Report on the 1988-89 Tax Expenditure Budget

Overview and Selected Reviews

Office of the Legislative Analyst

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Table of Contents

Introduction

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This report has been prepared pursuant to Assembly Concurrent Resolution 17 (Resolution Chapter 70, Statutes of 1985), which requires the Legislative Analyst to prepare a biennial review of the state's tax expenditure programs. These programs, as defined by ACR 17, include the various tax exclusions, exemptions, preferential tax rates, credits, and deferrals which reduce the amount of revenues collected from the state's "basic" tax structure. These provisions of law are called ***tax expenditure programs*** (TEPs), because the benefits they convey to individuals and businesses make them similar in their effects to direct governmental expenditure programs. However, there is a major difference between these two types of programs -- namely, the "cost" of tax expenditures is measured by reduced tax collections, rather than by the level of expenditures authorized through the normal legislative appropriations process.

Purpose of the Report

The objective of this report is to provide information which will assist the Legislature in reviewing the state's tax expenditure budget, including data on the size and composition of the tax expenditure budget, and information helpful in making decisions regarding which individual TEPs should be retained, renewed, modified or eliminated.

Contents of the Report

The report which follows is divided into two sections:

- *Part One* provides an *overview* of the state's tax expenditure budget for 1988-89. It summarizes the estimated individual and collective costs of the state's TEPs, the changes in these costs since 1987-88, and how these costs compare to the state's direct expenditure budget. It also identifies which individual TEPs have recently been enacted, modified, deleted or permitted to expire, including the effects of 1987 state tax reform legislation on state tax expenditures.
- *Part Two* contains ***detailed reviews*** of six selected individual TEPs, including in-

formation on the effectiveness of these programs in accomplishing their stated objectives in a least-cost manner, and recommendations regarding whether the programs should be left unchanged, modified, or eliminated. The six programs reviewed include the personal income tax deduction for mortgage interest expenses, accelerated depreciation for residential rental housing, the sales and use tax exemption for dry and packing ice, the in-lieu tax for racehorses, the partial property tax exemption for certain wildlife habitat lands, and the sales and use tax exemption for coins and gold or silver bullion.

Acknowledgments

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Executive Summary

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This report has been prepared pursuant to Assembly Concurrent Resolution 17 (Resolution Chapter 70, Statutes of 1985), which requires the Legislative Analyst to prepare a biennial review of the state's tax expenditure programs. These tax expenditure programs (TEPs), as defined by ACR 17, include the various tax exclusions, exemptions, preferential tax rates, credits and deferrals, which reduce the amount of revenues which normally would be collected from the state's "basic" tax structure. These programs are called "tax expenditures" because the benefits they provide make them very much like direct expenditure programs, except that they are paid for by reduced tax collections rather than through normal legislative appropriations.

The purpose of this report is to provide information which will assist the Legislature in reviewing the state's tax expenditure budget, including making decisions regarding which individual TEPs should be retained, renewed, modified, or eliminated.

Principal Findings

This report's findings fall into two main categories -- those relating to the characteristics of the overall tax expenditure budget (Part One), and those relating to the characteristics and cost-effectiveness of certain individual TEPs which we have selected for special review (Part Two).

Findings Relating to the Overall Tax Expenditure Budget (Part One)

Size of the tax expenditure budget

Determining the exact size of the state's tax expenditure budget is extremely difficult. One reason for this involves differences of opinion about whether or not certain tax provisions are TEPs, as opposed to part of the "basic" tax structure.

Another reason involves the numerous data limitations which make it hard to quantify the revenue losses from many TEPs. Given these problems, no one can say precisely what the size of the tax expenditure budget is. Rather, the best that can be done is to provide a general indication of the budget's overall magnitude. Given this qualification, our research indicates the following:

- There are over 220 individual state-level TEPs, plus an additional 65-plus state-established local property tax TEPs which cost the state money in the form of required subvention payments to local governments.

- Identifiable revenue losses from state-level TEPs total $17.3 billion for 1988-89. This means that the identifiable costs of the state's TEPs is equal in magnitude to over 40 percent of the 1988-89 direct expenditure budget ($42.0 billion).
- In addition, 1988-89 local revenue losses from state-established TEPs are estimated to exceed $3.4 billion, including over $2 billion for property tax TEPs and $1.4 billion for the local government share of sales and use tax TEPs. The property tax TEPs impose substantial costs on the state for school apportionments and other local subventions.
- Altogether, state-level TEPs will reduce by over 30 percent the amount of revenues which otherwise would be produced by the state's basic tax structure in 1988-89.

Composition of the tax expenditure budget

With respect to the individual taxes that comprise the state's revenue base:

- Personal income tax TEPs amount to at least $11.8 billion, or over 68 percent of total state tax expenditures.
- Sales and use tax TEPs amount to at least $4.1 billion, or nearly 24 percent of total state tax expenditures.
- TEPs for the bank and corporation tax and other state-level taxes have identifiable costs of about $1.4 billion, or about 8 percent of total state tax expenditures.

Growth in the tax expenditure budget

The estimated size of the state's tax expenditure budget in 1988-89 exceeds its 1987-88 level by $1.1 billion, or 6.8 percent. By comparison, growth in the 1988-89 direct expenditure budget is 7.3 percent for General Fund expenditures and 5 percent for total direct expenditures (that is, General Fund plus special fund expenditures, excluding bond funds). Thus, the tax expenditure budget is projected to increase less rapidly than the direct expenditure budget. The projected growth in the 1988-89 tax expenditure budget is explainable primarily by *economic and demographic factors* (such as expanded levels of economic activity, inflation, and increased numbers of taxpayers), *not* the expansion or enactment of new TEPs.

Effects of tax reform on the tax expenditure budget

During 1987, state tax reform legislation was enacted which significantly conformed California's income tax laws to those of the federal government. These measures (Ch 1138/87 and Ch 1139/87) had the net effect of *broadening* the state's tax base, and thus *reduced* the dollar volume of the state's tax expenditures from what it otherwise would have been.

Our best estimate is that identifiable tax expenditures in 1987-88 -- the first fiscal year affected by state tax reform -- were reduced by over $675 million from what they would have been without tax reform. As a result, 1987-88 growth in the state's tax expenditure budget was only 2.8 percent, compared to the 7.1 percent which would have occurred without tax reform.

The volume of tax expenditures in 1988-89 and thereafter also will be less than otherwise due to state tax reform. However, tax reform's distorting effect on the annual growth rate of the tax expenditure budget should be less in these years than it was in 1987-88, because the major effects of tax reform have now been incorporated into the underlying tax expenditure base.

Findings Relating to Individual Programs (Part Two)

The following individual TEPs were selected for detailed review in Part Two of this report:

- The personal income tax itemized deduction for mortgage interest expenses;
- The personal income tax and the bank and corporation tax accelerated depreciation deduction for residential rental housing (this review was statutorily required);
- The sales and use tax exemption for packing ice and dry ice;
- The in-lieu tax on racehorses;
- The partial property tax exemption for land under a wildlife habitat contract; and
- The sales and use tax exemption for coins and bullion (this review was statutorily required).

On what basis were these programs evaluated?

The main criterion we use in evaluating the merits and performance of a TEP is whether it achieves its objectives in the most cost-effective manner. That is, does the program both accomplish its objectives, and do so less expensively than could other approaches available to the state? We believe a program that is not cost-effective should either be modified or eliminated, unless it can be justified on some other grounds such as significant tax administration savings or elimination of undesirable inequities in the treatment of different taxpayers.

Conclusions

Our review of the above TEPs found that they had a variety of shortcomings, and in most cases were *not*, at least in their current form, the most cost-effective ways of achieving their objectives. Given this finding, our analysis further suggests that there are certain recommended actions which the Legislature may want to consider taking with regard to these programs.

Recommendations

In making recommendations to the Legislature regarding individual TEPs, we adopt the premise that when evidence is lacking that a TEP is a particularly cost-effective means of achieving its objectives, the Legislature ordinarily should either:

- *Modify* the TEP, so as to address its deficiencies and make it cost-effective;
- *Eliminate* the TEP altogether; or
- *Replace* the TEP with a direct expenditure program whose costs and benefits may be more accurately identified, and is a cost-efficient use of taxpayers' money.

Based upon our selected reviews of individual TEPs appearing in Part Two of this report, *we recommend that:*

- *The personal income tax deduction for mortgage interest expenses be modified,* so as to make the TEP a more cost-effective and equitable tool for assisting home owners and encouraging home ownership. Specifically, we recommend that the Legislature consider such steps as putting a limit on the amount of mortgage interest that may be deducted by a taxpayer, excluding the deduction in the case of second homes and mortgage-financed nonhousing expenses, substituting a mortgage interest tax credit in place of the current tax deduction, and relying more on targeted direct subsidy programs that will help those families most in need of housing assistance such as low-income households and first-time home owners.
- *The accelerated depreciation deduction for residential rental housing not be reenacted,* and that the Legislature *conform* the depreciation rules for residential

rental property under the bank and corporation tax to those in effect under the personal income tax.

- ***The sales and use tax exemption for packing ice and dry ice be discontinued,*** on the grounds that it cannot be justified by any of the three rationales commonly offered in support of it -- namely, that it is needed to provide "tax equity" between ice and other cooling processes because other cooling processes are not taxed, that it should be classified as a nontaxable "component part" of the products it cools, and that it is an efficient means of promoting the California economy's competitiveness.
- ***The in-lieu tax on racehorses be modified,*** so as to attain the joint objectives of limiting tax breaks for nonracing horses (such as show animals) and reducing the windfall benefits currently being realized by certain racehorse owners, while at the same time retaining the basic administrative advantages of the in-lieu tax approach. In addition, the in-lieu tax rates themselves should be reexamined.
- ***The partial property tax exemption for land under wildlife habitat contracts, such as duck clubs, be repealed.*** Instead of using this TEP, the state should rely fully on the direct expenditure program *which already exists* for the purpose of preserving such lands in California.
- Regarding the sales and use tax exemption for coins and gold or silver bullion, we have three recommendations. First, ***we recommend that the exemption for sales of bullion be continued*** on tax equity grounds, given that such other competing financial investment vehicles as stocks and bonds are not subject to sales taxation. Second, ***we recommend that the exemption be eliminated for numismatic coins*** (which we believe should be defined for tax purposes as coins having a sales price greater than 110 percent of the value of the bullion contained in them). The reasoning here is again tax equity, since exempting numismatic coins clearly conflicts and is inconsistent with the state's general policy of subjecting other types of collectibles to the sales tax. Third, *if* federal legislation is enacted that enables California to collect sales taxes on out-of-state purchases by Californians, ***we recommend that the Legislature at that time reexamine the entire tax expenditure program for coins and bullion.*** ❖

Part One

Part One

Overview of the 1988-89 Tax Expenditure Budget

Introduction

This part of the report provides an overview of the state's tax expenditure budget for 1988-89. Specifically, this section:

- Discusses exactly what the term "tax expenditure" means and the issues involved in measuring the dollar value of the state's total tax expenditure budget and its individual components.
- Presents estimates of the state's revenue losses due to tax expenditures in 1988-89 and compares these costs to the costs of providing tax expenditures in both 1986-87 and 1987-88.
- Provides a listing of recent changes in the individual tax expenditure programs (TEPs) that collectively comprise the state's total tax expenditure budget, including tax expenditure programs that have been recently enacted, extended, modified, deleted, or permitted to expire. In addition, a discussion is included as to the effects of 1987 state tax reform legislation on state tax expenditures.

What Is A Tax Expenditure?

In this report, tax expenditures are defined as in ACR 17 to include the various tax exclusions, exceptions, preferential tax rates, credits and deferrals which reduce the amount of revenue collected from the state's basic tax structure. These provisions are called *tax expenditures* because the benefits they provide to individuals and businesses make them very much like regular direct governmental expenditures, except that they are paid for by reduced tax collectionsrather than through the normal legislative appropriations process. Obviously, in order to apply ACR 17's definition of tax expenditures, it is necessary to first define the term "basic tax structure."

The "Basic Tax Structure"

At first glance, one might think that defining the term "basic tax structure" is a fairly straightforward and simple task. In practice, however, this is not so. In fact, although countless books, reports and articles have been written on the subject, the issue of what the "basic tax structure" is has never been -- and probably never will be -- fully resolved. This is because although individual economists and public policymakers generally agree with the fundamental concept of a "basic tax structure," they often differ as to the specific individual tax provisions that should be included within it. For example, there are some individuals who feel that an extremely comprehensive definition should be used for the tax base. Their listing of tax expenditures thus includes every identifiable deviation from this comprehensive base. In contrast, other individuals feel that the basic tax system should not be defined so all-inclusively, and that there are some features of the tax system which reduce the comprehensiveness of the tax base, but nevertheless should be considered to be part of the basic tax structure. For these latter individuals, tax expenditures tend to be viewed more as providing special or selective, as opposed to general, tax relief, and therefore their listing of tax expenditures tends to be more restrictive.

Given the above, a certain amount of disagreement is inevitable regarding exactly how the term "basic tax structure" should be defined, and therefore which features of the tax system should be included in a listing of state tax expenditure programs. Typical examples of tax provisions about which disagreement on this point often arises include, to name but a few, the standard deduction and personal tax credits for income tax filers, the portion of capital gains that is due solely to inflation, the portion of accelerated depreciation that merely serves to offset inflationary price increases in depreciable assets, and the sales and use tax exemption for food. (The specific reasons why these and various other individual tax provisions pose special classification problems from the perspective of tax expenditures are discussed on a case-by-case basis in the tax expenditure compendium contained in Volume II of last year's report--*Analysis of the 1987-88 Tax Expenditure Budget*, Report No. 87-1, January 1987.)

The Rationale for a Comprehensive Listing

This report adopts a fairly broad view of tax expenditures and the basic tax structure, by including as tax expenditures those provisions which provide either general or selective tax benefits. This broad view is used not because a more restrictive definition of tax expenditures is necessarily incorrect, but rather in recognition of the fact that individual legislators themselves have differing views about exactly which tax provisions should be defined as tax expenditures. Thus, by providing data on the *complete* menu of tax provisions which potentially may be classified as tax expenditures, this report attempts to ensure that the Legislature will have at its disposal all of the information that may be relevant to its review of the state's tax expenditure budget.

Measuring The Costs Of Tax Expenditures

In order to develop a "tax expenditure budget," the costs of the individual TEPs that comprise it must first be determined. However, because TEPs are funded not by direct appropriations but rather by foregone tax revenues, *their actual costs normally cannot be directly observed*. Therefore, these costs generally must be *estimated*. Three main problems are commonly encountered when attempting to develop these TEP cost estimates:

- First, ***data limitations often make it difficult to accurately identify the revenue losses from individual tax expenditure programs.*** For example, if certain types of income or transactions are not even required to be reported for tax purposes, there may be no reliable record of their exact dollar volume and thus no way of estimating how much revenue their taxation would produce. Efforts to overcome this problem through the use of taxpayer surveys, special studies, and data published by governments or industry trade associations, often are only partially successful.

- Second, ***even when a reasonably accurate direct revenue-loss estimate is available for an individual TEP, it often will overstate what the actual net revenue gain would be from eliminating it.*** This is because various "secondary effects" result from eliminating tax expenditures, because of behavioral changes that they induce in taxpayers. For example, the repeal of the state's solar tax credits several years ago (which produced a direct revenue gain) may have induced a drop in total business investment spending (which in turn could have dampened economic activity and thereby partially offset the direct revenue gain from eliminating the credit).
- Third, ***one cannot simply add together the revenue losses from individual TEPs to obtain an accurate measure of the cost of the total tax expenditure budget.*** This is because the total revenue gain that the elimination of all tax expenditures would produce can be either greater or less than the sum of the separately estimated revenue gains from individual TEPs, due to interactions between these different programs. For example, eliminating one type of itemized income tax deduction would increase the taxable incomes of certain taxpayers and move them into higher marginal income tax brackets. This would increase the revenue gain that would accompany the subsequent elimination of some *other* itemized deduction. Estimating the revenue effects of restricting or eliminating itemized tax deductions also is complicated by the interaction with the standard deduction, which can cause the actual loss in tax deductions for some taxpayers (and thus the increase in their tax liabilities) to be less than what the reduced itemized deductions themselves would have caused.

Given factors like the above, even the best possible estimates of tax expenditure costs inevitably will have shortcomings. With this qualification in mind, we now turn to our analysis of the state's 1988-89 tax expenditure budget.

Analysis Of The 1988-89 Tax Expenditure Budget

This section discusses the 1988-89 tax expenditure budget, including the budget's size and composition, and changes in the budget compared to prior years.

Overall Size and Composition of the Tax Expenditure Budget

Table 1 summarizes the size and composition of the 1988-89 tax expenditure budget. This budget includes over 220 individual state TEPs. In addition to these state-level TEPs, over 65 state-established local government property tax TEPs are included.

Why include local property tax programs?

Prior to proceeding further, our rationale for including reference to property tax programs in this report deserves mention. After all, because property taxes are a *local* revenue source, legislatively enacted special exemptions and other preferential treatments under this tax do not technically constitute state TEPs in the same sense as do the special tax provisions for state taxes. However, such property tax provisions *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 the resulting 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 exemptions for home owners and senior citizens. It is for these reasons that we have included property tax TEPs in this report. However, because these payments show up in the state's *direct* expenditure budget (for example, as part of the cost for state aid to K-12 school districts), we have *not* included them in our dollar totals for the state's tax expenditure budget.

How large is the state's tax expenditure budget?

In order to measure the dollar size of the tax expenditure budget, we have relied primarily upon data provided to us by the California Franchise Tax Board (which administers both the personal income tax and bank and corporation tax), the California Board of Equalization (which administers most other state taxes and state matters related to local property taxation), and the California Department of Finance (which conducts its own review of TEPs). In the case of some TEPs for which these agencies could not provide us with usable cost estimates, we have made our own estimates. However, there remains a significant number of TEPs for which no reliable revenue-loss estimate currently is available from *any* source, due to data limitations. It also must be stressed that even in the case of those TEPs for which we do have cost estimates, significant error margins accompany many of them due to data limitations. We have been working on an ongoing basis with the state's tax agencies to both increase the number and improve the quality of cost estimates for the state's TEPs. So far, however, our collective success has been only mixed, due to the seriousness of data problems.

With these data problems in mind, Table 1 indicates that the 1988-89 state tax expenditure budget totals $17.3 billion for those state programs where identifiable cost estimates are available. In addition, local property tax TEPs amount to about $2 billion (of which nearly one-half directly translates into state costs for school apportionments and other

Table 1
Identifiable Revenue Losses from Tax Expenditure Programs, by Major Tax Category[a]
1988-89

	Estimated Revenue Loss		
Program Category	*Amount (dollars in millions)*	*Loss as a Percent of Estimated Tax Collections*	*Loss as a Percent of Total Identifiable State-Level Tax Expenditures*
Personal income tax programs	$11,823	79.6%	68.1%
Sales and use tax programs	4,126	33.0	23.8
Bank and corporation tax programs	1,038	19.7	6.0
Programs for other state taxes	362	5.5	2.1
Subtotals, all state tax programs	$17,349	44.2%	100.0%
Local property tax programs	$2,033	16.7%	NA
Local share of sales and use tax programs	1,370	33.0	NA
Totals, all programs	$20,752	37.4%	NA

[a] Detail may not add to totals due to rounding. Figures shown are derived using the estimates of 1988-89 tax collections in effect at the time the 1988-89 budget was enacted.

local subventions), while the local share of revenue losses from sales and use tax TEPs totals about $1.4 billion. As noted earlier, however, there are many TEPs, especially involving sales and property taxes, for which cost estimates currently do not exist. Given this, the exact total cost of the 1988-89 tax expenditure budget remains unknown. Nevertheless, because cost estimates do exist for at least most of the major TEP programs, the $17.3 billion figure gives a reasonable overall indication of the general magnitude of the 1988-89 state tax expenditure budget.

By comparison, the 1988-89 *direct* expenditure budget totaled $42 billion (excluding bond fund expenditures), including $35.8 billion in General Fund expenditures. Thus, as shown in Chart 1, the tax expenditure budget is equivalent in size to over 40 percent of the total direct expenditure budget and nearly one-half of the General Fund direct expenditure budget.

Chart 1

1988-89 Tax Expenditure Budget Compared to the Direct Expenditure Budget

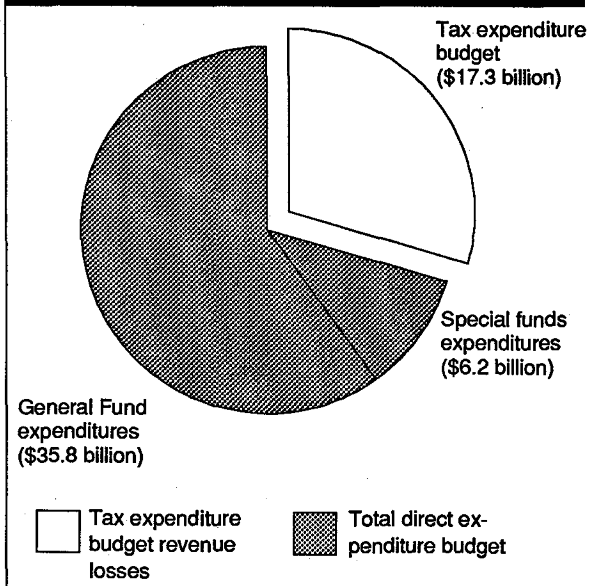
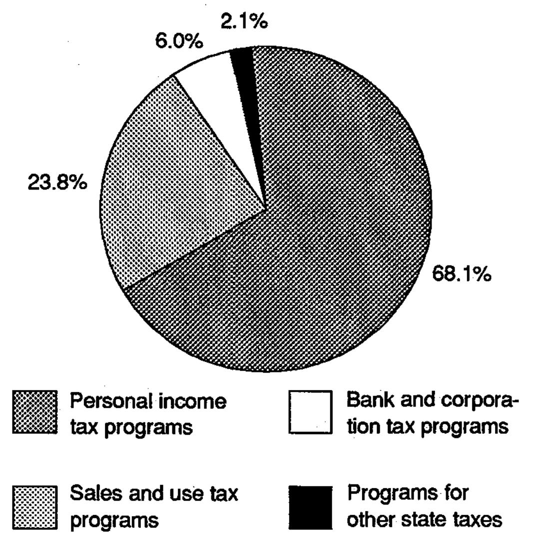


Chart 2

Composition of the Identifiable State Tax Expenditure Budget for 1988-89

Total budget = $17.3 billion



What is the composition of the tax expenditure budget?

Regarding the composition of the tax expenditure budget, Table 1 and Chart 2 indicate that:

- Personal income tax TEPs amount to at least $11.8 billion, or over 68 percent of total identifiable state tax expenditures;
- Sales and use tax TEPs amount to at least $4.1 billion, or nearly 24 percent of total identifiable state tax expenditures;
- Bank and corporation tax TEPs amount to at least $1 billion, or about 6 percent of total identifiable state tax expenditures;
- TEPs related to other state-level taxes amount to at least $362 million, or 2 percent of total identifiable state tax expenditures.

Thus, personal income tax TEPs and sales and use tax TEPs account for by far the largest dollar shares--over 90 percent combined--of total 1988-89 tax expenditures. Table 1 also shows that state TEPs amount to about 44 percent of projected 1988-89 state tax revenues, with personal income tax TEPs equaling 80 percent of projected personal income tax revenues, and sales and use tax TEPs equaling 33 percent of projected sales and use tax revenues. We have identified nearly 290 individual TEPs, including 72 for the personal income tax, 35 for the bank and corporation tax, 85 for the sales and use tax, 30 for other state-level taxes, and 65 for the property tax.

Major Individual Tax Expenditure Programs

Tables 2 through 6 summarize the most significant individual TEPs for which identifiable cost estimates currently are available. (Descriptive information about most of the remaining programs can be found in the tax expenditure compendium that was published as Volume II of last year's report--*Analysis of the 1987-88 Tax Expenditure Budget*, Report No. 87-1, January 1987.)

Personal income tax TEPs

The largest personal income tax TEPs (Table 2) are deductions for mortgage and nonmortgage interest expenses ($2.8 billion), income exclusions for employer contributions to pension plans ($2.1 billion) and health plans ($1.1 billion), deductions for charitable contributions ($652 million) and taxes paid ($500 million), and the income exclusion for social security benefits ($496 million). Altogether, these six TEPs amount to over $7.6 billion and account for almost two-thirds of the total identifiable costs of all personal income tax TEPs. In totaling the costs of personal income tax TEPs, we have excluded the personal exemption on the grounds that a strong case exists for defining it as part of the "basic" tax structure. In addition, we have included only that portion of the standard deduction that is in excess of the deductible expenses which nonitemizing taxpayers could have claimed in the absence of the standard deduction. We have done so because it is this amount that the state would collect in additional tax revenues if the standard deduction were to be eliminated.

Bank and corporation tax TEPs

The largest identifiable bank and corporation tax TEPs (Table 3) are the deduction for net operating loss carry-forwards ($338 million), the income exclusion for Subchapter S corporations ($295 million), "expensing" deductions for research and experimental costs ($175 million) and exploration and development costs ($59 million), and deductions for charitable contributions ($47 million). (The "expensing" deductions referred to above involve taking a tax deduction for the full cost of an asset in its *intial* year of operation, as opposed to depreciating the asset over its economic life.) These five programs account for over $900 million, or 90 percent of total identifiable costs for bank and corporation TEPs. However, other programs for which revenue losses have not been identified, such as accelerated depreciation, may be of even larger magnitude than those identified in Table 3.

Sales and use tax TEPs

The largest sales and use tax TEPs (Table 4) are the exemptions for food products ($1.6 billion) and for gas, electricity and water ($1.2 billion). These two programs account for two-thirds of the total identifiable costs of sales and use tax TEPs. The remaining one-third of identifiable costs are attributable to about a dozen smaller programs. However, there are over 70 additional sales and use tax TEPs for which revenue-loss estimates currently are not available.

Table 2

Identifiable State Revenue Losses from Personal Income Tax Expenditure Programs in 1988-89 (dollars in millions)[a,b]

Type of Tax Expenditure Program	*1988-89 Estimated State Revenue Loss*
A. Exclusions and Exemptions from Reported Income	
Employer contributions to pension plans	$2,120
Employer contributions to health plans	1,087
Social security benefits	496
Capital gains on sales of residences (combined programs)	426
Capital gains for inherited property	200
Life insurance proceeds	193
Compensation for injuries or sickness	180
Miscellaneous fringe benefits	152
Other programs with identifiable revenue effects	265
Subtotal	$5,119
B. Adjustments to Reported Income	
Contributions to IRA accounts	$148
Contributions to self-employed retirement plans	77
Alimony payments	42
Other programs with identifiable revenue effects	9
Subtotal	$276
C. Tax Deductions	
Mortgage interest	$2,238
Charitable contributions	652
Nonmortgage interest	515
Taxes paid	500
Miscellaneous expenses	420
Standard deduction	200
Medical and dental expenses	115
Other programs with identifiable revenue effects	127
Subtotal	$4,767
D. Tax Credits	
Renters' credit	$517
Dependent exemption credit	456
Child and dependent care expenses	76
Low-income individuals	56
Solar energy and energy conservation equipment	47
Senior citizen credit	43
Other programs with identifiable revenue effects	113
Subtotal	$1,307
E. Other Programs	
Special filing status for heads-of-households and surviving spouses	$354
Total, personal income tax programs	$11,823

[a] Detail may not add to totals due to rounding. Personal exemption credits other than the special added benefits provided to heads-of-households and surviving spouses have been excluded, on the grounds that they constitute part of the "basic" tax structure. The standard deduction revenue loss is based on the amount by which standard deductions claimed exceed the itemized deductions which nonitemizers could claim in the standard deduction's absence.

[b] All revenue loss estimates represent projections developed by the California Franchise Tax Board using 1985 base-year tax data except for the mortgage interest deduction, for which the projection was developed using 1986 base-year tax data.

Table 3
Identifiable State Revenue Losses from Bank and Corporation Tax Expenditure Programs in 1988-89 (dollars in millions)

Type of Tax Expenditure Program	*1988-89 Estimated State Revenue Loss*
A. Exclusions and Exemptions From Reported Income	
Subchapter S corporations[a]	$295
Tax-exempt corporations	29
Subtotal	$324
B. Tax Deductions	
Net operating loss carry-forwards	$338
Expensing of research and experimental costs	175
Expensing of exploration and development costs	59
Charitable contributions	47
Other programs with identifiable revenue effects	45
Subtotal	$664
C. Tax Credits	
Research and development	$25
Solar energy and energy conservation equipment	14
Other programs with identifiable revenue effects	11
Subtotal	$50
Total, bank and corporation tax programs	$1,038

[a] Revenue loss shown is net of the personal income tax revenue gain generated by the required pass-through of Subchapter S corporate earnings to individual shareholders.

Table 4
Identifiable State Revenue Losses from Sales and Use Tax Expenditure Programs in 1988-89 (dollars in millions)

Type of Tax Expenditure Program	*1988-89 Estimated State Revenue Loss[a]*
Food products	$1,598
Gas, electricity and water	1,175
Vessels and aircraft (various programs)	409
Cargo and returnable containers	219
Agricultural feed, seeds and fertilizers	180
Prescription medicines	125
Candy and confectionery items	85
Sales of mobilehomes (various programs)	65
Custom computer programs	52
Newspapers and periodicals	51
Leases of motion pictures	40
Bottled water	29
Other programs with identifiable revenue effects	98
Total, sales and use tax programs	$4,126

[a] Estimated local revenue losses to cities, counties and transit districts equal slightly over 33 percent of the state revenue losses shown, or approximately $1.4 billion in total.

TEPs for other state taxes

Of the remaining state taxes, the largest TEPs (Table 5) include the insurance tax exemption for nonprofit hospital service plans ($233 million), the excise tax exemption for jet fuel used by common carriers and the military ($65 million), and the reduced insurance tax rate for pension and profit-sharing plans ($41 million).

Property tax TEPs

The most significant property tax TEPs (Table 6) include the business inventory exemption ($703 million), the exemption for household furnishings and other personal effects ($587 million), the home owners' exemption ($351 million), the exemption for property associated with charitable nonprofit activities ($227 million), and the exemption for open-space lands and historical property ($85 million).

Table 5

Identifiable State Revenue Losses from Tax Expenditure Programs for Other Major State Taxes in 1988-89 (dollars in millions)

Type of Tax Expenditure Program	*1988-89 Estimated State Revenue Loss*
Insurance tax exemption for nonprofit hospital service corporations	$233
Aircraft jet fuel license tax exemption	65
Partial insurance tax exemption for employee pension and profit sharing plans	41
Cigarette tax exemption for distributions to the armed forces and Veterans' Administration	8
Other programs with identifiable revenue effects	15
Total, programs for other state taxes	$362

Table 6

Identifiable Local Revenue Losses from Property Tax Expenditure Programs in 1988-89 (dollars in millions)

Type of Tax Expenditure Program	*1988-89 Estimated Local Revenue Loss*
Business inventories	$703
Household furnishings	587
Home owners' exemption	351
"Welfare" exemption (various programs)	227
Open-space and historical properties	85
Real property owned by private colleges and seminaries	41
Computer programs	16
Other programs with identifiable revenue effects	23
Total, property tax programs	$2,033

1988-89 Changes to the Tax Expenditure Budget

Table 7 compares the 1988-89 tax expenditure budget for state-level TEPs with the tax expenditure budgets for each of the two preceding years, both in total and by individual major tax. The table indicates that the state tax expenditure budget has increased by an estimated $1.1 billion (6.8 percent) in 1988-89. This compares to an estimated increase of only $445 million (2.8 percent) that occurred in 1987-88. (As discussed below, this low growth in 1987-88 was due to the first-year effects of the state tax reform legislation that was enacted in 1987.) The 1988-89 growth includes increases of $606 million (5.4 percent) in personal income tax TEPs, $242 million (6.2 percent) in sales and use tax TEPs, $232 million (29 percent) in bank and corporation tax TEPs (this large increase again reflects tax reform distortions), and $31 million (9.4 percent) in TEPs associated with other state-level taxes. Table 7 also shows that local property tax TEPs are estimated to have increased by $72 million (3.7 percent), while the local share of sales and use tax TEPs is estimated to have risen by $108 million (8.6 percent).

Table 7
Growth in the Identifiable Revenue Losses from Tax Expenditure Programs 1986-87 through 1988-89 (dollars in millions)[a]

	Identifiable Revenue Losses			*Growth in Identifiable Revenue Losses*			
				1987-88		*1988-89*	
Program Category	*1986-87*	*1987-88*	*1988-89*	*Amount*	*Percent*	*Amount*	*Percent*
Personal income tax programs	$11,461	$11,217	$11,823	-$244	-2.1%	$606	5.4%
Sales and use tax programs	3,654	3,884	4,126	230	6.3	242	6.2
Bank and corporation tax programs	373	806	1,038	433	116.1	232	28.8
Programs for other state taxes	305	331	362	26	8.5	31	9.4
Subtotals, all state programs	$15,793	$16,238	$17,349	$445	2.8%	$1,111	6.8%
Local property tax programs	1,881	1,961	2,033	80	4.3	72	3.7
Local share of sales and use tax programs	1,162	1,262	1,370	100	8.6	108	8.6
Totals, all programs	$18,836	$19,461	$20,752	$625	3.3%	$1,291	6.6%

[a] Figures shown include the distorting effects of 1987 state tax reform legislation. For information on these effects see Tables 10 and 11.

What factors are most responsible for these budget changes?

Changes in the size of the tax expenditure budget from year to year are primarily due to two factors:

- First, ***the number and coverage of specific individual tax expenditure programs may change,*** as existing programs are eliminated, modified or allowed to sunset, and new programs are enacted.
- Second, ***the estimated revenue losses associated with existing programs may change,*** even though these programs' provisions themselves may be unchanged. This may occur for a variety of reasons. For instance, the number of taxpayers who qualify for a program may increase. Or, the dollar value of the tax base that a program applies to may increase, due to inflation or expanded economic activity.

The effect of changes to TEP programs. Tables 8 and 9 show the recent changes in the state tax expenditure budget due to the first factor noted above--changes in the number and coverage of individual TEPs. Specifically, Table 8 indicates that the combined first-full-year net identifiable revenue effect of changes to TEPs made in 1987 has been to reduce tax

Table 8

Selected Tax Expenditure Program Changes due to 1987 Legislation (dollars in thousands)[a]

		Estimated First-Full-Year Revenue Effect[b]
Program Extensions, Expansions and Enactments		**Revenue Loss**
STATE PROGRAMS		
Ch 1138/87	Conforms personal income tax law to federal law (PIT)	$633,000[c]
Ch 1139/87	Conforms bank and corporation tax law to federal law (B&C)	425,000[c]
Ch 1300/87	Partial exemption for cold food sold through vending machines (SALES)	13,200
Ch 1273/87	Revises pari-mutuel license fees for the northern racing zone; also reduces quarterhorse license fees (HORSES)	5,100
Ch 1103/87	Exemption for property purchased with food stamps (SALES)	3,700
Ch 1428/87	Expands enterprise zone program eligibility (PIT, B&C)	2,000
Ch 339/87	Exempts real estate mortgage investment conduits (PIT, B&C)	1,500
Ch 1481/87	Extends special deduction of scientific equipment to higher education (PIT, B&C)	1,000
Ch 1465/87	Exempts credit union earnings on investments (PIT, B&C)	800
Ch 1352/87	Extends exemption for fuel used by commercial fishing operators (SALES)	640
Ch 1471/87	Exemption for modifications to vehicles for the handicapped (SALES)	225
Ch 384/87	Expands exemption for orthopedic shoes and other supportive devices (SALES)	225
Ch 1280/87	Requires reimbursement of tax to owners who purchased defective vehicles (SALES)	145
Ch 945/87	Checkoff for Alzheimer's Disease research (PIT, B&C)	100
Ch 851/87	Exempts temporary teachers at private high schools from income tax withholding (PIT, B&C)	100
Ch 1095/87	Extends exemption for California Gold medallions (SALES)	48
Ch 1193/87	Checkoff for contributions to Vietnam Veterans' Memorial Fund (PIT, B&C)	35
Ch 1272/87	Reduces harness racing license fees at tracks longer than one mile (HORSES)	33
LOCAL PROPERTY TAX PROGRAMS		
Ch 186/87	Permits elderly home owners to "transfer" the value of a current home to a new home for property tax purposes	16,800
Ch 261/87	Removes fixtures from the definition of taxable property	15,900
Ch 48/87	Provides that certain parent-to-child property transfers are not a "change in ownership"	15,000
Ch 1469/87	Extends welfare exemption to low-income rental housing	3,500
Ch 1228/87	Exemption for nonprofit multispecialty outpatient clinics	800
Ch 144/87	Permits Williamson Act lands to be assessed at full market value if this value is lower than other assessment measures	250
Ch 1412/87	Exemption for city-owned nonprofit entity devoted to public purposes	72
Program Terminations and Reductions		**Revenue Gain**
STATE PROGRAMS		
Ch 1138/87	Conforms personal income tax law to federal law (PIT)	1,648,000[b]
Ch 1139/87	Conforms bank and corporation tax law to federal law (B&C)	88,000
LOCAL PROPERTY TAX PROGRAMS		**NA**
Summary of Revenue Effects		
Total Identifiable State Revenue Losses		$1,086,851
Total Identifiable State Revenue Gains		1,736,000
NET IDENTIFIABLE REVENUE GAIN		**$649,149**

[a] State taxes to which individual program changes apply are noted in parentheses for each program change shown, using the following notation: personal income tax (PIT), bank and corporation tax (B&C), sales and use tax (SALES), and the horse racing tax (HORSE).

[b] Revenue effects are for 1988-89 unless otherwise noted.

[c] This estimate is for 1987-88. Neither the Department of Finance nor the Franchise Tax Board have prepared an estimate for the effect of this measure in 1988-89. However, the 1987-88 estimate essentially represents the first-full-year effect of the legislation.

Table 9
Selected Tax Expenditure Program Changes due to 1988 Legislation (dollars in thousands)[a]

		Estimated First-Full-Year Revenue Effect[b]
Program Extensions, Expansions and Enactments		**Revenue Loss**
STATE PROGRAMS		
Ch 11/88	Expands the deductibility of net operating losses, and makes other tax conformity clean-up changes (PIT, B&C)	$17,000
Ch 1521/88	Establishes tax credit program for "small" employers who provide specified health care benefits to their employees (PIT, B&C)	13,000[c]
Ch 1239/88	Establishes tax credit program for employers who provide specified child care assistance to their employees (PIT, B&C)	8,500
Ch 1504/88	Conforms to federal provisions related to Employee Stock Ownership Plans effective 1/1/90 (PIT, B&C)	8,000
Ch 1227/88	Expands exemption of fuel and petroleum purchases for international airline flights (SALES)	2,150
Ch 32/88	Reinstates certain provisions related to enterprise zones (PIT, B&C)	1,000
Ch 1157/88	Expands exemption for goods and services used in the production of motion pictures and television programming (SALES)	400
Ch 1349/88	Expands eligibility for the joint-custody head-of-household tax credit (PIT)	375
Ch 905/88	Provides a use tax exemption for property donated by retailers to specified charitable organizations (SALES)	200
Ch 1647/88	Exempts transportation charges for fill dirt (SALES)	150
Ch 1437/88	Reinstates certain provisions related to ridesharing (PIT, B&C)	100
Ch 904/88	Exempts purchases of property for display by the California Museum of Science and Industry (SALES)	50
Ch 710/88 and Ch 711/88	Expands to youth organizations generally the partial exemption currently granted to specified youth groups for sales of prepared food (SALES)	50
Ch 1234/88	Expands eligibility for the military pay tax credit (PIT)	40
Ch 774/88	Extends through 1993 the partial exemption for non-motor-vehicle alcohol fuels (FUEL)	35
Ch 31/88	Increases the deductibility of certain "passive" activity losses related to low-income housing investments (PIT, B&C)	NA
Ch 1333/88	Extends the sunset date for a specified tax relief program for International Banking Facilities (B&C)	NA
Ch 1490/88	Excludes specified relocation assistance payments from taxable income (PIT)	NA
LOCAL PROPERTY TAX PROGRAMS		
Ch 411/88	Deletes residency requirement for the disabled veterans property tax exemption.	$1,500
Ch 1559/88	Exempts "supercomputer" at UC San Diego from possessory interest tax.	123
Ch 1296/88	Extends the welfare exemption for low-income rental housing to housing leased to a charitable organization.	25
Ch 1591/88	Expands welfare exemption to include property occasionally used for fund-raising and necessary employee housing.	NA
Ch 1625/88	Expands exemption from reassessment for transfers of mobilehome parks to tenant ownership corporations.	NA
Program Terminations and Reductions		**Revenue Gain**
STATE PROGRAMS		**NA**
LOCAL PROPERTY TAX PROGRAMS		**NA**
Ch 769/88	Requires reassessment on transfer of residence from a parent to a former son- or daughter-in-law.	NA
Ch 1076/88	Tightens eligibility for exemption from reassessment on purchase of mobilehome parks by tenants.	NA
Ch 1606/88	Provides partial denial of welfare exemption for property that also produces unrelated business income.	NA
Summary of Revenue Effects		
Total Identifiable State Revenue Losses		$51,050
Total Identifiable State Revenue Gains		--
NET IDENTIFIABLE REVENUE LOSS		**$51,050**

[a] State taxes to which individual program changes apply are noted in parentheses for each program change shown, using the following notation: personal income tax (PIT), bank and corporation tax (B&C), sales and use tax (SALES), and the use fuel tax (FUEL).

[b] First-full-year revenue effect will occur in 1989-90 for most provisions.

[c] This measure's provisions only become effective upon certification of specified fiscal conditions, but in no case does the measure become effective prior to January 1, 1990.

expenditures by about $650 million. Most of this reduction is due to the effects of state tax reform legislation. The net effect of the remaining 1987 legislation was to increase the 1988-89 tax expenditure budget by about $30 million. Regarding 1988 legislation, Table 9 indicates that its net effect is an increase in tax expenditures of about $51 million.

Exactly what has tax reform done to TEPs? Table 10 summarizes the major provisions of the federal-conformity tax reform legislation that the state enacted in 1987 (Chapters 1138 and 1139), while Table 11 specifically identifies the approximate effects of tax reform on tax expenditures. As shown in Table 10, tax reform broadened the state's tax base, primarily by eliminating various tax deductions and income exclusions. Tax rates also were lowered, with the objective being to make the legislation relatively revenue neutral. Table 11 shows that these and other features of tax reform *lowered* the total dollar-volume of state tax expenditures below what it otherwise would have been by over $675 million in 1987-88, the first fiscal year affected by tax reform. This effect carries over into 1988-89 and thereafter, although it is somewhat less than in 1987-88 because of how the revenue effects of certain individual tax reform provisions are phasing-in over time.

One thing in Table 11 that deserves special explanation is why the level of bank and corporation TEPs is shown to *increase* (that is, cause a larger revenue loss) under tax reform, despite both base broadening and lower tax rates. The reason is that the tax reform provisions for net operating loss carry-forwards and Subchapter S corporations shown in Table 11, which represent increases in TEPs and cost the state revenues to provide, are "paid

Table 10
Major Provisions of 1987 State Tax Reform
Chapters 1138 and 1139

PERSONAL INCOME TAX LAW	BANK AND CORPORATION TAX LAW
Base-broadening changes	***Base-broadening changes***
• Full taxation of capital gains	• Uniform capitalization rules
• Passive loss limits and "at risk" rules	• Limits on business and entertainment deductions
• Repeal of income averaging	• Restrictions on long-term contract accounting methods
• Other provisions, including elimination or reduction of various tax deductions and income exclusions[a]	• Limits on cash-accounting methods
	• Limits on expensing of intangible drilling costs
	• Various other provisions
Other changes	***Other changes***
• Reduction of marginal tax rates and revisions to tax brackets	• Conformity to federal rules for taxing Subchapter S corporations, accompanied by a special 2.5 percent surtax
• Conformity to the federal standard deduction	• Partial carryover of net operating losses
• Increases in personal and dependent credits, and allowances for senior credit	• Reduction in tax rate from 9.6% to 9.3%
• Enactment/expansion of other credits	• Other provisions[b]
• Provisions to encourage tax compliance	

[a] Affected areas include retirement contributions, pensions, moving expenses, alimony, charitable contributions, state and local taxes, consumer and investment interest, accounting methods, employee business expenses, business meals and entertainment, depreciation, and others.

[b] Includes increase in the basic minimum tax, conformity to the federal alternative minimum tax, conformity to various federal tax credits, and provisions relating to tax compliance and other subjects.

Table 11
Identifiable Revenue Effects of Significant Tax Conformity Provisions on 1987-88 TEPs (dollars in millions)[a]

Personal Income Tax Law		Bank and Corporation Tax Law	
I. *Program Extensions, Expansions and Enactments*			
Contributions to IRA accounts	-$75	Subchapter S Corporations	-$249
Contributions to Keogh plans	-60	Partial carryover of net operating losses	-176
Standard deduction	-50		
Charitable contributions	-50		
Dependent exemption credit	-304		
Other credits[b]	-94		
Subtotals	-$633		-$425
II. *Program Terminations and Reductions*			
Full taxation of capital gains	$764	Limits on business and entertainment deductions	$63
Employee business expenses and miscellaneous expenses	254	Limits on expensing of intangible drilling costs	25
Medical and dental expenses	65		
Taxes paid	213		
Nonmortgage interest	172		
Income averaging	180		
Subtotals	$1,648		$88
Total Effects	$1,015		-$337
Total Effect, Both Taxes			$678

[a] Source: Assembly/Senate Conference Committee on Tax Reform, Department of Finance and Franchise Tax Board.

[b] Includes credit for political contributions, and increases in the credits for child care and the elderly.

for" primarily by the revenue-increasing uniform capitalization rules adopted under tax reform. In our opinion, these uniform capitalization rules are most appropriately viewed as a *change in the state's "basic tax structure."* Thus, although these rules result in added state revenues, we do *not* show them as reducing tax expenditures.

The effect of economic factors. Given the above, most of the net increase in the tax expenditure budget in 1988-89 is attributable to the second factor cited above--increased costs of existing programs due to economic factors such as expanded business activity, inflation, and increased numbers of taxpayers. In other words, the 1988-89 growth in the tax expenditure budget is primarily *economically driven,* as opposed to being mostly caused by tax policy changes.

Historically tax policy changes have been a small factor

Tax policy changes have played a relatively *minor role* in the tax expenditure budget's growth in recent years--often a much lesser role, in fact, than in 1987 and 1988. For example, as summarized in Table 12, the net first-full-year effect of tax policy changes has been to increase the tax expenditure budget (that is, reduce state revenues) by only modest amounts in 1981, 1982 and 1984, and to actually *reduce* the tax expenditure budget (that is, increase state revenues) by fairly significant amounts in 1983, 1985 and 1986. Similarly, the revenue losses from new or expanded tax expenditure programs during the 1980s have been fairly small, never amounting to more than a fraction of 1 percent of the total tax expenditure budget. In fact, the data in Tables 11 and 12 indicate that even if one excludes the significant net reduction in tax expenditures caused by the state's 1987 tax reform legislation, the net effect of legislative policy actions during the decade of the 1980s still has been to *reduce* the size of the state's tax expenditure budget.

Table 12
Identifiable Revenue Effects of New Legislation Affecting the Number and Cost of State Tax Expenditure Programs 1981 through 1988 (dollars in millions)[a]

	First-Full-Year Revenue Effects		
Year Legislation Enacted	*Revenue Gains*	*Revenue Losses*	*Net Effect*
1981	--	$63.8	-$63.8
1982	$29.4	52.0	-22.6
1983	180.8	21.8	159.0
1984	13.0	43.1	-30.1
1985	122.7	17.1	105.6
1986	257.5	57.0	200.5
1987	1,736.0	1,086.9	649.1
1988	--	51.0	-51.0

[a] Figures shown for 1981 through 1985 are derived from data presented in the *1987-88 Governor's Budget*, pages 107 to 109. Figures shown for 1986 are derived from our report *Analysis of the 1987-88 Tax Expenditure Budget* (Volume I, Part I, Table 8, pages 16 to 17). Figures shown for 1987 and 1988 are derived, respectively, from Tables 8 and 9 above.

Summary

Given the above, tax policy changes typically have tended to have relatively *limited effects* on the total size and growth of the tax expenditure budget. Rather, year-to-year changes in the budget are mostly attributable to the expanding tax base of the economy and other economic and demographic factors, which *automatically* increase the costs associated with most TEPs.

Legislative Policy Issues Regarding Tax Expenditures

The main issue facing the Legislature with respect to tax expenditures involves its ongoing decisions regarding whether individual TEPs should be enacted, extended, modified, replaced with a direct expenditure program, or terminated altogether.

How Can the Legislature Best Approach Making Its Decisions About TEPs?

In making its decisions about TEPs, it is desirable that the Legislature do two things.

- ***First, the objective(s) of a TEP should be clearly agreed upon by the Legislature.*** The reason this is important is because the effectiveness and economic sensibility of a program cannot be properly evaluated without its purpose being known. The underlying rationales for most existing TEPs fall into three general categories -- to provide *tax relief* to specific individuals and/or businesses, to provide *economic incentives* to encourage certain types of private sector economic activity, or to *simplify or reduce the costs of state tax administration*. Whenever the Legislature reviews a TEP, it needs to determine if the TEP's objective is consistent with the Legislature's current policy objectives and spending priorities. If not, the TEP should be eliminated and the revenues gained from doing so used for a better purpose.
- ***Second, a judgment must be made regarding whether a TEP is a cost-effective means of achieving its agreed-upon objective(s).*** Assessing the cost-effectiveness of individual TEPs involves determining whether their objectives actually are being realized, whether a TEP's benefits exceed the revenues foregone to provide them, and whether there is a less-costly way of providing these same benefits.

Significant Data Limitations Exist

Unfortunately, it has been our experience that some very significant impediments can be encountered when attempting to evaluate many TEPs. By far the most important problem involves *data limitations*. For example:

- Basic information is frequently lacking on the *number and characteristics* of a TEP's actual beneficiaries. This makes it impossible to accurately estimate the cost of many TEPs, let alone evaluate exactly what types of taxpayers they are helping, including how a program's benefits are distributed by income class.
- Likewise, data usually are hard to come by regarding exactly how the *behavior of taxpayers* is affected by TEPs. This is an important roadblock to evaluating whether the economic incentives that some TEPs claim to offer, accomplish much more than simply providing "windfall benefits" to certain taxpayers.

Our own attempts to overcome these data problems, such as surveying target groups of taxpayers who we think may be affected by a particular TEP, have met with only mixed success. Thus, realistically speaking, there are many TEPs for which the Legislature may *never* have conclusive evidence as to their cost-effectiveness.

What Are the Options?

In the case of TEPs for which relatively good data exist, decisions about these programs preferably should be based primarily on whether they are *cost-effective* in meeting their objectives. However, what about the remaining TEPs, for which better data are needed but are either impractical or otherwise difficult to obtain? Here, we believe that the Legislature has three basic options:

- First, the TEP can be ***left in place,*** even though its exact cost-effectiveness cannot be determined. This option makes sense when the rationale for the program is extremely strong, there are obvious administrative savings of using a TEP instead of a direct expenditure program, and circumstantial evidence exists that the TEP is not bestowing large windfall benefits on taxpayers for whom the program really was not intended. In this case, however, the Legislature still should carefully review the TEP's eligibility requirements to ensure that whatever windfall benefits may be occurring are minimized.

- Second, the TEP can be ***replaced with a direct expenditure program,*** whose costs can be more directly controlled and whose benefits can be more accurately targeted than by using a TEP. This option makes the most sense when a program's rationale is strong, but there do not appear to be large administrative savings from using a TEP, and it appears likely that the TEP is producing significant windfall benefits which cannot easily be controlled. Given the current constraints of the state's constitutional appropriations limit, however, use of this option may require the elimination or curtailment of some other direct expenditure program in order to "free up" sufficient appropriations authority.
- Third, the TEP can be ***eliminated altogether.*** This option is especially worth considering when the Legislature feels strongly that a particular program must be cost-effective to justify its continuance, but there are no data or other evidence to prove that it is.

We believe that the use of standards such as these will help to ensure that whenever the Legislature evaluates TEPs, they will be subjected to the same general types of cost-effectiveness considerations that apply to the direct expenditure budget.

We now turn to Part Two of this report, which contains our detailed reviews of selected individual tax expenditure programs. ❖

Part Two

Part Two

Detailed Reviews of Selected Individual Tax Expenditure Programs

This part of the report presents detailed reviews of selected individual tax expenditure programs (TEPs), as required by ACR 17. Each review provides a description of the provisions of the TEP being considered and its rationale(s), an estimate of the state revenue losses caused by the TEP, an evaluation of the TEP's cost effectiveness in achieving its objectives, and recommendations regarding continuing, modifying or eliminating the TEP. The reviews appearing in this report were chosen on the basis of such criteria as their efficiency in achieving their objectives, their applicability to only limited groups of taxpayers, and to comply with existing statutory reporting requirements.

The six individual programs which have been selected for detailed review in this report include the following:

- The personal income tax itemized deduction for mortgage interest expenses;
- The special accelerated depreciation deduction for residential rental housing;
- The sales and use tax exemption for packing ice and dry ice;
- The in lieu tax on racehorses;
- The partial property tax exemption for land under a wildlife habitat contract; and
- The sales and use tax exemption for coins and bullion.

These individual reviews are presented below.

Review of the Personal Income Tax Deduction for Mortgage Interest Expenses

This is the state's single largest tax expenditure program. It allows taxpayers to claim an itemized personal income tax deduction for the interest expenses they incur for mortgage debt. This has the practical effect of allowing taxpayers who itemize their deductions to borrow money for purchasing homes at a government-subsidized, lower-than-normal interest rate. In the absence of this program, taxpayers who borrow money by taking out mortgage loans would receive no interest subsidy from the state.

Statutory Authorization and Legislative History

This program is authorized by Section 17201 of the California Revenue and Taxation Code, which conforms state law to federal Internal Revenue Code Section 163.

The mortgage interest deduction has been part of the state's Personal Income Tax (PIT) law since its inception in 1935. The deduction initially was adopted primarily to conform state law with federal law, which has allowed this deduction since 1913. Chapter 1138, Statutes of 1987 (AB 53), conformed California law to the new federal restrictions governing the deductibility of mortgage interest expenses which were enacted by the Federal Tax Reform Act of 1986. (California does not currently conform, however, to the additional federal law changes made in 1987. These changes are identified later in this review.)

Description of Provisions

This program allows taxpayers to claim an itemized income tax deduction for the amount of qualified mortgage interest which is paid or accrued within a taxable year.

Prior to 1987 the interest paid on *all* mortgage loans, including mortgage-backed loans like home equity loans, was fully deductible for state and federal tax purposes. However, the federal Tax Reform Act of 1986 enacted new restrictions on the amount of mortgage interest expenses that could be deducted by federal taxpayers, beginning with the 1987 income year. Under the federal rules enacted in 1986, which California conformed to under Chapter 1138, state taxpayers now can deduct only the mortgage-related interest paid on their principal residence and, if they have one, a second residence. These rules also limit the amount of mortgage debt on which interest is deductible to be the *lesser* of:

- The current fair market value of the residence involved; or
- The cost of acquiring the residence, *plus* the cost of home improvements made to it *and* the amount of debt incurred for certain specified medical and educational expenses (but no other types of expenses).

Thus, the practical effect of these new provisions is to "tighten up" on the ability of property owners to receive state interest subsidies for buying multiple residences, or for financing consumer spending from the built-up equity in their homes. This latter restriction on the deductibility of interest on home equity loans has been accompanied by recent state and federal restrictions on the deductibility of nonmortgage interest expenses as well. (Since the enactment of the federal Tax Reform Act of 1986, federal law regarding mortgage interest deductibility was again revised in 1987. This new federal law, to which California does *not* currently conform, places a limit of $1 million on the amount of mortgage indebtedness incurred for purchasing or improving residences on which a federal tax deduction for interest expenses may be claimed. In addition, federal law now permits only the interest on the first $100,000 of a taxpayer's home equity borrowing to be deducted, irrespective of the purpose of the borrowing and providing the debt does not exceed the full market value of the property backing the loan.)

Example

Suppose that a taxpayer purchased a principal residence in 1980 for $100,000, using a $20,000 cash down payment and an $80,000 mortgage loan. Suppose further that during the next several years the taxpayer made $30,000 worth of home improvements, paid for by cash withdrawn from a savings account. By 1988, the taxpayer finds that the home is worth $160,000 and the outstanding balance on the mortgage loan has fallen to $70,000. Thus, the taxpayer's home equity is $90,000. Given this large equity, the taxpayer decides to take out a second mortgage in order to use some of this built-up equity to buy a new car, put on a new roof, and take a vacation.

Under this program, the taxpayer could deduct the interest he pays on both the $70,000 outstanding balance on the original mortgage and the first $60,000 of his second mortgage (that is, the interest on a total of $130,000 worth of mortgage debt, since this equals the cost of the home and its improvements). Assuming that the taxpayer is paying an interest rate of 10 percent and is subject to the maximum state and federal marginal income tax rates, this program could reduce his taxable income by around $13,000, his direct *state* tax liability by about $1,200, and his *total* tax liability (after accounting for the interaction between state and federal taxes discussed below) by about $870.

Rationales for the Program

Three basic rationales have been advanced in support of the mortgage interest deduction.

The Home Ownership Rationale

The most commonly cited rationale for this program is that it provides an *incentive for home ownership*. This is because most home purchases require mortgage financing, and the deductibility of interest reduces the net after-tax cost of such financing. It often is claimed that home ownership is worth encouraging because it generates substantial public benefits, including neighborhood stability, promotion of civic responsibility, and encouragement of proper maintenance of residential structures by their occupants.

The Economic Stimulus Rationale

A second rationale frequently offered for the mortgage interest deduction is the claim that it *stimulates economic activity* in the construction and real estate industries, which in turn can benefit the overall economy by generating additional income and employment. It is certainly true that home building definitely can provide significant economic stimulus to the state's economy. However, this rationale suffers from failing to recognize that if this program were not in effect, the money used to fund it probably would be used in some *alternative* way, either by the state or taxpayers, that *also* would have stimulative economic effects.

This alternative stimulus would occur, for example, if the state were to use the tax savings from eliminating this program to fund capital infrastructure projects like highway construction, or if the savings were used to provide alternative types of tax benefits (such as other tax expenditures or reduced tax rates) that would increase taxpayers' after-tax disposable incomes and thus either stimulate their spending or increase the amount of household savings available to fund business investment. For these reasons, the economic stimulus rationale does *not* necessarily provide a convincing justification for this program.

The Tax Equity Rationale

A third argument sometimes advanced for this program is that owners of residential rental property get to deduct their mortgage interest costs, and not allowing the same deduction for home owners would be inequitable and discriminate against home ownership. This argument, however, fails to recognize that the interest costs associated with rental property are a direct *business* expense incurred by landlords in earning their rental income, which *is* subject to taxation. Home owners, in contrast, are *not* required to recognize as taxable income the implicit rental value of the housing services they derive from their homes.

The key point here is that both owner-occupied and rental homes generate housing services that their occupants consume, and these services have a market value and therefore generate income to the property owner. For home owners who invest in a house, the housing services they consume really are an investment return to them, just like the rents paid for a rental house are an investment return to the landlord. Thus, regardless of whether a home is rented or owned, the housing services it generates result in "income," even though this income must only be reported for tax purposes if a home happens to be rented.

Thus, the current tax treatment of income from owner-occupied housing and rental property is *not* at all analogous, and one cannot rationalize permitting home owners to deduct their mortgage interest costs just because the owners of rental property can do so as a business expense. (In fact, many economists argue that because home owners pay no taxes on their implicit rental income from their homes, permitting them to deduct their mortgage interest expenses is *itself* inequitable and discriminates against owners of rental property and their tenants.)

Given the above, we believe that the first rationale mentioned -- encouraging home ownership -- is the one that should be focused on when evaluating this program.

Evaluation of the Program

This section provides our evaluation of this tax expenditure program, including the program's usage and costs to the state in terms of foregone income tax revenues, the characteristics of its claimants, and its cost effectiveness in achieving its intended objectives. In preparing this analysis we have relied on tax return data provided by the Franchise Tax Board (FTB), and also have incorporated the findings of various economic research studies regarding the effects of mortgage interest deductibility.

Findings Regarding Program Usage and Revenue Losses

As noted earlier, the deduction for mortgage interest is the single largest itemized deduction claimed by state taxpayers. Chart 3 shows the number of taxpayers claiming the mortgage interest deduction and the total amount of deductions claimed for income years 1980 through 1987. The deductions claimed include interest paid on all mortgage and mortgage-backed debt, including home mortgage interest paid on principal residences, vacation homes and home equity loans.

Nearly 4 million taxpayers benefit

As shown in Chart 3, it is estimated that nearly $29 billion in mortgage interest deductions were claimed by about 3.8 million California taxpayers for the 1987 income year. Tax returns reporting the deduction represent approximately 30 percent of all personal income tax returns and over 70 percent of returns with itemized deductions. The average mortgage interest deduction per return is estimated to exceed $7,600.

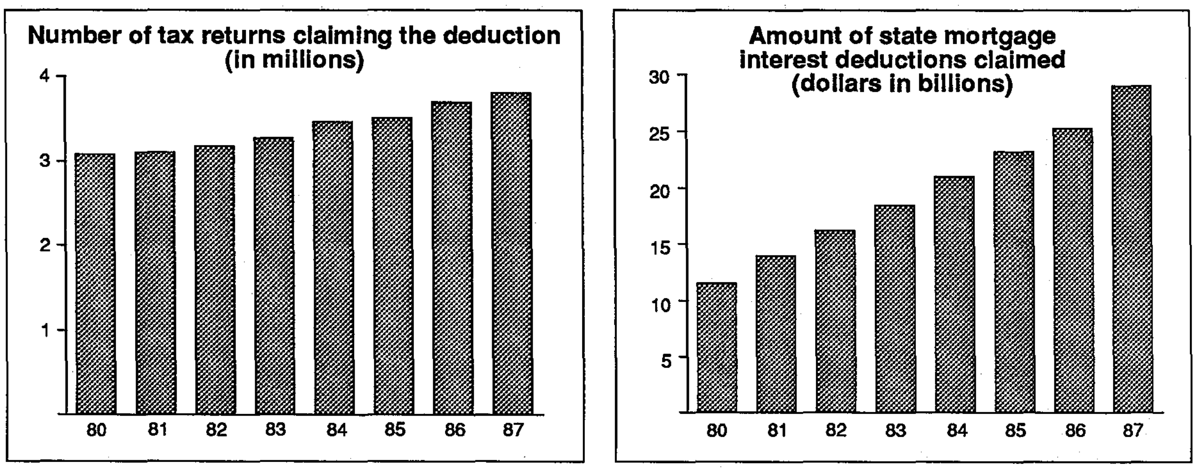
Program costs -- around $1.7 billion and growing

The state's costs of funding TEPs with income tax deductions usually are computed by multiplying the amount of deductions claimed by the average marginal tax rate of taxpayers using the program. Data from the FTB suggest that taxpayers claiming mortgage interest deductions have an average marginal tax rate of around 7 percent. Applying this rate to the nearly $29 billion in deductions claimed yields an estimated revenue cost for this program of over $2 billion.

Chart 3

State Mortgage Interest Deductions and Claimants

Income Years 1980 through 1987[a]



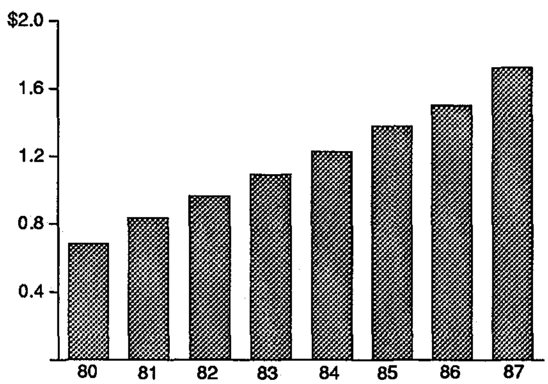
[a] *Data are from the California Franchise Tax Board. Figures for 1987 are estimated.*

However, the actual state revenue gain that would result if this program was eliminated would be *less* than this amount. This is because the dollar amount of the mortgage deductions that most taxpayers claim is such a significant share of their total itemized deductions, that eliminating this program would cause many taxpayers to be better off switching to the standard deduction instead of continuing to claim itemized deductions. For these taxpayers, not all of their eliminated mortgage interest deductions would result in more revenues to the state. For example, suppose that in 1987 a married taxpayer had total itemized deductions of $10,000, of which $7,500 were for mortgage interest expenses. Because eliminating this program would have reduced his itemized deductions to only $2,500, this taxpayer would have switched to claiming the state's $3,760 standard deduction. Thus, his actual deductions would only have fallen by (and thus his taxable income risen by) $6,600, and not his entire $7,500 worth of mortgage expenses.

Chart 4

Approximate Trend in Estimated State Revenue Losses from California's Mortgage Interest Deduction

Income years 1980 through 1987 (dollars in billions)[a]



[a] *Estimates by the Legislative Analyst, based on data from the California Franchise Tax Board. State revenue losses shown assume an average marginal state income tax rate of approximately 7 percent. They also assume that if the mortgage interest deduction was eliminated, the decline in total reported income tax deductions would equal only about 85 percent of the reported mortgage interest deductions, due to the interaction with the standard deduction.*

Based upon data from the FTB, it appears that the majority of taxpayers who would fall into this situation have incomes under $30,000, a group which accounts for a bit under 15 percent of total mortgage interest deductions. Given this, it appears that the general order of magnitude of the state's cost of providing this program is in the range of $1.7 billion. This estimate reflects the FTB's projected total amount of mortgage interest deductions for 1987, and assumes an average marginal state income tax rate of 7 percent. Data from the FTB also suggest that the average tax reduction per taxpayer claiming the deduction is around $535 per return for the state, or a net of $385 after taking account of the deductibility of state taxes on federal income tax returns.

Chart 4 indicates that the costs for this program have nearly *tripled* between 1980 and 1987. Some of this increase simply reflects demographic factors like population growth. However, much of it also is due to escalating California home prices and persistently high mortgage interest rates, along with the growing popularity during this period of financing nonhousing expenditures through home equity loans.

Findings Regarding Characteristics of Claimants

Charts 5 and 6 show the extent to which the state's mortgage interest deduction is claimed by taxpayers in different income categories. These data are for the 1986 income year, the most recent tax year for which such information had been published at the time we undertook our analysis.

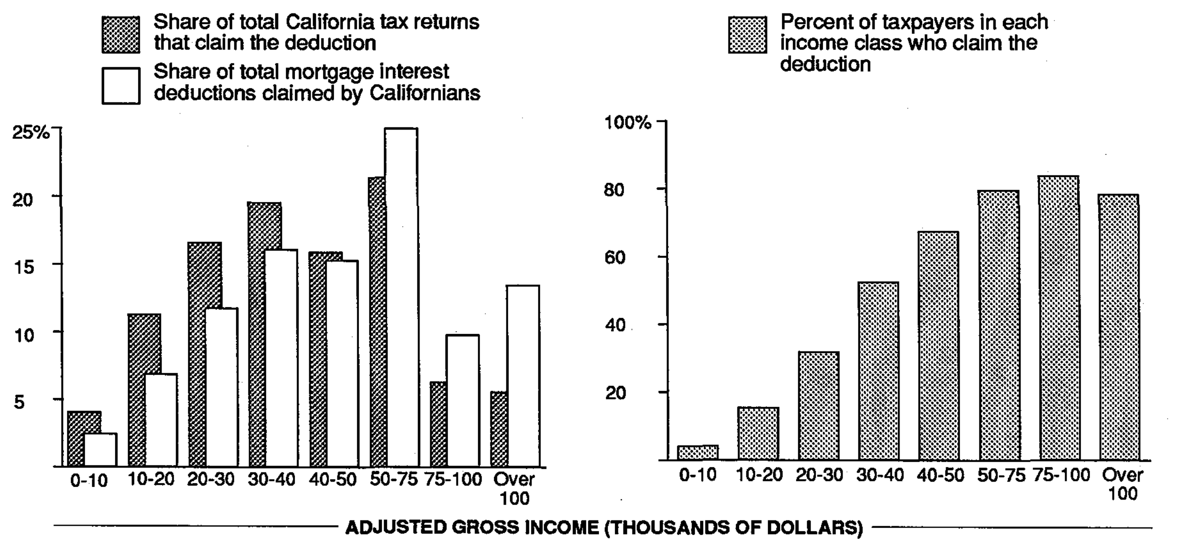
High-income taxpayers benefit disproportionately

Chart 5 indicates that the deduction is claimed by taxpayers throughout the *entire* income spectrum, and that the largest *number* of users have mid-level incomes. However, higher-income taxpayers are by far the heaviest users of the program in terms of both the

Chart 5

Use by California Taxpayers of the State's Mortgage Interest Deduction, by Income Class

Income Year 1986



Source: California Franchise Tax Board.

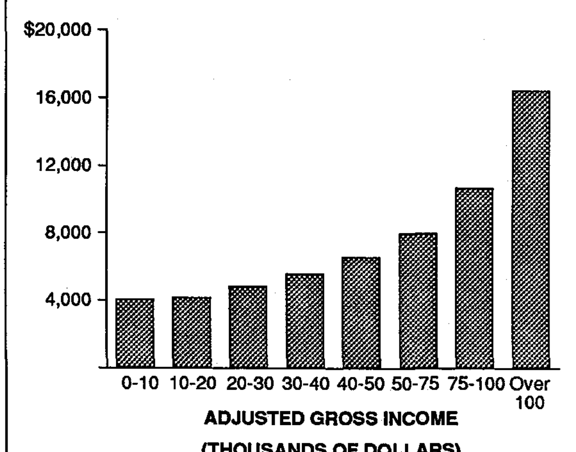
percentage who claim the deduction (see especially the graph on the right in Chart 5) and the average dollar amounts deducted (see Chart 6). For example:

- The deduction is claimed by only 15 percent of all taxpayers who have adjusted gross income (AGI) between $10,000 and $20,000 and by 32 percent of those who have AGI between $20,000 and $30,000, compared to about 80 percent of those taxpayers with AGI over $50,000.
- Taxpayers with AGI over $50,000 also account for about 48 percent of the total dollar amount of deductions claimed, even though this group comprises only one-third of all taxpayers who use the deduction. This occurs because the average dollar deduction claimed increases with income (see Chart 6).

Chart 6

Average Mortgage Interest Deduction Per Return, by Income Class

Income year 1986



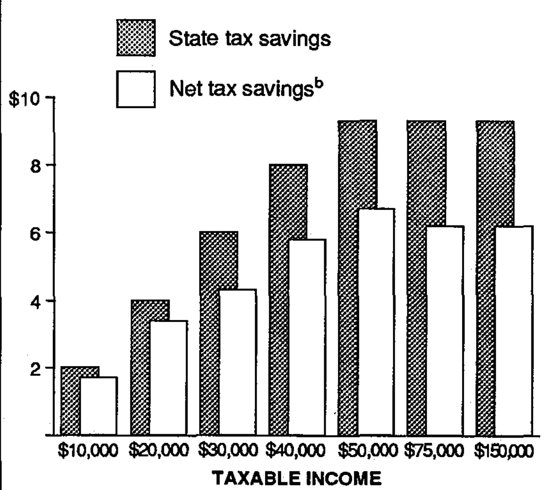
Source: California Franchise Tax Board.

Why Do High-Income Taxpayers Benefit Most? There are several reasons for the disproportionate usage of the program by high-income taxpayers. First, compared to taxpayers at lower income levels, such taxpayers are more likely to own homes rather than rent. In addition, higher-income taxpayers are able to afford more expensive homes, which generally means that they take out larger mortgage loans and therefore have more interest expenses. Finally, higher-income taxpayers are more likely to be able to itemize their deductions, and therefore to use this program, because they also tend to have significant other types of deductions such as charitable contributions. Conversely, lower-income taxpayers are more likely to be nonitemizers, in which case they cannot take advantage of this program.

Higher-income home owners also get more "bang for the buck." In addition to claiming larger amounts of mortgage interest deductions, higher-income taxpayers also receive a larger tax benefit per dollar of mortgage interest expenses than do lower-income taxpayers. This is illustrated in Chart 7, and is due to the state's progressive marginal tax rate schedule. For example, a joint-return taxpayer with 1987 taxable income of $47,900 or more falls into the state's highest marginal income tax bracket of 9.3 percent. Therefore, this taxpayer receives a $9.30 state tax reduction for every $100 in mortgage interest expenses claimed. In contrast, a joint-return taxpayer with $30,000 of taxable income falls within the 6 percent bracket, and thus receives a smaller state tax reduction--only $6--for the *same* dollar amount of reported interest expenses. (Chart 7 also shows what the *net* benefits become at different income levels after accounting for the deductibility of state taxes on federal tax returns. Here, too, the tax savings per $100 of deductions generally *rise with income*).

Chart 7

1987 Tax Savings Per $100 of Mortgage Interest Deductions, by Selected Income Levels[a]



[a] *Data shown apply to joint-return taxpayers.*

[b] *Net tax savings are less than state tax savings because state tax liabilities may be claimed as an itemized deduction on federal tax returns. Thus, lower state tax liabilities result in a partially offsetting increase in federal tax liabilities. The reason why the net tax savings drop off somewhat for taxable income above $50,000 is that the state's maximum marginal income tax rate (9.3 percent) is already in effect at $50.000, whereas the maximum federal rate has yet to be reached.*

Findings Regarding the Program's Cost Effectiveness

The major criterion for evaluating the merits of a tax expenditure program is whether it has achieved its objectives in the most cost-effective manner possible. That is, has the program accomplished its objectives, and done so less expensively compared to other approaches available to the state? As noted earlier, the most commonly cited rationales offered for this program are:

- To provide a *financial incentive* for families to buy homes; and
- To *benefit the economy* by stimulating activity in the construction and real estate industries, and thereby increase state income and employment.

Does the program really encourage home ownership?

There is no question that this program increases the incentive for taxpayers to purchase homes. This is because it lowers the after-tax cost of home ownership. The key issue from the perspective of cost effectiveness, however, is whether the response of taxpayers to this added incentive is large enough to justify the program's cost. For example, if the reduction in housing costs due to the program is simply too small to affect the home-buying decisions of most taxpayers, then the program is not cost-effective because it simply ends up giving "windfall benefits" to those taxpayers whose behavior would have been the same even in the program's absence. Thus, under these circumstances, the resources represented by the tax savings accruing to individual home owners may not be used in the most cost-effective fashion.

The actual effect of this program on home ownership depends primarily on two factors:

- The *amount* by which the program reduces the costs of home ownership; and
- The *sensitivity* of individuals' decisions about buying homes to this cost reduction.

Reductions in housing costs are relatively modest. For illustration purposes, Table 13 shows the net benefit of the program for a taxpayer, depending upon the taxpayer's mortgage loan size, mortgage interest rate, income level and marginal income tax bracket. Consider, for example, the case of a taxpayer who takes out a $125,000 mortgage loan at 10 percent interest to buy a $140,000 home, which was the approximate 1987 median purchase price of a single-family home in California. Assuming that this taxpayer spends about 30 percent of his monthly after-tax income on mortgage payments and has a marginal state income tax rate of 8 percent, Table 13 indicates that this program would save the taxpayer about $60 per month during the first year of the mortgage (this net savings incorporates the interaction between state and federal tax liabilities). This compares to his monthly loan payments of $1,097, plus an additional monthly cost of probably $150 to $250 for property taxes and home owners' insurance. Thus, the program's savings to the taxpayer would be about *5.5 percent* as a share of his mortgage expenses, or around *4.6 percent* when the costs of property taxes and insurance also are considered. As a share of monthly after-tax income, the savings would be about *1.6 percent.*

This is a *maximum* benefit for this taxpayer. Given the way home loans are amortized, the benefit would become *smaller* in subsequent years as the portion of the monthly loan payment that represents interest diminishes. For instance, Table 1 shows that the program's average monthly benefit over the *entire lifetime* of the mortgage loan would be only $27 in today's dollars, or *under 3 percent* of the taxpayer's mortgage expenses and *under 1 percent* of his income. Thus, the benefits are relatively modest.

Table 13
Income Tax Benefits of the State Mortgage Interest Deduction Under Alternative Economic Assumptions

Alternative Economic Assumptions			*Average Monthly Income Tax Benefit[a] (constant dollars)*			
			Benefit During First Year of Mortgage		*Benefit Over Lifetime of Mortgage*	
Original Mortgage Balance[b]	*Monthly Mortgage Payment[c]*	*Average State Marginal Income Tax Rate[d]*	*Dollar Benefit*	*Benefit as a Percent of Mortgage Payment*	*Dollar Benefit*	*Benefit as a Percent of Mortgage Payment*
$50,000	$439	5%	$15	3.4%	$7	1.6%
75,000	658	6	27	4.1	12	1.8
100,000	878	7	42	4.8	19	2.2
125,000	1,097	8	60	5.5	27	2.5
150,000	1,316	9	81	6.2	36	2.7
175,000	1,536	9	95	6.2	42	2.7
200,000	1,755	9	108	6.2	48	2.7

[a] The benefit figures shown adjust for the deductibility of state income taxes when computing taxable income for federal tax purposes. This adjustment causes the net benefit to taxpayers of the state's mortgage interest deduction to be less than their state tax savings.

[b] Assumes a mortgage loan equal to approximately 90 percent of a home's purchase price.

[c] Assumes a 30-year level-payment mortgage loan with an annual interest rate of 10 percent.

[d] Assumes that monthly mortgage payments equal approximately 30 percent of a home owner's after-tax income.

Low-income households get even smaller benefits. Table 13 also shows that both the dollar and percentage benefits of the program are *even less* than in the above example for taxpayers who have lower incomes and therefore the most difficulty buying homes. For example, savings to the taxpayer with annual after-tax income of $26,000 and a monthly mortgage payment of $658 would be about $27 per month in the first year, and would average $12 per month over the mortgage's life span.

Home ownership is encouraged, but program is inefficient. What effects do tax savings like those shown in Table 13 have on decisions about home purchasing? We believe that the effects are *mixed.*

On the one hand, the tax savings offered by the program *probably do enable certain taxpayers to buy homes,* especially those lower-income families who are literally "on the margin" about whether they have sufficient financial resources to make house payments. Studies by economists have shown that elimination of the federal deduction for mortgage interest would reduce both the number of households owning homes and the amount spent for homes (this assumes that the money the government would save from eliminating the deduction would not be used to fund some alternative type of program to assist home buyers). Analogous results would tend to apply for the state's deduction, although the effects would be much weaker than at the federal level because of the state's lower marginal tax rates and the deductibility of state taxes on federal returns (see below).

On the other hand, however, the interest rate subsidies made available under this program undoubtedly accrue in many instances simply as "windfall benefits" to taxpayers who would have purchased homes anyway, or encourage certain individuals to "over consume" housing by buying bigger and more expensive homes than they otherwise would. This means that regardless of how beneficial the program is in terms of helping some families to afford homes, it is *inherently inefficient* because it provides substantial subsidies to certain individuals -- especially higher-income taxpayers -- who do not really need them to acquire acceptable housing.

Federal government ends up with some of the benefits. Some of the state's revenue losses caused by providing this program do not even end up in the hands of California home owners, but rather "leak away" as benefits to the federal government. This adds to the program's inefficiency, and occurs because current federal law permits taxpayers to claim an itemized deduction for state income taxes paid when computing their federal taxable income. Thus, any reduction in state tax liabilities is partially offset by an increase in federal tax liabilities. This means that in addition to simply providing "windfall benefits" and unneeded subsidies to certain home owners, part of the state's revenues foregone to fund this program do not even directly benefit California taxpayers. Rather, they accrue to the federal government. This leakage is greatest for upper-income taxpayers in the highest federal tax brackets. For example, the benefits shown in Table 13 for high-income taxpayers have been reduced by about 28 percent to account for leakage to the federal government. (This reflects the fact that, beginning in 1988, the federal marginal income tax rate for these individuals is 28 percent.)

Other problems with the program

In addition to such problems as providing "windfall benefits" to certain taxpayers and the federal government, and disproportionately favoring high-income taxpayers, this program also is characterized by the following inefficiencies and inequities:

- ***Poor targeting.*** The program is not specifically tailored to focus on helping those groups who tend to be most in need of assistance if they are to become home owners, such as low-income households and first-time home buyers. As noted earlier, for example, low-income households receive a very small share of the program's total benefits.
- ***Expensive housing is subsidized.*** The program subsidizes taxpayers who voluntarily choose to spend much more money on housing than is "needed" simply to have decent living accommodations. For example, a wealthy individual who buys a mansion costing $2 million gets to deduct for state tax purposes, at the taxpayers' expense, *all* of the interest he pays on his mortgage.
- ***Rental housing is placed at a financial disadvantage.*** Owners of both owner-occupied and rental housing are allowed to deduct their mortgage interest costs. As noted earlier, however, only the owners of rental property must pay taxes on the income their property produces, since home owners are not taxed on the imputed rental income they receive from the homes they live in and implicitly rent to themselves. Thus, owner-occupied housing is given a financial advantage over rental housing, and many economists argue that this differential treatment promotes the former at the expense of the latter, and thus has detrimental impacts on both renters and rental property owners. For this situation to be acceptable from a tax policy standpoint, the Legislature must determine that giving special favor to owner-occupied housing is justified on such grounds as promoting neighborhood stability, civic responsibility and good property maintenance.
- ***Household debt is encouraged.*** Because the program gives a tax break for paying interest on mortgage loans, it encourages households buying a given home to finance a greater portion of its purchase price through borrowing than they otherwise might. This tends to increase the level of total household debt and thus the monthly burden of loan repayments, which some economists believe can make

consumer spending and therefore the overall economy more unstable.

- ***Nonhousing expenditures are subsidized.*** Although this program supposedly is intended to encourage home ownership, many taxpayers are able to use it to obtain a subsidy for certain *nonhousing* expenses. As discussed earlier, this is because taxpayers can take tax-deductible second mortgages out on their homes and then use specified amounts of the proceeds for personal consumption purposes, such as vacations and car purchases. (Recent research suggests that substantial portions of consumer-type home equity loans may not even be going for these "big ticket" items, but rather "everyday-type" spending needs.) In addition, taxpayers are allowed to deduct the interest on mortgage-backed loans for specified educational and medical purposes.

The subsidization of nonhousing expenditures is a concern for two reasons. First, there is *no direct relationship* between the home ownership-related objectives of the mortgage interest deduction and the need to provide an interest subsidy for nonhousing personal expenditures. The deductibility of *nonmortgage* interest is scheduled to be completely phased-out under both state and federal law by 1991, in response to concerns about the pro-borrowing incentive which the deduction created. Given this, it seems inconsistent to permit continued subsidization of *mortgage* interest that is incurred to finance such nonhousing spending.

The second concern about permitting nonhousing expenditures to be subsidized through the vehicle of the mortgage interest deduction involves inequities between taxpayers. One type of inequity is between different taxpayers who *use* the program, since the amount of the subsidy for nonhousing spending available under the state's mortgage interest deduction program is not only dependent on a taxpayer's marginal tax rate, but also on the amount of housing *equity* the taxpayer happens to have. A second type of inequity that arises from subsidizing nonhousing expenditures through this program is between households who qualify to use the program and those who do not. For example, taxpayers who rent their homes can receive no subsidy for nonhousing purposes, even though their "need" for medical treatment, education or personal items can be every bit as pressing as, and in many cases greater than, that of people who happen to own their homes.

Given the above, ***we conclude that although the mortgage interest deduction does work towards promoting home ownership, there are a number of inefficiencies and inequities associated with the program that should be addressed.***

Conclusions and Recommendations

Allowing taxpayers to deduct their mortgage interest expenses has been rationalized on several grounds, the most legitimate of which is the promotion of home ownership. The program does in fact work toward this end. However, it is far from perfect in terms of either cost-effectiveness or efficiency.

Given its shortcomings, some economists have recommended that the mortgage interest deduction be eliminated altogether. However, the fact should not be overlooked that the program is at least partly successful in achieving its objectives, and abruptly eliminating it could require difficult financial adjustments on the part of thousands of households who have made housing-related decisions while the program has been in place. (For example, monthly housing costs would rise and the value of owned homes would be somewhat less than otherwise.) Because of this and the fact that there are ways of addressing at least some of the program's shortcomings, ***we believe that it makes more sense for the Legislature to retain and improve the program than to eliminate it altogether. Given this finding, we recommend that the Legislature take steps to improve this program by minimizing some of its inherent inefficiencies and inequities.***

There are several approaches for accomplishing this. At the very minimum, ***the Legislature may wish to conform state law to the 1987 federal law changes regarding the mortgage interest deduction that were described earlier in this review.*** Beyond taking this step, however, the Legislature also may wish to consider the following other options.

1. An Effective Limit on the Amount of the Mortgage Interest Deduction

Even if the state conformed to current federal law, taxpayers still would be able to deduct the interest they pay on mortgage indebtedness of up to $1 million for purchasing or improving residences. Thus, for example, if mortgage rates were at 10 percent, a maximum deduction of close to $100,000 could be claimed. Instead, under this option, the state could simply place a lower, more realistic ceiling on how much mortgage interest each taxpayer could deduct in any year. This would address the current program's problem of providing large subsidies for expensive homes. The lower (higher) the ceiling, the greater (fewer) the number of taxpayers who would be immediately affected. For instance, if the ceiling were set at $10,000, we estimate that approximately 18 percent of all taxpayers would face some loss of tax benefits, compared to about 8 percent if the ceiling were set at $15,000.

2. Elimination of the Deduction for Second Homes and Nonhousing Expenses

Under this option the Legislature could restrict the interest deduction only to interest paid on the mortgage for a taxpayer's principal place of residence. Likewise, it could limit the deduction for mortgage interest to the original mortgage loan amount for this principal residence, thereby effectively eliminating use of the program to subsidize nonhousing expenses.

3. A Tax Credit for Mortgage Interest Expenses

This option would entail converting the current mortgage interest *deduction* to a tax *credit*. As indicated earlier, a tax deduction provides higher-income individuals with greater tax savings per dollar of mortgage interest than lower-income individuals, due to the progressivity of the state's tax rate structure. Switching to a tax credit would make the per dollar subsidy *equal* for all home owners, regardless of their income level. (The credit could even be made refundable if the aim was to ensure that all home owners would receive some designated amount of benefits, regardless of the level of their tax liability.)

4. Other Targeted Housing Subsidy Programs

If it is a special priority of the Legislature to help low-income households and first-time home buyers become home owners, it may wish to consider supplementing the current program with other programs that specifically target these two groups of households. The cost of such targeted subsidy programs could be paid for by the revenue gains from "tightening up" the current mortgage interest deduction program, such as by restricting its use for expensive and second homes, and nonhousing expenditures. An example of an existing targeted subsidy program is the special tax credit for construction or rehabilitation of low-income housing, which was established for federal tax purposes in the federal Tax Reform Act of 1986. The state conformed to this credit in 1987. However, there is no federal or state low-income housing credit that individual home owners themselves may claim.

Many public finance economists and tax experts would agree that, when it comes to giving financial subsidies to individual home owners, options like restricting and better targeting the mortgage interest deduction merit serious consideration by policymakers as alternatives to the current sole reliance on nontargeted and relatively unrestricted mortgage interest deductions. Naturally, it would be preferable for any changes in the mortgage interest deduction to be implemented in a manner that would not be overly disruptive to the majority of current home owners, thousands of whom have made their housing-related decisions with the current program in place. This could involve such approaches as phasing in the changes over time. In addition, the Legislature would have to carefully consider the current spending constraint imposed by the state appropriations limit if the mortgage interest deduction were changed in a way that resulted in significantly increased state revenues. For example, the limit could prohibit the Legislature from spending these added revenues on direct expenditure programs, in which case they would have to be used for such other purposes as funding other tax expenditure programs, reducing tax rates, or giving rebates to taxpayers.

The important point, however, is that ***there are steps the Legislature can take to reduce some of the inefficiencies and inequities characteristic of the current mortgage interest deduction program, while still maintaining the program as a basic feature of the state's income tax structure and a tool for achieving some of the Legislature's housing-related policy goals.*** ❖

Review of the Accelerated Depreciation Deduction for Residential Rental Housing

This tax expenditure program allows taxpayers to claim *an accelerated depreciation deduction* for the cost of qualified new residential rental property constructed and located in California.

Statutory Authorization and Legislative History

This program is available to corporate and personal income taxpayers owning qualifying property, and is authorized by Sections 24349.5 and 17250.5 respectively, of the California Revenue and Taxation Code. The program was originally established in 1984 by Chapter 1699 (SB 2198), which conformed both state personal income tax (PIT) law and bank and corporation tax (B&C) law to the federal depreciation provisions for residential rental property which were in effect at that time. These federal provisions have been subsequently revised. Chapter 1699 also requires the Legislative Analyst to evaluate the economic and fiscal effects of its provisions.

Description of Provisions

Both state and federal law permit taxpayers to recover their costs for acquiring business-related equipment and facilities, by claiming tax deductions for "depreciation." These depreciation deductions ordinarily must be spread over time based on the useful life of the assets involved.

This program allows certain taxpayers to depreciate the cost of qualified residential rental property over a shorter-than-normal time period, by using the federal Accelerated Cost Recovery System (ACRS). To qualify, a property must meet three conditions:

- First, the property must be located in California.
- Second, construction of the property must have begun between July 1, 1985 and December 31, 1986 for personal income taxpayers, and between July 1, 1985 and July 1, 1988 for corporate taxpayers.
- Third, 80 percent of the property's gross rental income must be derived from residential dwelling units, as opposed to, for example, commercial activities.

The Scope of the Program Has Recently Narrowed

For the 1985 and 1986 income years, the program applied both to individual and corporate taxpayers. Beginning in 1987, however, the program applies only to corporate taxpayers. This is because Ch 1138/87 directly conformed California's personal income tax law to the new federal ACRS depreciation rules that were adopted as part of the 1986 Tax Reform Act for business property generally (including the new residential property that this program previously covered). Thus, Chapter 1138 allows ACRS to be used for all business property subject to the personal income tax.

Summary of Depreciation Rules for Residential Rental Housing

Chart 8 summarizes California's depreciation rules for new residential rental property, including how they have evolved over time. The depreciation rules shown are complex, because they involve not only the time period over which an asset may be written-off, but also restrictions on the way that depreciation can be spread-out within this period and provisions for "recapturing" accelerated depreciation when assets are sold. However, the key things to note from Chart 8 are that:

- For 1985 and 1986, Chapter 1699 *significantly reduced* the period over which both individual and corporate taxpayers were required to spread their state depreciation deductions, from 40 years to only 18 years.
- Beginning in 1987, the depreciation rules applying to individuals became *different* from those applying to corporations. In the case of *individuals*, continued use of ACRS was permitted but taxpayers were required to use a *longer* depreciation period than previously--27.5 years instead of only 18 years. (This change occurred under Chapter 1138, which conformed much of the state's PIT law to 1986 federal income tax law, including its provisions regarding depreciation.) In contrast, however, the state depreciation rules for *corporations* were *not* affected by Chapter 1138 and thus remained still subject to Chapter 1699. Thus, for property with construction beginning during the period January 1, 1987 through July 1, 1988, corporations were still able to benefit by using ACRS over only an 18-year period. For rental property with construction commencing after July 1, 1988, however, neither Chapter 1138 nor 1169 applies, and thus corporate taxpayers are required to depreciate this property under the Asset Depreciation Range (ADR) system (see Chart 8), which prescribes a 40-year recovery period. This is the depreciation rule that was in effect prior to Chapter 1699.

Thus corporate and personal income taxpayers currently are required to use significantly *different* depreciation systems for the *same* type of business property.

An illustrative example

Suppose that in July 1985 a corporate taxpayer began constructing a multi-unit apartment building with a depreciable cost of $1 million. In this program's absence the taxpayer would have been required to depreciate the building over a 40-year period using the ADR system (see Chart 8). In contrast, under this program the building can be depreciated using the ACRS method over only an 18-year period. Thus, ACRS enables the taxpayer to fully recover his costs sooner than otherwise by claiming larger-than-normal depreciation deductions in the early years. These larger deductions result in lower tax liabilities. For example, if the apartment building was placed in service in January 1986, the taxpayer would have been able to claim a 1986 depreciation write-off of $90,000, compared to only $50,000 otherwise. The additional deduction permitted by ACRS -- $40,000 -- could have

Chart 8

State and Federal Tax Provisions for Depreciation of Residential Rental Property

	STATE LAW		FEDERAL LAW
INCOME YEAR	INDIVIDUALS	CORPORATIONS	(ALL TAXPAYERS)
Prior to 1981	Federal ADR - 40 years	Federal ADR - 40 years	ADR - 40 years
1981 to 1983	Federal ADR - 40 years	Federal ADR - 40 years	ACRS - 15 years
1984	Federal ADR - 40 years	Federal ADR - 40 years	ACRS - 18 years[a]
1985 and 1986	Federal ACRS - 18 years[b]	Federal ACRS - 18 years[c]	ACRS - 19 years
1987 and 1988	Federal ACRS - 27.5 years	Federal ACRS - 18 years[c]	ACRS - 27.5 years
After 1988	Federal ACRS - 27.5 years	Federal ADR - 40 years	ACRS - 27.5 years

DEFINITIONS

ACRS = Accelerated Cost Recovery System

ADR = Asset Depreciation Range[d]

Notes on Federal Depreciation Rules

- **Prior to 1981,** the period over which residential rental housing was depreciated for federal purposes was based on what is known as the Asset Depreciation Range (ADR) system. This system provided a 40-year recovery period. However, federal law also gave taxpayers the option of using other ways to determine recovery periods as long as the result was reasonable under specific conditions and circumstances. Historically, a recovery period of from 28 years to to 33 years generally has been acceptable for federal depreciation purposes.
- **In 1981,** Congress enacted the Economic Recovery Tax Act (ERTA). This act established the Accelerated Cost Recovery System (ACRS) for purposes of depreciating the cost of all new business-related property, including rental units. At the time of its enactment, the ACRS provided a 15-year cost-recovery period for residential rental property, to be used in conjunction with the 175-percent declining balance method to determine the annual depreciation deduction.
- **In subsequent years,** the ACRS recovery period was ***increased*** by Congress to 18 years for property placed in service in 1984, 19 years for 1985 and 1986, and 27.5 years for 1987 and thereafter. In addition to increasing the recovery period, the prescribed depreciation method was changed from 175-percent declining balance to straight-line depreciation. Both the extension of the recovery period and the change in depreciation method effectively reduce a taxpayer's annual depreciation deduction. These latest revisions were provided for in the Tax Reform Act of 1986, and represent current law.

Notes on California Depreciation Rules

- **Prior to 1985,** California tax law generally conformed to the federal ADR guidelines, which specify a 40-year write-off period for rental property. (California first adopted the federal ADR system in 1976, and continued to use it throught 1984, even though the federal government switched to ACRS in 1981.) However, as with federal law, taxpayers also have the option under state law to determine the recovery period using any other method that produces a reasonable result.
- **In 1985,** the state began allowing both its individual and corporate taxpayers to use the federal ACRS for depreciating residential rental housing. Specifically, Ch 1699/84 permitted state taxpayers to use the federal ACRS rules in effect as of December 31, 1984. This shortened the depreciation period for state tax purposes substantially - from 40 years to only 18 years (see above). To qualify for this treatment, Ch 1699 required that construction be commenced between July 1, 1985 and July 1, 1988. It also required that 80 percent of a property's gross rental income be derived from dwelling units, and that the property be located in California. These provisions were applicable for state taxes in the 1985 and 1986 income years.
- **Beginning in 1987** with the enactment of Ch 1138/87 (AB 53), California's ***personal income tax law*** was conformed to the modfied federal ACRS rules for business property which were established by the federal Tax Reform Act of 1986. This raised the state's depreciation period from 18 years to 27.5 years, beginning in 1987. These rules, however, were ***not*** adopted for ***corporations***. Thus, corporations could still use ACRS over an 18-year depreciation period for property whose construction commenced prior to July 1, 1988. For property built after this date, however, neither Chapter 1138 nor 1169 applies. Thus, corporate taxpayers must use ADR over a 40-year period, the rule in effect prior to Chapter 1699.

[a] Applies to property placed in service after March 15, 1984.

[b] Applies only to property for which construction began between July 1, 1985 and December 31, 1986.

[c] Applies only to property for which construction began between July 1, 1985 and July 1, 1988.

[d] Strictly speaking, the ADR system itself does not provide for a specific recover period for rental property. Rather, the ADR guidelines make reference to specified recovery periods that applied under previous federal regulations, including a 40-year period for apartment buildings.

produced a first-year California tax savings of up to $3,840 for the taxpayer, depending upon the size of his overall tax liability. (This calculation reflects the 9.6 percent corporate tax rate that was in effect in 1986. For 1987 and thereafter, the rate is 9.3 percent.)

Rationale for the Program

This program is intended to provide taxpayers with a financial incentive to make additional investments in residential rental property located in California, thereby increasing the availability of rental units and/or reducing the rents charged to their occupants. It attempts to do this by permitting such property to be depreciated sooner than otherwise, thereby increasing its profitability.

The program was enacted as part of a 1984 initiative by the Governor to stimulate the construction of rental housing. The Governor's initiative also included legislation which made changes to regulations affecting environmental review procedures and rental housing programs for senior citizens, and allowed the state to issue federally taxable bonds to provide funds for home mortgage loans.

Evaluation of the Program

This section discusses the costs of this tax expenditure program in terms of foregone state tax revenues, and evaluates whether the program is achieving its objectives in a cost-effective manner. In preparing this analysis, we have relied upon information from a variety of different sources including the Franchise Tax Board (FTB), Department of Finance, housing and construction industry representatives, other governmental entities, and academic and research institutions. We also have relied on the results of various research studies regarding the fiscal and economic effects of permitting ACRS for federal tax purposes.

Findings Regarding Program Usage and State Revenue Losses

We have had to develop our own rough estimates of the usage and state revenue losses incurred under this program, because no reliable data are available to directly measure them. Normally, the best and most reliable source of data for measuring the costs of PIT and B&C tax expenditure programs is tax return information collected by the FTB. However, there are several reasons why FTB data are not available in this case:

- First, neither the board's current automated data retrieval system nor its computer tax simulation models are set up to separately identify taxpayers who claim ACRS for rental property.
- Second, it was not feasible to obtain the information we needed by directly sampling and analyzing individual income tax returns. For example, our preliminary review of a sample of income tax returns at the FTB indicated that a very large number of returns -- probably in the thousands -- would have to be examined in order to make an accurate estimate of how many taxpayers own residential rental property that qualify for this program. Examining this many returns was simply outside the scope of this study. In addition, even for those sample returns that we identified as reporting residential rental property, the depreciation-related information that they contained often was not sufficiently detailed for our needs. For example, dates on which construction commenced usually were missing, as was information regarding the split of rental income from residential occupants versus commercial tenants.

Given the above problems, we therefore attempted to make our own rough revenue estimates using data from the Construction Industry Research Board (CIRB), which compiles and analyzes information from the U.S. Bureau of the Census (Department of Commerce) and individual governmental jurisdictions on the volume and value of new rental units constructed in California.

What volume of property is involved?

Based on CIRB information, we estimate that there are approximately 120,000 residential rental units whose construction began between July 1, 1985 and July 1, 1988, and that potentially qualify for this program. The CIRB data also suggest that depreciable construction costs for rental housing average in the general range of $40,000 per unit. Taken together, these data suggest that a general order of magnitude of about $4.8 billion in rental construction expenditures potentially qualify for ACRS depreciation under this program.

State revenue losses are in the millions

Table 14 shows the amount of additional depreciation deductions that potentially could be resulting under Chapter 1699 from this volume of residential rental construction and their associated potential state revenue losses. These potential revenue losses total approximately $7 million for the 1986 income year, $16 million in 1987, $16 million in 1988, and $15 million in 1989. In subsequent years, the revenue losses will continuously decline until they eventually disappear and are replaced by revenue gains. The reason why revenue gains will eventually appear is that ACRS does not increase the total amount of depreciation that may be claimed for an asset, but rather simply shifts its timing forward. Thus, there are future years when, under ACRS, depreciation will be less than in the absence of this program, and therefore taxes will be higher in these years than had ACRS not been used. However, the net effect of ACRS over the *lifetime* of the housing units is to *lower* taxes. This is because ACRS allows taxpayers to shift a portion of their tax burden into future years, when it can be paid with "cheaper" dollars that have less purchasing power.

Table 14

Estimated Effects of Chapter 1699 on State Revenues
1986 through 1989 Income Years
(dollars in millions)[a]

	Effect on Depreciation Deductions for Residential Rental Housing[b]			
Income Year	*Deductions Under Chapter 1699*	*Deductions Without Chapter 1699[c]*	*Change in Deductions*	*State Revenue Loss[d]*
1986	$146	$83	$63	$6.9
1987	380	201	179	16.1
1988	383	211	172	15.5
1989	375	211	164	14.8

[a] Source: Legislative Analyst's estimates, based on data from the Construction Industry Research Board.

[b] Assumes that there is a nine-month time lag between when a building permit is issued and when a project is completed and ready for occupancy, and therefore subject to depreciation.

[c] Assumes the ADR system with double-declining-balance depreciation. (Roughly speaking, double-declining-balance depreciation permits taxpayers to claim approximately twice the annual depreciation deduction that they could otherwise claim during the early years of an asset's life.)

[d] Assumes an average state marginal income tax rate of 11 percent for 1986 and 9 percent for all subsequent years.

Our research suggests that most of revenue losses under Chapter 1699 -- perhaps as much as 90 percent -- are accounted for by reduced personal income taxes paid by individuals and partnerships as opposed to corporation taxes. This reflects the ownership structure of the residential rental market, which in recent years has been dominated by limited partnerships and individual investors. Given this, most of the program's revenue losses are tied to rental units placed in service before the end of 1986, since after that date Chapter 1699 applied only to new rental property investments by corporate taxpayers.

Findings Regarding Cost-Effectiveness of the Program

The main criteria we use in evaluating the merits of a tax expenditure program are:

- First, is it achieving its objectives, which in the case of this particular tax expenditure include increasing the supply of new residential housing units?
- Second, are the program's benefits sufficiently large to justify the amount of tax revenues foregone, and is it the least-cost way of providing these benefits?

In order for a tax incentive program such as accelerated depreciation to have any significant economic impact, it must make investment projects more attractive thereby stimulating the overall number of them that are undertaken.

What factors influence investments in rental housing?

Decisions to invest in rental housing typically are influenced by a wide range of factors. These can include the future streams of rental-income and operating costs, the risks and uncertainties involved in projecting these revenues and costs, the total capital costs for the property, the terms of financing its acquisition, and the rate at which the property appreciates over time. However, the two factors that dominate most investment decisions are:

- A proposed project's *payback period* -- that is, the number of years required to recover the project's investment costs from its future net-income stream; and
- A project's *after-tax rate of return* -- that is, the average annual percentage return on the amount of money invested in the project, computed over the project's useful life span or the period that an investor owns it.

In general, the shorter the payback period and the higher the rate of return, the more attractive a rental housing investment project becomes. Thus, understanding the effects of state accelerated depreciation on the payback period and rate of return is the key to evaluating the type of impact this tax expenditure program has on decisions to invest in rental housing.

How significant are the tax benefits accelerated depreciation offers?

Reducing the time period over which depreciation allowances may be claimed improves the attractiveness of a rental housing project because it both reduces its payback period and increases its rate of return. It accomplishes this because a shorter depreciation period, while not changing the total amount of depreciation deductions which may be claimed over an asset's life, does allow these deductions to be claimed "sooner" rather than "later." Since depreciation deductions reduce the amount of taxes paid on an investment's profits, accelerated depreciation increases the amount of after-tax income realized in the early years of a project's life. This "shifting forward" of after-tax income from later years to earlier years enables the project to be paid-off sooner than otherwise. It also raises its average annual rate of return. This occurs due to the "time value of money" -- that is, a dollar of after-tax income realized "sooner" is worth more to the investor than the same dollar of income realized "later."

An illustrative example

Chart 9 provides an example which demonstrates the extent to which using ACRS for California tax purposes can affect the financial return on a typical residential rental housing project. The example assumes a 10-unit rental project with depreciable capital costs of $425,000, nondepreciable land costs of $75,000, a holding period of 10 years, and rental income of $60,000 per year (or $500 per unit per month). It also assumes the project is owned by a partnership subject to personal income taxation, and incorporates state tax provisions for 1986, the last year that the program applied under the personal income tax.

The investment incentives provided by state ACRS are small

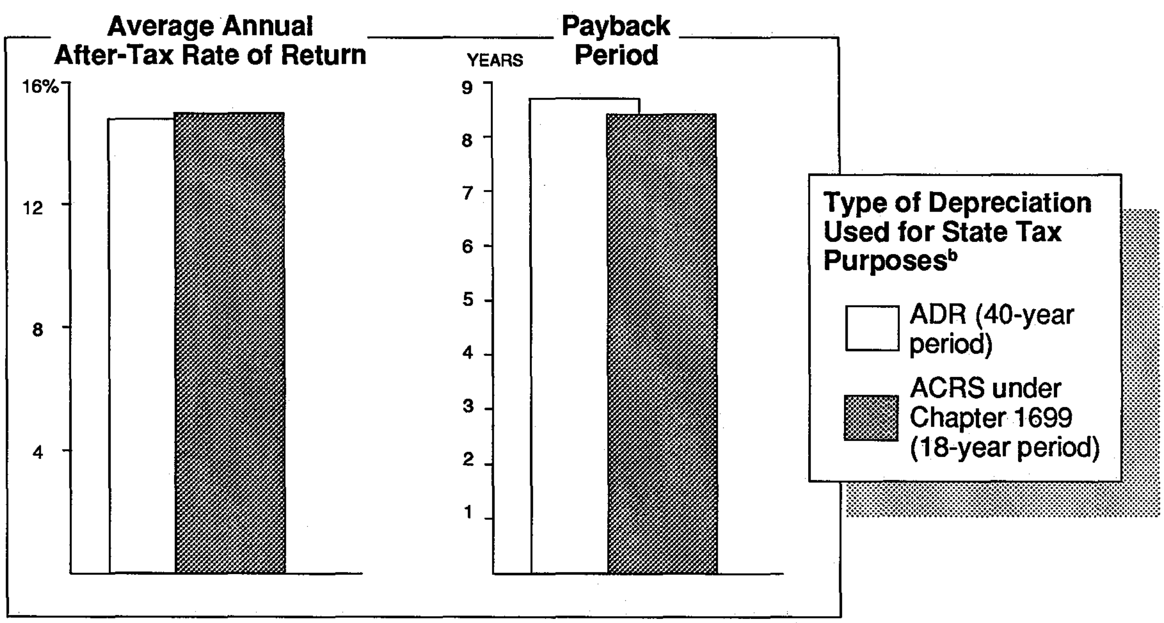
As shown in Chart 9, the effect of using ACRS at the state level is very small in terms of reducing payback periods and increasing rates of return. For example:

- The project's payback period is reduced by less than four months, from 8.7 years to 8.4 years.
- The project's average annual rate of return is increased by only 0.2 percentage points, from 14.8 percent to 15 percent.

There are several reasons why these effects are so small. One involves the interaction

Chart 9

Effects of Accelerated Depreciation on the Rate of Return and Payback Period for a Hypothetical $500,000 Rental Housing Project[a]



[a] This example assumes that 85 percent ($425,000) of project costs are for construction expenses and 15 percent ($75,000) are for land, and that 75 percent of the project costs are financed through borrowing at an interest rate of 12 percent. The example also assumes an average rental vacancy rate of 3 percent, a 10-year holding period, and $60,000 annual rental income.

[b] See Chart 8 for additional detail on depreciation provisions under ADR and ACRS. The effects shown of Chapter 1699 on the rate of return and the payback period differ only slightly for different assumptions about the holding period and annual rental income. For example, although increasing rental income by 20 percent (to $72,000) both increases the project's rate of return and reduces its payback period, the effect of using ACRS in place of ADR still rounds to a 0.2 percentage point gain in the rate of return and a 0.3 year fall in the payback period. When, in addition, the holding period is also raised to 20 years, the effect of ACRS still rounds to reducing the payback period by 0.3 years, while the rate of return gain increases slightly, to 0.3 percentage points.

between state and federal tax law, and another involves the "depreciation recapture" rules that apply when property is sold.

The diluting effects of state-federal tax interactions

There is a significant share of state tax benefits from using ACRS that California taxpayers do not even get to keep. This is because their state tax savings cause partially offsetting increases in their federal taxes. This occurs because state income taxes can be deducted from adjusted gross income on federal income tax returns when computing federal taxable income. Since California ACRS reduces state income taxes, it has the effect of raising the amount of income that is taxable at the federal level. For instance, in the example shown in Chart 9, state ACRS reduces the taxpayer's state liability by $1,870 in the property's first year of service. However, this state tax savings also increases the property owner's federal liability by $935. Thus, the actual net benefit to the investor turns out to be only one-half of the amount of the state tax savings. (This calculation reflects the maximum federal tax rate in effect during 1986 of 50 percent; a reduced rate of 38.5 percent applied to high-income taxpayers in 1987 and 33 percent applies thereafter.) The remaining portion of the state tax savings "leaks away" to the federal government.

Benefits can further be diluted because the government "recaptures" them if property is sold

State and federal 1986 tax law provides that when property is sold, the taxpayer's "basis" in the property must be reduced by the amount of depreciation deductions claimed in previous years. This adjustment is necessary in order to properly reflect the amount of capital gains that must be reported for tax purposes. Thus, when taxpayers use ACRS depreciation rules but sell their property before its useful life is over, their taxable gain will be larger than had ACRS not been claimed. (Moreover, under state and federal rules that applied in 1986, the portion of the gain representing "excess depreciation" -- that is, the amount of depreciation deductions claimed in excess of straight-line depreciation -- is taxed at a higher rate because it is deemed to be "ordinary income" rather than a capital gain.) As a result, under ACRS a significant portion of the tax benefits provided to investors early in a property's life are recaptured by the government if it is sold. For instance, recapture rules make the state taxes paid upon the sale of the rental property in Chart 9 about $19,000 higher when ACRS rules are used for California tax purposes.

ACRS incentives are even weaker under new law

Our analysis of this program's effects has incorporated state personal income tax provisions in effect prior to 1987, since beginning in1987 Chapter 1699 did not apply to personal income taxpayers. Although PIT taxpayers continue to qualify for ACRS under Chapter 1138, the investment incentives of ACRS under the new (1987) law are potentially even less than under 1986 law. This is because the new law reduced tax rates, repealed the partial exclusion for capital gains, limited the use of passive losses to offset earned income (such as salaries and wages), and imposed an alternative minimum tax (AMT). Taken together, these changes have the effect of reducing the value of real estate tax benefits, including accelerated depreciation. Taking these new law provisions into account, we estimate that the effect of using state ACRS for the project in Chart 9 would only add about 0.1 percentage points, instead of the 0.2 percentage points discussed earlier, to the rate of return.

What are the economic effects of the program's incentives?

The relatively small effect that state-level ACRS has on payback periods and rates of return suggests that its potential is quite limited for increasing investment in residential rental housing.

Maximum effects on investment probably are minor

Economists agree that ACRS can cause housing investment to increase, but have different opinions about the size and permanence of these gains. Some economists think that the long-run supply of housing is relatively unaffected by accelerated depreciation, and that whatever investment gains ACRS initially induces are simply offset by reduced investment later on. Many economists, however, believe that there can be some permanent increases in investment due to ACRS. If this latter view is correct, our review of the national-level studies on which it is based suggests that, *at most*, Chapter 1699 could potentially result in an additional 7,000 residential housing rental units. This is a relatively modest amount given that every year the state normally adds well over 100,000 new rental units to its housing stock, which itself exceeds 4.5 million units.

Even smaller effects are likely

There are several reasons for believing that the actual investment increase, if any, would be *much less* than even the above amount:

- First, economic research studies indicate that many taxpayers simply do not pay much attention to state tax factors when making investment decisions.
- Second, even when investment decisions do consider state tax factors, the improvements in payback periods and rates of return under this program probably would be discounted in many cases because they are so minor, especially when compared to the error margins about factors which "make or break" projects such as projected rent levels, vacancy factors and future appreciation.

What about the effect on rents?

Even if state-level ACRS does not do much to stimulate new construction, the owners of qualifying property still will realize increased after-tax incomes. If these income gains are simply "pocketed" by the owners, then Chapter 1699 will simply serve to provide "windfall benefits" to these investors. It is possible, though, that at least some of these benefits might be shared with tenants in the form of reduced rental fees. However, we estimate that even if all of the benefits of Chapter 1699 were passed on to tenants as lower rents (an unlikely outcome), the monthly rent reduction for a typical rental unit would be only about $14 in years when the ACRS benefit is greatest, and would average only $5 (constant dollars) over the unit's entire lifetime.

Summary Regarding Cost-Effectiveness

In order for tax incentives like accelerated depreciation to have significant positive economic effects, they must increase the level of investment in residential rental housing above what it would be otherwise. If they do not do so, the primary effect of these incentives is simply to redistribute income -- to those investors who do not change their behavior but nevertheless qualify for the incentives, and to the federal government. These "windfall benefits" come at the expense of the State Treasury and California taxpayers who ultimately must directly or indirectly pay for them.

Accelerated depreciation does both raise the rate of return on residential rental investments and shorten their payback periods. These effects, however, are relatively minor, especially when compared to the other factors affecting investment decisions such as interest rates, potential rental income, appreciation in property values, federal tax benefits, and so on. Recent changes in state and federal tax law will make the impact of state ACRS even less significant in the future. Accordingly, state-level ACRS offers only limited potential for stimulating new investments in California rental housing or reducing tenants' rents.

Conclusions and Recommendations

This program has very limited effects on investment payback periods and rates of return, and the evidence is lacking that it is either an effective or efficient means of achieving its primary objective of stimulating construction of residential rental property. Thus, we believe that permitting investors to depreciate their rental investments over only 18 years is *not* a good policy. This finding, combined with the Legislature's recent decision to have personal income taxpayers use new federal depreciation rules that were not in effect when Chapter 1699 was enacted, suggests that the Legislature should consider the following two recommendations.

First, ***we recommend that the 18-year depreciation period permitted under Chapter 1699 for residential rental projects with construction commencing before July 1, 1988, not be reenacted for rental property placed in service in the future.***

Second, ***we recommend that the Legislature amend the B&C law to make the depreciation rules used for residential rental properties the same as those used under PIT law.*** There are at least two strong arguments supporting this recommendation:

- First, when the Legislature enacted the state's tax reform legislation in 1987, it adopted a general policy of conforming state law to federal law where no good reason exists not to do so. One reason for such conformity is to simplify tax computations and reduce reporting burdens for taxpayers. This recommendation is consistent with this policy, since it would have the effect of conforming state B&C depreciation rules to the federal rules for corporations.
- Second, this recommendation would eliminate unjustifiable inequities between taxpayers. As discussed earlier, PIT law now uses ACRS with a depreciation period of 27.5 years, whereas under B&C law residential rental property constructed after mid-1988 must be depreciated over 40 years using the ADR system. We see absolutely no analytical basis for requiring taxpayers to use such different rules for depreciating otherwise similar residential rental property. This is especially so since such differences create inequities between both different property owners who must directly pay income taxes, and different tenants whose rents can be affected by the amount of these taxes. ❖

Review of the Sales and Use Tax Exemption for Packing Ice and Dry Ice

This tax expenditure program exempts from sales and use taxation packing ice and dry ice used to pack and ship food products for human consumption.

Statutory Authorization and Legislative History

This program is authorized by Section 6359.7 of the California Revenue and Taxation Code. The program was established in 1985 by Chapter 1045 (AB 1187). A related exemption had been established in 1945 for ice used in transporting food products interstate. However, that exemption was repealed in 1979.

Description of Provisions

As noted above, this program exempts from sales and use taxation ice which is used to pack and ship food products for human consumption. There are two main categories of food products that are most affected by this program -- certain types of agricultural produce, and fresh fish and seafood.

The Case of Agricultural Produce

There are primarily two ways that ice is used in conjunction with agricultural produce:

- First, "field heat" that builds up and is retained in farm produce generally must be removed from freshly harvested produce prior to shipping. There are a number of different techniques for accomplishing this. One of the most common ways is to place ice directly into the containers holding the produce, such as when ice is put into boxes of broccoli. (There also are non-ice methods for removing "field heat," such as hydrocooling, the use of forced air, and vacuum cooling. Hydrocoolers use ammonia or freon to cool water which is then applied to the produce. The forced air method uses ammonia or freon to cool air which is circulated through the produce. Finally, vacuum cooling involves placing the produce in a large tube and then extracting all of the air from the tube.)
- Second, fresh agricultural produce generally needs to be shipped to its final destinations in refrigerated trucks. Because refrigerated air can "dry out" produce, ice is commonly placed on top of shipments of such produce as broccoli, carrots, celery, sweet corn and green onions.

The Case of Fish Products

Most fish is iced immediately after being caught. Upon reaching land, the fish is commonly sold to a wholesale fish company that processes the fish before sending it on to a retailer or a smaller wholesaler for distribution to consumers. Fresh fish shipped for consumption *in California* is generally transported from the processor in boxes layered with fish and wet ice, using refrigerated trucks. In contrast, fresh fish exported *from California* is generally shipped via airplane and must therefore be cooled using some other product than wet ice, such as gel ice (that is, refreezable fluids and materials with specially designed plastic exteriors, which are not tax-exempt under this program). In the case of intrastate shipments, wet ice remains the preferred coolant because it surrounds and protects the fish best and thereby prevents its drying.

Some individuals and businesses using ice for purposes like the above both produce *and* consume their own ice. This ice would *not* be taxed even in this program's absence. However, all other ice which is purchased and used to pack or ship food products normally *would* be taxed without this TEP, and thus benefits from the program.

Rationale for the Program

Three principal rationales have been offered for this program:

- That it is needed to "equalize" the tax treatment of ice to that for non-ice coolants.
- That ice is a "component part" of the final food products it is used to cool, and as such should not be separately taxed.
- That the program will enhance the competitiveness of California's agricultural and fish industries relative to those of other states and nations, and also will hold down food prices paid by California consumers.

The Tax Equity Rationale

The argument offered here is that non-ice cooling is not subject to taxation the way that ice-based cooling normally would be in the absence of this program, because the sales tax is levied only on transfers of tangible personal property. Thus, ice is potentially taxable because it is tangible property, whereas non-ice coolants are not themselves directly taxable because they are not tangible property but rather the intangible end-products of processes such as hydrocooling. Therefore, proponents of this rationale argue that it is unfair, for example, to directly tax the cooling of broccoli with ice but not directly tax the cooling of lettuce with hydrocooling.

The problem with this line of reasoning is that it fails to recognize that the equipment used to generate such non-ice cooling *is itself taxed* when purchased, unless otherwise exempted. Because the taxable value of such equipment implicitly reflects the anticipated market value of the cooling benefits it provides over time, non-ice cooling therefore essentially *is* taxed, albeit in an indirect manner. (There is one notable exception to this -- when equipment is used in interstate commerce, and is thereby automatically exempt from state sales and use taxes.) In addition, the users of non-ice cooling systems directly pay sales taxes on the freon and ammonia these systems require, whereas the water used to make ice is not directly taxed. Thus, although the tax burden on purchased ice may differ from that for certain other coolants because both purchased ice and the equipment used to produce it are taxed, ice is not the only coolant that is effectively subject to taxation.

The "Component Part" Rationale

This second rationale argues that the ice used to cool fresh produce is a component part of the still-fresh produce eventually purchased by the consumer. Without ice, for example, broccoli would spoil and therefore not be fit for sale. Produce like broccoli is itself already exempted from the sales tax under provisions generally exempting food products for home consumption. Thus, this rationale argues that ice, as a "component part" of the marketed fresh broccoli, should also be exempted from taxation.

The flaw with this rationale is that it conflicts with how the term "component part" actually is applied under California's sales tax law. Under this law, an item is considered to be a "component part" only when it is *directly incorporated* into a final product, such as when raingutters are attached to a mobile home or ink is used to print a book. In contrast, items like the cardboard boxes used to transport fish that are not directly incorporated into the final product are not deemed to be a component part, and therefore are themselves subject to tax. Thus, this second rationale also is not applicable in the case of the sales tax exemption for ice.

The Economic Benefits Rationale

The one remaining suggested justification for the exemption is that the taxing of ice used to cool California-grown produce and fresh fish landed in California would raise the prices of these products, thereby making them less competitive with produce grown or fish caught in other states. The merits of this rationale are considered in the following section.

Evalution of the Program

This section provides an estimate of the cost of this tax expenditure program in terms of foregone state tax revenues, and evaluates the likely effects of the program on food prices and the overall economic competitiveness of California food products. In preparing this analysis we have relied on information from several different sources, including the California Departments of Fish and Game and Food and Agriculture, various trade associations, and telephone surveys of ice manufacturers and fish processors.

Findings Regarding Revenue Losses From the Program

There are no hard data on the current revenue losses resulting from this tax expenditure program. We have had to develop our own rough guess as to the program's current revenue losses. Our revenue-loss figure should be interpreted only as an approximate general order of magnitude, *not* a precise estimate.

Revenue loss probably is moderate

Table 15 shows that our "best guess" estimate of state revenue losses from this program is approximately $800,000 annually, based on 1986 data. (In addition, there is an estimated annual revenue loss of about $255,000 to local governments.) This estimate, which includes revenue losses associated with agricultural produce, fish processors, and fishing vessels, is subject to both upward and downward errors. For example:

- ***The estimate is understated*** to the extent that (a) ice usage and/or prices have risen since 1986 and (b) ice is used by some industries (such as chicken processing) on which we did not focus. Our estimate also does not account for ice usage by minor sources of fresh fish (such as inland fisheries and aquaculture), or qualifying ice purchases by retailers and small wholesalers. We simply were unable to obtain data in these areas.

- ***The estimate is overstated*** to the extent that (a) agricultural users of ice receive discounts from prices quoted by ice companies or use less ice per shipment than the recommended maximum amount (which our estimate assumes), (b) exports of California fish (which are cooled using nonexempt gel ice) are significant, (c) some portion of the total fish catch upon which our estimate is based is not sold fresh but rather is canned, breaded, frozen or smoked, and (d) some of the ice used by fishing vessels is self-made by their operators or directly given to them by processors. Again, data are not readily available in these areas.

Table 15

Estimated State Revenue Losses from the Tax Exemption on Packing Ice and Dry Ice[a] (dollars in thousands)

Type of Item	*Amount*
A. **Agricultural Produce**	
Broccoli	$600
Celery	20
Carrots[b]	25
Corn	20
Subtotal	$665
B. **Fish Products[c]**	
Fish processors	15[d]
Fishing vessels	120
Subtotal	$135
Total	$800

[a] Estimates are for 1986 as developed by the Legislative Analyst, using information from a variety of sources including the California Department of Food and Agriculture, the Western Growers Association, and the California Department of Fish and Game. All figures shown have been rounded to the nearest $5,000.

[b] Includes only carrots sold fresh, because carrots shipped for processing are generally not iced.

[c] Figures exclude tuna, halibut and anchovies, because generally they are not sold fresh.

[d] Assumes that 90 percent of ice used by processors is self-made.

In addition to these potential biases, our revenue-loss figure also does not reflect any behavioral changes which might accompany elimination of the exemption. Our research suggests that the current shipping and packing technology probably would limit the ability of produce and fish packers to switch from using ice to other coolants. However, it is possible that if removing the exemption caused ice prices to increase, this might induce at least some ice users to switch from purchasing ice (which would be taxable) to making their own ice (which would be tax-exempt). To the extent that this happened, the revenue gain from eliminating the exemption would be reduced.

Although we have been unable to quantify the above factors, we believe that their net effect probably would be more likely to reduce than increase our revenue-loss estimate.

Findings Regarding Cost-Effectiveness of the Program

The key issue here is: Does this program offer an effective means of accomplishing such objectives as increasing the competitiveness of California's agricultural and fishing industries, or reducing food prices to consumers? If the answer is "no," then the state's revenue losses under the program are simply accruing as windfall subsidy benefits to the industries most affected by the program. These include operators of fishing vessels, fish processors, and growers and shippers of celery, carrots, corn and especially broccoli.

Economic effects appear to be minor

In order for this program to have any significant economic effects, it is necessary for the exemption on ice to materially affect the costs of bringing fresh produce and fish products to market, and thereby reduce the prices of these items to consumers and/or improve the ability of producers to operate profitably. Table 16 shows what the tax savings offered by the exemption are relative to the estimated value of the products affected by it. *These effects are very minor*. For example, the table shows that in 1986 the estimated tax savings were:

- Less than two-tenths of a cent per dollar paid to producers of the most-affected agricultural produce (broccoli, celery, carrots and corn).
- Only one-tenth of a cent per dollar value of payments for fish made to fishing boat operators.

Implications for consumer prices

It is very questionable whether such small relative cost effects would ever even show up as reduced prices to consumers, and if they did, the price changes probably would be very minor.

Implications for the profitability of producers

To the extent that the program's tax benefits are not embodied into consumer prices but rather are retained by producers, their profits will be improved. However, in most cases this effect also should be relatively minor. We have been unable to obtain reliable data on the statewide profit margins of producers most affected by the exemption. However, according to the California Department of Food and Agriculture, net state farm income in 1986 was about 28 percent of gross farm income receipts.

Table 16

Estimated Revenue Losses from the Exemption Compared to the Values of Affected Products[a]

Type of Item	*State and Local Revenue Losses from the Exemption[b]*	*Market Values of Affected Products[c]*	*Revenue Losses as a Percent of Product Market Values*
A. **Agricultural Produce**			
Broccoli	$790,000	$214,000,000	0.37%
Celery	25,000	147,800,000	0.02
Carrots[d]	30,000	140,400,000	0.02
Corn	30,000	24,200,000	0.12
Subtotal	$875,000	$526,400,000	0.17%
B. **Fish Products[e]**	$175,000	$169,600,000	0.10%

[a] Estimates are for 1986 as developed by Legislative Analyst.

[b] All figures shown have been rounded to the nearest $5,000. Local sales taxes equal approximately 32 percent of state sales taxes on a statewide basis.

[c] "Market value" is rounded to the nearest $100,000 and is defined as payment to the initial producer, such as an agricultural grower or fishing vessel. Market value at the retail level would be higher than the amounts shown, due to markups.

[d] Includes only carrots sold fresh, because carrots shipped for processing are generally not iced.

[e] Assumes that 90 percent of ice used by processors is self-made.

If this same ratio were to hold for products affected by the exemption, the program's tax benefits would amount to less than one cent per dollar of net income. Even if the ratio of net-to-gross income for products affected by the exemption were as low as, say, 5 percent, the program's tax benefits still would only increase this ratio by less than 0.2 percentage points, or not even up to a level of 5.2 percent. Thus, the program's potential effects on producers' profits appear to be relatively limited.

Implications for California's economic competitiveness

Finally, we have found no convincing evidence that there would tend to be much effect on the interstate or international economic competitiveness of California. For example:

- *In the case of fish,* since fresh fish shipped out of state generally travels via airplane, tax-exempt wet ice is not used. While dry ice may sometimes be used and it does qualify for the exemption, the use of taxable gel ice is most common. Thus, because wet and dry ice are seldom used in transporting fresh fish out of California, a sales tax on these items should not materially reduce the competitiveness of the California fishing industry relative to other states and nations.
- *In the case of agricultural produce,* some is shipped to other states using wet ice. As discussed above, however, a tax on the ice used to ship this produce probably would have very little effect on the prices charged to consumers, and therefore would have little, if any, effect on the competitiveness of California's agricultural industries. Even in the case of broccoli, where the potential price increase from taxing ice would be greatest, the price increase still would amount to only slightly more than one-third of one cent for every dollar's worth of broccoli purchased (see Table 16).

Summary Regarding Cost-Effectiveness

Given the above, we find the evidence lacking that this program is having any significant impacts on the basic economic competitiveness of the affected California industries or on prices paid by consumers. Rather, it is likely that the revenue losses being incurred by the state (and localities) to fund the program are simply accruing as windfall benefits to the industries most directly affected by it. The program also places users of taxable non-ice coolants at a competitive disadvantage.

Conclusions and Recommendations

Exempting the sale of packing ice and dry ice used in transporting food for human consumption has been justified on the basis that it provides equity between the sales tax treatment of ice and other cooling processes. Also, it has been justified as an extension of the food exemption on the grounds that ice should be considered a "component part" of the products it cools. Lastly, it has been justified as a means of improving the economic competitiveness of certain California products, and keeping consumer food prices low.

Our analysis of these rationales and the cost-effectiveness of the program indicates that it cannot be justified on any of these grounds.

Therefore, ***we recommend that the sales tax exemption for packing ice and dry ice used to pack and ship food for human consumption be repealed.*** ❖

Review of the In-Lieu Tax on Racehorses

The in-lieu tax on racehorses provides what amounts to a partial exemption from the local property tax for qualifying racehorses. In the absence of this program, such racehorses would be considered business personal property subject to the regular 1 percent ad valorem local property tax. This program instead provides that qualifying racehorses are taxed according to a special schedule, which in most cases results in a lower tax liability than would be imposed by the ad valorem local property tax.

Although the program results in reduced tax revenues only at the local government level, it does result in a state cost. This is because it increases the amount of school apportionments that the state must provide to local school districts in order to replace these foregone local tax revenues.

Statutory Authorization and Legislative History

This program is authorized by Part 12 of the California Revenue and Taxation Code. The program was established in 1971 by Chapter 1759, and became operative on July 1, 1972.

Description of Provisions

As noted above, the in-lieu tax established by this program provides a special method for the taxation of racehorses. In order to qualify for the in-lieu tax, a horse must meet the following two-fold eligibility test:

- ***First***, a horse must be eligible to participate in, or produce foals which will be eligible to participate in, a horse racing contest in California for which pari-mutuel racing is permitted under rules and regulations prescribed by the California Horse Racing Board (CHRB). In order to meet this criterion, a horse need only be registered with one of five organizations recognized by the CHRB that represent racing horse breeds. These organizations include the Jockey Club (representing thoroughbred horses), the United States Trotting Association (representing standardbred or harness horses), the American Quarter Horse Association, the Appaloosa Horse Club and the Arabian Horse Registry of America.
- ***Second***, if a horse is over three years old, or over four years old in the case of an Arabian, the horse must in the previous

two years have *either* (1) participated in a horse race contest on which pari-mutuel wagering is permitted or (2) been used for breeding purposes in order to produce racehorses. In order to meet the second of these two conditions, the owner must have bred the racehorse with the intent, at time of breeding, of producing racing stock.

Thus, horses can qualify for in-lieu taxation up to the age of three, or age four in the case of an Arabian, *even if* the horse has never raced or been bred with the intent to produce racing horses. And older horses can qualify for in-lieu taxation, *even if* they only have raced or been used for racehorse breeding purposes once in the last two years.

Exactly How Are Racehorses Taxed Under This Program?

The amount of tax levied on horses that qualify under this program varies, depending on the characteristics of the animal. The tax schedule is summarized in Table 17. The amount of the tax varies from a minimum of $12 for a nonproducing broodmare, to a maximum of $1,000 for a stallion with a stud fee of $10,000 or more. The tax is payable on January 1 of each year. In addition, the law provides that foals born to a racehorse mare during any given calendar year are exempt altogether from property taxation for that year.

How Would Racehorses Be Taxed in the Absence of This Program?

In the absence of this program, qualifying racehorses would be considered to be business personal property and, as such, would be subject to the regular ad valorem local property tax. Such horses would be reappraised each year, and a tax rate of 1 percent (plus any additional tax for paying-off voter-approved bonded indebtedness) would be applied against the full market value of the horse. Thus, for example, a horse valued at $100,000 would pay a basic tax of $1,000.

It should be noted that horses subject to the local property tax generally include the permanent stock owned by any individual engaged in the *business* of breeding, training or showing horses. In contrast, horses which are owned as personal pets are considered to be household *personal* property, and therefore are *exempt* from the property tax. In addition, if a horse breeder can demonstrate that a particular horse is being held for sale, the horse is exempt from the property tax because it is classified as business inventory.

Rationale for the Program

Two primary rationales for the in-lieu tax on racehorses have been advanced, both of which ultimately relate to promoting the breeding, boarding and training of racehorses in California.

First, the program often is justified on *tax equity* grounds. The argument here is that counties are not uniform in how they appraise horses in order to determine their assessed value for regular property taxpurposes. The program's proponents point out that this lack of uniformity can result in inequitable treatment of certain horse owners, because the appraised values of comparable horses will vary depending on the county in which a horse is located. The proponents argue that this problem can be avoided under the in-lieu tax, because the tax is based not on an appraisal (that is, an estimate) of a horse's actual market value, but rather simply on such observable factors as its racing earnings and stud or brood fees.

The second main justification offered for the program relates to its value as a *tax incentive*. Proponents argue that the other major racing states currently do not tax horses at full mar-

Table 17
California's In-Lieu Tax Schedule for Racehorses[a]

TYPE OF HORSE	AMOUNT OF TAX: AGE 12 AND YOUNGER	AMOUNT OF TAX: AGE 13 AND OLDER
A. Stallions		
Stud fee classification		
$10,000 and up	$1,000	$650
7,500 and up	750	500
5,000 and up	500	330
3,000 and up	300	200
1,500 and up	150	100
1,000 and up	100	65
Less than 1,000	75	50
B. Broodmares		
Stakes-winning producing broodmares	$75	$50
Stakes-producing broodmares	75	50
Other producing broodmares	40	28
Stakes-winning nonproducing broodmares	35	25
Other nonproducing broodmares	20	12

C. Active Racehorses	AMOUNT OF TAX
Racehorses which in the previous calendar year earned:	
$100,000 or more	$150
Between 50,000 and 99,999	100
Between 25,000 and 49,999	60
Less than 25,000	40
Other Racehorses	
Stakes yearlings, stakes two-year-olds, stakes three-year-olds	35
Other yearlings, two-year-olds, three-year-olds, and nonactive racehorses	20

[a] Tax schedule in effect as of October 1988.

ket value, if at all. Given this, they claim that in the absence of this program, many racehorse owners might move their operations out of California in order to gain the tax advantages offered by other racing states. This, they say, could reduce the number of quality horses being bred, raised, trained and raced in California, which in turn would reduce economic activity in California, including the amount of attendance and wagering at California's racing meets. As a result, both the economy generally and state revenues, including pari-mutuel wagering tax receipts, could be hurt.

Evaluation of the Program

This section (1) identifies the probable magnitude of the cost of this tax expenditure program in terms of foregone local property tax revenues, (2) discusses how the in-lieu tax is working from an administrative perspective, and (3) evaluates whether the program is meeting its intended objectives in a cost-effective manner. In preparing this analysis, we have relied on information from a variety of sources including the California Board of Equalization (BOE), the CHRB, county assessors' offices, trade associations and their publications, and interviews with various industry representatives.

Findings Regarding Revenue Losses From the Program

It is extremely difficult to accurately determine the local revenue losses and state school-apportionment costs associated with this program. This is because, as discussed below, we have found that county assessors' offices generally do not maintain very complete statistics concerning the number, type or value of horses qualifying for the in-lieu tax, and that some unknown portion of the taxes actually owed under current law is not even being collected at all. Nevertheless, the available evidence suggests that the revenue losses associated with the program probably are fairly substantial.

Revenue loss probably is in the millions

The 1985 National Equine Survey reported that there are over 70,000 thoroughbreds in California, over 100,000 quarterhorses, and more than 3,000 standardbreds. Of these horses, over 25,000 thoroughbreds were reported to be used for racing, as well as 4,000 quarterhorses and 2,000 standardbreds. All of these horses would qualify for the in-lieu tax. In addition, there are many other horses that probably would qualify for the in-lieu tax as racehorse breeding stock. Our research suggests that the revenue losses on these horses due to the in-lieu tax would, on average, be in the range of tens to hundreds of dollars per horse for active racehorses, horses in training, and broodmares. For syndicated stallions, the average loss magnitude probably would be in the range of hundreds to thousands of dollars per horse. Given these data, we believe it is not unreasonable to conclude that the general order of magnitude of the revenue losses under this program is in the millions of dollars.

Findings Regarding Administration of the In-Lieu Tax

As noted earlier, the in-lieu tax offers the administrative advantage of taxing horses based on a simple schedule using observable information about a horse's physical attributes and performance, rather than having to estimate a horse's actual market value. Our analysis indicates, however, that the in-lieu tax is currently characterized by inconsistent application and various other administrative problems. For example, a recent survey of county assessment practices conducted by the Ventura County Assessor's Office indicates that:

- Some counties do not tax horses at all, others who do tax horses do not bother to use the in-lieu tax, and others which do use it do not attempt to distinguish between racehorses (which qualify for the in-lieu tax) and nonracing show horses (which do not qualify).
- The appraisal staff in certain counties appear to be misinformed about the specific conditions under which a horse qualifies for the in-lieu tax. For example, we have identified cases where young horses, including young nonracing Arabian show horses, have been disqualified from using the in-lieu tax because they cannot fulfill the "intent to race" criterion, even though this criterion does not apply to young horses.

Why do these administrative problems exist?

These and other administrative problems involving the in-lieu tax appear to result from several sources. In some cases, inadequate auditing efforts are being made by assessors to ensure that the proper amounts of in-lieu taxes, which are self-assessed, are being paid. This problem can be addressed simply by increased or more effective auditing efforts, to the extent they are cost-effective. As discussed below, however, the current in-lieu tax law also contains certain ambiguities, especially with regard to eligibility, which can make its consistent application difficult even for the most conscientious of assessors. For example, individual appraisers will inevitably differ from one another in the judgments they must make as to whether older nonracing horses have been bred with the "intent to race" their offspring, which qualifying for the in-lieu tax requires. Addressing problems of this sort requires modifying and clarifying the in-lieu tax law itself.

Findings Regarding Cost-Effectiveness of Program

This section considers whether this program is achieving its objectives and, if so, whether it is doing so in the most cost-effective manner. That is, does the program achieve its objectives and can the costs of the program be justified?

Cost-effectiveness in terms of the tax-equity rationale

We find that the first rationale described earlier -- tax-equity -- is an *extremely weak justification* for this program. Admittedly, the in-lieu tax eliminates the problem that can occur under the regular property tax of comparable horses being assessed at different values in different counties, because of county differences in assessment practices for determining the market values of racehorses. In our view, however, a special tax expenditure program like the in-lieu tax is not necessary to address this particular problem. Rather, it could be addressed through *improved guidelines for standardizing property tax assessments.* The BOE's existing assessment standards program already is responsible for ensuring consistency of assessment practices between counties. If counties do, in fact, differ in how they would treat racehorses under the regular property tax, it is the BOE's job to identify and then resolve these differences, such as by assessment training programs and improved operational assessment standards. Thus, from this perspective, the tax-equity rationale is itself insufficient justification for the in-lieu tax expenditure program.

The current program has its own tax inequities

There are several ways in which the current in-lieu tax actually creates new tax inequities between the owners of horses that would not exist under the regular property tax. For example:

- The program permits *all* young horses registered with one of the five earlier-mentioned equine organizations to qualify for special tax treatment -- *even if* their owners neither race them nor even intend to ever race them or their foals (as in the case of expensive Arabian show horses) -- yet does *not* give this same tax break to *other* nonracing horse breeds, like Morgans or Tennessee Walking Horses.
- Regarding older horses, the program's eligibility requirements are so loose that they make it possible for horses who have little if any regular involvement in racing activities to get the tax break, even though the break really is intended for racing horses. For instance, an older horse can qualify for the tax break even if it (1) races as infrequently as *once every two years*, or (2) *never* has any of its progeny actually "make it" to the track, so long as it has been bred within the past two years with the "intent" to produce racehorses.

As an example, an expensive Arabian stallion used to produce high-quality show horses can get the tax break as long as it runs in just one race every other year. The owner of such a horse has a strong financial incentive to establish the animal as "racing stock" given the potential tax benefits involved under the program -- on average about $300 to $600 annually in the case of California Arabians. Given the very minimal racing requirement for eligibility and the difficulty county assessors have in disproving breeders' claims about their "intent" to produce racehorses, the potential for abuses and inequities under this program is considerable. If the program is continued, this problem can be addressed by tightening up its eligibility requirements.

Cost-effectiveness in terms of the tax-incentive rationale

The key issue here involves the extent to which this program encourages the breeding, boarding and training of racehorses in California, and the associated positive impacts of this on the state's economy. These effects depend primarily on two factors:

- The degree to which the program increases the economic returns realized by taxpayers who invest in racehorses; and
- The effect that these increased investment returns have on the ability of horse-related enterprises to profitably operate, and to choose to locate in California instead of in other states.

Investment returns are modestly increased

The effect of the in-lieu tax on the economic returns to horse owners and investors depends on a variety of factors, including a horse's income from racing or stud fees, its maintenance costs, and its current market value. Because these factors differ so much from one horse to another, it is next to impossible to define a "typical" horse which can be used to portray the effects of the in-lieu tax on horses generally. Rather, the program's effects depend on the specific characteristics of each individual racehorse. As an illustration:

- Suppose that an investor purchases a top-quality racing horse for $1 million. The horse earns $200,000 annually in purse money and generates a net investment return after expenses of 15 percent ($150,000) per year. Table 17 shows that the in-lieu tax on this horse is $150, whereas a 1 percent ad valorem property tax would amount to $10,000. Thus, this program increases the horse's annual investment return by $9,850, or about 1 percentage point (that is, from 14 percent to about 15 percent).

- Alternatively, take the case of a lesser-quality horse worth $50,000 with a more marginal earnings potential of $10,000 annually in purse money and a 5 percent ($2,500) net investment return per year. Table 17 shows that the in-lieu tax on this horse would only be $40, which would represent a tax savings of $460 and an increase in the annual rate of return of about 0.9 percentage points (from 4.1 percent to 5 percent).

Effects of the tax break on the economy are unknown

There is no question that the increased investment returns to horse owners from the in-lieu tax promote the financial health of the horse racing industry in California, both by increasing the number of horse-related businesses that can profitably operate, and discouraging the relocation of certain horse-related activities, such as breeding, boarding and training, from California to other states. The latter effect is especially pronounced because most other major horse racing states effectively exempt horses from property taxation.

Because of data limitations, however, we have been unable to actually quantify the extent to which the in-lieu tax has increased the number of horses located in California, as opposed to simply giving "windfall benefits" to horse owners who would be in business in California even if the in-lieu tax break did not exist. Consequently, although the program undoubtedly has provided at least some stimulus to economic activity, we cannot say whether the value of this increased economic activity is greater or less than the property tax revenues given up to provide the program, or thus whether the program is cost-effective from a tax-incentive standpoint.

Summary and Recommendations

Our analysis of the in-lieu tax expenditure program for racehorses indicates that the program:

- Results in local property tax revenue losses in the *millions of dollars* annually, along with *unknown though significant costs* to the state for school apportionments.
- Potentially offers certain *administrative advantages* as an alternative to the ad valorem property tax, but also currently suffers from a number of *administrative problems and shortcomings.*
- In its current form, creates certain types of *tax inequities*, primarily because certain horses can qualify for the program that are not really involved in racing-related activities. For example, it is possible for expensive Arabian show horses to receive significant tax breaks.
- Increases modestly the rate of return to the owners of most horses that qualify for the program, and thus has some *positive impact* in terms of promoting the breeding, boarding and training of racehorses in California. However, the program also results in *windfall benefits* to many horse owners whose behavior is unaffected by it. There are no reliable data to determine whether the program's economic benefits are greater or less than the revenues given up to provide the program. Thus, whether or not the program is cost-effective as a tax incentive is *unknown*.

What Should the Legislature Do About This Program?

Given the above findings, we believe that there are two key questions facing the Legislature regarding this program:

- ***First, should the in-lieu tax continue to be used in place of levying the regular property tax on racehorses?*** We have no analytical basis for recommending that the in-lieu tax itself be abolished, given the potential administrative advantages it offers. However, should the Legislature retain this program, the current administrative problems and tax inequities associated with the in-lieu tax need to be addressed.

- ***Second, at what levels should the in-lieu tax rates be set?*** Even if the in-lieu approach to taxing horses is retained on administrative grounds, the question still remains of whether horse owners should be allowed to pay less taxes under the in-lieu tax schedule than they would under the regular property tax, and if so, how large a tax break should be allowed. This is essentially a tax policy issue for the Legislature to decide, given that reliable data are unavailable to measure how cost-effective the current tax break is as a tax incentive to stimulate economic activity in California.

Recommendations

Given the above, our recommendations regarding this program are as follows:

- First, providing that the Legislature decides to retain the in-lieu approach to taxing horses, ***we recommend that the Legislature consider "tightening up" the program's eligibility requirements regarding older horses.*** Specifically, the Legislature may wish to limit the ability of older nonrace horses, such as Arabian show horses, to receive tax breaks. For example, the Legislature might want to consider requiring horses to participate in horse races more frequently than once every two years, and defining more specifically what it means to breed horses "with the intent" of producing racing stock.
- ***Second, we recommend that the Legislature review the state's policy of automatically allowing the owners of younger horses to receive tax breaks regardless of whether a horse is currently involved, or ever will be involved in the future, in racing-related activities.*** Specifically, as with older horses, the Legislature may wish to restrict younger horses not involved in racing-related activities from getting tax breaks.
- Third, ***we recommend that the Legislature review the in-lieu tax schedule itself.*** The tax rates contained in the in-lieu schedule have not been reviewed since the tax was first established 17 years ago. The purpose of the review should be to determine whether the taxes paid by qualifying horses are set at appropriate levels. For example, the Legislature may want to adjust the tax rates upward to account for inflation. Or, given the lack of evidence about whether or not the current tax break is a cost-effective tax incentive, the Legislature may want to consider such options as making the in-lieu tax assessments more in line with those which the ad valorem property tax would otherwise generate. ❖

Review of the Partial Property Tax Exemption for Land Under a Wildlife Habitat Contract

This tax expenditure program provides what amounts to a partial exemption from local property taxes for certain lands which are restricted to wildlife habitat uses. It accomplishes this by providing a special alternative method of determining the assessed values of such properties. To the extent that this alternative assessment method lowers a property's assessed value, it also reduces the local property taxes that its owners must pay.

Although the program results in reduced revenues only at the local government level, it does impose a state cost. This is because it increases the amount of school apportionments that the state must provide to local school districts in order to replace these foregone local tax revenues.

Statutory Authorization and Legislative History

This program is authorized by Sections 421 (f), 422 (e) and 423.7 of the California Revenue and Taxation Code. The program was established in 1973 by Chapter 1165, and became effective on January 1, 1974.

Description of Provisions

As noted above, this program provides a partial exemption from the property tax to certain qualifying property that is legally restricted for use as a wildlife habitat. In order to qualify for the program, the property must be subject to a contract with a state or federal agency limiting the use of the land for 10 or more years to habitat for native or migratory wildlife, or as native pasture. In addition, the property must comprise at least 150 acres, and must be eligible to receive water for waterfowl or waterfowl management purposes from the federal government. The only properties that meet these qualifications are a number of private duck-hunting clubs located within the Grasslands Water District in Merced County.

Tax Treatment Under the Program

The special method of valuing qualifying duck-club property for tax purposes under this program allows property values to be based on the average per-acre sales price of corporate stock or membership shares in a duck club. For example, if a 50-acre share in a club sells on average for $5,000, then this program would value the property at $100 per acre. The county assessor would then compare this assessed value with the assessed value that would result under ordinary assessment practices (see below), and the property tax would be levied on the lower of these two values.

Tax Treatment in the Program's Absence

In the absence of this program, qualifying wildlife habitat property in Merced County would be treated the same for property tax purposes as other property generally. Specifically, under current law the property tax would be based on the lesser of:

- ***The Proposition 13 "base-year value" of the property.*** Section XIII A of the California Constitution generally defines a property's "base-year value" as the assessor's valuation of the property as shown on the 1975-76 tax bill. This value is then adjusted annually by the rate of inflation, up to a maximum of 2 percent per year. The base-year value can be increased to reflect a property's current fair market value only when there is a change of ownership, or to the extent that new construction increases a property's fair market value.
- ***The current "full cash value" of the property.*** California Revenue and Taxation Code Section 110 defines "full cash value" (a term equivalent to fair market value) as the price the property would bring if it was offered for sale on the open market. The county assessor generally determines the full cash value of the property based on sales of comparable properties. (A property's current full cash value can be less than its Proposition 13 base-year value if agricultural property values have become depressed, due to such factors as depressed farm prices, surplus inventories of agricultural production that limit the ability to market farm products, and environmental and weather problems that reduce agricultural production yields.)

Treatment of Duck Clubs in Williamson Act Counties

Although waterfowl habitat lands outside of the Grasslands Water District in Merced County do not qualify under this program, those lands located in other counties may qualify for a partial property tax exemption under the California Land Conservation Act (CLCA, also known as the Williamson Act or Open Space program). This program, enacted in 1965, provides a partial property tax exemption for certain agricultural and open space lands. It is only available in counties which have passed an ordinance making the program operative. (Merced County does not participate in the program, so that habitat lands located there are not eligible for CLCA benefits.) To qualify for the CLCA program, the owner must voluntarily enter into a contract with the city or county in whose jurisdiction the property is located. This contract must limit the use of the land to open-space or agricultural purposes. The land is then assessed based on its *restricted use* value, which is based on the property's anticipated future income from this restricted use.

At the current time, 48 counties participate in the CLCA. Duck club owners in these counties have the option to enter into a restrictive use contract in order to receive the property tax benefits offered under CLCA. In fact, many duck clubs do receive a property tax benefit under CLCA.

Duck clubs that are not located in CLCA counties, including those in Merced County, cannot qualify for the CLCA tax benefit. As a practical matter, the partial property tax exemption we are reviewing here was "tailored" to the Grasslands duck clubs in Merced County so as to allow them to get a tax break similar to that provided for duck clubs in CLCA counties.

Rationale for the Program

This program's rationale is not specified in statute. However, our review of bill analyses and other documents dating back to the program's enactment indicates that the program's primary rationale was to provide an incentive for private duck club owners to maintain their land as wildlife habitat. The program attempts to do this by reducing the owners' cost of maintaining the property as a waterfowl refuge, by reducing property taxes.

The Argument for Promoting Waterfowl Refuges

Program proponents point out that California lies along the Pacific Flyway, which is one of the most important waterfowl flyways on the American continent. These proponents argue that it is important to maintain resting, feeding and wintering grounds for the more than eight million waterfowl that migrate through or winter in California. Proponents further point out that over *90 percent* of California's original two to five million acres of natural wetlands have been converted to other uses. Thus, it is argued that the state and federal governments should actively promote waterfowl habitat conservation to ensure that adequate wetlands are available along the Pacific Flyway.

Most Habitat Lands Are Private and Thus Subject to Property Taxes

Of the 300,000 acres of waterfowl habitat remaining in California, approximately 200,000 acres are in private hands and are generally used for private hunting clubs. As private real property, these clubs are subject to property taxes. The hunting clubs typically are owned by shareholders who pay an annual fee to cover the costs of property maintenance, including property taxes. According to industry sources, the costs to private owners of maintaining wetlands suitable for wintering waterfowl are in the range of approximately $50 to $100 per acre in Merced County. These maintenance costs include the costs of water, the cultivation of waterfowl feeding crops, and other costs such as facility upkeep, insurance and local property taxes.

It is argued that, as these maintenance costs increase over time, shareholders who are unwilling to pay those costs may seek to sell their club ownership shares. Should this happen, it is possible that the land will be acquired by farming interests and be converted to agricultural uses. Another possibility for clubs whose members become unwilling or unable to bear the costs of maintaining the club would be to simply stop cultivating the land as waterfowl habitat. In either case -- whether the land is sold for farming or allowed to lie fallow -- the land would not as effectively serve the needs of wintering or migrating waterfowl.

By Reducing Taxes, the Program Can Reduce Maintenance Costs

As noted above, property taxes are one component of the maintenance expenses that duck club owners must pay if they are to remain in business. This program seeks, by reducing these property taxes, to reduce the maintenance costs associated with duck clubs and thereby provide an incentive for private hunting club owners to maintain their lands as waterfowl habitat.

Evaluation of the Program

This section provides our analysis of this tax expenditure program. It first describes the extent to which the program has been used and summarizes the program's costs, both in terms of foregone local property tax revenues and the increased state school apportionment costs which are thereby generated. It then evaluates whether or not the program's property tax incentives have encouraged the preservation of waterfowl habitat in a cost-effective manner. In preparing this analysis we have relied on information from a variety of sources, including the California Board of Equalization, the Merced County Assessor's Office, the U.S. Fish and Wildlife Service (USFW), the California Department of Fish and Game, the Grasslands Water District, the U.S. Soil Conservation Service and the California Waterfowl Association.

Findings Regarding Revenue Losses and State Costs

At the time this program was enacted in 1973, the Merced County Assessor's Office estimated that it would reduce local property tax revenues by approximately $150,000 annually. Table 18 indicates that the program's costs have fallen drastically since that time, and that the property tax revenue losses attributable to it in recent years are *very* minor. For example, the table shows that the local property tax reductions caused by this program during the past several years appear to have ranged between about $10,000 to $20,000 annually. About 40 percent of this loss represents a cost to the state, which under current law must give increased school apportionments to Merced County because of the reduction in the county's property tax base caused by the TEP.

Table 18

Effects of Ch 1165/73 on Assessed Values, Property Tax Liabilities, and Government Revenues and Costs 1985-86 through 1987-88[a]

	1985-86	*1986-87*	*1987-88*
Reduction in Assessed Values	$1,463,490	$1,021,773	$2,051,096
Reduction in Property Taxes	15,843	10,810	21,000
Net Local Cost	9,697	6,519	13,085
Net State Cost	6,146	4,291	8,615

[a] Source: Merced County Assessor's Office. The Merced County property tax rate equals about 1.058 percent for the three years shown, and includes a tax levy for retiring voter-approved debt. The state cost shown reflects increased school apportionments to Merced County.

The low level of tax benefits produced by the program is attributable to the following four factors:

- First, due to the passage of Proposition 13, Merced County's current average property tax rate (about 1.06 percent) is considerably lower than its average property tax rate at the time the program was enacted (2.5 percent).
- Second, the property upon which the affected duck clubs are situated does not change ownership very frequently. As noted earlier, in the absence of a change in ownership, growth in the "base-year value" of property is limited to 2 percent annually. As a consequence, the "base-year value" of many duck clubs is actually *lower* than the reduced value offered under this program. As a result,

some duck clubs do not "come out ahead" under this program, and thus do not use it.

- Third, the depression in agricultural values in recent years has resulted in a situation where the current fair market value of many clubs is lower than either their Proposition 13 "base-year value" or the reduced value allowed under this program. This again means that not all duck clubs would benefit under this TEP.
- Fourth, the USFW operates a conservation easement program in the Grasslands Water District. Under this program, perpetual easements are purchased on a willing-seller basis from waterfowl habitat owners in the Grasslands Water District area. To comply with the stipulations of the easement, the landowner cannot alter the land in any way that is detrimental to waterfowl use. In addition, USFW retains the right to apply water to the land, if necessary. Landowners participating in the program may sell their land, but the easement applies to the new owner. The USFW has purchased easements on 28,000 acres in and around the Grasslands District. Since these properties are assessed based on their value in the restricted use, we have no reason to believe that they would benefit from the partial tax exemption for wildlife habitat provided by the tax expenditure program.

Distribution of Benefits Under the Program

Regarding the distribution of tax benefits under the program, our research indicates that:

- There were 151 duck clubs in Merced County that were qualified to participate in this program during 1987-88.
- Of these 151 clubs, tax data from the Merced County Assessor indicates that only 20 clubs actually were participating in the program and receiving tax benefits under it during 1987-88.
- Three duck clubs received 50 percent of the total benefits accruing to these 20 participating clubs.

Thus, this program benefits a very small number of organizations to begin with, and half of its dollar benefits in 1987-88 were concentrated in only three duck clubs.

Findings Regarding Cost-Effectiveness of the Program

The major criterion we use in evaluating the merits of a tax expenditure program is whether it has achieved its stated objectives (which in this case involves encouraging landowners to maintain their land as waterfowl habitat) in the most cost-effective manner. That is, has the program achieved its objectives and done so less expensively than could be accomplished using other strategies for waterfowl habitat conservation? Given this criterion, the central issues associated with this particular program are (1) the extent to which the program results in the preservation of waterfowl wintering grounds and (2) whether the same level of habitat preservation could be achieved using some other means at a cost lower than the amount of property tax revenues lost through this program.

How Has the Program Affected Costs of Maintaining Wildlife Habitat?

Our analysis of tax data from the Merced County Assessor's Office indicates that, in 1987-88, this program resulted in average tax savings of approximately $4.00 per acre. These savings are equivalent to about 4 percent to 8 percent of the total per-acre costs of maintaining wetlands. However, our analysis also indicates that the per-acre tax savings varied considerably from one parcel to another, from a low of $0.05 per acre to a high of $9.39 per acre. The higher per-acre benefits tend to accrue to property which has recently changed hands, and thus has a higher "base-year value" for tax assessment purposes.

What Effects Have These Cost Savings Had?

The key question here is: What effect, if any, do tax savings of these magnitudes have on wildlife habitat land-use decisions?

Unfortunately, due to data limitations, it is difficult to answer this question and evaluate whether these savings have been effective in inducing wildlife habitat property owners to maintain their current land use. According to the U.S. Fish and Wildlife Service, between 2,000 and 3,000 acres in the Grasslands Water District have been converted from wetlands to agricultural use since 1971. Unfortunately, however, it cannot be determined how much of this conversion occurred prior to 1974 when the program went into effect. Furthermore, it cannot be determined how much land would have been converted in the absence of this program. A number of factors contribute to decisions concerning land use, including the relative value of the land for hunting versus agricultural purposes, and the preferences of property owners for land preservation. The relative effects of these factors on decisions about using land that has qualified under this program in unknown.

The Program's Current Effects on Land Use Probably Are Limited

Despite the above uncertainties, in our judgment it is unlikely that this program currently is having any significant impacts on land use decisions. This is not to say that certain properties have not been affected, but rather that these cases are probably relatively limited. The main reason for this involves the alternative uses available for the lands involved.

Alternative agricultural uses for Grasslands properties are limited

Agricultural experts have indicated to us that land in the Grasslands Water District is of limited value for agricultural purposes. This is because this land is generally too salty and uneven to be cultivated profitably. In order to convert such land to agricultural uses, it is necessary for the property owner to drain the land, flatten it, and then treat the soil with gypsum to remove salt deposits. Even then, the land is generally only suitable for lower-valued crops such as alfalfa or beets. Furthermore, there is limited water available for most such property. In order to receive water from the Grasslands Water District, the land must be used as a waterfowl habitat. Although drain water is available, this water tends to contain high concentrations of salts and contaminants. Finally, alternative fresh water sources are extremely expensive.

Given these limitations on land use and the current softness in agricultural land values, the highest and best use of Grasslands property appears to be for waterfowl hunting. In fact, the Grasslands Water District reports that some of its acreage currently is being converted back from agricultural use to wetlands property. Thus, it appears unlikely at the current time that property in the Grasslands Water District would be converted to agricultural use even in the absence of this program.

Effects Could Be Greater in the Future

Although the program's current overall effect on habitat preservation appears to be limited, this effect could be substantially greater in the longer term. For example, if the agricultural economy improves sufficiently in future years, certain Grasslands properties may become more attractive for farming. To the extent that this occurs, land owners would have more of an incentive to convert their wetlands properties to agricultural uses. Furthermore, in coming decades California's population is expected to become increasingly concentrated in the Central Valley corridor where most habitat land is located. Thus, there may be a tendency in the long run for urban development to encroach upon waterfowl habitat, again increasing the potential for land conversion due to higher land values. Given this, the program's partial tax exemption may have more of an effect on land-use decisions in the future than at present.

Findings Regarding Tax Equity

Our analysis indicates that this program results in certain inequities in the tax treatment of waterfowl habitat lands. Specifically:

- This program is available only to wetlands within the Grasslands Water District. There are comparable properties elsewhere in Merced County and other areas of the state which cannot receive this special tax treatment, because they do not have the contractual arrangements discussed earlier that are required to qualify for the TEP.
- This program is not available to restricted wetlands properties which are smaller than 150 acres in area. As of 1987-88, there were 39 clubs in Merced County which were under the restrictive land-use contracts described above and were less than 150 acres in size. Because of their size, these smaller duck clubs do not qualify for the TEP.

Summary and Recommendations

Our analysis of the tax expenditure program for wildlife habitat indicates that the program:

- Results in *very minor* local revenue losses and state costs at the present time;
- Benefits only a *limited number* of taxpayers in only *one* water district of the state;
- Does *not apply uniformly* to similar waterfowl habitat lands; and
- Probably has *little effect* on land-use decisions at the current time.

In sum, providing this program does not impose much of a fiscal burden on state and local government. However, neither does it appear to be an effective, equitable or efficient tool for ensuring the preservation of wildlife habitat lands.

What Are the Legislature's Policy Options?

What steps, if any, should the Legislature take regarding this program, given that it is in the public interest to maintain waterfowl habitat lands, especially in light of the threats to such habitats posed by future land-use trends?

Revising the Current Program Has Limitations

One option is for the Legislature to eliminate some of the program's inherent inequities, such as by making it available to small-acreage properties and lands outside of the Grasslands Water District. The problem with this option, however, is that the program does not appear to be an efficient means of achieving its objectives, and expanding its use would simply exacerbate this shortcoming.

A Direct-Expenditure Approach Is Preferable

Given the above, ***we recommend that the Legislature repeal this program and rely fully on an existing direct-expenditure program for preserving wetlands habitat in California.***

In 1987, the California Waterfowl Habitat Program (CWHP) was established by Chapter 633 to protect land for the conservation of waterfowl. This program allows private duck club owners to receive state payments in return for entering a 10-year renewable contract to maintain existing habitat that benefits migratory waterfowl. These payments are funded from the interest on funds in the California Waterfowl Habitat Preservation Account (CWHPA), which was created by Chapter 633. Chapter 633 appropriated $100,000 from the California Environmental License Plate Fund in start-up funding for the program.

Because such payments can be directed towards the waterfowl habitat areas that the state thinks are most valuable and at the greatest risk of degradation, an approach like CWHP appears to offer a more efficient means of providing for the preservation of waterfowl habitat lands than the current tax expenditure program. Furthermore, this alternative approach allows the Legislature more direct control over desired funding levels for preserving waterfowl habitat areas, thereby ensuring that the proper amounts of public funds are being expended to accomplish this objective.

For these reasons, we recommend that the Legislature use the CWHP in lieu of the existing property tax exemption for preserving waterfowl habitat lands. ❖

Review of the Sales and Use Tax Exemption for Coins and Gold or Silver Bullion

This tax expenditure program exempts from sales and use taxation sales of coins and gold or silver bullion having a market value greater than $1,000.

Statutory Authorization and Legislative History

This program is authorized by Section 6355 of the California Revenue and Taxation Code. The exemption was initially established on a limited basis in 1973 by Chapter 1019. Under that law, only coin sales by commodity brokers with a total *face value* greater than $1,000 were exempt. In 1977, the State Board of Equalization (BOE) extended the exemption to cover sales of foreign coins with a *market value* greater than $1,000, based on a California appellate court decision involving the exemption's coverage *(Alan Van Vliet Enterprises, Inc. v. California State Board of Equalization)*. Following this, Chapter 849, Statutes of 1980, deleted the requirement that exempt sales be made by commodity dealers. Finally, Chapter 1128, Statutes of 1985, further extended the exemption to cover gold and silver bullion, and changed the threshold for the exemption to $1,000 of market value for all coin and bullion sales. The provisions of Chapter 1128 sunset on January 1, 1991. The sunset date would have been eliminated by SB 1630 (Campbell), which passed the Legislature in 1988 but was vetoed by the Governor.

Chapter 1128 also requires the Legislative Analyst to report to the Legislature by January 1, 1989 on this tax expenditure program, a requirement which this review has been prepared to satisfy.

Description of Provisions

As noted above, this program exempts from sales and use taxation coins and gold or silver bullion, when the amount sold or purchased has a market value of at least $1,000. The reason for the $1,000 threshold is to limit the exemption to "bulk" sales to investors, rather than sales to hobbyists or curiosity buyers whose behavior presumably would be relatively unaffected by the added cost of the sales tax.

Gold and silver *bullion* qualifying for this program generally takes the physical form of solid bars. The value of these bars depends entirely on the current market value of gold or silver.

Regarding *coins*, these may be made of any metal, provided that at some time they are, or have been, used as a medium of exchange under the laws of California, the United States or any foreign nation. American Arts gold medallions (authorized by federal law) and California Gold medallions (authorized by state law) also qualify for the exemption.

The coin market itself consists of two distinct segments:

- First, there are *numismatic coins*, which are collectors' items. The value of a numismatic coin depends primarily on the scarcity of that type of coin, the quality of the individual coin, and the desirability of the coin due to its aesthetic or historical appeal. Little or none of the coin's value may be due to the actual metal in it.
- Second, there is *monetized bullion*, which consists of coins whose value depends almost entirely on the commodity value of the metal in them. Several nations currently issue these types of coins in convenient weights for investors, the most common being one-ounce gold coins. Examples of such coins include the U.S. American Eagle, the Canadian Maple Leaf and the Chinese Panda. Although these coins may have an actual designated face value (for instance, $50 for the one-ounce American Eagle), their bullion value is *much higher*. Generally, monetized bullion coins sell for a small premium over the commodity price of the metal itself. For instance, on October 17, 1988 the London gold price was $413 per ounce, while the price for both the American Eagle and Canadian Maple Leaf was $428 -- a premium of 3.6 percent over the commodity price. The coins command such a premium because they are easier to buy and sell than bullion.

In some cases, such as rare gold coins, coins may have *both* numismatic and bullion value.

Rationale for the Program

The following four principal rationales have been put forward for this program:

- The amount of tax revenues foregone by California due to the exemption *is nil*, because coin and bullion purchasers can easily avoid paying the sales tax by making their purchases out of state and have a strong incentive to do so.
- The exemption results in *additional economic activity* within California from activities related to coin and bullion sales that would otherwise take place in other states.
- The exemption *protects consumers* because, in its absence, consumers would have an incentive to deal through unknown and potentially unreliable or unscrupulous out-of-state businesses, instead of in-state businesses that can be dealt with in person and whose credentials may be easily verified.
- The imposition of a sales tax on coins and bullion *is unfair*, because no sales tax is charged on competing investment vehicles, such as stocks, bonds and real estate.

The Nil Revenue Loss Rationale

The crux of this argument is that it would be easy and relatively inexpensive for Californians to avoid paying sales tax on bullion and coins if the exemption were repealed, meaning that imposing a sales tax on these transactions would generate very little revenue. For example, the combined 6 percent basic state-local sales tax on three American Eagle coins, valued at current market prices (around $1,285), would be about $77. However, a California buyer could avoid this tax simply by calling a dealer in another state and having the coins delivered by registered mail. The shipping and handling charge for the delivery normally would be less than $5 per coin. Thus, on a three-coin purchase (the minimum number of coins that would have to be purchased in order for the sale to exceed the $1,000 threshold needed for the exemption to apply), the net savings from purchasing out of state would be about $62. Likewise, a purchaser of 30 coins, whose value at current market prices is $12,850, could realize a net savings of $620. Given the ease of mail-order buying, these savings would be a strong incentive to shift purchases out of California. As a result, it is unlikely that the state would gain much revenue from repealing the exemption.

Although purchasers of coins and bullion technically would be liable for the *use tax* if the exemption were not available, as a practical matter this tax is rarely collected from buyers in out-of-state mail-order sales. The Legislature enacted legislation in 1987 (Chapters 1144 and 1145) requiring mail order, telemarketing and television shopping businesses which target California to collect use tax on purchases sent to California. According to staff at the State Board of Equalization, however, this legislation probably would not be very effective in enforcing use tax collection on sales of bullion and monetized bullion coins. This is because out-of-state dealers can solicit California investors effectively through national advertising as opposed to advertising which is targeted at California purchasers.

Of course, the argument that the sales tax provides an incentive to make out-of-state purchases could be used to justify exempting *any* item subject to the tax. The proponents of this rationale argue, however, that bullion and coins are a special case for the following reasons:

- The value of these items is high compared with shipping costs.
- Purchases in excess of $1,000 generally are for investment purposes and physical possession is not crucial.
- Bullion and monetized bullion coins are standardized commodities available from reliable sources, so that inspection by the purchaser is not essential.

In our view, these arguments have *substantial validity* in the case of bullion and monetized bullion coins. Large purchasers especially would have a very strong economic incentive to avoid the sales tax and would have several convenient means available to do so. Only those purchasers who are uninformed, or who have a strong preference for personal inspection and immediate possession, would buy in-state and pay the sales tax.

The preceding arguments, however, are *less persuasive* in the case of numismatic coins. Although these coins may be purchased for investment purposes, they are primarily collectibles. Thus, physical inspection and possession of these coins is more important to their buyers than it is for bullion, because the quality and specific characteristics of these coins determine their value. Purchasers also may experience substantial enjoyment from their display. In this respect, numismatic coins are similar to such other types of collectible investments as rare stamps, jewels and art, all of which *are* subject to the sales tax.

The Economic Stimulus Rationale

The argument here is that the sales tax exemption results in additional economic activity in California associated with the buying and selling of coins and bullion.

Based on our discussions with coin and bullion dealers and available information on sales volumes, the sales tax exemption does appear to shift into California certain sales of coins and bullion that otherwise would have occurred in other states, and likewise to keep certain sales within California that otherwise might have shifted into other states. Given this, there appears to be some validity to the economic stimulus rationale.

Consumer Protection

According to this rationale, removing the exemption might make California investors more vulnerable to out-of-state scam operators who might capitalize on the possibilities for tax avoidance as a selling point. Because these operations would be located outside of California, California investors would not be in a convenient position to check out a firm's reputation and ensure that they would in fact receive their order, before parting with their money.

This particular problem, though perhaps real, does not justify the tax exemption. This is because the expenditure of state funds to protect persons who seek to *avoid* paying state taxes is counterproductive.

Comparable Treatment With Other Investment Vehicles

This rationale contends that it would be unfair to levy a sales tax on coins and bullion, while transactions involving other types of investment vehicles, such as stocks and bonds, are not subject to sales taxation. We believe that there is considerable substance to this argument when applied to bullion. Financial investment vehicles like stocks and bonds represent by far the largest share of the nation's financial investment assets, and thus should be the items focused on when considering the equity of this program. Clearly, taxing transactions involving items like bullion puts these investments at a financial disadvantage, since transactions involving their most important competing financial assets are not subject to sales taxation.

On the other hand, the exemption for numismatic coins is not consistent with the treatment of other collectibles under the sales and use tax. It is indeed true that items like jewels, rare stamps, artworks, vintage wines and antiques are subject to sales taxation, even though they often are purchased for investment purposes. However, the purchasers of these items more often than not also have other motivations for buying them, including display. In this sense, these items are not like bullion.

Evaluation of the Program

Evaluating the sales tax exemption for coins and bullion requires addressing both the net revenue effect and the tax equity of the exemption. The exemption's net revenue effect depends on (1) the amount of direct revenue that the state would gain from eliminating the exemption and (2) whether this gain would be greater or less than the reduction in economic activity and accompanying indirect revenue loss that would result if economic activity shifted out of California and into other states. With regard to tax equity, the question is whether the sales tax exemption for bullion and coins is comparable with the taxation of other financial investments and collectibles.

Impact on State Revenues of Eliminating the Exemption

Program usage

Unfortunately, no comprehensive data are available on the total value of coin and bullion sales in California, the proportion of sales within each of the three main market segments (bullion, monetized bullion and numismatic coins) or the amount sold to California residents. *As a result, it is not possible to provide a reliable quantitative estimate of what the revenue gain would be from eliminating this exemption.* Some information is available, however, that indicates the rough order of magnitude of the coin and bullion market, and thus some rough concept of how much money might be involved under this program.

Information provided by the U.S. Mint and the World Gold Council indicates that about 2.1 million ounces of newly minted or imported gold coins (primarily American Eagles and Canadian Maple Leafs) were sold in the U.S. in 1987. In addition, about 91,100 ounces of newly manufactured gold bullion were sold in the U.S. in 1987, excluding large bars that always remain in depositories. At current prices, this represents sales of about $932 million nationwide. California's share of this amount is unknown. However, if this share was similar to the state's share of national personal income (about 12 percent), the amount would be $112 million. This total represents only gold bullion and monetized bullion coins, and thus is *conservative*. The total coin and bullion market also would include sales of silver and numismatic coins, plus secondary market sales.

A survey conducted on behalf of the California Coin Dealers' Association indicated total 1987 sales of $388 million for the 20 percent of the association's 130 members who responded. Only $1.3 million of these sales were taxable according to the survey. The survey, however, did not identify how much of these sales were to other dealers for resale and would not have been taxed even without the exemption.

Given the above, it appears reasonable to conclude that the coin and bullion market in California involves several hundred million dollars of annual transactions. Discussions with California coin dealers indicate that bullion and monetized bullion coins (versus numismatic coins) account for most of their sales, and that sales under $1,000 account for only *a minor* portion of total sales.

Findings regarding revenues

Although a quantitative estimate of the net revenue effect of this tax expenditure program is not possible, *it appears likely that the sales tax exemption for bullion and monetized bullion coins results in little or no net revenue loss to the state*. This conclusion primarily reflects purchasers' strong financial incentive to avoid the sales tax, and the relative ease with which this can be done through the use of out-of-state dealers. Future changes in federal law, however, could warrant a reevaluation of this conclusion. Congress has considered legislation to enable states to collect sales tax on some interstate transactions. If such legislation is enacted and permits effective collection of sales taxes on interstate bullion sales, the revenue gain from eliminating the exemption could be much greater. Even then, however, investors could avoid taxation by buying and storing their bullion in states that do not tax it.

With respect to *numismatic coins*, the argument that there is little if any revenue loss is *much less convincing*. The advantage of doing business with a trusted local dealer who provides expert advice and where it is convenient to inspect coins visually provides a strong incentive to many collectors to make purchases locally.

Conclusions and Recommendations

Our analysis indicates that if the sales tax exemption for *bullion and monetized bullion coins* were eliminated, most of these sales would shift to out-of-state dealers, and the state would therefore collect relatively little in direct sales taxes on these items compared with the reduction in economic activity that would occur. This conclusion is based on the state's current inability to collect sales and use taxes on most interstate coin and bullion transactions. The conclusion should be *reevaluated,* however, *if and when* future changes in federal law make the collection of these taxes feasible.

In the case of *numismatic coins,* their nature as collectibles provides considerably less justification for their exemption under the current program. Exempting numismatic coins clearly conflicts and is inconsistent with the state's general policy of applying the sales tax to other types of collectibles. In addition, a smaller proportion of sales would be likely to move out of state than would be the case with bullion or monetized bullion coins, thereby making it likely that eliminating the exemption for numismatic coins would result in a net revenue gain to the state.

All of the commonly recognized monetized bullion coins sell for premiums of less than 10 percent over their metal value (that is, their cost is less than 110 percent of the value of the bullion in them). Consequently, limiting the exemption to coins selling for no more than 110 percent of their current metal value effectively would eliminate the exemption for numismatic coins since the value of numismatic coins generally is much greater than the value of the metal in them.

What Steps Should the Legislature Take?

Given the above findings, we recommend that the current program for exempting coins and bullion from sales and use taxation be modified to eliminate the sales tax exemption for numismatic coins (which we believe should be defined for tax purposes as coins with a sales price greater than 110 percent of the value of the bullion in them). In addition, if federal legislation is enacted that enables California to collect sales taxes on out-of-state purchases by Californians, we recommend that the Legislature at that time reexamine the entire tax expenditure program for coins and bullion. ❖