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Tax Expenditures

LEGISLATIVE ANALYST'S OFFICE

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Tax Expenditures—General Background

☑ ***What Are Tax Expenditures?*** Tax expenditure programs, or TEPs, are special tax provisions that reduce the amount of revenues the "basic" tax system would otherwise generate in order to provide:

- *Benefits* to certain groups of taxpayers, and/or
- *Incentives* to encourage certain types of behavior and activities.

☑ ***What Types of TEPs Are There?*** The main types involve tax exemptions, deductions, and credits.

☑ ***How Many TEPs Exist?*** Determining whether a tax provision is a TEP depends on one's definition of the basic tax structure. However, based on our last inventory and using a broad definition:

- California has several hundred TEPs with an estimated 2011-12 value of around $45 billion.
- There are dozens of TEPs relating to income taxes. Of these, personal income tax (PIT) TEPs total around $30 billion, while corporation tax (CT) TEPs total about $5 billion (see pages 3 and 4).
- Sales and Use Tax (SUT) TEPs are worth around $9 billion (see page 5).
- There also are other TEPs associated with the insurance tax and other state taxes.
- In addition, there are other state-imposed local property tax TEPs not included in the above state totals. These do impose certain state costs—such as increased state funding for Proposition 98.

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Tax Expenditures—General Background
(Continued)

- ☑ ***Caps and Applications for a Few TEPs.*** A few small TEPs—such as the film and hiring credits—are "capped" at a maximum value per year or over several years. Taxpayers have to meet various documentation requirements to benefit from a TEP. In a few cases, such as the film credit or the alternative energy manufacturing SUT exclusion, more detailed application processes are required.

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Largest Tax Expenditure Programs—Personal Income Tax

Estimated 2011-12 (In Millions)

Tax Expenditure Program	State General Fund Revenue Reduction
Mortgage Interest Deduction	$4,300
Employer Contributions to Pension Plans Exclusion	3,500
Employer Contributions to Health Plans Exclusion	3,200
Basis Step-Up on Inherited Property	2,500
Social Security Benefits Exclusion	2,400
Charitable Contribution Deduction	1,500
Real Estate, Personal Property, and Other Tax Deduction	1,400
Cafeteria Plan Benefits Exclusion	1,100
Dependent Exemption Credit in Excess of Personal Exemption Credit	1,100
Sale of Principal Residence Capital Gain Exclusion	1,100
Personal Exemption	1,150[a]
Employee Business and Miscellaneous Expense Deduction	1,100
Standard Deduction	1,070[a]
Life Insurance and Annuity Contract Proceeds Exclusion	1,000
State and Local Government Obligation Interest Exclusion	900
Head of Household and Qualifying Widow(er) Filing Status	750
Contributions to Individual Retirement Accounts Deduction	600
Unemployment Insurance Benefits Exclusion	600
Contributions to Self-Employed Retirement Plans Deduction	550
Medical and Dental Expense Deduction	310
Miscellaneous Fringe Benefits Exclusion	260
Federal Government Obligation Interest Exclusion	190
Senior Citizen Exemption Credit	180
Self-Employed Health Insurance Premium Deduction	150
Transportation-Related Fringe Benefit Exclusion	150
Renter's Credit	140

[a] Reflects 2008-09 estimate.

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Largest Tax Expenditure Programs—Corporation Tax

Estimated 2011-12 (In Millions)

Tax Expenditure Program[a]	State General Fund Revenue Reduction
Research and Development Expenses Credit[b]	$1,200
Elective Single Sales Factor Business Apportionment Formula	1,000
Water's-Edge Election Special Filing Status	650
Enterprise Zones and Similar Areas[b]	600
Depreciation Amounts Beyond Economic Depreciation	550
Subchapter S Corporations Special Filing Status[c]	370
Accelerated Depreciation of Research and Experimental Costs[b]	270
Double-Weighted Sales Factor Business Apportionment Formula	210
Tax-Exempt Status for Qualifying Corporations	170
Film Credit	160

[a] Excludes net operating loss NOL deduction tax expenditures, which have been suspended in recent years. In a typical year, we estimate that NOL TEPs would reduce revenues by $800 million to $900 million.
[b] Includes personal income tax amounts for this tax expenditure program. Rough estimates.
[c] Estimate from Department of Finance 2011-12 tax expenditure report.

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Largest Tax Expenditure Programs—Sales and Use Tax

Estimated 2011-12 (In Millions)

Type of Exemption or Exclusion	State General Fund Revenue Reduction
Food Products	$3,814
Gas, Electricity, Water, and Steam	2,391
Prescription Medicine	1,570
Candy, Confectionary, Snack Foods, and Bottled Water	535
Animal Life, Feed, Plants, and Drugs	323[a]
Custom Computer Programs	174
Farm Equipment	95
Fuel Sold to Common Carriers	89
Lease of Motion Picture and Television Films and Tapes	65[a]
Water Common Carriers	41
Diesel Fuel Used in Farming and Processing	33
Rentals of Linen Supplies	28

[a] Reflects 2008-09 estimate.

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Difficult to Evaluate TEPs

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

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

☑ ***TEP Evaluations Are Very Hard to Do.*** Due to the challenges listed above, policymakers should regard many TEP evaluations with skepticism. Analysis of alternative uses of public funds is difficult and often omitted entirely from such studies. These studies also usually rely on extensive and sometimes subjective assumptions, which, if changed, can produce very different results.

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Using TEPs to Achieve Policy Goals

- ***Both Pros and Cons Exist.*** There are both advantages and disadvantages to using TEPs versus direct spending to achieve legislative policy goals, depending on a program's objectives, characteristics, and target population.

- ***Advantages of TEPs.*** The main advantage of TEPs is that they generally require only limited administrative effort. This is because:
  - They work by enabling individuals and businesses to simply pay fewer taxes than otherwise.
  - Thus, there is no need to hire people and maintain equipment and facilities to operate and oversee programs and pay out funds.

- ***Disadvantages of TEPs.*** The negative aspects of TEPs compared to direct expenditure programs include a weakening of legislative oversight and budgetary control. For example:
  - ***Limited Legislative Review.*** Once a TEP is established, resources are allocated to the program automatically each year, generally without further legislative review.
  - ***Little Spending Control.*** Because program funding does not have to be annually appropriated through the budget process, there is normally no limit or control over the amount of money spent. (By contrast, for the few currently capped TEP programs, these may be too small to have a meaningful effect on a large industry [such as films] or the economy as a whole [such as the hiring credit].)
  - ***Enforcement Problems.*** Although TEPs have lower direct administrative costs and are fairly unintrusive, they also often present serious enforcement problems. The TEPs offer many opportunities for tax evasion, especially given the relatively low level of tax auditing the state undertakes.

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Using TEPs to Achieve Policy Goals *(Continued)*

- ***Vote Requirement.*** The TEPs only require a majority vote to establish but a two-thirds vote to be scaled back or eliminated if found to be ineffective or cost-inefficient—just the opposite of direct expenditure programs.

- ***Targeting Problems.*** It is often more difficult to effectively target TEPs to desired beneficiaries than direct expenditure programs. As a result, TEPs often experience large "windfall benefits" from compensating individuals and businesses for actions they would undertake anyway.

☑ ***Bottom Line—Skepticism About TEPs Is Justified.*** Given the problems listed above, we advise the Legislature to approach proposals to adopt, extend, or maintain TEPs with skepticism. As alternatives to TEPs, broad-based tax rates can be maintained or lowered or spending on high-priority programs can be increased. It is rare that the value of TEPs can be demonstrated conclusively compared to these alternate uses of tax dollars. If the Legislature wishes to use TEPs, despite these challenges, it is important that TEPs be used cautiously, structured carefully, and reviewed regularly to consider if they operate in an effective and cost-efficient manner.