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Tax Expenditures and Revenue Options

LEGISLATIVE ANALYST'S OFFICE

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Hon. Charles Calderon, Chair

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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.

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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

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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.

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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.

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TEP Reporting and Evaluations

☑ ***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.

TEP Reporting and Evaluations *(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.

☑ ***Challenges in Evaluating TEPs.*** Our knowledge about the effectiveness, cost-efficiency, and fiscal effects of TEPs varies considerably. For example:

- For some TEPs, reasonably good data are available regarding the extent of their use, such as for certain PIT and CT TEPs that are claimed on tax returns.
- For other TEPs, however, such as many under the SUT and certain PIT and CT exclusions, hard data are more limited and sometimes non-existent. This includes information about the distribution of their benefits among different categories of taxpayers, like income groups.
- Measuring whether TEPs are effective and cost-efficient in achieving their objections is even more difficult, due to problems in identifying their direct impacts and the behavioral effects they can produce.
- Conducting full-blown dynamic analyses for TEPs is even harder, due to modeling difficulties and knowing how the revenues to fund them would have otherwise been used.

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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.

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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.

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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.

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Research and Development (R&D) Credit

☑ The Proposal

- Limit the amount of credit applied in a tax year to two-thirds of the taxpayer's liability in that year.
  - Current law allows taxpayers to offset all tax liabilities except the minimum tax and the alternative minimum tax with R&D credits earned in the current or past tax years. Unused credits can be carried forward indefinitely.

☑ Rationale

- Limiting the use of R&D credits to two-thirds of a firm's liabilities would provide substantial current fiscal relief to the state while being unlikely to have a significant adverse impact on investments in research.

☑ Projected Revenues

- $335 million in 2008-09 and $290 million in 2009-10.

☑ LAO Comments

- Our proposal would affect approximately 1,000 CT taxpayers, or about 55 percent of those claiming R&D credits.
- There are more than $10 billion in unused state R&D credits being "carried over" for future use. For taxpayers with large amounts of unused credits, current R&D decisions are unlikely to be affected by their ability to stockpile additional credits.
- California's R&D credit rate is the third highest in the country.

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Net Operating Losses (NOLs)

☑ **The Proposal**

- Limit NOL deductions to 50 percent of a taxpayer's net income in a given year.
  - Current law allows NOL deductions to offset all of the taxpayer's income. Unused deductions can be carried forward for up to ten years.

☑ **Rationale**

- Limiting the use of NOL deductions would provide substantial current fiscal relief to the state while retaining the ability for taxpayers to claim their deferred tax benefits in the future.

☑ **Projected Revenues**

- $330 million in 2008-09 and $410 million in 2009-10.

☑ **LAO Comments**

- This deduction was suspended for the 1991, 1992, 2002, and 2003 tax years, during times of severe budget shortfalls.
- Our proposal would affect about 25,000 corporate taxpayers, or about 20 percent of those claiming NOLs.

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Enterprise Zones (EZs)

The Proposal

- Cancel recent redesignations of EZs, and phase out other existing EZs as they reach the end of their 15-year authority.
  - The EZ program includes hiring credits to employers for qualified employees, credits for sales taxes paid on certain investments, credits for employees for qualified wages, deductions for qualified business expenses, and deductions for qualified interest received on loans to EZ businesses.
  - Under our proposal, new EZs could still be established.

Rationale

- Limiting the duration of EZ tax benefits would recognize that a different approach to addressing blight is needed—such as redevelopment—when an EZ remains blighted after 15 years of subsidies.

Projected Revenues

- $100 million in 2008-09 and $120 million in 2009-10.

LAO Comments

- Some EZs had their original 15-year designation extended for 5 years, then were redesignated for an additional 15 years, for a total of 35 years of temporary benefits.
- Evidence suggests that EZs can be effective at shifting economic activity within a geographic region, but that they generate little new economic activity.

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Exemptions for Industry-Specific Equipment

The Proposal

- Eliminate partial SUT exemptions for industry-specific equipment.
  - Current law exempts the *state* portion of SUT for farming equipment, timber harvesting equipment, and equipment used in post-production services (such as editing, subtitling, and special effects) for television and films.

Rationale

- General tax policy suggests that all industries should be treated similarly for tax purposes, and it is not evident why these particular industries are more deserving of a tax exemption than many other industries in the state.

Projected Revenues

- $143 million in 2008-09 and $146 million in 2009-10.

Industry Category ***(In Millions)***	**2008-09**	**2009-10**
Farm equipment and machinery	$120	$123
Timber harvesting equipment	3	3
Teleproduction and post-production equipment	20	20
Totals	**$143**	**$146**

LAO Comments

- Since these exemptions are only partial exemptions, it is administratively feasible to implement changes and realize their revenue benefits in the near term. There are a variety of other SUT exemptions benefiting specific industries that may be deserving of a similar review, but they pose greater administrative difficulty.

Tax Reform Options

☑ ***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.

Tax Reform Options *(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.
- Telecommunications has been a rapidly growing and changing industry but its taxes are largely based on an industry structure that no longer exists, suggesting a need for reform. Key issues include:
  - Should specific telecommunications activities be taxed, and if so for what purpose, in what manner, and at what rates?
  - Can the existing telecommunications tax system be simplified to be more transparent, equitable, and easier to administer?
- 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.

☑ ***The Issue of SUT Base-Broadening.*** As shown in the figure (next page), taxable sales as a percent of disposable personal income, and SUT revenues as a percent of total General Fund revenues, have both fallen considerably in recent decades. This partly reflects changes in the economy. There are two areas that come to mind involving possibly broadening the SUT base to address such changes, and thereby being able to raise a given amount of revenues with lower tax rates:

- ***Taxation of Services.*** The SUT applies primarily to exchanges involving tangible items, and relatively few services are directly taxed.

Tax Reform Options *(Continued)*

- Taxation of services would treat different types of purchases more equally, and thus reduce the inequities of the current system.
- However, services taxation also raises challenging issues about what services should be taxed and which are feasible administratively.

- ***Taxation of Other Intangibles.*** Due to technological changes, digital exchanges of such things as music and movies are of growing importance. Incorporating them when administratively feasible into the SUT base, from which they are currently excluded, would also equalize the SUT treatment of different types of consumption and allow for lower SUT rates.