LAO
65 YEARS OF SERVICE

February 27, 2008

Informational Hearing on Tax Expenditures

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Senate Revenue and Taxation Committee

Jenny Oropeza, Chair

LAO
65 YEARS OF SERVICE

Tax Expenditures—General Background

☑ ***What Are Tax Expenditures?*** The term tax expenditure programs, or TEPs, refers to various special tax provisions that reduce the amount of revenues the "basic" tax system would otherwise generate in order to provide:

- *Benefits* to certain groups of taxpayers, and/or
- *Incentives* to encourage certain types of behavior and activities.

☑ ***What Types of TEPs Are There?*** Although TEPs can take a number of different forms, the main types involve tax exclusions, exemptions, deductions, credits, special filing statuses, and preferential tax rates.

☑ ***How Many TEPs Exist?*** Determining whether an individual tax provision is a TEP depends on one's definition of the basic tax structure. However, based on our last inventory and using a broad definition:

- California has several hundred TEPs with an estimated 2008-09 value of nearly $50 billion.
- There are more than 80 TEPs relating to income taxes. Of these, Personal Income Tax (PIT) TEPs total over $35 billion, while Corporation Tax (CT) TEPs total over $4 billion (see pages 2 and 3).
- The Sales and Use Tax (SUT) has about 95 TEPs worth over $9 billion (see page 4).
- There also are several dozen TEPs associated with the insurance tax and other state taxes.
- In addition, there are over 70 state-imposed local property tax TEPs not included in the above state totals. Although property taxes are a local revenue source and thus their special provisions do not technically constitute state TEPs, they do impose certain state costs—such as increased state funding for Proposition 98.

LAO
65 YEARS OF SERVICE

Largest PIT Tax Expenditure Programs

Estimated 2008-09
(In Millions)

Program	Type of Provision	State Revenue
Mortgage Interest Expenses	Deduction	$5,695
Employer Contributions to Pension Plans	Exclusion/Exemption	4,905
Employer Contributions to Accident and Health Plans	Exclusion/Exemption	3,690
Basis Step-Up on Inherited Property	Exclusion/Exemption	3,170
Capital Gains on the Sale of a Principal Residence	Exclusion/Exemption	3,683
Social Security and Railroad Retirement Benefits	Exclusion/Exemption	1,735
Dependent Exemption	Credit	1,700
Charitable Contributions	Deduction	1,570
Exclusion of Benefits Provided Under Cafeteria Plans	Exclusion/Exemption	1,470
Real Property Tax Deduction	Deduction	1,262
Exclusion of Proceeds From Life Insurance and Annuity Contracts	Exclusion/Exemption	1,230
Personal Exemption	Exclusion/Exemption	1,150
Standard Deduction	Deduction	1,070
Employee Business and Miscellaneous Expense Deduction	Deduction	845
Head of Household and Qualifying Widower Status	Deduction	710
Individual Retirement Accounts	Exclusion/Exemption	685
Depreciation Amounts Beyond Economic Depreciation	Deduction	585
Self-Employed Retirement Plans	Deduction	460
Exclusion of Miscellaneous Fringe Benefits	Exclusion/Exemption	295
Medical and Dental Expense Deduction	Deduction	290

LAO
65 YEARS OF SERVICE

Largest CT Tax Expenditure Programs

Estimated 2008-09
(In Millions)

Program	Type of Provision	State Revenue
Subchapter S Corporations[a]	Special Filing Status	$1,025
Research and Development Expenses Credit[b]	Credit	955
Water's-Edge Election	Special Filing Status	640
Carryforward of Net Operating Losses	Deduction	792
Activities in Economically Depressed Areas	Credit	290
Double-Weighted Sales Apportionment Formula	Apportionment Rule	181
Tax-Exempt Status for Qualifying Corporations	Exclusion/Exemption	120
Charitable Contributions	Deduction	105
Manufacturers' Investment Tax Credit	Credit	83
Exploration, Development, Research, and Experimental Costs	Deduction	80

a Net effect that takes into account the associated personal income tax revenue increase.

b Accounts for increased deductions that would occur without the credit.

LAO
65 YEARS OF SERVICE

Largest SUT Tax Expenditure Programs

Estimated 2008-09 (In Millions)

Largest SUT Tax Expenditure Programs

Estimated 2008-09
(In Millions)

Type of Exemption	State Revenue Reduction[a]
Food Products[b]	$3,793
Gas, Electricity, Water, and Steam	2,270
Prescription Medicines	1,776
Candy and Snack Foods	338
Animal life, feed, plants, and drugs	323
Farm Equipment and Machinery[c]	120
Fuel Sold to Air Common Carriers	104
Rental of Linen Supplies	73
Lease of Motion Picture and Television Films and Tapes	65
Bottled Water	64
Custom Computer Programs	53
Diesel Fuel Used in Farming and Food Processing[c]	44
Motion Picture Production Services	33
Diesel and Use Fuel Tax	29

a General Fund only.
b Excludes candy and snack foods.
c Partial state exemption.

LAO
65 YEARS OF SERVICE

Previous TEP Reports

☑ ***TEP Reports by the Administration.*** The tax expenditure concept was developed in the late 1960s. Soon thereafter, California appears to have been the first state to have explored the use of tax expenditure information in the budget process. For example:

- In 1971, the Legislature enacted Chapter 1762, which required the Department of Finance (DOF) to publish two general reports on the state's use of TEPs.
- Four years later, in the *1975-76 Governor's Budget*, the department provided the first estimates of the revenue loss from specific tax expenditures.
- Since that time, the department has periodically prepared TEP reports.

☑ ***Major LAO TEP Reports.*** The LAO has done studies on individual TEPs and made recommendations regarding their modification for many years, whether in response to statutory requirements or on its own volition. For example:

- In 1982, we issued a 100-plus page report entitled *Options for Modifying State Tax Expenditure Programs.* It identified 17 options for helping to address the 1982-83 major budget shortfall by eliminating or modifying various TEPs.
- In 1989, in response to ACR 17 (Resolution Chapter 70, Statutes of 1985), we issued an overview report on TEPs and a number of reviews and recommendations regarding individual TEPs. This was followed in 1991 by a detailed compendium of all TEPs identifying their provisions, rationales, economic effects, and revenue impacts.
- In 1999, we issued another comprehensive TEP report, including an updated detailed compendium of all such programs and their characteristics.

LAO
65 YEARS OF SERVICE

Previous TEP Reports *(Continued)*

- We have updated the fiscal effects of all TEP programs twice since then, including identifying new TEPs and their revenue impacts.

☑ ***LAO Reports on Individual TEPs.*** In addition to these comprehensive TEP reports, we have produced many stand-alone studies of individual TEPs, including the manufacturers' investment tax credit, research and development tax credit, enterprise zones, mortgage interest deduction, bunker fuel SUT exemption, accelerated depreciation provisions for cogeneration and alternative energy equipment, and cargo container property tax exemption.

LAO
65 YEARS OF SERVICE

Using TEPs to Achieve Policy Goals

☑ ***Both Pros and Cons Exist.*** There are both advantages and disadvantages to using TEPs versus direct spending to achieve legislative policy goals, depending on a program's objectives, characteristics, and target population.

☑ ***Advantages of TEPs.*** The main advantage of TEPs is that they generally require only limited administrative effort. This is because:

- They work by enabling individuals and businesses to simply pay fewer taxes than otherwise.
- Thus, there is no need to hire people and maintain equipment and facilities to operate and oversee programs and pay out funds.

☑ ***Disadvantages of TEPs.*** The negative aspects of TEPs compared to direct expenditure programs include a weakening of legislative oversight and budgetary control. For example:

- ***Limited Legislative Review.*** Once a TEP is established, resources are allocated to the program automatically each year, generally without further legislative review.
- ***Little Spending Control.*** Because program funding does not have to be annually appropriated through the budget process, there is normally no limit or control over the amount of money spent.
- ***Enforcement Problems.*** Although TEPs have lower direct administrative costs and are fairly unintrusive, they also often present serious enforcement problems. The TEPs offer many opportunities for tax evasion, especially given the relatively low level of tax auditing the state undertakes.

LAO
65 YEARS OF SERVICE

Using TEPs to Achieve Policy Goals *(Continued)*

- ***Vote Requirement.*** The TEPs only require a majority vote to establish but a two-thirds vote to be scaled back or eliminated if found to be ineffective or cost-inefficient—just the opposite of direct expenditure programs.
- ***Targeting Problems.*** It is often more difficult to effectively target TEPs to desired beneficiaries than direct expenditure programs. As a result, TEPs often experience large "windfall benefits" from compensating individuals and businesses for actions they would undertake anyway.

☑ ***Bottom Line—TEPs Should Be Used Cautiously.*** Given the above, it is important that TEPs be used cautiously, structured carefully, and reviewed regularly to ensure that they operate in an effective and cost-efficient manner.

LAO
65 YEARS OF SERVICE

Tax Reform Options, Including Dealing With Volatility

☑ ***The Key Question—What Needs to Be Fixed?*** In considering tax reform, the place to start is to identify the features of a good tax system, highlight the shortcomings in the current system, and then take steps to address the problem areas.

☑ ***What Characteristics Should a Good Tax System Have?*** Among other things, a good tax system should be:

- ***Broad Based With Low Rates.*** This enables the funding of public services to be shared and spread widely across different types of economic activity and different taxpayers.
- ***Diversified.*** This protects the revenue base from being overly dependent on the health of a limited number of industries or income sources.
- ***Economically Neutral.*** This ensures that the tax system does not unduly distort economic decision making.
- ***Able to Grow With the Economy.*** This allows the revenue base to fund the additional public goods and services over time as demographic and economic growth requires.
- ***Not Overly Volatile.*** This permits the funding for public services to be sufficiently stable and predictable.

☑ ***How Does California Currently Score?*** The performance of the state's current tax system is mixed—it scores relatively well in some areas but not so well in others. For example:

- ***Positives.*** It is highly diversified, fairly broad based, and grows in line with the economy.
- ***Negatives.*** On the other hand, it is vulnerable to volatility, due to its relatively heavy reliance on high-income taxpayers and such income sources as capital gains and stock options. Its tax base also has not fully evolved with the economy, especially the strong growth in the services sector and the increased use of remote transactions like the Internet.

LAO
65 YEARS OF SERVICE

Tax Reform Options, Including Dealing With Volatility *(Continued)*

☑ ***So, What Reform Ideas Come to Mind?*** A number of things could be considered. For example:

- Base broadening could be applied in many areas—including the PIT, SUT, and CT—by the elimination or modification of ineffective and inefficient tax expenditures. Some examples are the 12 TEPs we have suggested for modification or elimination in our alternative budget proposal (see following page).
- Telecommunications has been a rapidly growing industry but its taxes are largely based on an industry structure that no longer exists, suggesting a need for reform.
- To the extent fluctuations in revenues related to capital gains and stock options are of concern, these could be addressed by various means. For example, partial exemptions, reduced tax rates, or income averaging over a multiyear period could be considered.

LAO
65 YEARS OF SERVICE

Summary of LAO Revenue-Increasing Proposals

(In Millions)

	Revenue Gain	
	2008-09	**2009-10**
Proposals Unique to Personal Income Tax		
Reduce dependent credit	$1,330	$1,070
Eliminate senior credit	125	130
Eliminate partial exclusion of capital gains on small business stock	55	55
Subtotals	($1,510)	($1,255)
Proposals Applying to Both Personal Income and Corporation Tax		
Limit the research and development credit	$335	$290
Limit net operating loss deductions	330	410
Phase out enterprise zone programs	100	120
Eliminate exclusion for "like-kind" out-of-state property exchanges	25	50
Subtotals	($790)	($870)
Unique Sales and Use Tax Proposals		
Eliminate exemptions for industry-specific equipment	$143	$146
Eliminate certain diesel fuel exemptions	73	75
Eliminate exemption for leasing of films and tapes	65	70
Eliminate exemption for custom computer programs	53	48
Adopt one-year standard regarding use tax on out-of-state purchases	21	21
Subtotals	($355)	($360)
Totals	**$2,655**	**$2,485**

- We believe that TEPs should be evaluated using the same approach as for direct expenditure programs—namely, asking whether they are achieving their stated purposes in an effective and cost-efficient manner, or are of low priority.
- Many TEPs merit attention from this perspective.
- In our alternative budget, we propose 12 specific TEP changes that we believe should be considered to help address the budget problem.

LAO
65 YEARS OF SERVICE

Static Versus Dynamic Revenue Estimates

☑ ***What Distinguishes Dynamic Analysis From Static Analysis?*** The main difference is that:

- Dynamic revenue analysis attempts to take into account both the *direct behavioral effects* and the *broader economic feedback effects* of tax law changes on the amount of revenues collected.
- In contrast, static analysis does not attempt to measure these dynamic effects. Rather, it assumes that such things as the size of the tax base, and spending and other decisions by individuals and businesses, are unaffected by tax law changes.

☑ ***Good in Theory, Hard in Practice.*** In theory, revenue estimates should incorporate all dynamic effects in order to accurately measure how actual tax collections will be affected by law changes. In practice, however, a number of factors make this a challenge. For example:

- ***Accurately Modeling Dynamic Effects Is Inherently Difficult.*** This in part is due to data limitations and lack of knowledge about exactly how taxpayers behave.
- ***The Way That Tax Changes Are Financed Matters.*** For example, does a tax reduction result in lower governmental services of some sort or involve backfilling lost revenues from another source? The dynamic effect on revenues is affected by the specific answer.
- ***Dynamic Effects Can Be Very Complicated.*** They can involve a wide range of considerations from spending and investment decisions, to interstate migration flows, to decisions about working. In addition, the timing of dynamic effects can be hard to pinpoint.

Given these and other issues, questions have been raised about the reliability of dynamic estimates, whether or not they should be used in budgetary calculations, and whether they make sense from a cost-benefit perspective.

LAO
65 YEARS OF SERVICE

Static Versus Dynamic Revenue Estimates *(Continued)*

☑ ***Where Does California Stand Regarding Dynamic Analysis?***

- California had a dynamic revenue estimating requirement in place for DOF from 1994 through 2000 under Chapter 393, Statutes of 1994 (SB 1893, Campbell).
- The state worked with University of California economists to construct a large economic model capable of looking at dynamic effects, and DOF was given resources to provide information on dynamic effects in its analyses of tax bills and proposals.
- Despite not routinely doing full-blown dynamic analysis for tax measures, current revenue estimates for tax bills do often incorporate significant assumptions about the direct behavioral responses of taxpayers affected. As one example, proposals to increase cigarette taxes incorporate research results about how higher cigarette prices reduce consumption.