SENATE OFFICE OF OVERSIGHT AND OUTCOMES

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Over a decade, ten tax breaks cost $6.3 billion more than anticipated, report finds

SACRAMENTO—Some California tax breaks are acting as blank checks, costing the state billions of dollars more than anticipated when they first were put in place, a new report by the Senate Office of Oversight and Outcomes has found.

The office looked at 10 major tax breaks approved during the past two decades, comparing initial estimates of foregone state revenue with actual losses listed years later in annual tax expenditure reports. In the 2010-11 fiscal year, the tax expenditures, as they are known, cost $1.3 billion more than anticipated, according to the oversight office's analysis. Over ten years, the state gave up $6.3 billion more than expected as the result of these tax preferences.

The biggest loser was the research and development credit, intended to induce businesses to spend more on innovation. It was amended repeatedly in the 1990s, eventually becoming one of the most generous in the U.S. Despite questions about its efficacy, its cost has continued to mount far beyond expectations. In the 2010-11 fiscal year, the credit cost $953 million more than anticipated, the oversight office found. The credit has swelled so much that its elimination would save enough to lower the overall corporate tax rate by 14 percent.

Another hit on the state treasury came from the double-weighted sales factor, a method for apportioning a multi-state corporation's California tax liability. It was expected to boost state revenues when it was passed in 1993. Instead, the formula has been a money loser. By the 2010-11 fiscal year, it had become one of the largest corporate tax breaks, costing the state $230 million. It has now been supplanted by another apportionment formula with an even bigger price tag.

Other tax breaks that cost more than anticipated include sales tax exemptions for equipment and diesel fuel used in farming, a sales tax exemption for shipping fuel, and a two-year exemption from the minimum franchise tax for new corporations.

The oversight office found that three tax expenditures cost less than expected, but that the revenue gains were dwarfed by losses from those that overran initial cost estimates.

The report, "Bleeding Cash: Over a Decade, Ten Tax Breaks Cost California $6.3 Billion More than Anticipated," is available here.

Tax expenditures are deviations from normal tax law, including credits, exemptions, deductions from gross income and preferential tax rates. They lower the tax liability of individual taxpayers and corporations, but cut revenue to the state by an estimated $50 billion a year. One criticism of tax expenditures has been that, in many cases, costs are not capped and surpass expectations with little notice.

The oversight office found that overruns occurred for a variety of reasons. Original estimates use three-year-old data. Taxpayers may change behavior to maximize benefits, sometimes on the advice of consultants who show businesses how to reap tax savings they may have overlooked. Tax boards and courts may expand the scope of the tax preference beyond what was envisioned by those who made the original estimates.

The state publishes two separate reports summarizing the annual costs of tax expenditures. But the oversight office found that the state does little in response to the information contained in the reports. Unlike a few other states, California does not consider tax expenditures alongside its regular budget and has no regular process for evaluating whether tax breaks are doing their job or should be considered for elimination.

California is not among the handful of states that attempt to do dynamic economic modeling of the effects of tax expenditures, taking into account factors such as reduced government spending or higher tax rates that result from the state foregoing revenue. In many cases, analysis is hampered by the simple lack of a stated reason for the tax preference. In its 2009-2010 annual report, the Department of Finance was able to identify legislative intent for only 12 of the 82 tax expenditures it listed.

The oversight office report recommends the creation of a commission, similar to one in the state of Washington, to annually review tax expenditures and recommend for elimination those whose costs outweigh public policy benefits. It suggests listing the original estimates alongside actual costs in tax expenditure reports so that policymakers can see at a glance which tax breaks are surpassing expectations.

The non-partisan Senate Office of Oversight and Outcomes was created in 2008 by Senate President pro Tempore Darrell Steinberg (D-Sacramento) to bolster the Senate’s ability to gauge government performance.

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