OVERVIEW OF CALIFORNIA'S TAX EXPENDITURES

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DEPARTMENT OF FINANCE

FORECASTING UNIT

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GENERAL BUDGETARY CONDITION OF THE STATE

- Revenue outlook substantially different than last two years, with the 2023-24 Governor's Budget projections $29.5 billion lower.
- Budget gap for 2023-24 is estimated at $22.5 billion.
- Proposed Budget uses funding delays and shifts, various reductions, and limited borrowing and revenue solutions to close gap, while budgetary reserves are maintained at $35.6 billion.
- Cash results since the Governor's Budget are below forecast by $3.3 billion through February.

DEFINITION OF TAX EXPENDITURES

- Section 13305 of the California Government Code defines tax expenditure as "a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state.“
- Although this definition is very broad, Finance has interpreted it to mean that aspects of the law that are basic to the tax structure are not tax expenditures.
- Judgment is required in determining what is basic to the tax structure, therefore different tax expenditure reports may include different items.

EXPENDITURE REPORTS FROM DOF, FTB, AND CDTFA

- The Department of Finance is statutorily required to publish an annual Tax Expenditure Report since 1984 (biennial from 1971 to 1984).
- The Franchise Tax Board as part of its best practices annually releases the California Income Tax Expenditures, Compendium of Individual Provisions: Report.
- The California Department of Tax and Fee Administration releases Publication 61 Sales and Use Taxes: Exemptions and Exclusions.

CONTENT OF FINANCE'S TAX EXPENDITURE REPORT

- A comprehensive list of tax expenditures exceeding $5 million.
- The statutory authority for each provision.
- A description of the legislative intent of each provision, if specified in the enacting legislation.
- The sunset date of each provision.
- The beneficiaries of the provision.
- An estimate of the state and local revenue loss for the current and two subsequent fiscal years.

CONTENT OF FINANCE'S TAX EXPENDITURE REPORT

- For personal income tax expenditures, the number of taxpayers and returns affected for the most recent tax year.
- For corporation and sales tax expenditures, the number of returns or businesses affected for the most recent year for which data is available.
- A listing of any comparable federal benefit.
- A description of any tax expenditure evaluation or compilation of information completed by any state agency since the last tax expenditure report by the Department of Finance.

EXAMPLES NOT CONSIDERED TAX EXPENDITURES

- Sales tax not applied to sales or leases of real property, sales of services, wholesale transactions, or sales of securities and insurance.
- Net operating loss deductions.
- California's progressive income tax rate structure.
- Exemptions or exclusions required by the U.S. Constitution, the California Constitution.
- Changes in tax law that alter penalties or interest, or that accelerate or defer tax payments are generally not considered tax expenditures.
- Apportionment rules.

EXAMPLES OF TAX EXPENDITURES

- Research and Development Tax credits
- Employer Provided Health Insurance
- Exclusion of Capital Gains on Sale of Principal Residence
- Home Mortgage Interest Deduction

TYPES OF TAX EXPENDITURES

- Tax expenditures may be classified into the following two broad groups:
  - Those which provide an incentive for a particular type of behavior.
  - Those which provide tax relief for taxpayers facing a particular economic hardship.

CHALLENGES IN EVALUATING TAX EXPENDITURES

- It can be difficult to evaluate the cost and benefits of tax expenditures due to taxpayer behavior, limited data availability, indirect effects, and opportunity costs.
- Tax expenditures intended to incentivize behavior can result in windfall benefits—the benefit may go to businesses or individuals that would have undertaken the activity in the absence of the benefit.
- Evaluating the extent of windfall benefits, which increases a tax expenditure’s cost relative to its benefit, is challenging.

REVENUE AND TAXATION CODE SECTION 41

- Legislation that creates a new tax expenditure after January 1, 2015, is required to include specific goals, purposes, objectives, performance measures, and data collection requirements to allow the Legislature to evaluate the effectiveness of the tax expenditure.
- The requirement has to include the specific data and baseline measurements to be collected and remitted in each year the tax expenditure is in effect, in order for the Legislature to measure the change in performance indicators, and the specific taxpayers, state agencies, or other entities required to collect and remit data.

TAX EXPENDITURES VERSUS DIRECT EXPENDITURES

- Tax expenditures can be reviewed less frequently than direct expenditures once they are in place.
- There is no control over the amount of foregone revenue that results from a tax expenditure once that provision has become part of the tax code. Exceptions are capped and allocated tax credits such as the film tax credit or the Cal Competes Tax Credit.
- Tax expenditures are accounted for as a revenue reduction rather than an expenditure.

TAX EXPENDITURES VERSUS DIRECT EXPENDITURES CONT.

- The vote requirements for tax expenditures and direct expenditures may be different.
  - Tax expenditures that are adopted legislatively (except those adopted as urgency measures) require approval by a simple majority of both houses of the Legislature.
  - The repeal of a tax expenditure requires a two-thirds majority vote, while direct expenditures can be repealed with a simple majority vote.

REVENUE ESTIMATES FOR TAX EXPENDITURES

- Revenue estimates are uncertain, particularly with sales tax exemptions, where there may be no tax data.
- Due to the effects of tax law interactions and taxpayer reactions to changes in tax law, the estimates for any individual tax expenditure do not necessarily reflect the revenue gain that would occur if the tax expenditure was repealed.

THANKS

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