Informational Hearing
Assembly Committee on Revenue and Taxation
Reviewing California's Tax Expenditure Programs

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February 22, 2023

It is an honor to have the chance to get to present to you at this hearing. You have already heard from others about the scope and nature of tax expenditures. I see my task as helping to provide a conceptual framework for evaluating current and proposed tax expenditures.

I think it appropriate to start with my working definition of a tax expenditure. A tax expenditure represents a tax rule that is different from the rule that would be prescribed by the principles underlying the tax at issue – and typically to advance some policy goal. This definition is slightly different from what is used by the Department of Finance.[1]

I will now proceed to principles I think should guide the Legislature in this area.

1. **All tax expenditures narrow the tax base and on that ground alone should be avoided**. California is governed by a balanced budget rule.[2] If a tax generates less revenue because of tax expenditures then the loss of revenue has to be paid for by other taxpayers or by the other Californians who are denied the public goods and services that could otherwise be provided. Further, to raise the same amount of money from a narrower base requires higher tax rates. All else equal, higher tax rates cause greater economic distortion. Consider the trouble you would go through to avoid a 5% tax as opposed to a 20% tax.[3] Thus tax expenditures distort economic activity far beyond their narrow targets.

2. **There is strong consensus that narrow tax incentives do not accomplish much**. Despite billions of dollars spent on tax incentives by state and local governments for years and years, the general scholarly consensus is that they do not make much difference in stimulating growth, subject to a few exceptions.[4] These finding make sense: businesses have more pressing needs (like finding the right workforce) than saving a little bit on taxes. The politics of incentives are another matter. I understand that you will likely end up approving new incentives because proponents will argue that their incentive is the exceptional one that is worth it, but I encourage as skeptical an attitude towards narrow incentives as possible.

3. **Be very careful when creating new expenditures**. The Legislature can reduce taxes by majority vote, but can only increase taxes with a

supermajority.[5] In order to prevent a perpetual – and expensive - one-way ratchet, tax expenditures should always be approved subject to some kind of fiscal control. Sunsets are ideal, along with some obligation to study the expenditure. At a minimum, expenditures should be subject to caps so they do not cost far more than expected.

4. **Not all tax expenditures on the list are "really" tax expenditures**. The Department of Finance considers the Manufacturing and Research & Development Equipment Exemption a tax expenditure under its analysis of the sales tax. Yet as a matter of sales tax theory, an exemption for business inputs is appropriate in order to limit pyramiding of the sales tax.[6] Note that if it makes sense to exclude sales from the sales tax base on principled grounds, it would be right to expand the base for the same reasons. See the discussion of digital goods under #6 below.

5. **Not all tax expenditures are problematic**. The Earned Income Tax Credit (EITC) is listed as a tax expenditure. In a sense it is, as sending money back to working taxpayers is not part of an income tax, and yet it is so different it is worth considering whether this label is really helpful. The EITC is a wage subsidy provided to the working poor that is (properly, in my opinion) administered through the tax system because the tax system has the information concerning taxpayer income.[7] It is not really a deviation from a principled income tax but should be evaluated as a spending policy.

6. **There are major tax expenditures not on the list**. The largest single corporate tax expenditure ($4.8bn projected by the DOF in 2023-24) is the income lost because California does not do very much to combat the shifting of income out of the US and California tax bases by large multinational corporations; this is the so-called Water's Edge Election.[8] Since this is a deviation from sound corporate tax policy and can be readily remedied by eliminating the election, it is appropriately on the list. Yet what is not on the list is that the federal corporate tax now contains at least two other provisions meant to combat income stripping. These two provisions are known are the taxation of "Global Intangible Low Tax Income" (GILTI), added by the Tax Cuts and Jobs Act in 2017 and the Corporate Alternative Minimum Tax (CAMT) added by the Inflation Reduction Act in 2022.[9] California conforms to neither of these, which means that California is doing less to combat income stripping than the Trump Administration thought appropriate. Now, no doubt conforming to these federal provisions would bring back some (most, all?) of the same income as eliminating the water's edge election, but it is important to note that not conforming to federal law is a further (poor) choice that California has made these last 5 years.

   The failure to tax shifted corporate profits is worth another moment of attention. First, as a percentage of the relevant tax base, it is not just absolutely large, but by my rough reckoning one of the largest of all tax expenditures as a percentage of its tax base (over 10%, usually more than that).[10] Second, unlike other large expenditures, this one does not even have a shaky rationale. That is, to take another large expenditure as an example, the exclusion for employer-provided health care arguably helps at least some Californians get a little more health insurance, but what good can failing to tax shifted corporate profits even theoretically achieve?

Another example: **digital goods and services**. The sales tax should reach all final consumption; it should not matter whether a customer purchases a physical book or an e-book.[11] The current trend among the states is to tax digital goods, but California does not.[12] The failure to take digital products is a deviation from sound sales tax policy, but its cost is not included as a tax expenditure.[13]

7. **Consider interactions with the federal system and other important policies**. Tax expenditures do not exist in a vacuum. Consider the home mortgage interest deduction. There is a similar deduction at the federal level, which provides much more benefit because federal taxes are higher. Thus, even if one believes that the home mortgage interest deduction is a sensible federal expenditure, it is much harder to argue that California's additional incremental tax break does any good - especially for the price in lost revenue. This deduction is also likely at cross-purposes with other state goals. That is, if the state-level home mortgage interest does anything, it likely increases the cost of housing, which is clearly not a wise policy objective.

8. **Consider distributional effects**. Since tax expenditures represent spending through the tax system, the distribution of the spending should be considered. It is hard to imagine the Legislature explicitly spending tax dollars with distributive impacts as skewed as most state tax expenditures likely are. I will let this chart, which shows the distribution of federal expenditures – most of which have state analogues – speak for itself:

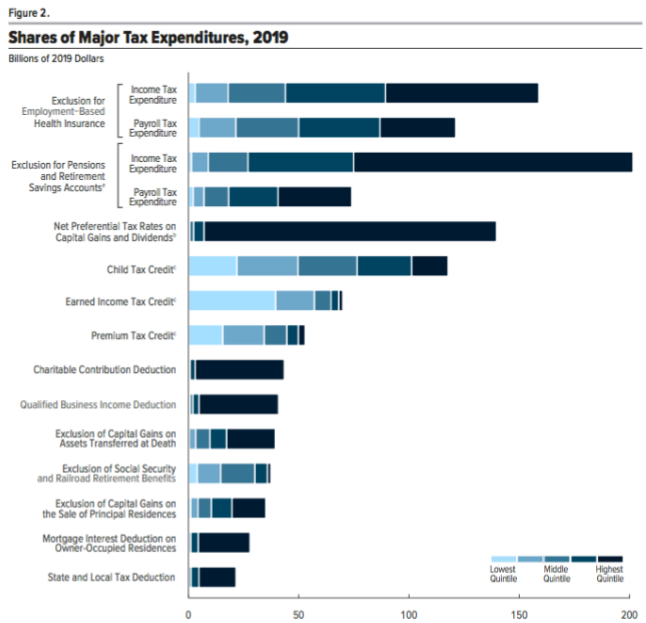

Figure 2.
Shares of Major Tax Expenditures, 2019

Source: https://www.cbo.gov/system/files/2021-10/57413-TaxExpenditures.pdf

9. **Consider creative ways to cap expenditures**. Eliminating or even capping a particular expenditure can be politically challenging and, as a policy matter, one might reasonably believe that many expenditures do some good while worrying about their overall cost. There are ways to address this. For instance, Section 68 of the Internal Revenue Code used to impose a kind of cap on personal deductions like the home mortgage interest deduction; California still applies this rule, though one might think too generously.[14] Similarly, California has a corporate minimum tax calculation that – appropriately – does not permit the use of many credits, but the credits that are permitted (like the R&D credit) against the minimum tax are very costly.[15] It would seem appropriate for the minimum tax to prohibit the use of all credits.

   There are other ways one might approach the issue. For instance, one might forbid the use of R&D (and other) credits against the minimum tax, but only for taxpayers that have taken the water's edge election. In this way, the state would be saying to profitable businesses that we will support your growth very generously, but when you make money you need to share a minimum amount or adopt a methodology that demonstrates that you are not inappropriately shifting profits.

[1] For the sake of clarity, I will refer only to the Department of Finance report. CA DOF, Tax Expenditure Report 2022-23.
[2] Cal. Constit., Art. XVI, Sec. 1.
[3] See Jonathan Gruber, *Public Finance and Public Policy* 591 (4th ed. 2013).
[4] See, e.g., Timothy J. Bartik, Upjohn Inst., *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States* at p. 7 (2017): "The majority of studies suggest incentives are not cost-effective, with either no statistically significant effects or large costs per job created. However, the incentives' research literature has exceptions . . ."
[5] Cal. Constit. Art. XIIIA, Sec. 3.
[6] A sales tax is supposed to tax all final consumption, but just once. If a state taxes intermediate business purchases then this leads to tax on top of tax – i.e., pyramiding.
[7] David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 Yale L.J. 955 (2004).
[8] Ca. Revenue and Tax Code secs. 25110-25113. For a brief discussion of why this election should be revoked see Darien Shanske, *White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting*, 89 State Tax Notes 1181 (2018).
[9] For further discussion of conformity to GILTI, see Darien Shanske & David Gamage, *States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A*, 94 Tax Notes State 121 (2019). For further discussion of conformity to the CAMT, see Darien Shanske and David Gamage, *Why States Should Conform to the New Corporate AMT*, 107 Tax Notes States 601 (2023) (attached).
[10] Compare with the projected amount of corporate tax collections in the Governor's 2023-24 budget at p. 135.
[11] For further discussion, see Orly Mazur and Adam Thimmesch, *Closing the Digital Divide in State Taxation: A Consumption Tax Agenda*, 98 Tax Notes State 961 (2020). For the argument that a special gross receipts tax on digital ads is a complementary reform to fill gaps in the sales tax, see Christine Kim and Darien Shanske, *State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)*, 98 Notre Dame Law Review 741 (2022).
[12] See Karl Frieden et al., *Down the Rabbit Hole: Sales Taxation of Digital Business Inputs*, 105 Tax Notes State 265 (2022) at p. 267, Figure 1.
[13] There are other examples. One prominent example includes the failure not even to impose a withholding tax regime on the unrealized gains of the super wealthy. It is possible to do so and President Biden's Billionaire Minimum Income Tax provides one template for how it might be done. See here for more details.
[14] Ca. Revenue and Tax Code sec. 17077.
[15] Ca. Revenue and Tax Code sec. 23036(d).