| **Total[4]** | **$1,133** |
| Local government revenue loss (2.92 percent average rate)[5] | $663 |

| Bank and Corporation Tax | Full Year Cost |
|---|---|
| Subchapter S-corporations | $1,900 |
| Research and development credit | 520 |
| Carryover of net operating losses | 370 |
| Water's edge election | 360 |
| Manufacturers' investment credit | 340 |
| Corporations exempt from minimum tax | 120 |
| Expensing costs of research, exploration and development | 120 |
| Enterprise Zone hiring and sales tax credits | 85 |
| Charitable contributions deduction | 65 |
| Low income housing credit | 44 |
| Exclusion of life insurance investment income | 42 |
| Percentage depletion of mineral and other natural resources | 15 |
| Los Angeles revitalization zone incentives | 10 |
| Credit union treatment | 10 |
| **Total** | **$4,001** |

1 5.00 percent General Fund rate.

2 Unknown, dependent on the volume of purchases that could be shifted out of state.

3 Unknown, range indicates the estimated order of magnitude.

4 Assumes a mid-range estimate for tax expenditures whose value is unknown and displayed as a range.

5 Includes 0.50 percent Local Revenue Fund, 0.50 percent Local Public Safety Fund, 1.25 percent Uniform Local Sales Tax, and 0.67 percent average county add-on rate.

## TABLE THREE

### MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF $10 MILLION OR MORE, 2001-02—DOLLARS IN MILLIONS

| OTHER TAXES | FULL YEAR COST |
|---|---|
| **Motor Vehicle Fuel Tax** | |
| Aircraft jet fuel used by common carriers and military | $71 |
| Diesel and use fuel used by transit districts and schools | 21 |
| **Total** | **$92** |
| **Insurance Tax** | |
| Fraternal benefit societies | $108 |
| Pension and profit-sharing plans | 32 |
| Earthquake | 11 |
| Total | $151 |
| Cigarette Tax | |
| Sales to the military | $30 |

## TABLE FOUR

### MAJOR IDENTIFIABLE PROPERTY TAX EXPENDITURES OF $10 MILLION OR MORE, 2001-02—DOLLARS IN MILLIONS

| | FULL YEAR COST |
|---|---|
| Computer programs | $101 |
| Open space and historical property | 97 |
| **Total** | **$198** |

# APPENDIX B

Legislative Analysts Office

December 2001

Memorandum Regarding
Tax Expenditure Programs

LAO
60 YEARS OF SERVICE

**Date:** December 20, 2001

**To:** Hon. Ellen M. Corbett, Chair
Assembly Committee on Revenue and Taxation
Attention: Ms. Eileen Roush, Senior Consultant

**From:** Mark A. Ibele MA
Principal Fiscal and Policy Analyst

**Subject:** Tax Expenditure Programs

You have requested that our office provide to you an update of the fiscal estimates for the tax expenditure programs (TEPs) that were identified in our February 1999 report entitled *California's Tax Expenditure Programs.*

In Figure 1 (attached), we have provided a list of all current TEPs for the Personal Income Tax (PIT), Bank and Corporation Tax (BCT), Sales and Use Tax (SUT), other state taxes, and the property tax. For PIT and BCT, the Franchise Tax Board, which administers these taxes, prepares fiscal estimates for all major TEPs on an annual basis. The most recent estimates for these TEPs are for 2001-02, which are shown in Figure 1. For SUT, other state taxes, and the property tax, which are administered in whole or in part by the Board of Equalization, estimates of TEPs are not prepared on a regular basis. For these TEPs, the most recent estimates are for 1998-99, which were presented in our report and are restated in Figure 2 (attached) for your convenience.

In addition to the above fiscal estimates, we have provided information regarding: (1) any additional TEPs enacted and (2) changes in existing TEPs, that occurred since the publication of the report.

Other than the changes noted in the figures, the basic nature of the various TEPs remain unchanged from our report. If you would like further explanation of the various programs or require additional information please contact me at 319-8308.

Attachments

# ATTACHMENT 1

**Figure 1**

**California's Tax Expenditure Programs**
**Taxes Administered by the California Franchise Tax Board**

*(Dollars in Millions)*

| | Estimated Revenue Loss 2001-02 | Comments |
|---|---|---|
| **A. Personal Income Tax** | | |
| **Exclusions** | | |
| Capital Gains at Death | $1,000 | |
| Capital Gains on Sales of Principal Residences | 600 | |
| Employer Contributions to Health Plans | 2,700 | |
| Pension Contributions and Earnings | 3,200 | |
| Unemployment Insurance Benefits | 49 | |
| Social Security Benefits | 1,200 | |
| Employer Contributions to Life Insurance | 84 | |
| Investment Income on Life Insurance and Annuity Contracts | 900 | |
| Meals and Lodging Furnished by Employer | 30 | |
| Benefits Provided Under Cafeteria Plans | 360 | |
| Miscellaneous Fringe Benefits | 300 | |
| Scholarships, Fellowships, and Grants | 49 | |
| Income for Investment in Economically-Depressed Areas | N/A | |
| Foster Care Payments | 19 | |
| Employer-Provided Child Care | 23 | |
| Payments for Recycled or Redeemed Beverage Containers | N/A | |
| State Lottery Winnings | 51 | |
| Scholarshare Trust Income | 8 | |
| Small Business Stock | 43 | 1999 legislation removed sunset date. |
| Employer-Provided Educational Assistance | 7 | |
| AMT Elimination for Exemption Credits | 2 | |
| Graduate Student Expenses | 10 | 2000 legislation for employer-paid expenses. |
| **Exemptions** | | |
| Interest on California and Local Debt Obligations | $340 | |
| Compensation for Injuries and Sickness | 210 | |
| Employee Stock Ownership Plans (ESOPs) | 1 | |
| Limited Partnerships Investment Source Rule | 10 | |

*Continued*

**Figure 1**

## California's Tax Expenditure Programs
## Taxes Administered by the California Franchise Tax Board

*(Dollars in Millions)*

| | Estimated Revenue Loss 2001-02 | Comments |
|---|---|---|
| **Adjustments** | | |
| Contributions to Individual Retirement Account (IRA) | $71 | |
| Education IRA | 37 | |
| Contributions to Self-Employed Retirement Plans | 350 | |
| Health Insurance Paid by Self-Employed Taxpayers | 85 | 1999 legislation increased the deduction percentage. |
| Moving Expenses | 16 | |
| **Deductions** | | |
| Standard Deduction | $1,000 | |
| Medical and Dental Expenses | 135 | |
| Real Property Taxes | 790 | |
| Other Taxes | 95 | |
| Home Mortgage Interest | 3,200 | |
| Charitable Contributions | 1,200 | |
| Contributions Through Tax Return Check-offs | —[a] | |
| Casualty Losses | 15 | |
| Employee Business and Miscellaneous Expenses | 800 | |
| Reserve Method for Bad Debts | N/A | |
| Accelerated Depreciation of Rental/ Low-Income Housing | 99 | |
| Accelerated Depreciation of Other Structures/ Child Care Facilities | 19 | |
| Accelerated Depreciation of Equipment/ Pollution Control Equipment | 260 | |
| Accelerated Depreciation of Cogeneration and Alternative Energy Equipment | N/A | |
| Accelerated Depreciation of Reforestation Expenditures | N/A | |
| Enterprise Zone/Program Area Accelerated Write-off and Interest Exclusion | N/A | |
| Expensing Agricultural Costs | 6 | |
| Expensing Exploration, Development, and Research Costs | 6 | |
| Expensing Environmental Remediation Costs | —[a] | |
| Expensing Magazine Circulation Costs | 2 | |
| Carryover of Net Operating Losses (NOLs) | 79 | |
| Percentage Depletion of Mineral and Other Natural Resources | 8 | |

***Continued***

**Figure 1**

## California's Tax Expenditure Programs Taxes Administered by the California Franchise Tax Board

*(Dollars in Millions)*

| | Estimated Revenue Loss 2001-02 | Comments |
|---|---|---|
| Subchapter S Corporations | -$370 | Revenue gain due to taxation at the individual level. |
| Medical Savings Accounts | 11 | |
| Student Interest | 17 | |
| **Credits** | | |
| Personal Exemption | $980 | |
| Dependent Exemption | 1,300 | |
| Senior Exemption | 110 | |
| Blind Exemption | 2 | |
| Qualified Senior Head of Household | —[a] | |
| Renters' Credit | 100 | |
| Enterprise Zone Hiring, Sales and Use Tax | 25 | |
| Research and Development | 25 | |
| Residential Rental and Farm Sales Carryover | 2 | |
| Low-Income Housing | 5 | |
| Employer Child Care Expenses | 2 | |
| Recycling Equipment and Carryover | —[a] | |
| Ridesharing Expenses and Carryover | 1 | |
| Prison Inmate Labor | —[a] | |
| Tax Incentive Zones[b] | 1 | |
| Los Angeles Revitalization Zone (LARZ) | 2 | |
| Manufacturers' Investment Credit (MIC) | 41 | |
| Trout Habitat | —[a] | |
| Enhanced Oil Recovery | —[a] | |
| Farmworker Housing | —[a] | |
| Rice Straw | —[a] | |
| Transport of Agri-Products Donation | —[a] | |
| Child Adoption | 2 | |
| Credentialed Teachers | 190 | 2000 legislation granted credit of up to 50 percent of teacher-related income. |
| Long-Term Care of Elderly or Disabled | 38 | 2000 legislation granted $500 credit for home care of elderly and disabled. |
| Child Care Expenses | 190 | 2000 legislation granted refundable, income-limited credit. |
| National Heritage Preservation | 55 | 2000 legislation granted credit for conservation of certain lands. |
| Solar Energy Systems | 8 | 2001 legislation granted credit for the purchase of approved solar energy systems. |

***Continued***

**Figure 1**

## California's Tax Expenditure Programs
## Taxes Administered by the California Franchise Tax Board

*(Dollars in Millions)*

| | Estimated Revenue Loss 2001-02 | Comments |
|---|---|---|
| **B. Bank and Corporation Tax** | | |
| **Exclusions** | | |
| Investment Income on Life Insurance and Annuity Contracts | $42 | |
| Income for Investment in Economically-Depressed Areas | N/A | |
| Payments for Recycled or Redeemed Beverage Containers | N/A | |
| Minimum Tax for New Corporations | 60 | 1999 legislation eliminated minimum tax for first two years. |
| **Exemptions** | | |
| Exempt Status for Qualified Corporations | $120 | |
| Water's-Edge Election | 360 | |
| ESOPs | 3 | |
| **Deductions** | | |
| Charitable Contributions | $65 | |
| Casualty Losses | —[a] | |
| Reserve Method for Bad Debts | N/A | |
| Enterprise Zone/Program Area Accelerated Write-off and Interest Exclusion | N/A | |
| Accelerated Depreciation of Rental/ Low-Income Housing | N/A | |
| Accelerated Depreciation of Other Structures/ Child Care Facilities | N/A | |
| Accelerated Depreciation of Equipment/ Pollution Control Equipment | N/A | |
| Accelerated Depreciation of Cogeneration and Alternative Energy Equipment | N/A | |
| Accelerated Depreciation of Reforestation Expenditures | N/A | |
| Enterprise Zone/Program Area Accelerated Write-off and Interest Exclusion | N/A | |
| Expensing Agricultural Costs | 5 | |
| Expensing Exploration, Development, and Research Costs | 120 | |
| Expensing Environmental Remediation Costs | 4 | |
| Expensing Magazine Circulation Costs | 2 | |
| Carryover of NOLs | 370 | 2000 legislation increased the percentage of NOL carryover on a phased-in basis. |

***Continued***

**Figure 1**

## California's Tax Expenditure Programs
## Taxes Administered by the California Franchise Tax Board

*(Dollars in Millions)*

| | Estimated Revenue Loss 2001-02 | Comments |
|---|---|---|
| Percentage Depletion of Mineral and Other Natural Resources | $15 | |
| Expensing Employer Ridesharing Program Costs | N/A | |
| Subchapter S Corporations | 1,900 | |
| Credit Union Treatment | 10 | |
| **Credits** | | |
| Enterprise Zone Hiring, Sales and Use Tax | $85 | |
| Research and Development | 520 | 1999 legislation increased credit rate to 12 percent; 2000 legislation increased credit rate to 15 percent and increased alternative credit. |
| Low-Income Housing | 44 | |
| Employer Child Care Expenses | 5 | |
| Recycling Equipment and Carryover | —[a] | |
| Ridesharing Expenses and Carryover | —[a] | |
| Prison Inmate Labor | —[a] | |
| Tax Incentive Zones[b] | 5 | |
| Los Angeles Revitalization Zone (LARZ) | 10 | |
| Manufacturers' Investment Credit (MIC) | 340 | |
| Trout Habitat | —[a] | |
| Enhanced Oil Recovery | —[a] | |
| Farmworker Housing | —[a] | |
| Rice Straw | —[a] | |
| Transport of Agri-Products Donation | —[a] | |
| National Heritage Preservation | 55 | 2000 legislation granted credit for conservation of certain lands. |
| Solar Energy Systems | 17 | 2001 legislation granted credit for the purchase of approved solar energy systems. |

[a] Estimated revenue loss of less than $500,000.

[b] Includes Local Area Military Base Recovery Area, Targeted Tax Area, and Manufacturing Enhancement Area.

# ATTACHMENT 2

**Figure 2**

**California's Tax Expenditure Programs**
**Taxes Administered by the State Board of Equalization**

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| **A. Sales and Use Tax** | | |
| Gas, Electricity, Water, Steam, and Heat | $3,264 | |
| Organic Products Grown Expressly for Fuel Purposes | —[a] | |
| Agricultural, Timber, Municipal, and Industrial Waste By-Products | N/A | |
| Use of Refiners' Gas | N/A | |
| Animal Life | 47 | |
| Animal Feed | 207 | |
| Seeds and Plants | 30 | |
| Qualified Fertilizer | 52 | |
| Poultry Litter | 1 | |
| Food Products | 2,698 | |
| Candy, Gum, and Confectionery Products | 217 | |
| Bottled Water | 93 | |
| Packing Ice and Dry Ice | N/A | |
| Carbon Dioxide Used in Packaging | —[a] | |
| Prescription Medicines | 709 | |
| Specified Medical-Related Products | N/A | |
| Medical Identification Tags | —[a] | |
| Specified Medical Health Information | N/A | |
| Health and Safety Insignia and Educational Materials | N/A | |
| Food Animal Medicines | 4 | |
| Medicated Feed and Drinking Water | —[a] | |
| Printers' Aids | N/A | |
| Partnership Property Used to Produce Motion Pictures | N/A | |
| Newspapers and Periodicals, Distributed Free of Charge or by Subscription | 74 | |
| Leases of Motion Pictures | 32 | |
| Master Tapes and Master Records | N/A | |
| Printed Advertising Materials | N/A | |
| Motion Pictures and Production Services | N/A | |
| Mobile Transportation Equipment Leases | N/A | |
| Vessels That Transport Over 1,000 Tons | N/A | |
| Vehicles Modified for Physically Handicapped Persons | N/A | |
| New or Remanufactured Trucks and Trailers For Out-of-State Use | N/A | |
| Property Used in Space Flights | 12 | |
| Aircraft Repair and Related Equipment | 16 | |
| Railroad and Related Equipment | —[a] | |
| Leases of Specified Linens | 44 | |
| Leases of Household Furnishings | —[a] | |

*Continued*

**Figure 2**

## California's Tax Expenditure Programs
## Taxes Administered by the State Board of Equalization

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| Factory-Built Housing | —[a] | |
| New Mobilehomes | N/A | |
| Used Mobilehomes | $24 | |
| Custom Computer Programs | 276 | |
| California Gold Medallions | —[a] | |
| Monetized Bullion, Gold and Silver Bullion, and Numismatic Coins | N/A | |
| Returnable Containers | N/A | |
| Containers Whose Contents are Tax-Exempt | N/A | |
| Original Artworks and Displays For Specified Museums | N/A | |
| Single-Use Mailing Lists | N/A | |
| Sale-Leasebacks Involving Certain Governmental Entities | N/A | |
| Motor Vehicle Fuel Used in Airplanes | N/A | |
| Fuel Sold to Air Common Carriers For International Flights | 20 | |
| Fuel Used in Water Common Carriers | 18 | |
| Meals and Food Products Served in Schools | N/A | |
| Hot Food Products Served To Airplane Passengers | N/A | |
| Meals Served to Patients and Residents of Health Care Facilities | N/A | |
| Meals Provided to Qualified Low-Income Senior Citizens | N/A | |
| Meals Delivered to Elderly and Disabled Individuals | —[a] | |
| Meals Prepared in Common Kitchen Facilities For Qualified Senior Citizens | N/A | |
| Meals and Food Products Served by Religious Organizations | N/A | |
| Food Stamp Purchases | N/A | |
| Health Care Professionals Treated as Consumers | N/A | |
| Veterinarians Treated as Consumers | N/A | |
| Aircraft for Common Carriers or for Use by Foreign Governments or Nonresidents | N/A | |
| Trailers And Semitrailers Moved to Place of Sale | N/A | |
| Qualified Watercraft and Their Component Parts | N/A | |
| Vehicles, Vessels, and Aircraft Transferred Within a Family | N/A | |
| New Vehicles Sold to Foreign Residents For Foreign Shipment | N/A | |
| Occasional Sales | —[b] | |
| Occasional Sales of Vehicles, Vessels, or Aircraft | N/A | |
| Occasional Sales of Other Products by Hay Producers | N/A | |
| Membership Fees Charged by Consumer Cooperatives | N/A | |
| Clothing Alterations by Clothes Cleaning and Dyeing Businesses | N/A | |

*Continued*

Figure 2

## California's Tax Expenditure Programs
## Taxes Administered by the State Board of Equalization

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| Flags Sold By Veterans' Groups | —[a] | |
| Vending Machine Sales of Nonprofit Operators | —[a] | |
| Photocopy Sales By Libraries | N/A | |
| Prisoner-of-War Bracelet Sellers | —[a] | |
| Veterans Memorial Lapel Pins | —[a] | |
| Qualified Sales of Youth Groups | N/A | |
| Yearbook and Catalog Sales by Student Organizations | N/A | |
| Replacements for Destroyed Museum Exhibits | N/A | |
| Sales By PTAs, Co-Op Nursery Schools, and Friends of the Library | N/A | |
| Rummage Sales by Qualified Nonprofit Organizations | —[a] | |
| Handcrafted Items Sold by Qualified Organizations | —[a] | |
| Charitable Organization Sales and Donations | N/A | |
| Property Loaned to Educational Programs | N/A | |
| New Clothing Donated to Elementary School Children | N/A | |
| First $400 of Foreign Purchases Hand-Carried Into California | —[a] | |
| Charitable Donations Made by Sellers | N/A | |
| Auctions Involving Nonprofit Organizations | —[a] | |
| Sales by Thrift Stores Operated By Nonprofit Organizations | —[a] | |
| Option to Pay Tax on Cost Rather Than Lease Receipts | N/A | |
| Tax Liability on "Bad Debts" | N/A | |
| Acquisition Sale-Leaseback Arrangements | N/A | |
| Factory-Built School Buildings | —[a] | |
| Endangered Animal and Plant Species | —[a] | |
| Investments by Manufacturers | $6 | |
| Rural Investment Exception | 5[c] | 2000 legislation exempted certain purchases. |
| Farm and Forestry Equipment | 20[d] | 2001 agriculture assistance package. |
| Liquified Petroleum Gas in Rural Areas | 7[d] | 2001 agriculture assistance package. |
| Thoroughbred Breeding Stock | 1[d] | 2001 agriculture assistance package. |
| Diesel Fuel for Agriculture | 19[d] | 2001 agriculture assistance package. |
| **B. Other State Taxes** | | |
| Alcohol Used in Trades, Professions, and Industries | N/A | |
| Beer Consumed by Brewers' Employees | —[a] | |
| Distilled Spirits Used in the Manufacture of Food Products | N/A | |
| Distilled Spirits Used for Research And Medical-Related Purposes | N/A | |
| Distributions of Tobacco Products to U.S. Armed Forces and the U.S. Department of Veterans' Affairs | 21 | |

*Continued*

Figure 2

## California's Tax Expenditure Programs
## Taxes Administered by the State Board of Equalization

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| Distributions of Tobacco Products To Veterans' Institutions | —[e] | |
| Small Shipments of Cigarettes Transported Into California | —[e] | |
| Natural Gasoline | N/A | |
| Ship or Aircraft Fuel Ultimately Distributed to the U.S. Armed Forces | N/A | |
| Fuel for Off-Highway Vehicle Operations | N/A | |
| Fuel Sales to Consulate Officers And Employees | N/A | |
| Fuel for Race Cars | N/A | |
| Fuel for Common Carriers and the Military | $80 | |
| Fuel for Construction and Agricultural Machinery | N/A | |
| Fuel for Nontransportation Purposes | N/A | |
| Fuel for Off-Highway Vehicle Operations | N/A | |
| Fuel for Local Transit and School Bus Operators | 22 | |
| Fuel for Out-of-State Tour Buses | N/A | |
| Fuel for Public Agency Vehicles Operated on Military Installations | N/A | |
| Fuel for Operation of Vehicles on U.S. Department of Agriculture Roads | N/A | |
| Fuel for the U.S. Government And Its Instrumentalities | N/A | |
| Fuel Used in Public Transit Vehicles | N/A | |
| Liquified Petroleum Gas | 2 | |
| Ethanol and Methanol | —[a] | |
| Natural Gas | —[a] | |
| Flat Tax Rate for Liquified Petroleum Gas and Natural Gas Fuels | N/A | |
| Employee Pension and Profit Sharing Plans | N/A | |
| Fraternal Benefit Societies | N/A | |
| **C. Property Taxes** | | |
| Homeowners' Exemption | $362 | |
| Household Furnishings | 500 | |
| Transfers Between Spouses | N/A | |
| Transfers Between Family Members | 1 | |
| Replacement Housing Purchased by Senior Citizens | N/A | |
| Transfers Within a Joint-Tenancy Agreement | N/A | |
| Mobilehome Park Property Transfers to Tenant Cooperatives | N/A | |
| Business Inventories | 1,940 | |
| Financial Assets | N/A | |
| Business Records | N/A | |
| Transfers of Interests in Corporate or Partnership Property | N/A | |
| Transfers to Employee Benefit Plans | N/A | |

*Continued*

**Figure 2**

**California's Tax Expenditure Programs**
**Taxes Administered by the State Board of Equalization**

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| Computer Programs | $100 | |
| Motion Pictures | N/A | |
| Hand Tools | 1 | |
| Returnable Containers for Soft Drink Beverages | N/A | |
| State and Local Governments | N/A | |
| Leases by a Nonprofit Corporation To a Government | N/A | |
| Volunteer Fire Departments | N/A | |
| Restricted Historical Property | N/A | |
| Aircraft Owned by a Government Agency | N/A | |
| Federal Property Used for Migratory Fowl | —[a] | |
| Hospital, Educational, Museum, Scientific, or Charitable Purposes ("Welfare Exemption") | 415 | |
| Religious Worship or Religious Purposes ("Church Exemption") | 89 | |
| Transfers Within The Same Religious Denomination | 1 | |
| Leases by a Charitable Organization To a Government for Charitable Purposes | N/A | |
| Private Property Used by a Public Library or Free Museum | 1 | |
| Public Schools, Colleges, and Universities | 1 | |
| Private Colleges and Seminaries | 72 | |
| State College Management | N/A | |
| Student Bookstores | 1 | |
| Student Body Organizations | N/A | |
| Nonprofit Entities Using Property for Selected Public Purposes | N/A | |
| Designated Institutions | N/A | |
| Cemetery Property | 5 | |
| San Diego Supercomputer Center | N/A | |
| Disaster-Damaged Property | N/A | |
| Property Damaged by Misfortune or Calamity | 1 | |
| Environmental Contamination | 1 | |
| Property Condemned Pursuant to Eminent Domain Proceedings | N/A | |
| Earthquake Safety Improvements | N/A | |
| Fire-Safety Improvements | N/A | |
| Improvements for Disabled Accessibility | 10 | |
| Homes and Improvements for Disabled Persons | N/A | |
| Active Solar Energy Systems | N/A | |
| Veterans' Exemption | —[a] | |
| Disabled Veterans' Principal Residence | 12 | |
| Real Property of Specified Veterans' Organizations | —[a] | |
| Personal Property of Specified Veterans' Organizations | —[a] | |

*Continued*

**Figure 2**

## California's Tax Expenditure Programs
## Taxes Administered by the State Board of Equalization

*(Dollars in Millions)*

| | Estimated Revenue Loss 1998-99 | Comments |
|---|---|---|
| Open-Space Contracts (The "Williamson Act") | $97 | |
| Growing Crops | 1 | |
| Fruit Trees, Nut Trees, and Grapevines | 1 | |
| Diseased Grapevines | N/A | |
| Restricted Timberlands | N/A | |
| Low Harvest-Value Timber | N/A | |
| Seed Potatoes | 1 | |
| Vessels | N/A | |
| Documented Vessels | 3 | |
| Vessels Under Construction | N/A | |
| Vessels With a Market Value of $400 or Less | N/A | |
| Air Carrier Ground Time | N/A | |
| Aircraft Being Repaired | N/A | |
| Private Railroad Car Repair Days | —[a] | |
| Cargo Containers Used in Ocean Commerce | N/A | |
| Exhibition Exemption | N/A | |
| Works of Art Available for Display | N/A | |
| Works of Art Owned by the Artist | N/A | |
| Aerospace Museum Displays | N/A | |
| Aircraft of Historical Significance | 1 | |
| Assessments of $5,000 or Less | N/A | |
| Supplemental Roll Tax Assessments Of $20 or Less | N/A | |
| Fixtures Excluded From the Supplemental Roll | 49 | |
| Interests That Represent Less Than Five Percent of the Property's Total Value | N/A | |
| Senior Citizens' Relief | 214[c] | 2000 legislation granted one-time property tax relief. |

[a] Estimated revenue loss of less than $500,000.

[b] Revenue loss unknown, but likely in excess of $10 million.

[c] Estimated revenue loss for 2000-01.

[d] Estimated revenue loss for 2001-02.

[e] Revenue loss incorporated into "Distribution of Tobacco Products to U.S. Armed Forces and the U.S. Department of Veterans' Affairs."

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SENIOR CONSULTANT
IRENE FRAUSTO
COMMITTEE SECRETARY
STATE CAPITOL
P.O. BOX 942849
SACRAMENTO, CA 94249-0114
(916) 319-2098

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
ELLEN M. CORBETT, CHAIR
EIGHTEENTH ASSEMBLY DISTRICT

# REVIEW OF TAX EXPENDITURES

## Agenda and Witness Materials Submitted to Committee

Tuesday, January 8, 2002
State Capitol, Room 126
Sacramento, California

MEMBERS
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ELLEN M. CORBETT, CHAIR
EIGHTEENTH ASSEMBLY DISTRICT

# AGENDA

## INFORMATIONAL HEARING ON

## REVIEW OF TAX EXPENDITURES

**Tuesday, January 8, 2002**
**10:00 a.m. - 1:00 p.m.**
**State Capitol, Room 126**
**Sacramento, California**

I. OPENING REMARKS

II. INTRODUCTION TO TAX EXPENDITURES

A. A Tax expenditure (TEP) Primer: what they are, how many there are, how much they cost, who tracks them, how they're evaluated - Mr. Mark Ibele, Fiscal and Policy Analyst and Mr. Dave Vasche, Director, Economics, Taxation, & Fiscal Forecasting, Legislative Analyst's Office (15 minutes)

B. Measuring the cost is a lot easier than measuring the benefit, but measuring the cost is difficult, too - Mr. Dave Hayes, Manager, Research & Statistics, State Board of Equalization and Mr. Phil Spilberg, Director, Economic & Statistical Research Bureau, Franchise Tax Board (15 minutes)

C. Dynamic revenue estimation -- the fiscal impact of tax expenditures once their effects have rippled through the economy - Mr. Bruce Smith, Principal Economist, Department of Finance (10 minutes)

D. How do tax expenditures affect local governments? Ms. Pat Leary, Legislative Representative, California State Association of Counties (5 minutes)

III. DO TAX EXPENDITURES WORK? What rulers should we use to measure effectiveness?

Panel discussion (5 minutes each)

Mr. Michael Coleman, Chief Consultant, League of California Cities
Mr. Lenny Goldberg, California Tax Reform Association
Mr. Fred Main, Sr. VP & General Counsel, California Chamber of Commerce
Mr. Tom Rankin, President, California Labor Federation, AFL-CIO
Mr. Gerry Meral, Planning and Conservation League
Mr. Chris Micheli, Carpenter, Snodgrass & Associates
Ms. Jean Ross, Executive Director, California Budget Project
Mr. Ray Rossi, Director, External Affairs, Intel Corporation
Mr. Greg Turner, General Counsel/Legislative Director, California Taxpayers Association

III. PUBLIC COMMENT

IV. CLOSING REMARKS

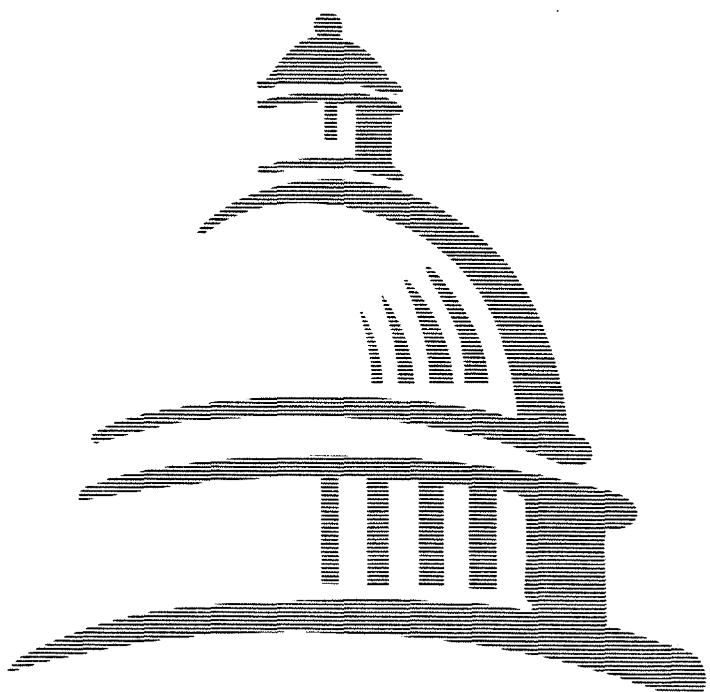
LAO
60 YEARS OF SERVICE

January 8, 2001

# California's Tax Expenditure Programs: Overview of the Issues

LEGISLATIVE ANALYST'S OFFICE

Presented To:
Assembly Committee on Revenue and Taxation



January 8, 2002

LAO
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# What Are Tax Expenditures?

- ☑ Tax expenditure programs (TEPs) are the various exclusions, exemptions, deductions, credits, preferential tax rates, and other special tax provisions that represent deviations from the state's "basic" tax structure and reduce the revenue receipts that would otherwise occur.

- ☑ The definition of the basic tax structure is fundamental to the process of identifying and measuring TEPs.

- ☑ There is considerable difference of opinion about what constitutes the basic tax structure, and thus, what constitutes a TEP. What might be construed as a tax expenditure to one person may simply be part of the basic tax structure to another, and vice versa.

- ☑ The LAO treats the basic tax structure fairly broadly for the purpose of TEP reporting. This approach ensures that the Legislature will have at its disposal, TEP-related information that can accommodate the differing viewpoints of all of its Members.

- ☑ The taxes our reports cover include: the Personal Income Tax (PIT), Bank and Corporation Tax (BCT), Sales and Use Tax (SUT), other state taxes, and the property tax.

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# Tax Expenditures are Implemented For Several Reasons

- ☑ California has typically enacted TEPs for a variety of policy reasons.
- ☑ Some TEPs are enacted in order to provide an *incentive* for a particular type of economic behavior by individuals or businesses.
  - For example, the research and development tax credit provides an incentive under the BCT and PIT to engage in experimental or research activities that otherwise might not occur.
- ☑ Certain TEPs provide for *tax relief* on a broad-based or targeted basis for certain businesses or individuals.
  - For example, the dependent credit exemption provides tax relief for households with dependent children or other dependents.
- ☑ Other TEPs have been enacted in order to address a perceived *inequity* in the tax system or for other equity-based policy reasons.
  - For example, the standard deduction available for PIT filers represents an attempt to achieve some parity between taxpayers who do not itemize deductions and those taxpayers who do itemize deductions.

## Tax Expenditures are Implemented For Several Reasons *Continued*

☑ Certain TEPs are enacted for the purpose of achieving *particular social goals*.

- For example, the deduction of mortgage interest represents an attempt to encourage homeownership.

☑ Finally, some TEPs are enacted for reasons of *administrative simplicity* and *ease of compliance*.

- For example, under the SUT, purchases at occasional sales (garage sales) are exempt from taxation due the difficulty in fairly enforcing the tax. Similarly, conformity with federal income tax actions often occurs in order to ease the compliance burden on taxpayers.

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## Why Reviewing TEPs Is Important

- ☑ Periodic review of TEPs is important because like *direct* expenditure programs, they constitute a commitment of resources.

- ☑ Tax expenditure programs are different from direct expenditure programs in that they are provided for through the tax system as opposed to the budget process.

- ☑ In other respects, however, TEPs are *similar* to direct expenditure programs in that they convey benefits to individuals, businesses, and various organizations.

- ☑ Whereas direct expenditure programs *are* routinely reviewed and funded through the normal course of the annual state budget process, *no* such process generally occurs for TEPs.

- ☑ As a result, it is important that TEPs receive periodic review to ensure that they are appropriate, effective, and efficient, and therefore merit continued financial support from the public and taxpayers at large.

  - Those TEPs designed to provide incentives should be evaluated as to their effectiveness and efficiency in achieving their stated objectives.
  - Those TEPs put in place for equity reasons, such as to provide targeted tax relief or to address social goals, should be evaluated as to whether such policies are appropriate and most effectively achieved through the tax system.
  - Those TEPs designed for ease of compliance or administrative simplicity should be evaluated, with the costs in administrative and taxpayer savings weighed against foregone revenues.

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# Number of TEPs and Their Revenue Effects

- ☑ We have identified over 250 individual state-level TEPs. The estimated sum of their individual identifiable revenue reduction is in excess of $30 billion. These estimates are based on 2000-01 data for the PIT and BCT and 1998-99 data for all other taxes.

- ☑ Regarding the importance of different types of TEPs:

    - There are over 80 TEPs under the PIT, with the sum of their individual revenue effects totaling approximately $22 billion.
    - There are over 40 TEPs available under the BCT, with the sum of their individual revenue effects totaling approximately $4 billion.
    - There are about 100 TEPs available under the SUT, with the sum of their individual *state* revenue effects totaling approximately $6 billion.
    - The TEPs for other state taxes number about 30, with the sum of their individual revenue effects equal to approximately $125 million.

- ☑ In addition to state-level TEPs, there are 74 property tax TEPs.

- ☑ We include property tax TEPs and the local portion of the sales tax TEPs in our reports because, although they primarily involve local revenues, they are state-established and may result in additional fiscal costs to the state.

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# Number of TEPs and Their Revenue Effects *Continued*

☑ Individual TEPs with the largest identifiable revenue effects for the PIT, BCT, and SUT are presented below.

- For the PIT, the largest TEPs are:
  - — Exclusion of Pension Contributions and Earnings ($3.2 billion).
  - — Deduction of Home Mortgage Interest ($3.2 billion).
  - — Exclusion of Employer Contributions to Health Plans ($2.7 billion).
  - — Dependent Credit Exemption ($1.3 billion).
  - — Exclusion of Social Security Benefits ($1.2 billion).
- For the BCT, the largest TEPs are:
  - — Subchapter S Filing Status ($1.9 billion).
  - — Research and Development Credit ($520 million).
  - — Deduction for Carryover of Net Operating Losses ($370 million).
  - — Water's-Edge Election ($360 million).
  - — Manufacturer's Investment Credit ($340 million).

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# Number of TEPs and Their Revenue Effects *Continued*

- For the SUT, the largest TEPs (with respect to state revenues only) are:
  - — Exemption of Gas, Electricity, Steam, and Heat ($2.5 billion).
  - — Exemption of Food Products ($2.1 billion).
  - — Exemption of Prescription Medicine ($540 million)
  - — Exemption of Custom Computer Programs ($210 million).
  - — Exemption of Candy, Gum, and Confectionery Products ($165 million).

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# Challenges in Estimating The Effects of TEPs

☑ ***Analyzing TEPs Can Be Difficult.*** Accurately estimating the effect of TEPs often is an extremely difficult undertaking, for several reasons.

☑ ***Data Problems.*** Reliable data are not always available.

- This can especially be a problem when taxpayers have never been required to report any data regarding a TEP.
- Data seem to be a particular problem for many SUT TEPs.

☑ ***Interactions Between TEPs***. Interactions *between* TEPs sometimes makes it difficult to isolate the effects of individual programs.

- Changing one TEP program can affect the costs and effectiveness of another, such as when the addition of a tax exclusion puts taxpayers into lower marginal income tax brackets, and thereby reduces the tax benefits of their deductions.

☑ ***State-Federal Interactions.*** When TEPs exist at both the federal and state levels, as is true for many income tax TEPs, it can be difficult to isolate out the state TEP's effect separately. This is partly because the state effect generally is dominated by the federal TEP's effect, due to the higher federal marginal tax rates.

☑ ***Behavioral and Dynamic Effects.*** Often, there is limited information regarding how a TEP affects taxpayer behavior and how the economy changes because of a TEP being in place. Thus, the "full" fiscal effects of TEPs can differ from their "first stage" effects.

- Although the Department of Finance maintains a dynamic estimation model, this model—like every other economic model of its type—is subject to uncertainty given data limitations and lack of information regarding behavioral responses by taxpayers.

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# Legislative Review of TEPs

☑ The LAO provides a comprehensive overview of the state's TEPs on a periodic basis.

- Recent comprehensive overview reports were provided to the Legislature in 1987, 1991, and most recently in 1999.

☑ Attempting comprehensive annual assessments of all TEPs is unrealistic, given the resources it would entail.

☑ A more targeted approach, however, which focuses on designated individual TEPs of special interest to the Legislature is a more realistic endeavor.

- Detailed reports on the effectiveness and appropriateness of several TEPs have been provided to the Legislature in the past, including reports on: tax credit for Low-Emission Vehicles (LEVs), mortgage interest deduction, rapid amortization of alternative energy equipment, rapid amortization of cogeneration equipment, exclusion of capital gains on small business stock, and sales taxation of bunker fuel.

☑ The following three-step approach would make sense with regard to *existing TEPs* of interest to the Legislature:

- ***First***, review their objectives and rationales.
- ***Second***, review available evidence or see if evidence can be developed or collected on their effectiveness and cost efficiency.
- ***Third***, act to modify or eliminate TEPs that are not merited because they no longer meet current policy objectives or spending priorities, or are not as good as other options for achieving their objectives.

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## Legislative Review of TEPs *Continued*

☑ Selected options for improving the legislative review process for *proposed* TEPs are:

- For some or all newly created TEPs, include a sunset provision to ensure that they do not continue indefinitely unless merited.
- Require proponents of particular TEPs to provide estimates of their likely efforts and evidence of their actual impacts.
- For select TEPs, include a reporting requirement by the state's tax agencies or require that studies be prepared that assess and report on their effectiveness.
  - — In some cases, this review could require that data be provided by the taxpayer or that survey work be conducted. These approaches have been used in the past with regard to the tax credit for LEVs and the exclusion of capital gains on small business stock.

# Dynamic Revenue Analysis

## Presented to:

## Assembly Revenue and Taxation Committee

**January 8, 2002**

**By:**

**Bruce Smith**

**Department of Finance**

# What is dynamic revenue analysis? (a.k.a. dynamic scoring)

**It's neither extreme:**

- Voodoo economics
- Rejection of failed tools of Keynesian liberals

**But is the middle ground:**

- Done right, it can answer only one question: to what extent should we adjust our revenue forecasts to account for a reasonable estimate of the impact of private economic agents reacting to tax laws?

# What is an example?

A 10 cents per gallon increase in the gas tax, would lead to the following estimates:

- Assume about 15 billion gallons sold in California.
- The pure static estimate would be an increase in revenues of $1.5 billion ($15 billion X 10 cents per gallon).
- The normal static estimate would incorporate the decline in demand for gasoline by individual households and businesses (the so-called own-price elasticity of demand).

# How would this change for a dynamic estimate?

- The dynamic estimate would extend the search for effects through the entire economy, including:
  - The employment effects on refiners, distributors and retailers of gasoline, and how this will affect PIT.
  - The consumption effects, and how this will affect sales & use taxes.
  - The profits of California firms and how this will affect bank & corp. taxes.
  - The expansion by suppliers to the government… and so on.

# Why did we do this?

Chapter 383, Statutes of 1994 said:

- LAO would analyze budget revenue proposals; and
- DOF would analyze revenue bills:
  - with $10 million or more ‘static’ estimate,
  - taking into account the reactions of economic agents.

# Why Finance didn't quit dynamic scoring Jan. 1, 2000:

- It made too much sense to incorporate the reactions to tax law when setting that law.
- We learned how to analyze things using microeconomic theory.
- It has proved to be a good starting point for our other analyses.
- We had an analytic engine with which to analyze other proposals.

# What approach was chosen?

**Computable General Equilibrium model (CGE):**

- It has a solid connection to theory.
- It can be immune from the Lucas Critique.
- It is best for ‘what if’ analyses.

**Not chosen:**

- Input-Output
- Micro-Simulation
- Econometric Simulation

# What was built?

- 1,000+ nonlinear-equation CGE
- 28 industries, 8 household groups, 45 government units, 2 factors, 1 ROW
- CES Production
- Flexible functional form for consumption.
- Armington trade functions
- Labor supply responds to real, after-tax return to labor.
- Investment responds to real, after-tax return to capital.
- Middle values chosen for elasticity parameters.

# How was it built?

## General Principles

- DOF to have in-depth knowledge of model, uses.
- Exploit comparative advantage, get working quickly and reliably.
- Use external for 1-time costs.

## Staffing

- DOF: economist + analyst
  build model, government
  spending research.
- ARE: professor, post-doctoral,
  student
  literature search,
  theory, challenge

# What are typical results?

There are no free lunches for tax cuts!

BUT

Dynamic analysis suggests long term effects very different from those implied by static analysis!

# Standard Experiments

- Bank & Corporation (profits tax), Personal Income and Sales & Use taxes each cut by $1 billion static estimates.
- Base Cases: use basic assumptions about elasticity parameters, budget balance, Prop. 98, block grants, PIT deductions, etc.
- Where time permits, test other assumptions.

# Standard Experiment Results

## Bank & Corporation Tax

- + 20% Revenue feedback
- + $500 million Investment
- + 10,000 jobs

## Personal Income Tax

- + 3% Revenue Feedback
- + $50 million Investment
- + 15,000 jobs

## Sales & Use Tax

- + 10% Revenue Feedback
- + $120 million Investment
- + 10,000 jobs

# How has bill analysis process changed?

**Not Much:**

- FTB prepares their static/ behavioral estimate, as before
- DOF revenue function documents and presents Administration's position, as before.
- Dynamic language is added to DOF bill analysis as a separate section.
- Short-term fiscal analysis does not change due to dynamic revenue analysis.

# Typical Dynamic Bill Analysis Language:

**Dynamic Revenue Analysis**

AB xx

Amendment date: 01/04/01

The Department of Finance has performed a dynamic revenue analysis of this proposal and finds that the long-term dynamic revenue effects would be to decrease the static estimates of revenue loss by 10 percent, *i.e.* the static estimates overestimate the revenue loss by this amount. Revenue feedback is expressed in terms of all forms of General Fund and special fund revenues, approximately five years following implementation.

<u>Summary of the feedback effects, five years after implementation</u>:

- Revenue feedback: 10 percent of static estimates. For example, a static estimate of a $200 million revenue loss in the long run results in an $180 million dynamic estimate of revenue loss. The lower estimate of revenue loss arises from the net expansive effect of decreased business profits taxation.
- Private non-residential investment: Approximately $100 million in additional private non-residential investment in buildings and equipment can be expected in the long run.
- Employment: no measurable change in employment can be expected in the long run.

# The Role of Tax Incentives

*By Chris Micheli, David R. Doerr and Fred Main*

*Chris Micheli is an attorney and lobbyist for Carpenter Snodgrass & Associates.*

*David R. Doerr is chief tax consultant for the California Taxpayers' Association.*

*Fred Main is senior vice president and general counsel of the California Chamber of Commerce.*

For a long time, the California Legislature has been struggling with the issue of whether tax incentives are effective. More recently, legislators have been examining methods of ensuring greater accountability with tax incentives. Some are pursuing a fundamental policy proposal that all tax incentive legislation contain a sunset clause, measures to determine the effectiveness of tax incentives and public disclosure of taxpayer information.

While there are competing demands on state revenues, and there should be accountability in tax policy, a "one-size-fits-all" approach is poor tax policy. The California Legislature, where deemed appropriate, makes selective reporting requirements now. In fact, the business community supports such efforts on specific provisions.

We also need to be competitive with other states. While broad tax relief is always preferable, it is not always fiscally possible. Targeted tax incentives are less of a drain on the state's General Fund and they promote competitiveness with other states.

The business community does not object to periodic review of tax incentives. In fact, this already occurs. There is a regular Legislative Analyst's Office report on Tax Expenditure Programs. Also, the Franchise Tax Board provides an annual listing of all tax credits and the number of taxpayers claiming the credits, as well as the total amount of credits claimed.

Most of the tax law benefits have been provided to personal income taxpayers. The major tax breaks available to personal income taxpayers are:

- Home mortgage interest deduction ($3 billion).
- Employer contributions to employee pension plans ($2.6 billion).
- Dependent exemption credit ($1.3 billion).

The largest corporate tax incentive is the manufacturers' investment credit (MIC), which provides $365 million annually in tax relief.

## Examining Effectiveness

It is actually quite difficult to determine with great certainty the effectiveness of tax policy changes. Moreover, there are a number of concerns relating to making a determination of effectiveness and collecting the raw data to analyze to make such a determination. For example, who establishes the criteria? Are the criteria the same with all legislation? How is the data collected? How is the data evaluated?

In some cases, it will be necessary to actually contact the individual taxpayers and ask probative questions: "As a result of this change in the law, did you make additional purchases?" "Did you hire new people?" To what secondary level should we examine dynamic effects?

## Sunset Dates

One of the fundamental concerns of imposing sunset dates is that it is difficult for businesses to plan for the future. In fact, a sunset date can render a tax incentive meaningless when taxpayers, dealing with an early sunset date, will be loath to invest on a long-term basis. Such sunset dates simply allow the opponents of tax incentives to make the argument that the incentive will only benefit the businesses that were going to invest anyway.

As a result, the Legislature has wisely used this approach on a selective basis. Some measures that were subject to a sunset date, but later made permanent, include the research and development tax credit, as well as the treatment of the employee stock ownership plan.

Provisions that automatically expired due to sunsets in California law and have not been reinstated include the tax credit for employer-subsidized transit passes, the Los Angeles Revitalization Zone (LARZ), and the credits for solar energy equipment and jobs.

## Selected Studies

Despite protests from some groups opposed to corporate tax incentives, a number of such measures have been studied. For example, the research and development tax credit has been recently studied.

A 1998 study by Coopers & Lybrand found that, at the federal level, the R&D tax credit is such a powerful incentive that it will ultimately pay for itself due to its impact on productivity gains and economic growth, which thereby increase federal revenue.

## Good Tax Policy

Many opponents of tax relief simply miss the boat by arguing that all tax cuts must provide incentives. Changes in tax laws are not always designed to provide an incentive to growth. They are also meant to underwrite the costs of socially desirable activities or to produce equity in tax statutes.

For example, while the MIC and R&D tax credits are meant to stimulate economic growth, the child-care credit is not. Certainly we are not trying to "incentivize" or encourage people to have additional children. Moreover, some proposed tax law changes are matters of tax equity, such as interest rate equalization, treatment of net operating losses, etc.

## Worker Benefits

Workers are benefiting by businesses being more competitive in the global marketplace. High-tech and biotech industries, in particular, are creating high-wage, high-skilled quality jobs for Californians. Good wages and benefits are needed for all California workers, but you cannot mandate those in exchange for tax cuts. Otherwise, there will be a disincentive to invest.

With a tight labor market, businesses are competing for fewer available workers. As a result, they are responding with more generous and more creative compensation packages for their employees.

## Business Tax Incentives Warranted

While California bank and corporation tax revenues have remained at about $5 billion annually for several years (due to a number of factors including the significant decline in the state's average corporate apportionment factors, as well as credits), it is these businesses that have created the record number of jobs over the past five years that has led to record employment levels.

Also, these businesses have provided generous stock options and market values that have made people wealthy, that have also increased personal income tax (PIT) revenues. Since 20 percent of PIT revenues are related to stock capital gains, California should want to ensure that companies continue to do well so that their stock values keep growing. The portion of capital gains receipts from sales of stock and the exercise of stock options is due to corporations performing well. This trend needs to be encouraged.

California must continue fostering a positive business climate. Employment levels in this state are at an all-time high with businesses hiring a record number of people. This business expansion has been fostered in part by tax incentives adopted in the 1990s.

California faces continued competition from other states. Others continue to entice California businesses with economic incentives to lower the cost of doing business in their states. To encourage a dynamic business climate, favorable tax policies need to be a part of the product mix.

***Many opponents of tax relief simply miss the boat by arguing that all tax cuts must provide incentives.***

# Reviewing California's Tax Expenditures

Jean Ross, Executive Director
California Budget Project
921 11th Street, Suite 502
Sacramento, CA 95814
(916)444-0500

January 2002

# Why Should Tax Expenditures Be Evaluated?

- The four characteristics of good tax system:
  - **Sufficiency:** A good tax system generates enough revenue for the government to finance the desired level of public services.
  - **Simplicity:** A good tax system is easy to administer and is understandable, which leads to increased compliance.
  - **Equity:** A good tax system taxes those in similar situations the same (vertical equity) and it taxes those in different situations according to their ability to pay (horizontal equity).
  - **Efficiency:** A good tax system does not interfere with the flow of resources to their most economically efficient uses.
- Economists would further argue that the best tax system is one that meets the goal of sufficiency with the lowest rates and the broadest base.
- A proliferation of tax expenditures makes it difficult to achieve these four goals.
- $27.5 billion (1998-99) is spent through the state's various tax expenditure programs. This represents resources that could be used to finance public services or provide relief through lower rates.

# How Should We Measure Effectiveness?

- Tax expenditures should have a clear goal and purpose and, wherever possible, measurable performance standards. If performance standards are not met, the program should be discontinued.
- At present, neither policymakers nor the public has the information that is needed to measure the effectiveness of tax expenditure programs.
- In a soon-to-be released study, the CBP examined and categorized state economic development incentives. We found that tax expenditures accounting for 90.5 percent of the total revenue loss have **no** evaluation or reporting standards. This is true even though we applied a **very** minimal standard (for example, we classified the manufacturers' investment credit as having output measurement, since it required a 100,000 increase in employment in specified industries). Only 2.0 percent have true outcome evaluation.

# What Criteria Should Be Applied?

- **Clearly articulated goals**. Tax expenditures should have clearly articulated policy goals. If the goal is tax relief, the desirability of a tax expenditure should be measured against lower rates.
- **Cost effectiveness**. The cost per unit of benefit should be evaluated and compared to other means of achieving the same outcome taking into account the fact that many tax expenditures reward taxpayers for doing what they would do in the absence of the provision. The Low Income Housing Tax Credit, for example, produces $0.50 - $0.60 of housing for each dollar of tax credit – an overhead percentage that would not be tolerated in an on-budget program. Similarly, the revenue loss for mortgage interest deductions should be evaluated within the context of state housing goals (i.e., should the state subsidize "entry level" or luxury housing).
- **The state's overall policy priorities.** How does the cost of a tax expenditure measure up against competing budget and tax priorities? Our study of economic development programs, for example, found that 72 percent of the cost of tax expenditures went to general business relief versus 17 percent for promoting research and technology and 0.2 percent for developing a skilled workforce.

# What Should Be Done?

- **Collect data needed for evaluation.** At this point, the basic information needed to evaluate whether tax expenditures are effective does not exist. For example, since the state does not collect employment information for firms that claim business tax credits, there is no way of knowing whether the firms that claim tax credits are increasing or decreasing employment or the quality of jobs they provide.
- **Require periodic review and evaluation**. Data collected through the prior recommendation should be used to evaluate the effectiveness of tax expenditures. Several years ago, for example, a study of the recycling equipment tax credit disclosed the fact that most of the businesses claiming the credit were unaware of its existence at the time they made the investment qualifying for the credit. This information was critical in the Legislature's decision to let the credit sunset.
- **Require sunset dates.** Because of the 2/3 vote requirement for provisions that increase state taxes, sunset dates are essential for ensuring that review actually works to eliminate ineffective tax expenditures.

**Ray Rossi**
**Director, External Tax Affairs**
**Intel Corporation**

# TAX EXPENDITURES HEARING – 1/8/2002

**Do tax expenditures work? What rulers should we use to measure effectiveness?**

- **Measurement against what?**

  **Normative Tax System – determined:**

  **Objectively?**

  **Theoretically "pure" system**

  **Subjectively?**

  **Our "pure" system**

  **By predominant characteristics in other, comparable systems (i.e., the majority of states)?**

- **Measurement of which items?**

  **Credits/Deductions?**

  **What about clear-reflection-of-income items, such as net operating loss carryovers?**

  **What about policy items, such as the non-taxation of manufacturing inputs through sales tax exemptions?**

- **Measurement over what time period?**

  **Yearly or longer-term impact?**

- **Measurement by what standard?**

  **Gross or net cost?**

  **Inter-related provisions**

  **Behavioral effects**

  **Static or dynamic cost (just the "buck" or the "bang" for it too)?**

  **Measurement of revenue "but for" the provision difficult, especially for stimulus provisions**

- **Because of the above questions, among others, the federal government (as indicated by the Treasury Dept. in its most recent Tax Expenditures Report) has challenged the viability, and value, of tax expenditure lists. In April, the Administration stated that it believes the concept of a tax expenditure is of questionable analytical value. Seventeen states currently do not produce tax expenditure lists.**

- **It is important to have visibility of the effects of tax policy, but limitations on the disclosure of tax return information must also be respected – data should only be reported on an aggregate basis.**

- **If the most productive measure of tax expenditures is their cost versus their benefits, to-date the state has not achieved maximum success – historically, the state has typically acted only in economic down-turns (the very time it has the most difficulty funding the provisions) and also too late to "cushion" the down-turn. The most effective tax expenditures are those given the time needed to produce the intended effects of job creation and economic growth.**

Assembly
California Legislature

STAFF
KIMBERLY MITCHELL BOTT
CHIEF CONSULTANT
EILEEN A ROUSH
SENIOR CONSULTANT
IRENE FRAUSTO
COMMITTEE SECRETARY
STATE CAPITOL
P.O. BOX 942849
SACRAMENTO, CA 94249-0114
(916) 319-2098

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
ELLEN M. CORBETT, CHAIR
EIGHTEENTH ASSEMBLY DISTRICT

# REVIEW OF TAX EXPENDITURES

## Public Testimony
## Submitted to Committee

Tuesday, January 8, 2002
State Capitol, Room 126
Sacramento, California

# Tax Reform 2000
United Californians for Tax Reform

Eileen Roush
Senior Consultant
Assembly Revenue and Taxation Committee
Capitol Bldg. # 4121
Sacramento CA 95814
Jan 7, 2001
Subject: Review of Tax Expenditures

Dear Ms Roush; In examining The Tax Expenditure Report for the Year 2001-2002 Prepared by the Department of Finance We have found a number of errors and omissions in Table 3 page 10 which should be addressed before any legislation is contemplated. for example:

CORRECTIONS AND COMMENTS
1 The Home mortgage interest deduction is overstated by 250% A more accurate figure would be $1,410 million rather than the $3,200 million depicted in table 3. This Error is hard to explain considering that an independent analysis verifies the accuracy of the cost of the real estate and other tax deductions, as well as the contributions to self employed retirement plans and to IRA's. The exemption Credit for Senior Citizens also seems accurate.

2 While the direct cost of Defined Contribution Pension plans are accurate, their true cost is negligible considering that these plans merely defer taxes, not eliminate them. Today these plans pay out nearly as much as social security and are fully taxable. Any promised increase in revenue from these sources are an illusion and would be unfair to those who save for their retirement years.

3 The Exclusion of Social Security Benefits from taxation by the State of California constitutes a very sizable benefit to our Senior Citizens and may negate the need to continue the senior tax credit.

4 The exclusion of pension contributions can be considered another form of tax deference rather than tax reduction and should be retained especially as concerns defined contribution pension plans.

5 The Exclusion of employer Contributions to health plans can be considered to be a simple evasion of taxation and could be fairly taxed at the average rate of taxation on the personal income of the workers or instead at 1/2 the rate of taxation of business incor ɘ as an approximation of the true revenue loss.

6 The renters credit and the Property tax exemptioı are intended to protect citizens from excessive property tax levies. The people of California through the initiative process has given us all a much more valuable protection in the 1% rate of tax established in prop 13. Additional tax reduction is unnecessary.

OMISSIONS

1 The personal tax credit imposes a loss in revenue of $1100 million. Replacing this credit with an increase in the standard deduction would provide an incentive to simplify taxes for millions of Californians.

2 The child dependent tax credit imposes a loss in revenue of over 900 million. This credit could be replaced with a tax credit for those who place their children in private schools. This change would encourage competition in education while increasing the funding available for public schools. a sizable saving in tax expenditures would result even if the credit were increased to $500 or $1000.

CONCLUSIONS

While the Magnitude of the tax expenditures reported by the Department of finance may be overstated by as much as 50 percent, they present an opportunity to fund major reform and simplification to the California Tax Code. for example;

1 Harmonizing the tax brackets with the federal code. Congress Reserves its highest tax bracket for taxpayers who earn twice the salary of a Congressman ($ 288,000) while the State of California Imposes its top tax bracket at one third the salary of an Assemblyman. Rectifying this obvious injustice without loss in revenue could be achieved by eliminating 4 billion dollars in tax expenditures.

2 Most Californians are prevented from using the 540 2EZ tax form because of unnecessary restrictions carried over from the federal tax code. Removing these restrictions and limiting the tax rate to 2.5% would allow up to 90 percent of our citizens to file on the 540 2EZ Tax Form. This simple one page tax form would require two pages of instructions rather than the 63 pages of unintelligible instructions required by form 540 Long Form. The expected Loss in revenue could be made up by eliminating 600 million dollars in tax expenditures

3 The standard deduction in California is less than 20% of the California minimum wage Yet the congress allows over 40%. Wouldn't it make more sense to establish the standard deduction at 1/2 the minimum wage and pay for the resulting loss in revenue by eliminating 250 to 300 million in tax expenditures?

FINALLY

This is a wonderful opportunity to reform and simplify the tax code by using the elimination of tax expenditures as a funding mechanism. To simply use this opportunity to raise taxes on the overburdened California taxpayer would be a cruel hoax and unworthy of the members of this committee.

Roland Boucher

Roland Boucher, Chairman