Written Remarks of Allen Prohofsky, Manager, Tax Policy Research Section, Franchise Tax Board for the Commission on the 21st Century Economy.

To set the stage for this discussion I would like to say a few words about the term 'tax expenditure'. The phrase is attributed to former Assistant Secretary of the Treasury for Tax Policy Stanley Surrey. He chose the phrase to remind us that there are many features of the tax code could that could be replaced by equivalent direct expenditure programs. For example, ignoring administrative costs, a taxpayer is neither better nor worse off if they claim a $100 research and development tax credit than they would be if they received no tax credit, but instead received a $100 grant from the government to engage in the same research. The term tax expenditure itself is descriptive, not pejorative. It simply describes a class of programs that have been deliberately placed in the tax code by the Legislature, each for a specific reason. Part of the definition of tax expenditures is that they are deviations from "normal" tax law. Since there are disagreements about the definition of normal tax law, there are some features of tax law that are classified as tax expenditures by some commentators, but not by others.[1]

The problem with tax expenditures is that there is a bias in our political discourse in which tax expenditures often receive less oversight than would the same program if it were administered via a direct expenditure program. For example, suppose that in our current budget situation we reluctantly determine that we ought to decrease the state's contribution to health care. A number of options immediately spring to mind such as reducing Medi-Cal payments to doctors or reducing wages for In-Home Supportive Services. Other options, that are administered through the tax code, do not, however, occur to us as readily. Alternative policy choices such as raising the floor for the itemized medical expense deduction or capping the exclusion for employer-provided health insurance could also be used to reduce the total impact of health care spending

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[1] Details on our view of what constitutes a tax expenditure can be found in our report, *California Income Tax Expenditures*, which is available at www.ftb.ca.gov/aboutftb/taxExp08.pdf.

on the state. I am not saying that we would necessarily choose to restrict these tax expenditures rather than reduce direct state spending on health care; but I am saying that we should at least ask which programs more efficiently use state resources.

My personal recommendation to policymakers is that they not treat the spending and taxing sides of the budget as separate entities. Rather, they should first prioritize all programs whether they be direct expenditures or tax expenditures. Then, after choosing the programs to be adopted, they should ask whether each remaining program can be administered more efficiently outside or inside the tax code. And, of course, the question of priorities should be reviewed on a regular basis.

When determining whether a particular program would be more efficiently administered inside or outside of the tax code, it is useful to remember a number of features common to many tax expenditures. One such feature is that most tax expenditures are entitlements. This means that any taxpayer who qualifies for one of these expenditures may benefit from it. There are at least two disadvantages of entitlements. One is that for tax expenditures whose purpose is to alter taxpayer behavior, there is no way to distinguish between beneficiaries who are likely to have actually changed their behavior and those who are receiving windfalls for activities that they would have engaged in anyway. A second disadvantage is that the size of these programs may change substantially over time even in the absence of any legislative action.

There are some tax expenditures that are not designed as entitlements. For example, the Natural Heritage Preservation Credit is capped and relies on the California Wildlife Conservation Board to authorize taxpayers to use specific amounts of the credit. It is not obvious, however, why the Board should assign tax credits rather than making direct payments to the current recipients of the tax credits.

Another feature of tax incentives to bear in mind is that, because we have progressive tax rates, the same size deduction or exclusion results in a larger tax savings for wealthier taxpayers than for poorer ones. In 2006, about 5.6 million resident California personal income taxpayers owed no tax at all. These taxpayers would not receive any benefits from additional tax expenditures (except for refundable credits) and may be receiving limited or no benefits from the tax expenditures they are already reporting.

Similarly on the corporate side, taxpayers in a loss position receive no immediate benefit from many of the tax expenditures they report.[2] Even if they receive some benefit in the future from either carryover credits or the use of net operating losses, these programs are, because of the time value of money, less valuable to corporations in a loss position than to those that are profitable.

Finally, it should be kept in mind that there is an institutional asymmetry in California because direct expenditures can be modified or eliminated with a simple majority vote, but any reduction in a tax expenditure requires a supermajority vote. Tax expenditures, therefore, are less able than direct expenditures to adapt as policy needs evolve over time.

Below, I present a chart showing the largest California income tax expenditures. It is important to understand how these tax expenditures are measured and how they should be interpreted.

Most tax expenditures fit into one of three categories. The easiest type of tax expenditure to measure is credits. The claiming of credits is the very last step in the calculation of a taxpayer's liability. The cost reported for credits in our *Tax Expenditure Compendium* are simply equal to the amount of each credit that was used to reduce tax.

A second type of tax expenditure is the income tax deduction. These are amounts that taxpayers are allowed to subtract from their income prior to the calculation of the tax due on their income. The impact of most deductions is relatively straightforward to measure. We maintain a large tax calculator with hundreds of thousands of observations of actual tax return data. To estimate the impact of a deduction we add the amount of, say, charitable contributions back into income

[2] Starting in 2011, these taxpayers will receive immediate benefits to the extent that the tax expenditures create usable net operating loss carrybacks.

for each taxpayer in our sample and recalculate their taxes, then compare the result to the amount actually paid.

The impact of some deductions, however, is more difficult to measure. The most difficult to deal with are special rules for accelerated depreciation. It is not obvious just from looking at a tax return how much of the depreciation reported would have been allowed absent acceleration, or how this year's acceleration will affect future years' taxes; so we need to base our estimates on other sources of information regarding the amount of property likely to be affected by the provision being studied.

The third common type of tax expenditure is the exclusion, in which a taxpayer receives something of value, such as an employer contribution to a pension plan, but is not required to report that value as income. There are a few exclusions, such as the exclusion of interest on federal debt obligations, whose amounts are reported on tax returns. Like most deductions, these exclusions are measured in our microsimulation model by adding the reported amounts back into income and recalculating taxes at the individual level. For most exclusions, however, the amount excluded is generally not reported on the tax return, so we need to estimate the effects of exclusions from non-tax data, rather than being able to calculate actual tax changes for specific taxpayers. In practice, we rely on federal estimates for many exclusions, adjusting the federal estimates to reflect things like California's share of the national population and differences between state and federal tax rates.

It is very important to understand what the expenditure estimates are not. They are not the same as repeal estimates. There are a number of reasons why the amount of revenue that would be gained from repealing a tax expenditure may be different from the current cost of the expenditure.

The first reason is that policymakers may opt to phase in an expenditure's repeal. For example, the mortgage interest deduction could be repealed, but with mortgages issued before the repeal date being grandfathered. In that case, the full revenue effect of repeal would not be realized until all existing mortgages were paid off.

A second reason that repeal estimates are often lower than expenditure estimates is that if one expenditure were eliminated, many taxpayers would be able to increase their use of other expenditures. For example, there are taxpayers who have more potential tax credits than they have tax against which to use the credits. If a taxpayer is currently using their enterprise zone credits, but not all of their research and development credits, then, if the enterprise zone program were eliminated, the taxpayer would start using more R&D credits. The revenue gain to the state from eliminating EZs would, in this case, be less than the measured usage of zone credits. There are currently about $10 billion in unused R&D credits and about $1 billion in unused EZ credits that could become useable under the right circumstances.

A third source of difference between expenditure estimates and repeal estimates is that a change in one tax expenditure could cause changes in the economy that could affect the size of another tax expenditure. For example, elimination of the mortgage interest deduction could lead to a decrease in housing prices which, in turn, could reduce the cost of the property tax deduction, even though the latter deduction had not been altered.

In some cases different tax expenditures may be connected through explicit changes in taxpayer behavior. For example, if the exclusion of income from Section 529 education plans were eliminated, taxpayers may shift funds to excluded Coverdell education plans. The revenue estimate for eliminating just the Section 529 exclusion would be the net of the savings from eliminating 529 plans and the lost revenue from increased participation in Coverdell plans.

In our report, *California Income Tax Expenditures*,[3] we identify 74 items as tax expenditures. In total, we estimate the cost in 2008/09 of these California income tax expenditures to be approximately $40 Billion. This suggests, subject to all of the caveats described above, that if all tax expenditures were eliminated we could lower tax rates by as much as 40 percent and still raise approximately the same amount of revenue. The 20 largest of these tax expenditures, accounting for more than 90 percent of the total value, are presented in the table below.

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[3] The full report is available at www.ftb.ca.gov/aboutftb/taxExp08.pdf.

Largest California Income Tax Expenditures Fiscal Year 2008/09 (Dollars in Billions)	
Provision	**Amount**
Mortgage Interest Deduction	$5.1
Exclusion of Employer Contributions to Pension Plans	4.5
Basis Step-up on Inherited Property	4.2
Exclusion of Capital Gains on the Sale of Principal Residence	3.6
Exclusion of Employer Contributions to Accident and Health Plans	3.5
Charitable Contribution Deduction	2.1
Exclusion of Social Security Benefits	1.8
Real Property Tax Deduction	1.4
Dependent Exemption Credit in Excess of Personal Exemption Credit	1.4
Exclusion of Benefits Provided Under Cafeteria Plans	1.4
Research and Development Expenses Credit	1.3
Exclusion of Proceeds from Life Insurance and Annuity Contracts	1.1
Employee Business and Miscellaneous Expense Deduction	0.9
Head of Household and Qualifying Widower Filing Status	0.7
Water's-Edge Election	0.7
Individual Retirement Accounts	0.7
Depreciation Amounts Beyond Economic Depreciation	0.6
Special Treatment for Economically Depressed Areas	0.5
Self-Employed Retirement Plans	0.4
Medical and Dental Expense Deduction	0.3

Source: California Income Tax Expenditures Compendium of Individual Provisions, Dec. 2008

The three largest tax expenditures, worth more than $4 billion each, are the mortgage interest deduction, the exclusion of employer contributions to pension plans, and the basis step-up for inherited property.

The top expenditures on the list can change from year to year. Most dramatically, we estimate the value of the exclusion of capital gains on principal residences to have been over $6 billion in 2005, before the recent decline of the housing market.

Interestingly, there are no corporate tax expenditures in the top 10. This is partly because the corporate tax is smaller than the personal income tax. It is also, however, reflective of the fact that the California corporate tax is not as closely conformed to federal law as is the personal income tax. In particular, California does not conform to the largest single federal corporate tax expenditure, accelerated depreciation. The largest California corporate tax expenditure is the research and development credit. Overall, corporate tax expenditures account for only about $3 billion of the $40 billion total.

Another point worth noting is that 8 of the top 10 and 15 of the top 20 are items for which California is in conformity with federal tax law. Although there are currently many areas of tax law where California has not conformed to federal law, those items to which we do conform are sometimes more difficult to modify because it seems somehow 'unfair' for the same circumstances to be treated differently for federal and state purposes. On the other hand, there may be situations where the federal tax provision has already provided the taxpayer with either sufficient compensation for their hardship or sufficient incentive to change their behavior that no further state benefit is necessary to achieve the optimal policy.

Finally, remember that all or nothing repeal is not the only option. Many of these expenditures could be modified in ways that would reduce their costs. For example, a number of commentators have recommended replacing the mortgage interest deduction with a more tightly targeted, and hence less costly, credit. Another potentially cost-reducing reform would be to narrow the definition of eligible recipients for charitable contributions.

I hope that the Commission finds this background information on California income tax expenditures useful for informing its recommendations for improving the performance of California's tax system.