Darien Shanske
Testimony on California's Tax Expenditure Programs and their Effectiveness
Joint Oversight Hearing: Assessing Tax Expenditure Programs in Light of California's Fiscal Challenges
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Thank you; it is an honor to address you today. You have already heard some very incisive analyses of tax expenditure issues. Indeed, the FTB, BOE, DOF, LAO and legislative staff have already provided you with world-class analyses.

As someone who has read a good portion of the literature on tax expenditures, my goal today is to distil this literature in a manner that provides you with relatively actionable principles and proposals.

I. Conceptual Overview

At the micro-level, tax expenditure analysis is confused. Academics can argue forever about any given tax expenditure. I do not intend to do so. This is because, at the macro level, there is a great deal of consensus and it is from this consensus that I wish to begin.[1]

First, the extraordinary scale of tax expenditures is not in question. The Department of Finance's recent estimate of a total of $29 billion[2] in tax expenditures just in the personal income tax is over three times the deficit California is facing ($9.2 billion).[3]

Second, the economic inefficiency of tax expenditures in general is not in question.[4] Every tax expenditure narrows California's tax base, requiring higher rates to raise the same amount of revenue, and higher tax rates cause greater distortions to economic activity.[5] Put another way, the tax economist's mantra is: *broaden the base, lower the rates*, but every tax expenditure in effect does the opposite. It is worth noting that base narrowing and rate raising is also a recipe for revenue volatility, a California specialty.

The policy prescription is simple: *reduce tax expenditures*, but, as I already indicated, getting into the details of individual tax expenditures ex post, though extremely worthwhile, is a tricky endeavor. I therefore want to propose to you a grab bag of ways that California might tackle tax expenditures on a macro level given the dissensus at the micro level.

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[1] Edward D. Kleinbard, The Congress Within Congress, 36 Ohio Northern University Law Review 1, 7 (2010) ("I will say, however, that having read a large swath of the academic literature in this area, I believe much of the criticism has been overblown, and that the legislative process has been the worse for it. Tax expenditure analysis is a pragmatic exercise, and the existence of a handful of close questions should not obscure the fact that literally hundreds of other cases can be labeled as tax expenditures without much controversy."); Daniel Halperin, Tax Expenditures: Budget Control and the Nonprofit Sector, Tax Notes (Jan. 23, 2012), at 447.
[2] California Department of Finance, Tax Expenditure Report 2011-12, at 3.
[3] California Legislative Analyst's Office, Overview of the Governor's Budget (Jan. 11, 2012), at 5.
[4] There are excellent efficiency arguments in favor of specific tax expenditures – further complicating analysis of individual provisions. David A. Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 Yale Law Journal 955 (2004)
[5] Jonathan Gruber, Public Finance and Public Policy 594 (3d. ed. 2011).

II. General Ex Ante Presumptions

1. *There should be a presumption in favor of credits versus deductions*. I will not say too much about why credits are superior as a matter of equity, [as this was just discussed]. I would just add that, on the business side, use of refundable credits is a way to encourage businesses that are just starting up.

2. *There should be a presumption that tax credits will be available in fixed amounts*. Since tax credits are analogues to spending,[6] the legislature should not give out blank checks in the form of deductions but should decide just how much revenue a certain program should be allocated.[7] If a program is over or under-subscribed then the legislature can modify the program accordingly. I think the testimony you are about to receive about two recent credits is a paradigm of good management in this regard.[8]

III. Strategic Presumptions

The presumptions I just offered apply to the federal government as well as to the states. I think, however, that states, especially a state like California, should also take a more strategic perspective.

3. *California should treat federal tax expenditures as subsidies to be leveraged and this should generally mean not just throwing state money on top of federal money.* This point was made, for example, in the recent and aptly named *Bleeding Cash* report in connection with R & D credits.[9] The question is: does California get a net benefit from the revenue it sacrifices – and not just some benefit but sufficient benefit given what that revenue might have been used for otherwise. In making this opportunity cost calculation we should again remember that tax expenditures, by their nature, are destabilizing an already volatile tax base and that volatility itself has costs.

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[6] Daniel N. Shaviro, Rethinking Tax Expenditures and Fiscal Language, 57 Tax Law Review 187, 220 (2003) (emphasizing that tax expenditure analysis is helpful in addressing the "specious[]" distinction between taxing and spending).

[7] See Halperin supra. Note that Halperin makes the additional point that, since tax expenditures are so close to direct spending, it is also desirable that they be monitored by expert agencies. Id.

[8] Note that tax expenditures may well have (justifiable) goals that are not economic, which makes their impact even harder to assess.

[9] John Hill, Bleeding Cash: Over a Decade, Ten Tax Breaks Cost California $6.3 Billion More than Anticipated, A report prepared for the California Senate Rules Committee (September 8, 2011), at 11-12 (also noting similar point made by LAO and FTB). As with almost all tax expenditures, it is controversial to question R&D credits. We can instead choose the mortgage interest deduction or bonus depreciation – the latter being an area in which California actually did decouple from the IRC. Cal. Rev. & Tax § 71250(A)(4) (not conforming to IRC § 168(k)). These latter tax expenditures also have their defenders, of course – hence the macro proposal.

4. *Should California add new tax expenditures – and it generally should not - it should do so by looking to new areas, particularly as to inter-governmental relations, where it can likely achieve better results*. Put another way, whereas the federal government uses it much bigger carrot to encourage certain private behaviors, it does not do so as much relative to local governments, and this is a lacuna where I believe there is much that California can accomplish. For example, it is well known that California needs hundreds of billions of dollars in infrastructure investment. There are good projects out there, projects that should pay for themselves that are not being built for lack of financing – even at a time when construction labor is cheap. Many of these infrastructure projects were originally built using local government finance techniques, such as assessment districts or general obligation bonds. These financings generally must be approved by the voters - often by a super-majority. But a liquidity-constrained voter, say a retiree on a pension, has good reason to be wary of paying even for a good project because a new assessment is still a new expense. Yet for low to middle income California taxpayers, the California income tax could provide a partially refundable credit for certain categories of infrastructure financing.[10] Thus, such a voter would not have as strong an incentive to vote against a promising infrastructure project.

IV. A Macro-proposal

These presumptions could help California going forward, but what should California do with its current tax expenditures?

The legislature should act to cut tax expenditures generally. The proposal is, in the abstract, a tautology: Since we are certain that tax expenditures should be cut in general, they should just be cut in general. This can be done in many ways; there are examples of such provisions in current law and in proposals from various bi-partisan commissions, including the Commission on the 21st Century Economy.[11] I want to highlight a few specific proposals, two of which can already be found in California law.

1. *California should cut in absolute terms the value of itemized deductions for the wealthiest taxpayers*. The federal government did as much in 1990 with the addition of Section 68 to the IRC. We will not dwell on the details, but the point was and is that for taxpayers with an income over a certain level[12] their itemized deductions were usually cut by 3%.[13] This limitation on tax expenditures was phased out by the Bush tax cuts and

[10] Such a credit would loosely resemble AB 1552 Silva, which proposes making *all* Mello-Roos taxes deductible, but, per the arguments just made, I think a more targeted credit is a superior approach.
[11] California Commission on the 21st Century Economy, Final Report (2009), at 43.
[12] It would be $173,650 this year. General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 67, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.
[13] Rough example: if the threshold were $175,000 and one's AGI were $199,000, then one's total itemized deductions would be reduced by 3% * $24,000, or $720.

may or may not return. California's version of this tax expenditure limitation was not phased out.[14] Should the federal government not restore Section 68, California should look to increase the amount of deductions disallowed, as the original provision assumed the federal government was already limiting deductions. This would be an example of strategic thinking on the part of California, taking revenue that the federal government has essentially ceded. Indeed, even if Section 68 *does* return to the IRC, California should consider limiting the deductions it allows under its PIT.

2. *California should limit the relative value of tax expenditures*. Here too California has already conducted experiments, in particular with a cap on business credits. For two years starting in 2008, at the height of the financial crisis, businesses with over $500,000 in net business income could not decrease their tax liability by means of tax credits by more than 50%.[15] The accumulated credits could then be used in 2010.[16] This provision could be made permanent at a higher threshold.[17]

I also want to highlight an approach that the Obama Administration has proposed now for several years.[18] This is limiting the *percentage* that an itemized deduction reduces one's tax burden.[19] What such a provision does is insist that taxpayers in the highest brackets do not benefit more from deductions than taxpayers in lower brackets. To the extent that we are not sure exactly which tax expenditures are most problematic

[14] Cal. Rev. & Tax § 17077, added by SB 169. California's diallowance rate is higher (6%), but its threshold for disallowance for married taxpayers is also higher, currently $333,134 for a joint return versus $173,650 at the federal level (the California threshold for an individual is much closer to the federal level - $166,565). Franchise Tax Board Memorandum, 08/22/2011. And this was deliberate – the idea being not impose a "marriage penalty" by having just one "low" threshold income as in the IRC, but also not to sacrifice revenue and hence the higher percentage. See Assembly Committee on Revenue and Taxation Bill No. AB 27, Hearing Apr. 22 1991, Comments § 2.

[15] AB 1452 (2008), adding Cal. Rev. & Tax § 17039.2.

[16] This meant that the State got more revenue and then lost revenue, which was not an unreasonable choice in the midst of the crisis. AB 1452 Bill Analysis, http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1451-1500/ab_1452_cfa_20080917_123549_asm_floor.html (fiscal effects).

[17] In 2008, the LAO recommended 2/3 in connection with the R&D credit, which seems reasonable to me. LAO Revenue–Raising Proposals (2008-09), http://www.lao.ca.gov/analysis_2008/2008_pandi/pi_anl08006.aspx.

[18] See, e.g., The American Jobs Act of 2011, Sec. 401; see also General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 73-74, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

[19] So, for instance, for certain high-income taxpayers – the threshold is $200,000 – the value of itemized deductions would be capped at 28% even though the marginal rate of these taxpayers is higher. That is, currently, a taxpayer in the 35% bracket benefits in reducing her tax by $3,500 for $10,000 in deductions. Under the Obama plan, the benefit would be $2,800. This is still a large amount, does not pick on any one deduction, and thus still allows taxpayers to decide which itemized deductions to pursue and in what amount.

and how much, this is another promising expedient for taking control of tax expenditures.[20]

V. Conclusion

Thank you for the opportunity to address you today. Let me end on a positive note. As a general matter, cutting tax expenditures is inherently desirable because this reduces the economic distortions caused by the tax system. Furthermore, because of the scale of California's tax expenditures, it would take only smallish cuts to tax expenditures to bring the budget into balance. Finally, only relatively simple structural expedients are needed to make these adjustments. Thus, with a few simple changes, California could simultaneously raise more revenue *and* help its economy.

[20] In California, given its current rates, I could imagine a similar proposal would limit itemized deductions to 6% versus the current maximum rate of 9.3%. Cal. Rev. & Tax § 17041.