✦ TABLE OF CONTENTS

✦ INTRODUCTION

This two-part report on tax expenditure programs (TEPs) is the fourth in a series of such reports produced by the Legislative Analyst's Office. The initial reports were prepared in response to Resolution Chapter 70, Statutes of 1985 (ACR 17, Bates). Tax expenditure programs, as defined by ACR 17, include various tax exemptions, exclusions, deductions, credits, and other special tax provisions which affect the amount of revenues collected through the state's tax system. The term "tax expenditure" generally has been used to define programs which result in exceptions to the "basic" tax structure of the state. As we discuss this part of this report, considerable differences of opinion exist regarding the definition of the term basic tax structure, and thus, what constitutes an exception to this base.

WHY REVIEWING TEPS IS IMPORTANT

A periodic review of *tax* expenditure programs is important because, like *direct* expenditure programs, they constitute a commitment of resources. Direct expenditure programs are reviewed and funded during the course of the annual state budget process. However, the same process does not generally occur in the case of TEPs. Tax expenditure programs are different from direct expenditure programs in that they are provided through the tax system and their costs are funded from the reduction in state or local revenues stemming from their provisions, as opposed to through direct appropriations.

Other than the manner in which the two types of programs are put into effect, TEPs are similar to direct expenditure programs in that they convey benefits to individuals and businesses. Yet, they are not typically subject to an annual programmatic or funding review process. As a consequence, it is important that TEPs be periodically reviewed through reports such as this or other processes, to ensure that they are effective and merit continued financial support from the taxpayers at large. The underlying objective of this report is to provide information that can assist the Legislature in reviewing TEPs from both a budgetary and tax policy perspective, including analyzing the appropriateness and effectiveness of various TEPs.

CONTENTS OF THE REPORT

This report analyzes TEPs associated with the state's major sources of revenue—the personal income tax (PIT), bank and corporation taxes (BCT), sales and use taxes, and certain other state taxes. We also discuss TEPs associated with property taxes, largely because this is a tax over which the state exercises a large amount of control through its policy decisions.

The report is divided into two parts. This part, entitled *California's Tax Expenditure Programs: Overview*, provides an overview of TEPs in the context of the state's overall tax system. This overview consists of:

- A discussion regarding alternative definitions of the tax base and how these relate to the notion of tax expenditures.

- A review of issues associated with the revenue estimation process for TEPs.
- A brief overview of the issue of tax incidence, including a discussion of the distributional impacts associated with taxes and TEPs.
- An identification of TEPs with a significant fiscal impact, along with estimates of revenue reductions from both these programs individually and TEPs in the aggregate, by general tax type.
- An identification of recently enacted and recently eliminated TEPs along with their estimated revenue effects.
- A discussion of the use of TEPs as a policy tool and the effectiveness of tax expenditure reporting from a budgetary perspective.

Part Two of the report, published as a separate document and entitled *California's Tax Expenditure Programs: Compendium of Individual Programs*, presents an overview of each type of tax and detailed descriptions and commentary regarding individual TEPs, by program type. For each program, the following information is provided:

- ***Legal Authorization.*** In most cases, the legal citation provided references the California Revenue and Taxation Code. There are some cases however, where program authorization is given by the California Constitution or other state code sections. For those income tax programs that conform partially or fully to federal law, the appropriate Internal Revenue Code Section is noted.
- ***Revenue Effect.*** Estimates of the fiscal effect of each program, measured by the foregone tax revenues associated with it, are provided for 1996-97 through 1998-99. These estimates were developed by the state's two major tax agencies—the California Franchise Tax Board (FTB), for income taxes, and the State Board of Equalization (BOE), for all other taxes.
- ***Description***. A description of each TEP's basic provisions, and conditions under which they are applicable, is provided. A sunset date is provided if the program's authorization contains such a provision.
- ***Rationale.*** In most cases, the rationale for a TEP can be categorized as a tax incentive to encourage certain behavior and/or as tax relief to certain groups or individuals. Also, in certain cases, TEPs may facilitate effective and efficient tax administration. For each TEP, the rationale provided represents our attempt to identify the apparent logic or motivation behind the program's establishment and/or continuation. This rationale should not be viewed, however, as necessarily providing evidence as to a program's cost-effectiveness or value to the public.
- ***Distributional Effects.*** For a limited number of TEPs relating to PIT and BCT, we present information regarding the distribution of program benefits by income class (for PIT), or size of firm and type of industry (for BCT).
- ***Comments.*** For many TEPs, we provide comments that may assist the Legislature or other readers in understanding a program's application or impact. These comments may relate, for example, to the TEP's legal history, its relationship to comparable federal programs, or empirical findings regarding the effectiveness of the TEP.

At the end of Part Two, we provide an index that cross-references by general subject area the TEPs contained in the report, in order to assist readers in locating those programs that might be of particular interest or concern to them.

ACKNOWLEDGMENTS

The principal author of this report was Mark A. Ibele. Michael Cohen was responsible for the section dealing with property taxes. The report's preparation was overseen by David Vasché. We gratefully acknowledge the assistance of the FTB, the BOE, and the California Department of Finance in providing various background information and fiscal data used in the report.

✦ OVERVIEW OF TAX EXPENDITURE PROGRAMS

This part of the report provides an overview of California's tax expenditure programs (TEPs). Specifically, in this part we:

- Discuss alternative definitions of "tax expenditures," and how the definition used affects the calculation of the overall tax expenditure budget.
- Address measurement issues associated with the estimation of the fiscal impacts of TEPs.
- Discuss TEP-related issues involving tax incidence—that is, who initially and ultimately bears the burden of taxes and realizes the benefits of TEPs.
- Provide available estimates of the size of the largest TEPs by type of tax, and identify recently enacted and eliminated TEPs.
- Discuss the use of TEPs as a tax policy tool, and evaluate the effectiveness and implications of tax expenditure reporting.

WHAT ARE TAX EXPENDITURES?

Tax expenditures generally are defined as tax provisions—such as exemptions, exclusions, deductions, credits, deferrals, and preferential tax rates—which deviate from the "basic" tax structure and result in a reduction in government revenues. Tax expenditure programs can provide benefits to individuals and businesses just as direct governmental expenditure programs, except that TEPs are paid for by reduced tax collections rather than through the Legislature's annual direct appropriations process.

Given this general definition, TEPs have meaning only within the context of the "basic" tax structure. The definition of the basic tax structure is, in fact, fundamental to the process of identifying and measuring TEPs. It also, however, can be and often is a source of considerable disagreement among economists, public policy analysts, and policy makers themselves. These disagreements largely revolve around what provisions should be included in the definition of the basic tax structure and, as a consequence, whether or not individual tax provisions are actually TEPs or simply part of the tax base. Put simply—what may be a "tax break" to one person may simply be part of the basic tax structure to another, and vice versa. Given that the state's tax code contains literally hundreds of individual provisions, disagreements about defining TEPs are commonplace and to be expected.

The appropriateness of classifying a specific tax provision as a TEP is most commonly called into question when it is broadly available to all taxpayers and benefits most everyone in some fashion. The standard deduction is such an example. In contrast, consensus is more common regarding tax provisions that apply to only a limited number of taxpayers in special circumstances. Certain targeted tax credits, such as the credit for research and development expenses, would fall into this more narrow category.

In recognition of the fact that individual legislators have differing views about which tax provisions should be included as part of the basic tax structure versus which are TEPs, this report takes a comprehensive view in terms of the scope of the information that is presented. Thus, it includes those programs which provide benefits on a broad basis to taxpayers as well as those programs available to only a select group of taxpayers. The report thereby ensures that the Legislature will have at its disposal TEP-related information that will accommodate the differing views of all of its members. This comprehensive approach should help facilitate the review, discussion, and policy decisions regarding any and all individual tax provisions.

MEASURING THE REVENUE EFFECTS OF TAX EXPENDITURES

In order to gauge the overall fiscal effect of TEPs on government, the impact of individual TEPs must be calculated. Assessing the exact revenue effects associated with individual TEPs, however, is difficult. This is because these effects generally are not *directly* measurable, since these programs are funded through uncollected tax revenues, not through the legislative appropriations process. Therefore, *estimates* of their fiscal effects must be made using whatever information is available. There are several key problems often encountered when making such estimates.

Data Limitations. If information on certain types of transactions is not required to be reported on tax forms (such as is the case for personal income tax exclusions and certain exemptions), there may not be a reliable source of data available on them. Often, estimators will try to overcome these limitations by collecting data through taxpayer surveys, special studies, or industry sources. However, these approaches often have inherent limitations. For example, experience has shown very mixed results in terms of the willingness of taxpayers to voluntarily participate in surveys, and the statistical reliability of the results obtained often proves unsatisfactory or difficult to assess. In other cases, where comparable federal-level data are available, attempts are made by estimators to "scale" these data to apply to California. This approach presents its own set of issues and problems regarding exactly what adjustments are necessary to ensure that valid estimates result.

Taxpayer Behavioral Effects. Most estimates of TEPs do not account for any changes in taxpayer behavior that have resulted from the TEP, and thus, that likewise may emerge from its alteration or elimination. This is partly because much is unknown about these behavioral effects. Nevertheless, these "dynamic" or "indirect" effects can have significant impacts on state revenues. For example, if the sales tax exemption on food were repealed, this action initially would work to raise food prices and cause various changes in food-related consumption decisions. This, in turn, could affect the consumption of other goods and services. The latter behavioral change could reduce expenditures and sales tax revenues associated with nonfood items and, thus, partially offset the direct revenue increase from eliminating the food-related TEP.

Similarly, certain TEP income tax credits and deductions, such as the manufacturers' investment credit, may lead to economic activity that otherwise would not have occurred. Thus, while eliminating such a program would lead to *direct* revenue gains, it also could *indirectly* lead to revenue losses stemming from reduced investments that would serve to partially offset the direct revenue gains.

As these examples illustrate, direct revenue estimates can overstate the amount of revenue gain associated with restricting or eliminating TEPs.

Program Interactions. To provide a sense of the overall revenue effect of TEPs, individual TEP estimates often are added together (as they are done below) to arrive at a total aggregate figure. Such an exercise provides a useful order of magnitude of the effect of TEPs. However, it is important to be aware that this aggregate figure may either overestimate or underestimate the actual revenue effect from eliminating these TEPs, because TEPs often *interact* with each other. For example, if certain itemized deductions were eliminated, some taxpayers would fall into higher tax brackets. This would leave them with higher tax liabilities and make them eligible for claiming certain unused tax credits. Thus, the *actual* state revenue increase from eliminating the itemized deductions would be *lower* than the direct estimate.

As a result of these and various other factors, even the best estimates of the revenue effects of TEPs will be imprecise. In certain instances, in fact, the actual revenue losses may differ by a significant margin from the estimates due to data difficulties. Nevertheless, the estimates presented in this report provide a fairly reliable indicator of the *general order of magnitude* of the revenue impact of TEPs, and thus can assist the Legislature in its decision making.

DISTRIBUTIONAL ISSUES AND TAX INCIDENCE

In the compendium presented in Part Two of this report (published as a separate volume), estimates are provided of the distributional effects of TEP-related benefits for certain large income tax programs. For PIT programs, the distributional data include one or more of the following: (1) the distribution of TEP benefits in dollar amounts by income class; (2) the distribution by income class of the number of taxpayers actually claiming (and receiving) the special tax treatment; and (3) the average dollar benefit for taxpayers in each income class. For BCT programs, the selected distributional information includes TEP benefits based on corporate gross receipts and / or the type of industry sector in which the corporation falls.

It should be noted that the distributional information presented in the report reflects only the *initial impact* of a tax expenditure's benefits. In the tax policy area, this initial impact is known as "statutory incidence." Statutory incidence is defined as falling on the party who is ultimately responsible for *paying* the tax. Thus, the statutory incidence of the personal income tax is attributed to such parties as the wage earners and owners of income-producing assets that file the tax returns on which such income is reported.

Statutory incidence, however, provides only a partial view of the distributional impacts of taxes and tax expenditures. In many cases, the actual ultimate *burden* of a tax or the ultimate *benefit* of a tax expenditure is shared among various economic parties. Where the tax burden or tax expenditure benefit ultimately rests is known as its *economic incidence*. The process by which the burden of a tax or the benefit of a TEP moves from its initial statutory form to its ultimate economic incidence is called *tax shifting*. This economic incidence depends primarily on the type of tax involved, the supply and demand characteristics of the market involved, and the time period allowed for adjustments to occur.

For example, in the case of taxes on wage and salary income, these are *initially paid* by employees. Because of the characteristics of labor supply, the weight of the economic evidence suggests that their *ultimate incidence* is also largely born by employees. On the other hand, although the BCT is *initially paid* by corporations, its *ultimate incidence* is shared to varying degrees by corporate stockholders, consumers, and employees.

The economic incidence of TEPs occurs in a manner similar to that of taxes themselves. Thus, although the distributional information appearing in the compendium provides interesting insights as to the beneficiaries of TEPs, it is important to remember that their ultimate beneficiaries can include parties other than the taxpayers themselves.

REVENUE EFFECTS OF TEPS

This section provides estimates of the size and composition of the state's tax expenditure budget. Also included is information on TEPs that were repealed or sunsetted after 1990, as well as new ones that have been enacted.

The Overall Number and Dollar Magnitude of TEPs. This report identifies a total of 278 TEPs, including (1) 82 income tax (PIT and BCT) TEPs, (2) 95 sales and use tax TEPs, (3) 28 other state tax TEPs, and (4) 73 property tax TEPs. We have included the property tax and the local portion of the sales and use tax in our report because, although these TEPs primarily involve a local government revenue source, they are state-established. As such, the state may end up funding some of them either through subventions to local governments or payments under Proposition 98. Given this, they can directly impose a fiscal cost on the state. Many local governments also have their *own* TEPs, which are *not* included in this report.

Each of the 278 TEPs we have identified are discussed separately in Part Two of this report. The state's two tax agencies—the Franchise Tax Board (FTB) and the Board of Equalization (BOE)—provided the estimated revenue effects for the TEPs described below. Figure 1 summarizes these data, providing an estimate of the total revenue reduction from state-level TEPs and state-controlled local TEPs, where estimates are available.

As Figure 1 shows, with respect to those TEPs for which estimates are available, total TEPs are estimated to result in a revenue reduction of approximately $32.6 billion. State-level TEPs comprise 83 percent of this amount, totaling approximately $27.1 billion. The revenue reduction associated with state-controlled local TEPs is approximately $5.5 billion, or approximately 17 percent of total state and local TEPs. These estimates provide a sense of the magnitude of the total revenue reduction associated with all of the state and state-controlled local TEPs we have identified.

Figure 1

Identifiable TEP Revenue Reductions

1998-99
(Dollars in Millions)

Tax Program	Total Tax Revenue Collected[a]	TEP Revenue Reductions: Amount	TEP Revenue Reductions: As Percent of Tax
State Programs			
Personal Income Tax	$28,526	$17,821	62.5%
Bank and Corporation Tax	5,926	3,178	53.6
Sales and Use Tax[b]	22,554	5,965	26.4
Other State Taxes	16,290	125	0.8
Subtotals	$73,296	$27,089	37.0%
State-Controlled Local Programs			
Property Tax	$20,400	$3,666	18.0%
Sales and Use Tax[c]	7,105	1,879	26.4
Subtotals	$27,505	$5,545	20.2%

a *1999-00 Governor's Budget* and Board of Equalization.
b Includes tax rates of 5 percent General Fund, 0.5 percent Local Public Safety Fund, and 0.5 percent Local Revenue Fund.
c Based on weighted-average local tax rate of 1.89 percent.

It should be noted that many of the programs for which descriptions are provided in Part Two of this report do not have fiscal estimates available; therefore, the *actual* total revenue effect of all TEPs is unknown. Since some of the TEPs for which no fiscal estimates are available are considered to be major programs, it is likely that the total revenue effect shown here of all TEPs is a substantial understatement.

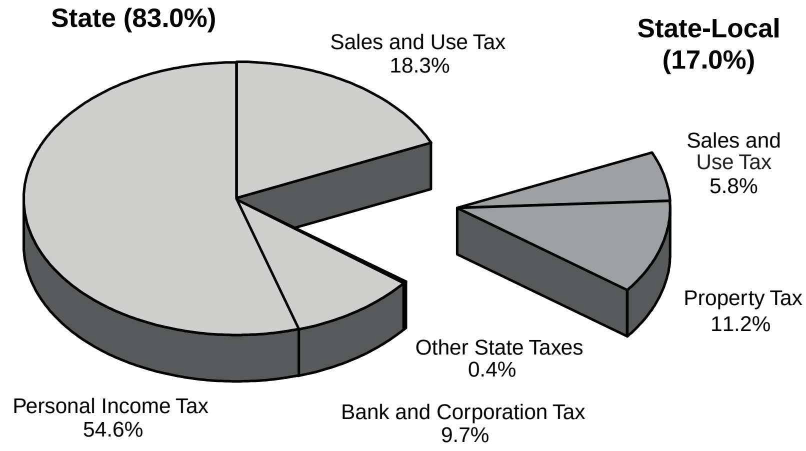
The Magnitude of TEP Revenue Effects, by Tax. Figure 2 shows the percentage distribution of TEPs, by type of tax. The figure shows that state personal income tax TEPs comprise almost 55 percent of total estimated state and state-controlled local tax expenditures in 1998-99, or $17.8 billion.

The next largest program category is the state sales and use tax, with a TEP revenue reduction of nearly $6 billion, constituting approximately 18 percent of total TEPs. This is followed by (1) property tax TEPs, which result in an estimated revenue reduction of $3.7 billion, constituting over 11 percent of all TEPs, and (2) bank and corporation tax TEPs of $3.2 billion, representing nearly 10 percent of total TEPs. Local sales and use tax TEPs account for approximately $1.9 billion or 6 percent of the total.

Figure 2

Indentifiable TEP Revenue Reductions

1998-99



MAJOR INDIVIDUAL TEPS

In Figure 3 through Figure 7, estimated revenue effects are provided for the largest individual TEPs in each tax area. The TEPs included on these lists are those for which estimates are available. There are numerous programs with significant fiscal effects which are not included because their estimates are currently unavailable.

Personal Income Tax TEPs. Figure 3 lists major PIT TEPs with revenue reductions estimated at $50 million or greater. These 27 TEPs result in an estimated revenue reduction of over $17.7 billion, which is over 99 percent of the total cost of all identifiable PIT TEPs. The deduction for home mortgage interest expenses is the largest PIT TEP, with an estimated cost of about $3 billion. The next two largest PIT TEPs are exemptions associated with employer contributions to employee pensions ($2.6 billion) and to health plans ($1.9 billion).

Sales and Use Tax TEPs. Figure 4 provides a list of those sales and use tax TEPs with estimated revenue reductions of $10 million or more. The 18 TEPs listed have an estimated state and local revenue cost of $7.8 billion, comprising over 99 percent of the total estimated state and local revenue cost of sales and use tax TEPs. The two largest sales and use tax TEPs are the exemptions for gas, electricity, water, steam, and heat ($3.3 billion), and food products ($2.7 billion). These two programs are among the state's three largest TEPs, and represent about three-fourths of the total estimated revenue reduction from sales and use tax TEPs. The revenue reduction figures shown break out the portion attributable to the state and that attributable to local governments. It should be noted that the revenue reduction figures reported in Part Two of this report reflect the combined state-local effect.

Figure 3

Personal Income Tax—TEP Revenue Reductions[a]

1998-99
(In Millions)

Tax Expenditure Program	Type of Provision	Revenue Reduction
Mortgage Interest Expenses	Deduction	$3,030
Employer Contributions to Pension Plans	Exclusion/Exemption	2,610
Employer Contributions to Accident and Health Plans	Exclusion/Exemption	1,910
Dependent Exemption	Credit	1,356
Standard Deduction	Deduction	950
Personal Exemption	Credit	860
Social Security and Railroad Retirement Benefits	Exclusion/Exemption	850
Charitable Contributions	Deduction	810
Capital Gains on the Sale of a Principal Residence	Exclusion/Exemption	750
Proceeds from Life Insurance and Annuity Contracts	Exclusion/Exemption	730
Certain Taxes Paid	Deduction	706
Capital Gains on Inherited Property	Exclusion/Exemption	650
Employee Business and Miscellaneous Expenses	Deduction	450
Interest on Government Debt Obligations	Exclusion/Exemption	380
Depreciation in Excess of Straight Line	Deduction	305
Benefits Provided Under Cafeteria Plans	Exclusion/Exemption	220
Miscellaneous Fringe Benefits	Exclusion/Exemption	210
Contributions to Self-Employed Retirement Plans	Adjustment	170
Compensation for Injuries or Sickness	Exclusion/Exemption	140
Renters' Credit	Credit	133
Medical and Dental Expenses	Deduction	120
Carryforward of Net Operating Losses	Deduction	90
Senior Exemption	Credit	87
Employer Contributions to Life Insurance	Exclusion/Exemption	65
Contributions to Individual Retirement Accounts	Adjustment	62
Unemployment Insurance Benefits	Exclusion/Exemption	53
Health Insurance Premiums	Adjustment	50
Total		**$17,747**

[a] Programs with identifiable revenue reduction of $50 million or greater.

Figure 4

Sales and Use Tax—TEP Revenue Reductions[a]

1998-99
(In Millions)

Tax Expenditure Program	Type of Provision	Revenue Reduction State[b]	Revenue Reduction Local[c]	Revenue Reduction Total
Gas, Electricity, Water, Steam, and Heat	Energy	$2,482	$782	$3,264
Food Products	Food	2,052	646	2,698
Prescription Medicines	Medical	539	170	709
Custom Computer Programs	Business	210	66	276
Candy, Gum, and Confectionery Products	Food	165	52	217
Animal Feed	Food	157	50	207
Bottled Water	Food	71	22	93
Free Newspapers and Periodicals	Business	56	18	74
Qualified Fertilizer	Food	40	12	52
Animal Life	Food	36	11	47
Leases of Specified Linens	Business	33	11	44
Leases of Motion Pictures	Business	24	8	32
Seeds and Plants	Food	23	7	30
Used Mobilehomes	Housing	18	6	24
Fuel Sold to Common Carriers for International Flights	Business	15	5	20
Fuel Used in Water Common Carriers	Business	14	4	18
Aircraft Repair and Related Equipment	Business	12	4	16
Property Used in Space Flights	Business	9	3	12
Totals		**$5,957**	**$1,876**	**$7,833**

a Programs with identifiable revenue reduction of $10 million or greater.
b Based on statewide tax rate of 6 percent.
c Based on weighted-average local tax rate of 1.89 percent.

Bank and Corporation Tax TEPs. Figure 5 shows those BCT TEPs with an estimated revenue reduction of $10 million or more. Most of these programs were established since the Federal Tax Reform Act of 1986 (many provisions to which California conformed). The figure shows that these 13 TEPs have an estimated revenue reduction of approximately $3.2 billion, which is over 99 percent of total BCT TEPs.

The largest BCT TEPs include special treatment of income from Subchapter S corporations ($1.2 billion), the manufacturers' investment credit ($390 million), the carryforward of net operating losses ($375 million), and the "water's-edge" treatment of income from multinational corporations ($355 million). It should be noted, however, that other programs for which revenue estimates are not available, such as accelerated depreciation for certain equipment, may be larger in magnitude than those listed in the figure.

Other State-Level TEPs. Figure 6 provides a list of the largest TEPs that are associated with other state taxes, including cigarette taxes and motor vehicle fuel taxes. The revenue reductions for these TEPs total an estimated $123 million, which is over 99 percent of the total identifiable revenue reductions for this TEP category.

Figure 5

Bank and Corporation Tax—TEP Revenue Reductions[a]

1998-99
(In Millions)

Tax Expenditure Program	Type of Provision	Revenue Reduction
Subchapter S Corporations	Special Filing Status	$1,235
Manufacturers' Investment Tax Credit	Credit	390
Carryforward of Net Operating Losses	Deduction	375
Water's-Edge Election	Exclusion/Exemption	355
Increased Research and Development Expenses	Credit	350
Activities in Economically-Depressed Areas	Credit	114
Tax-Exempt Status for Qualifying Corporations	Exclusion/Exemption	99
Exploration, Development, Research, and Experimental Costs	Deduction	93
Charitable Contributions	Deduction	41
Proceeds From Life Insurance and Annuity Contracts	Exclusion/Exemption	36
Percentage Resource Depletion Allowance	Deduction	30
Low-Income Rental Housing Expenses	Credit	24
Credit Union Treatment	Exclusion/Exemption	13
Total		**$3,155**

[a] Programs with identifiable revenue reduction of $10 million or greater.

Figure 6

Other State Taxes—TEP Revenue Reductions[a]

1998-99
(In Millions)

Tax Expenditure Program	Type of Tax	Revenue Reduction
Fuel For Common Carriers and the Military	Fuel	$80
Fuel For Local Transit and School Bus Operators	Fuel	22
Various Distributions of Tobacco Products[b]	Tobacco	21
Total		**$123**

[a] Programs with identifiable revenue reduction of $10 million or greater.
[b] Includes (1) Distributions of tobacco products to U.S. Armed Forces, the U.S. Department of Veteran Affairs, and veterans' institutions.

Property Tax TEPs. Figure 7 lists those property tax TEPs with revenue reductions of $10 million and over. The figure provides estimates for 11 programs, totaling over $3.6 billion, which is approximately 99 percent of the total estimate for all property tax TEPs.

The most significant of these property tax TEPs include the business inventory exemption ($1.9 billion), the household furnishings exemption ($500 million), the exemption for property used exclusively for charitable purposes ($415 million), and the homeowners' partial property tax exemption ($362 million). The estimated revenue reduction amounts shown in Figure 7 and reported in Part Two of this Report are based on the statewide 1 percent tax levy provided for under Proposition 13.

Although property taxes primarily are a local revenue source—and therefore legislatively enacted exemptions and preferential treatments under this tax do not technically constitute state TEPs—they *do* impose certain state costs. For example, property tax TEPs reduce local property tax allocations to schools, and the state is required under current law to replace such revenues lost to schools with increased school apportionments. The state also provides subventions to various other local government entities to compensate them for revenue losses from certain state-imposed TEPs, such as the property tax exemption for homeowners. It is for these reasons that we have included property tax TEPs in this report. We do not separately identify the state costs from these TEPs in our report, however, because those show up as payments to local governments in the state's direct expenditure budget.

Figure 7

Property Tax—TEP Revenue Reductions[a]

1998-99
(In Millions)

Tax Expenditure Program	Area of Application	Revenue Reduction
Business Inventories	Business	$1,940
Household Furnishings	Individual	500
Hospital, Educational, Museum, Scientific, or Charitable Purposes (“Welfare Exemption”)	Non-Profit	415
Homeowners' Exemption	Individual	362
Computer Programs	Business	100
Open-Space Contracts (“Williamson Act”)	Agricultural	97
Religious Worship or Religious Purposes (“Church Exemption”)	Non-Profit	89
Private Colleges and Seminaries	Non-Profit	72
Fixtures Excluded From the Supplemental Role	Other	49
Disabled Veterans' Principal Residence	Structure	12
Improvements for Disabled Accessibility	Structure	10
Total		**$3,646**

[a] Programs with identifiable revenue reduction of $10 million or greater.

Recently Enacted And Recently Eliminated TEPs

Recently Enacted TEPs. Figure 8 includes a list of TEPs that have been enacted since 1990. Of those listed, the exclusion for capital gains on the sale of a principal residence is estimated to have the largest revenue effect—$750 million in 1998-99. (This exclusion replaces the capital gains rollover and capital gains exclusion for those over the age of 55, which together were of roughly the same dollar magnitude as the new program). The manufacturer's investment tax credit is estimated to have the next largest state revenue effect—$390 million in 1998-99.

In numbers, most new TEPs in the 1990s have been in the income tax category, with PIT and BCT TEPs accounting for 46 percent of all new TEPs. The next largest group of new TEPs falls under the sales and use tax, constituting 30 percent of all new TEPs.

Figure 8

Revenue Reductions of Recently Enacted TEPs

TEPs Enacted Since 1990
(In Millions)

Program Category and Description	1998-99 Revenue Reduction[a]
Personal Income Tax	
Exclusions/Exemptions	
Capital Gains on the Sale of a Principal Residence[b]	$750
Capital Gains on Small Business Stock	15
Limited Partnership Investment Source Rules	10
Scholarshare Trust Income	1
Small Business Alternative Minimum Tax	NA
Tuition Reduction or Waiver	NA
Deductions/Adjustments	
Health Insurance Premiums	25
Small Business Expensing	11
Medical Savings Accounts	10
Contributions to Education Individual Retirement Accounts	7
Employee Stock Ownership Plans	1
Credits	
Manufacturers' Investment Credit	$34
Child Adoption Expenses	1
Salmon/Steelhead Trout Habitat Restoration	Minor
Enhanced Recovery Costs	Minor
Farmworker Housing Costs	Minor
Rice Straw	Minor
Disabled Access Expenditures	Minor
Transportation of Donated Agriculture Products	Minor
Bank and Corporation Tax	
Exclusions/Exemptions	
Credit Union Treatment	$13
Small Business Alternative Minimum Tax	NA
Deductions/Adjustments	
Employee Stock Ownership Plans	3
Credits	
Manufacturers' Investment Credit	390
Enhanced Recovery Costs	2
Salmon/Steelhead Trout Habitat Restoration	Minor
Farmworker Housing Costs	Minor
Rice Straw	Minor
Disabled Access Expenditures	Minor
Transportation of Donated Agriculture Products	Minor
Sales and Use Tax	
Fuel Used in Water Common Carriers	$18
Aircraft Repair and Related Equipment	16
Property Used in Space Flights	12
Investments by Manufacturers	6
Food Animal Medicines	4
Poultry Litter	1

Continued

Program Category and Description	1998-99 Revenue Reduction[a]
Carbon Dioxide Used in Packaging	Minor
Medicated Feed Drinking Water	Minor
Railroad and Related Equipment	Minor
Sales by Thrift Stores Operated by Nonprofit Organizations	Minor
Auctions Involving Nonprofit Organizations	Minor
Veterans Memorial Lapel Pins	Minor
Handcrafted Items Sold by Qualified Organizations	Minor
Meals Delivered to Elderly and Disabled Individuals	Minor
Single-Use Mailing Lists	NA
Property Tax	
Improvements for Disabled Accessability	$10
Hand Tools	1
Environmental Contamination	1
Low Harvest Timber Value	NA
Diseased Grapevines	NA

[a] "NA" indicates revenue reduction estimate is not available. "Minor" indicates estimated revenue reduction is less than $1 million.
[b] Replaced two previous programs (see Figure 9).

Recently Eliminated TEPs. Figure 9 provides a list of TEPs that have been eliminated since 1991. Most of these programs contained sunset provisions and simply were not subsequently renewed after the sunset date. As the figure shows, the majority of these programs were tax credits applicable to PIT and BCT. The eliminated TEPs with the largest estimated revenue reductions included the exclusion for capital gains on the sale of a residence ($630 million), insurance tax exemption for nonprofit hospital service corporations ($450 million), child and dependent care tax credit ($191 million), exclusion of capital gains on the sale of a principal residence for taxpayers over age 55 ($165 million), and tax credit for sale or exchange of rental or farm property ($89 million). As noted in the previous section, the two programs involving the special treatment of capital gains from the sale of a principal residence have been replaced by a new program.

Figure 9

Revenue Reductions of Eliminated TEPs

TEPs Eliminated Since 1990
(In Millions)

Program Category and Description	Last Year in Effect	Last Year Revenue Reduction[a]
Personal Income Tax		
Exclusions/Exemptions		
Deferral of Capital Gains on Sale of a Residence[b]	1996-97	$630
Exclusion of Capital Gains on Sale of Principal Residence for Taxpayers Over Age 55[b]	1996-97	165
Employee Death Benefits[c]	1996-97	2
Compensation for Slander or Libel[d]	1995-96	NA
Employer-Paid Group Legal Assistance	1991-92	5

Continued

Program Category and Description	Last Year in Effect	Last Year Revenue Reduction[a]
Deductions/Adjustments		
Accelerated Depreciation for Cogeneration and Alternative Energy Equipment[d]	1990-91	NA
Accelerated Depreciation for Low-Income Housing[d]	1990-91	NA
Credits		
Ridesharing Expenses[d]	1995-96	$4
Low Emission Vehicles	1994-95	Minor
Child and Dependent Care	1993-94	191
Manufacturing Equipment Using Recycled Materials[d]	1993-94	Minor
GAIN Employees	1993-94	Minor
Solar Energy Systems	1993-94	NA
Small Employer Health Benefits	1992-93	40
Agriculture Product Donations	1992-93	Minor
Clinical Testing of Orphan Drugs	1992-93	Minor
Capital Gains From Sales or Exchange of Residential Rental or Farm Property	1991-92	89
Low Income Individuals	1991-92	22
Military Pay	1991-92	5
Political Contributions	1991-92	5
Low Income Elderly Individuals	1991-92	4
Bank and Corporation Tax		
Deductions/Adjustments		
Accelerated Depreciation for Child Care Facilities[d]	1996-97	NA
Accelerated Depreciation for Cogeneration/Alternative Energy Equipment[d]	1990-91	NA
Accelerated Depreciation for Low-Income Housing[d]	1990-91	NA
Credits		
Ridesharing Expenses[d]	1995-96	Minor
Low Emission Vehicles	1994-95	Minor
GAIN Employees	1993-94	1
Manufacturing Equipment Using Recycled Materials[d]	1993-94	Minor
Solar Energy Systems	1993-94	NA
Small Employer Health Benefits	1992-93	$60
Agricultural Product Donations	1992-93	Minor
Clinical Testing of Orphan Drugs	1992-93	Minor
Sales and Use Tax		
Exemptions		
Low Emission Vehicles	1994-95	Minor
Fuel Used in Airborne Common Carriers[e]	1994-95	NA
Cargo Containers	1993-94	NA
Other Taxes		
Exemptions		
Nonprofit Hospital Service Corporations (Insurance Tax)	1991-92	$450
Motor Vehicle Fuel Used in Airplanes (Fuel Tax)	1991-92	4
Property Tax		
Exemption		
Civil Air Patrol	1994-95	NA

a “NA” indicates revenue reduction estimate is not available. “Minor” indicates estimated revenue reduction is less than $1 million.
b Replaced by new program (see Figure 8).
c Still applicable, under certain conditions, to survivor benefits paid to a public safety officer's family.
d Program eliminated but with remaining carry-over amounts still resulting in revenue reductions.
e Local exemption only.

BUDGET

Given the large number of TEPs in existence and their diverse characteristics, approaching a review of the state's tax expenditure budget is a formidable task. Assembly Concurrent Resolution 17 (see Introduction) envisioned a process for tax expenditure reviews that was somewhat similar to the regular budget process—including formulation of a Tax Expenditure Budget Bill containing provisions for modification or elimination of selected individual TEPs. Practical considerations suggest that comprehensive annual assessments of the state's tax expenditures are unrealistic, given their extensive number and variety. Rather, it would seem that a more targeted approach, focusing on designated individual TEPs of special interest, is a more realistic endeavor.

In approaching its reviews of selected individual TEPs, we believe that the Legislature would best be served by relying on the following three-step approach:

- First, it should review the objectives and rationales of existing TEPs.
- Second, it should review the available evidence on the overall effectiveness and economic efficiency of individual TEPs.
- Third, it should take actions to modify or eliminate those TEPs that no longer meet its current policy objectives or spending priorities.

Each of these steps is discussed below.

Review TEP-Related Objectives and Rationales

As noted previously, the compendium presented in Part Two provides detailed information on each individual TEP we have identified, including its intended purpose and apparent rationale. The specific purpose or rationale for creating individual TEPs, particularly those established many years ago, is not always known with certainty. In many of these cases, however, the rationale can be discerned from the characteristics of the particular program. In addition, in some cases, the original rationale for the TEP no longer applies, and the program has simply continued due to inaction or taxpayer opposition to its elimination. The basic rationales which apply for most TEPs are briefly discussed below.

Provision of Tax Incentives. One frequent purpose for TEPs is to provide incentives to *promote* certain economic behavior by taxpayers that otherwise would not occur, for various reasons. In some cases, this may be because the desired behavior may not be economically feasible for taxpayers. As one example, investment in certain types of research and development activity that could eventually prove beneficial to society may require significant "up-front" investment without a guarantee that such research will result in a profitable outcome for the investor. Supporters of the research and development tax credit argue that it may offset some of these costs and thus encourage beneficial research and development that otherwise would not occur.

In certain other incentive-related cases, TEPs may be used to provide incentives to *curb* behavior viewed as harmful to society. For example, undesirable amounts of pollution may occur because those parties producing the pollution are not required to bear its full costs to society. One method of curbing such behavior may include offering TEPs to encourage alternative behavior. In past years, a number of TEPs were created with this intent, including accelerated depreciation for the use of cogeneration and alternative energy equipment, and tax credits for low-emission vehicle purchases and conversions.

Provision of Tax Relief. Another common rationale for TEPs is to provide tax relief for certain segments of society. Such tax relief may be based on the desire to redistribute income among taxpayers. An example of this includes the various low-income tax credits that have been offered in recent years. In other cases, tax relief may be justified on the basis of equal treatment for competitive industries. For example, fuel tax exemptions have been established separately for both airborne and waterborne carriers, on the grounds that they serve similar purposes via different transportation modes. In addition, tax relief may be granted to certain groups in society that are active in providing beneficial services to others, such as sales of goods by nonprofit or charitable organizations that will use the proceeds for servicing those in need.

Facilitate Tax Administration. Tax expenditure programs may also serve to facilitate the effective administration of taxes. For example, occasional sales by individuals and certain organizations (such as rummage sales) are exempted from the sales and use tax for the purposes of administrative ease. Also, because the California PIT and BCT tax calculations rely on the federal income tax calculation in various ways, a number of state income tax TEPs have been created or modified to conform to federal law for ease of administration.

Determine Whether TEPs Are Merited

While TEPs may be created to accomplish specific purposes, it is important to remember that they may or may not achieve their desired results, or do so in an inefficient manner. For example, TEP-related benefits may go to unintended taxpayers, such as those that would have behaved in the desired manner even without an incentive-based TEP in place. As another example, certain lower-income taxpayers who do not currently pay state income taxes may not be influenced by specific income tax TEPs because they receive no direct benefits from them. Tax expenditure programs may also push choices in certain directions to the exclusion of others, such as choosing certain pollution abatement devices to the exclusion of others, which may not be optimal for society in the long-run.

Eliminate or Modify TEPs

While it may still be desirable in some cases to allow TEPs that result in unintended side effects to remain in place, in other cases modification or elimination of the TEP may be a better choice. Thus, periodic review and evaluation of TEPs and their effects can provide meaningful information for evaluating the efficiency and cost-effectiveness of individual TEPs. It also increases the likelihood that only those TEPs meeting current policy objectives and spending priorities remain in place.

What Has California's "Scorecard" Been In Managing Its TEP Budget?

Although reviewing TEPs poses a formidable challenge, it should be noted that California seems to be further along in this regard than most states, at least with regard to collecting and providing periodic information on the various TEPs in effect. For example, most states do not conduct periodic, comprehensive tax expenditure studies like California has done—although the practice is becoming more widespread as policy makers realize the fiscal effects of TEPs. Similarly, California has conducted more targeted reviews of individual TEPs over the years than have most other states. In fact, as one of the first states to require tax expenditure analyses, California has been viewed by other states as one of the leaders in conducting tax expenditure studies.

Significant Challenges Remain. Despite California's accomplishments, the state's tax expenditure reporting has had mixed results as an effective tax-policy and budgetary-management tool. One key problem is that TEP review or approval is not now part of any regular process. Most TEP discussions occur in policy committees and generally take place when TEPs are created or renewed. No procedure currently is in place in California (or any other state for that matter) to periodically review or approve as part of the budget process existing TEPs that do not have a sunset date. As noted previously, TEPs do not require an annual appropriation, and as a consequence are not automatically subject to annual legislative review. In addition, the fact that they require a two-thirds vote for elimination increases the likelihood that some may remain "on the books" longer than merited.

Reviewing the TEP Budget. A systematic, annual review of all TEPs as part of the budget process would be a significant departure from the current practice and require a substantial commitment of resources. An alternative approach that the Legislature may wish to consider is to review a specified number of TEPs annually and rate their effectiveness based on predetermined criteria. This approach could be applied to existing TEPs which are of particular interest from a budgetary or tax-policy perspective. In addition, the Legislature could require that newly-created TEPs include a sunset provision, which would require that the TEP be evaluated in a manner similar to the reviews currently required for direct expenditure programs as part of the regular budgetary process. Under such a system, TEP reports such as this one could provide valuable information to be used for these reviews.