

## **What is a "Tax Expenditure"?**

California provides various credits, deductions, exclusions, and exemptions for particular taxpayer groups. In the late 1960s, United States Treasury officials began arguing that these features of the tax law should be referred to as "expenditures," since they are generally enacted to accomplish some governmental purpose and there is a determinable cost associated with each in the form of foregone revenues.

According to the Franchise Tax Board (FTB), the most common types of income tax expenditures are tax credits, deductions, and exclusions of certain types of income from tax. Tax expenditures are enacted for a host of reasons, including a desire to assist certain types of taxpayers such as the blind and a desire to provide incentives to alter taxpayer behavior ( e.g. providing a sales and use tax exemption for alternative energy equipment). Additionally, tax expenditures are sometimes enacted to promote administrative simplicity or to conform to federal law.

In its annual report, the FTB also identifies potential adverse consequences of tax expenditures to include:

- Higher tax rates for taxpayers not receiving the tax expenditure;
- Increased complexity of California tax law;
- Windfall payments to taxpayers that would have behaved in the same manner absent the tax incentives; and,
- Undesirable responses by taxpayers taking advantage of the preferential treatment.

The Department of Finance (DOF) is required to annually publish a report on tax expenditures by September 15 of each year. The 2011-2012 DOF report includes a list of 85 major tax expenditures totaling \$43 billion in State General Fund revenue losses and \$9 billion in local government revenue losses.

According to the FTB, "There are potentially many good reasons for using tax expenditures within a tax system. However, policy makers should give careful thought to the reasons why the tax expenditure is needed, and the potential adverse consequences of adopting or retaining the tax expenditure. The pros

and cons of each tax expenditure should be weighed as carefully as the pros and cons of any regular government expenditure program."

### **Tax Expenditures vs. Direct Expenditure**

As the DOF notes in its annual Tax Expenditure Report, there are several key differences between tax expenditures and direct expenditures. First, tax expenditures are reviewed less frequently than direct expenditures once they are put in place. This can offer taxpayers greater certainty, but it can also result in tax expenditures remaining a part of the tax code without demonstrating any public benefit. Second, there is generally no control over the amount of revenue losses associated with many tax expenditures. Importantly, this is not the case with the three tax credits that will be examined by the joint committees: the film and television tax credit, the low-income housing tax credit, and the new jobs credit.

Finally, it should be noted that, once enacted, it generally takes a two-thirds vote to rescind an existing tax expenditure absent a sunset date. This effectively results in a system whereby tax expenditures can be conferred by majority vote, but cannot be rescinded, irrespective of their efficacy, without a supermajority vote.

### **How Tax Expenditures Are Currently Evaluated**

There is currently no requirement for the Legislature itself to review existing tax expenditures through the legislative or budget processes. However, several state agencies are required to issue annual tax expenditure reports. In 1985, the Legislature passed ACR 17 (Bates), which requires the Legislative Analyst's Office (LAO) to prepare and provided updated "tax expenditure" reports. According to the LAO, the state needs a way to routinely monitor tax expenditures, although it noted that multiple evaluation challenges and data limitations exist.

While the DOF report includes a description of each expenditure, along with the number of taxpayers or businesses affected, it does not evaluate tax expenditures against their original purpose or initial revenue loss estimate. In many cases, it is difficult to determine the original purpose. Of the 85 tax expenditures listed in the 2011-2012 report, the legislative intent was only listed for 11.

Since 2007, the FTB has been required to prepare an annual report, "*California Income Tax Expenditures*," describing tax expenditures found in the Personal Income Tax (PIT) and the Corporate Tax (CT) laws. This report provides more detail on the types of businesses that benefit and a discussion of the merits of the tax expenditures from a public policy perspective.

Over the years, there have been numerous legislative attempts to statutorily create a mechanism to evaluate the effectiveness of tax expenditures and their compatibility with current policy objectives and budget constraints (See attached). Last year, SB 508 (Wolk) would have required any newly enacted tax credits to include specific goals, data collection requirements, performance indicators and mandatory sunset dates. Governor Brown vetoed SB 508 stating that "While I agree that we should consider sunset clauses for personal income and corporate tax credits, one size does not fit all. The legislature should examine all its bills to determine how long they should exist or, indeed, whether they should exist at all."

Proponents of SB 508 and similar legislative attempts argue that once enacted, tax expenditures have limited legislative review, many have no cap on the amount of foregone revenues and are created with a simple majority vote, but require a 2/3 supermajority to repeal. Opponents argue that mandatory sunset dates create uncertainty regarding long-term tax planning and adversely affect business decisions to locate in California.

As a practical matter, the Assembly Committee on Revenue and Taxation typically includes built-in repeal dates in the vast majority of tax expenditure bills passed out of committee. However, in recent years, most of the significant tax policy changes have been negotiated and enacted as part of the budget process despite the fact that tax expenditures are not considered alongside other state expenditures for similar purposes.

According to the LAO in a briefing provided to the Senate Committee on Revenue and Taxation, "tax expenditures should be evaluated using the same approach as for direct expenditure programs—namely asking whether they are achieving their stated purposes in an effective and cost-efficient manner, or are of low priority."

California, along with the majority of other states, does not provide a dynamic revenue evaluation for tax expenditures. The LAO notes that ideally, tax expenditures should be subjected to a dynamic revenue analysis; one that tries to account for the direct behavioral effects as well as the broader economic

effects of tax law changes on the amounts of revenue collected. The LAO concludes that this method is good in theory but challenging in practice due to data limitations, the consequences of a tax expenditure on other governmental services, or the backfilling of lost revenues.

Between the years of 1994 and 2000, California required the DOF to provide dynamic revenue estimates. Working with University of California economists, the DOF attempted to construct an economic model capable of looking at dynamic affects for its analyses of tax bills and proposals. The model attempted to estimate the secondary effects of tax law changes and the complex relationships in the California economy. The controversial model ultimately determined that tax expenditures only provide a maximum 20 percent offset to the static revenue loss. Finance no longer uses this model.

### **Prior Legislation Relating to Tax Expenditures**

SB 1272 (Wolk), introduced in the 2009-10 legislative session, was similar to SB 508. Governor Schwarzenegger vetoed SB 1272 stating that "While the sponsors seem intent on eliminating measures that will generate jobs and stimulate the economy, the average California taxpayer would probably be better served if the Legislature were willing to automatically sunset every new spending entitlement, program expansion and business mandate after 7 years."

AB 2171 (Charles Calderon), introduced in the 2009-10 legislative session, would have conditioned the allowance of a tax benefit on the passage of a separate statute. AB 2171 was held under submission by the Assembly Committee on Appropriations.

AB 2641 (Arambula), introduced in the 2009-10 legislative session, would have required the Legislature to review, before January 1, 2014, and every fifth year thereafter, each tax expenditure, as specified, and provided that every new tax expenditure that is enacted after the effective date of AB 2461 shall be repealed automatically on January 1, 2015, and on January 1 of every fifth year thereafter, unless otherwise provided. AB 2641 was held under submission by the Assembly Committee on Appropriations.

ACA 6 (Charles Calderon), introduced in the 2009-10 legislative session, would have amended the State's Constitution to, among other things, limit the operative period to seven years from the date of the enactment of a new or amended tax credit. ACA 6 failed on the Assembly Floor.

AB 831 (Parra), introduced in the 2007-08 legislative session, would have required any legislation creating a new tax expenditure, or extending the operation of an existing tax expenditure, to include a sunset provision. AB 831 failed in the Senate Committee on Revenue and Taxation.

AB 1933 (Coto), introduced in the 2005-06 legislative session, would have required any legislative measure creating a new tax expenditure, or extending the operation of an existing tax expenditure, to include legislative findings regarding the purpose of the tax expenditure, an estimate of the attributable revenue losses, a specific methodology for measuring the anticipated benefits, and a sunset date no later than five years in the future. AB 1933 failed in the Senate Committee on Revenue and Taxation.

AB 2199 (Brown), introduced in the 1995-96 legislative session, would have required all tax expenditures to be authorized via an appropriation in the annual Budget Act. AB 2199 failed to pass out of the Assembly Committee on Revenue and Taxation.

AB 2884 (Villaraigosa), introduced in the 1995-96 legislative session, would have required the LAO, together with the DOF, FTB, and the Board of Equalization, to conduct an evaluation of all tax expenditures, as defined. AB 2884 failed to pass out of the Assembly Committee on Revenue and Taxation.

SB 1233 (Hayden), introduced in the 1993-94 legislative session, would have required the LAO to review each tax expenditure program, as directed by the Senate and Assembly Committees on Revenue and Taxation, to determine if its objectives are being realized, whether its benefits exceeded its revenue costs, and whether there is a less costly way of providing the same benefits. Governor Wilson vetoed SB 1233.