

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 08, 2011



Prepared by John Hill

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Oversight and Outcomes

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Executive Summary

Some tax breaks enacted by the state of California over the past two decades have turned into blank checks, with actual costs to state government surpassing initial estimates of foregone revenue by billions of dollars, according to an analysis by the Senate Office of Oversight and Outcomes.

In the 2010-11 fiscal year, the state lost \$1.3 billion more than anticipated as a result of major tax breaks – often referred to as “tax expenditures” – passed since 1990. The oversight office examined ten tax expenditures whose first-year costs were greater than \$20 million. Over ten years, these tax preferences cost the state \$6.3 billion more than expected.

Tax expenditures are deviations from normal tax law. They take the form of credits, exemptions, preferential tax rates and deductions from gross income granted to businesses and individuals. The total cost to the state in foregone revenue from all tax expenditures approaches \$50 billion a year.

Tax expenditures are seen as an attractive approach to public policy, encouraging desirable behavior such as providing employee health care or preserving land as open space without governmental overhead. They cut taxes instead of increasing spending. Many tax expenditures are intended to create jobs or encourage activities that might not occur if the market were left to itself.

But unlike direct government spending, most tax expenditures are not capped or reviewed by lawmakers when they write budgets. While spending programs are subject to annual review in the state budget, the foregone revenue from tax expenditures can swell far beyond initial projections with little notice.

That is exactly what happened with six of the ten tax expenditures examined by the oversight office. Together, they cost the state \$1.44 billion more than expected in the 2010-11 fiscal year. Three other tax preferences cost less than anticipated, but the savings - \$149 million – were not nearly enough to offset the overruns in the other tax measures.

The oversight office examined bill files to find estimated costs when tax expenditures became law. Depending on the nature of the tax expenditure, we applied a growth factor to estimate revenue losses in ensuing years. These expected losses were compared to actual foregone revenue included in annual tax expenditure reports by the Franchise Tax Board and the Department of Finance.

The biggest unexpected losses came from the research and development tax credit, which through a series of amendments in the 1990s became one of the most generous in the nation. The growth in the credit has occurred despite doubts, from its inception, about whether it induces an increase in research and development beyond what occurs in response to the federal R&D credit. As more companies take advantage of the credit, costs have soared. In the 2010-11 fiscal year, it cost \$953 million more than would have been expected by adding up the initial cost estimates done by the Franchise Tax Board and the estimates done each time it was amended, according to our analysis.

If the research and development credit were eliminated, the overall corporate tax rate could be cut 14 percent, boosting California's ranking as a place to do business.

The double-weighted sales factor, a method for corporations to allocate income between states, was supposed to reward California-based businesses while also giving the state a revenue windfall. Instead, in the 2010-11 fiscal year, it cost \$230 million, resulting in an unanticipated hit to state coffers of about \$250 million. (The double-weighted sales factor has since been supplanted by another formula expected to cost the state more.)

The remainder of the overrun came from a minimum franchise tax exemption for new corporations, a sales tax exemption for fuel used by shipping companies, and sales tax exemptions for machinery and diesel fuel used in farming.

How could the costs to the state escalate so far beyond expectations? One explanation is that those who prepare estimates at the state's tax boards must use economic and demographic data that is already three years old. Economic forecasting is by nature an inexact science. Some tax expenditures have been passed at the last minute to cement deals on the state budget, giving analysts little time to assess the potential impacts on the state treasury.

But other factors play an even larger role. Taxpayers change their behavior to maximize the financial advantage of tax breaks, moving into an

enterprise zone, for instance, or figuring out ways to increase reported revenue generated outside of California, reducing their in-state tax burden.

Consider this statistic: California accounts for about 12 percent of the national economy. Yet, in 2008 state tax returns, multi-state companies report only 5.4 percent of total national sales in California. Under the double-weighted sales factor, in-state sales drove up a company's tax liability, giving them an incentive to minimize the ratio of sales they reported within California.

For some tax expenditures, consultants advise businesses how to reap benefits that they may have overlooked when they first filed their tax returns, offering to amend the returns for a share of the savings. Lastly, courts and tax boards may broaden the application of tax expenditures beyond what was envisioned by those who made the original estimates of foregone revenue.

California has been in the vanguard of reporting on the costs of tax expenditures. Two state entities – the Department of Finance and the Franchise Tax Board – publish annual reports listing the amount of foregone revenue from tax expenditures, their statutory authority, and aggregate information about the types and numbers of taxpayers who benefit. But these reports do not compare expected and actual costs. Nor are they used in California's budget-making process. The state has no standard process for reviewing the efficacy of tax expenditures and deciding whether to continue them.

A handful of states have taken these steps. Some consider tax expenditures along with their regular budgets. Washington state decided to review all of its tax expenditures every ten years, and set up a citizen's commission to schedule the reviews and hold public hearings. The reviews themselves are conducted by the Joint Legislative Audit and Review Committee, part of the Legislature.

Connecticut and a handful of other states conduct dynamic analyses of their tax preferences. A dynamic analysis looks beyond the direct effects of a tax expenditure to take into account the reduced government spending or higher tax rates for other taxpayers that result from the state foregoing revenue. It also factors in the ripple effects of tax expenditures that create jobs or otherwise stimulate the economy. California stopped using a dynamic economic model in 2000.

The Franchise Tax Board's reports have won praise nationally for evaluating whether tax expenditures are achieving public policy goals.

But in many cases, a lack of data prevents the tax board from reaching definitive conclusions. The board does not attempt to model the effects of reduced government spending or higher rates for taxpayers who don't benefit from the break. Nor does it compare anticipated and actual costs, as we do in this report. In many cases, it's difficult or impossible for analysts to gauge the efficacy of a tax break because the original purpose cannot be discerned. In 70 of 82 tax expenditures reviewed by the Department of Finance, for instance, the department concluded that the legislative intent was "not specified."

We recommend that the Legislature consider the creation of a commission like the one in Washington state to perform annual reviews of existing tax expenditures. For major tax expenditures, analysts may want to revisit dynamic economic modeling to take into account secondary effects such as reduced government spending. Given the overruns that have occurred with several recent tax expenditures, we recommend that the Department of Finance and the Franchise Tax Board, in their annual reports, list the original estimates of foregone revenue alongside the actual cost. This would allow legislators and other policymakers to easily discern tax expenditures whose costs are swelling far beyond expectations and take action accordingly.

Some Revenue Losses From Tax Expenditures Far Surpass the Original Estimates

The state has been losing far more money than expected as a result of tax breaks passed since 1990. For the tax expenditures we examined, in the 2010-11 fiscal year, the state lost \$1.3 billion more than anticipated when the tax breaks first became law.

Six of the tax expenditures cost more than expected, surpassing original estimates by a total of \$1.44 billion. The biggest part came from the research and development credit, which exceeded estimates by \$953 million. The double-weighted sales factor also accounted for a large share: \$257 million. The remainder came from overruns in a two-year exemption for new corporations from the minimum franchise tax, a sales tax exemption for fuel used by shippers, and sales tax exemptions for farm machinery and diesel fuel used in farming.

Three other tax expenditures cost less than anticipated, but these revenue windfalls for the state added up to only \$149 million and were not nearly enough to offset the unexpected losses. These tax expenditures included the renter's credit, the credit for child and dependent care and the exclusion of capital gains for small business stock. The remaining tax expenditure that we examined, for the Joint Strike Fighter defense program, was no longer in effect in the 2010-11 fiscal year.

Over ten years, the tax breaks we examined cost the state \$6.3 billion more than expected.

The Blank Check Effect

Our findings provide an illustration of a phenomenon others have noted: Tax expenditures, unlike direct spending, can balloon far beyond initial expectations with little notice or control.

In an April 2010 audit, the Missouri State Auditor examined 15 state tax credits, comparing the amount claimed by taxpayers to the original

The pros and cons of tax expenditures

There has been much debate – in California and elsewhere in the U.S. – about the virtues of tax expenditures. Economic fairness, job creation, and correcting market failures are obviously desirable goals. Tax expenditures can further public policy aims without government overhead. They appeal to many elected officials because, unlike direct spending, they appear to reduce taxes instead of increasing spending.

But in recent years many researchers have pointed out downsides.

There's no such thing as a fiscal free lunch. When a government forgoes tax money, it must either cut public services or raise revenue elsewhere. Both of these options come with economic consequences. Government jobs may be lost, for instance, or overall tax rates may be increased, making a state's business climate appear less attractive.

Many tax expenditures are meant to correct economic inefficiencies – that is, encourage desirable activity that markets would fail to pursue on their own. But tax expenditures that miss the target and don't really address market failures can lead to economic distortions, attracting unwarranted resources to a "tax-favored activity," according to a March 2011 background paper by the U.S. Congress Joint Committee on Taxation. When employer-funded health care is not taxed, for instance, employers may increase benefits and encourage workers to use services of marginal value that appear to be "free," the joint committee staff wrote. Such a policy can artificially draw resources into one economic sector at the expense of others.

Researchers generally have had a hard time determining whether businesses that benefit from tax expenditures would have engaged in the desired behavior anyway. Surveys of those who run economic development departments and the businesses that benefit from the tax incentives have proven unreliable, according to "Evaluating Business Development Incentives," an influential 1999 report prepared for the U.S. Department of Commerce.

In many cases, the same policy ends could be achieved by direct spending. That adds to government overhead costs, but comes with greater control and oversight. Even without direct spending, governments have the power to mandate certain behavior, according to the California Franchise Tax Board's annual tax expenditure report.

"For example, the Low-Income Housing Expenses Credit could be replaced with requirements that lenders or developers divert a portion of their economic activity to the low-income market," according to the report.

The goal of many tax expenditures is to spur job growth and stimulate economic activity. But some researchers question whether tax breaks, especially on the state level, play much of a role in a business' decision where to locate. In one 2005 study, business executives in Louisiana ranked tax exemptions far down the list - 18th - in factors they considered when deciding where to locate. Among the variables they ranked higher were a skilled workforce, crime rates, housing availability, access to highways, and the quality of health facilities and public schools. Paradoxically, many of these higher priorities are underwritten by tax revenues. Policies that go too far in starving public services to pay for tax breaks may sour the business climate rather than improve it.

States compete for business, and may approve tax breaks to lure corporations from other states or prevent existing ones from relocating. Experts have pointed out that, when looked at on a national scale, these types of tax breaks are not creating new economic activity but merely moving it across or keeping it within state borders.

One of the biggest criticisms of tax expenditures – and the one most germane to this report – is that they can act like blank checks. Some tax expenditures are capped at a certain dollar amount, and others are required by law to undergo periodic review to make sure that the benefits exceed the cost in foregone revenue. But open-ended tax breaks, like most of those in California law, can swell far beyond initial estimates – with little or no notice.

Many state policymakers have talked about the need to cap tax expenditures or to subject them to regular sunset reviews to control the loss of tax revenue. Several of California's most recent tax expenditures have included such provisions. But the overwhelming majority of those approved in past decades remain part of the tax code with little or no review. Most states have found it difficult to reverse tax expenditures, which tend to be backed by political constituencies reluctant to let them go. In California, the challenge is even greater because of the requirement that tax increases – a definition that includes revoking a tax break – must be approved by two-thirds of each house of the Legislature. As a result, tax expenditures that have outlived their usefulness or are of questionable value continue to diminish state revenues year after year. Senate Bill 1272 in 2010 would have required that new tax credits – but not other types of tax expenditures - specify their goals, include detailed performance measurements, and be subjected to a sunset review every seven years. The bill was approved by the Legislature, but vetoed by then-Gov. Arnold Schwarzenegger. A new version, Senate Bill 508, was approved by the Legislature and awaits Governor Jerry Brown's signature.

estimates. The audit found that the credits surpassed estimates by more than \$1.1 billion over five years. A historic preservation tax credit was projected to add up to \$71.5 million in foregone revenue from 2005 to 2009. It ended up costing \$637 million, almost nine times that amount. Likewise, a low-income housing tax credit estimated to cost \$61 million came in at \$413 million, almost seven times the original projection.

The overruns occurred for a variety of reasons, the Missouri auditor found. Among them were that more taxpayers participated than predicted, projections underestimated the losses, and tax officials increased the limits of the credit after it became law. The audit recommended that Missouri legislators cap tax credits or make them subject to periodic review to reevaluate cost effectiveness.

In an infamous case in another state, Arizona, a tax credit for vehicles that run on alternative fuels cost so much more than expected that the Legislature had to step in to prevent a crisis in the overall state budget. The “alt-fuel” credit in 2000 was expected to cost \$3 million, but was so lucrative that car buyers flooded the state with claims, according to news accounts. The price tag for the state threatened to balloon to \$680 million before the Legislature and the governor intervened and limited the hit to \$140 million – still almost 50 times the original projection.

In California, estimates for corporation and personal income tax expenditures are calculated by the Franchise Tax Board. Sales tax expenditures are handled by the Board of Equalization.

The difficulties in projecting foregone revenue start with incomplete or stale data. By the time the Franchise Tax Board makes its estimate, financial data can already be three years old, said Allen Prohovsky, an economist with the board. Tax returns are not filed until April of the year after the taxable activity occurred. Six-month extensions are granted as a matter of routine. It then takes several months to process the returns. Corporate taxes can take even longer to be reported, Prohovsky said, because they’re filed at different times of the year. When all of this is taken into account, tax board analysts must work with data that’s three years old. Demographic data that can affect estimates is similarly out-of-date.

The estimates also are subject to the vagaries of projecting overall economic trends – far from an exact science.

Many tax expenditures are passed as last-minute provisions to cement a deal on the state budget. They may avoid vetting by policy committees, said Jean Ross, executive director of the California Budget Project.

Ross formerly worked as a consultant for the Assembly committee that considers tax measures. Because of the last-minute nature of such deals, Ross said, tax board analysts must work with numbers in flux. This is likely to become less of an issue with the 2010 passage of Proposition 25, which allows budgets to be passed by a simple majority.

Even if analysts had complete data and ample time, they would face other uncertainties.

Taxpayers may change their behavior to take advantage of tax preferences. A business might change its location to be within the boundaries of an enterprise zone, for instance. Or a corporation might find new ways to report revenue to minimize the percentage of company sales that are made within California, thus reducing its tax burden. For some tax expenditures, consultants have found a niche in advising companies how to maximize the potential benefit.

“Taxpayer behavior has a lot to do with it,” said Jay Chamberlain, who compiles tax expenditure reports for the Department of Finance and formerly worked with Prohofsky on the reports published by the Franchise Tax Board. “It’s difficult to predict, especially when you have consultants” who offer to examine a company’s books to find unclaimed tax breaks.

Another difficulty is that courts and the Board of Equalization, which hears tax case appeals, may broaden the application of the tax expenditure in ways that the analysts did not anticipate.

The classic case involved Save Mart Supermarkets. The grocery chain argued that it could claim the manufacturer’s investment credit, a tax expenditure designed to promote spending on equipment, because it used machinery in its bakery and meat departments. The Franchise Tax Board disagreed, finding that because Save Mart was a retail business and not a manufacturer, the company failed to qualify for the tax break. In 2001, the Board of Equalization overruled the Franchise Tax Board.

“We believe the MIC (manufacturer’s investment credit) should be interpreted liberally in favor of taxpayers,” according to the Board of Equalization’s published opinion. The manufacturer’s investment credit has since been rescinded because the number of manufacturing jobs in the state failed to reach benchmarks required for the tax credit to continue. But the lesson remains: Tax expenditures can take on lives of their own after they’re passed by the Legislature.

Since the Save Mart case, the Franchise Tax Board has tried to look at the possibilities more broadly, Chamberlain said. Analysts ask board attorneys

whether a court or tax board could reach certain conclusions that would increase foregone revenues. This approach has led bill authors to tighten up language to clarify the intent.

These are some of the overarching issues that complicate tax expenditure projections. But each tax expenditure follows its own twists and turns, leading some to far surpass original estimates. Here are some examples.

The Research and Development Credit: Costs Up, Effectiveness Unknown

Among the states, California offers one of the most generous research and development credits. Over the past two decades, it has been repeatedly expanded and now approaches the scope of the federal research and development credit. It has become the largest corporate tax expenditure in California, accounting for upwards of \$1.4 billion in foregone revenue in recent years.

Corporations with gross receipts above \$1 billion claimed by far the biggest chunk of research and development credits in 2007 - \$1.2 billion, or 84 percent, according to the annual tax expenditure report published by the Franchise Tax Board. The total number of corporations claiming the credit in 2007 was 2,185. The Franchise Tax Board estimates that if the tax were eliminated, the overall corporate tax rate could be reduced by 14 percent.

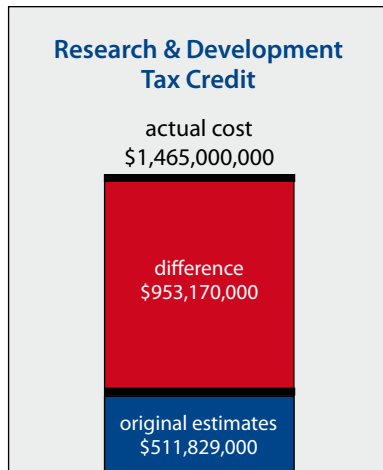
The credit is meant to encourage companies to increase their research and development spending. The California Chamber of Commerce says that the credit is essential to the state maintaining its leading edge in innovation.

It's based on the difference between current spending and a four-year base period. Companies get a credit for 15 percent of this difference. For research conducted at universities or scientific research organizations, the credit increases to 24 percent. Companies may choose a different formula based on an alternative way of calculating the credit offered by the federal government.

From the credit's inception in 1987, experts have debated whether it induces more research. In 1991, when the Legislature considered extending the tax credit, Jean Ross – then a committee analyst - cited a General Accounting Office report from two years earlier that found that the federal credit stimulated only 14 to 36 cents of new research spending for every dollar the federal government gave up. The GAO report suggested that direct grants might be more efficient.

In 2003, the non-partisan Legislative Analyst's Office concluded that the state research and development credit was probably less effective than its federal counterpart. The LAO could not determine how the credit compared to other means of encouraging R&D spending, such as grants. Neither was it known what level of credit was optimal. The LAO

recommended that lawmakers not expand the credit, and consider reducing it or phasing it out altogether, "especially given the substantial direct revenue losses associated with the program and the state's current budgetary situation."



In its 2008 analysis of the budget, the LAO followed up with a proposal to limit research and development credits to two-thirds of a taxpayer's total liability. The analysis pointed out that the federal credit might already be inducing the optimal amount of research spending, meaning that California's credit was bestowing a windfall on corporations that would have been doing the R&D anyway. That year, the Legislature put a two-year cap on all business tax

The Expanding R&D Credit

The original legislation creating the Research and Development credit in 1987 included a sunset six years later, in 1993.

- A bill in 1991 extended the sunset to the end of 1997.
- In 1993, the credit was made permanent and adjustments were made to which years would count as the baseline for calculating increases in R&D.
- In 1996, the amount of the credit was increased from 8 percent of new R&D to 11 percent, and research done at universities or other scientific research organizations went up from 12 percent to 24 percent.
- In 1997, the Legislature allowed companies to use the alternative federal formula, and the following year increased the percentage of the federal alternative rate that California companies could claim on their state taxes.
- In 1999, the Legislature upped the tax credit rate from 11 to 12 percent and the following year to its current level of 15 percent.
- In 2000, the percentage of the federal alternative formula that California companies could claim was increased from 80 to 90 percent.

breaks, including the research and development credit, limiting claims to one-half of the taxpayer's total liability. In return, starting in 2010, businesses could share R&D tax credits among affiliate or subsidiary companies.

The Franchise Tax Board's annual tax expenditure report makes many of the same points.

"The amount of California R&D activity that would not have taken place in California in the absence of the credit is not known," the report states. "Credits granted for R&D that would have occurred even in the absence of the credit may be considered a windfall."

On the plus side, the tax board report found, more research in California might result in companies that benefit from discoveries concentrating here, a phenomenon known as "economies of agglomeration." But whether that has happened "is not known," the report concluded.

Despite these uncertainties, the Legislature has repeatedly expanded the research and development credit. These steps, on their own, would have increased the amount of foregone tax revenue. But our analysis showed that the costs far exceeded the sum of all of the projections that were made when each of the changes occurred. In the past ten years, the cost of the research and development credit calculated by the Franchise Tax Board has exceeded projections by a total of \$4.5 billion, or an average of \$450 million a year.

How did the original estimates get it so wrong?

Bill analyses submitted to then-Governor Pete Wilson on the 1993 expansion of the credit contain some clues. The Department of Finance wrote that the last-minute nature of the tax bill, which also contained provisions on several other tax expenditures, made it hard to analyze.

"Due to severe time constraints and the unavailability of language until the afternoon of the last day of the session, a thorough analysis of this bill was not possible," the department wrote in its enrolled bill report.

The Franchise Tax Board, in its report to the governor on the same bill, pointed out that the new law would measure new R&D spending by comparing it to a baseline period from 1984 to 1988. While the federal government used the same base years, its R&D credit was temporary. Because California's was permanent, companies far in the future would be chalking up R&D spending increases using a baseline that was set a decade or more earlier.

“At some future point, the intent, that this credit benefit taxpayers who exhibit a recent practice of increasing the amount of their research expenditures and therefore help improve current and future economic conditions, is lost,” the Franchise Tax Board wrote.

As the research and development credit has been expanded, more taxpayers have become aware of it. The number of taxpayers who claimed the credit increased 63 percent between 2001 and 2007, according to figures compiled by the Franchise Tax Board.

Double-Weighted Sales Factor: Corporations Maximized Benefits

When the double-weighted sales factor was created in 1993, analysts projected that it would boost state revenues by \$15 million a year. In fact, it's been a money loser. Over the past decade, it has lost an average of \$200 million a year.

The tax expenditure was intended to reward companies that base their operations in California while shifting the tax burden to those that relied on sales here but did not employ California workers or maintain a physical presence. The sales factor was part of a formula used to apportion income of companies that do business across states. Starting in the 1960s, states used an apportionment formula that gave equal weight to sales, payroll and property. The new formula adopted in 1993 gave double weight to sales. That meant that the proportion of sales within the state counted for 50 percent of the income allocation, instead of 33 percent under the old formula. Companies with workers and property in California, but a high proportion of sales elsewhere, stood to gain. Those that made a high percentage of their sales in California without having a physical presence here would pay more taxes. When gains and losses were added up, the Franchise Tax Board estimated that the state would net \$15 million more a year.

The Department of Finance made no recommendation on the bill, deferring to the Trade and Commerce Agency, which supported it. But Finance did cite some arguments against the double-weighted sales factor. It would reward companies with a tax windfall for doing nothing. Many companies with sales in California would be punished with higher taxes for maintaining jobs outside the state even though it wasn't feasible for them to move workers here. And there was no evidence that the change would induce companies to locate in California.

In its annual tax expenditure report, the Franchise Tax Board points out that the companies that must pay higher taxes under the formula view it as a production cost and pass it on to consumers. For the tax expenditure

to be considered a success, the report states, the benefits in the form of jobs and investments would have to outweigh these added costs. The problem: No one knows whether they do.

“It is not known how much investment or employment currently located in California would have occurred in the absence of this program,” the report states, “nor is it known if this program has affected either consumer prices or the availability of goods in California.”

But one side of the cost-benefit equation is known: The revenue lost because of the double-weighted sales factor escalated beyond what anyone expected. Instead of increasing state revenues, it turned into one of the major corporate tax expenditures. The double-weighted sales factor amounted to an invitation for corporations to employ new strategies to shrink their tax liability in California. One of those strategies involved trying to maximize the reported sales outside of California. That lowers a company’s tax liability, because the sales factor is the ratio of sales within California to total sales. When sales outside of California increase, the ratio – and tax liability – goes down.

Corporations have tried to maximize reported out-of-state sales, leading the Franchise Tax Board to challenge their accounting. In a series of court cases, Microsoft, General Motors and General Mills have quarreled with the Franchise Tax Board on the issue of what can be included in the out-of-state sales category. Each case has involved gross receipts that are peripheral to the company’s core business. Microsoft tried to count its sales of marketable securities. GM sought to include financial instruments called repurchase agreements. General Mills argued that it should be allowed to count commodity futures contracts in its total sales.

Each of these complicated cases hinged on its own points of law. The Franchise Tax Board won the Microsoft and GM cases. The General Mills case is still being appealed. But the victories for the state may have been Pyrrhic. While courts have ruled that it would distort the companies’ tax liability to allow them to count these types of gross receipts, and that an alternative formula should be used, they have also acknowledged that the controversial transactions do meet the definition of gross receipts.

“The courts said taxpayers can do this, but that you can’t be too outrageous,” Chamberlain said. So even though the companies lost, the strategies for reducing California tax liability were still in play – as long as they didn’t go too far.

The overall picture of how companies reacted to the tax break can be discerned in statistics. California represents 12 percent of the U.S.

economy. Yet in 2008, total sales reported on multi-state companies' tax returns in California add up to only 5.4 percent of the national total, according to Franchise Tax Board figures.

The other two factors that go into the allocation formula – property and payroll – are 10.3 percent and 12.8 percent of the national total respectively, in line with California's share of the economy. It seems to be more than coincidence that the factor with double the weight in the tax allocation formula adds up to less than half of what one would expect.

Now those considerations have been obviated by the state's adoption of still another allocation formula, expected to lead to greater foregone revenue. The optional single sales factor allows companies to choose to base their tax liability on sales alone. It went into effect this year. This time, in light of its experience with the double-weighted sales factor, the Franchise Tax Board worked with legislative staff to specify what kinds of out-of-state gross receipts could be counted as part of the formula.

Other variables may have been at play in the unexpected costs of the double-weighted sales factor. After it was first approved in 1993, the economy shifted to include fewer goods and more services. There is far more opportunity, Prohofsky said, for companies to claim that services should be counted as out-of-state transactions, lowering their California tax liability.

With any tax allocation formula, there will be winners and losers, Chamberlain said. One problem with projecting the cost of the double-weighted sales factor was that gains and losses were big numbers that nearly offset each other, making the impact to state revenue appear minimal. But even small changes in the predicted growth rates of the economic sectors that stood to gain or lose under the formula had the potential to throw off the original estimate significantly.

Farm Equipment and Diesel Fuel: Tax Board Expanded Application

Farm equipment and diesel fuel exemptions on the state portion of the sales tax are a prime example of a tax expenditure growing beyond projections because of subsequent actions by a tax board or court.

Both were part of a last-minute deal to win Republican votes for the 2001-02 fiscal year budget. One justification was that agriculture was a sector of the economy left behind by the dot-com boom. Others pointed out that California was one of only four states to impose a sales tax on farm equipment.

But budget-writers did not know the true cost. Over the past eight fiscal years, the farm equipment sales tax cost \$643 million more than expected – an average of \$80 million a year. These figures take into account the growth in the agricultural economy. Over the past five fiscal years, the sales tax exemption on diesel used in agriculture cost \$83 million more than projected, an average of \$16.6 million a year, even after increases in the cost of diesel fuel are factored in.

In his signing message, then-Gov. Gray Davis lauded the purpose of the tax break. But he called for further action to “better define that it is intended only to apply to the delivery to the first destination from the farm. This will target the benefits to those intended – the farmers.”

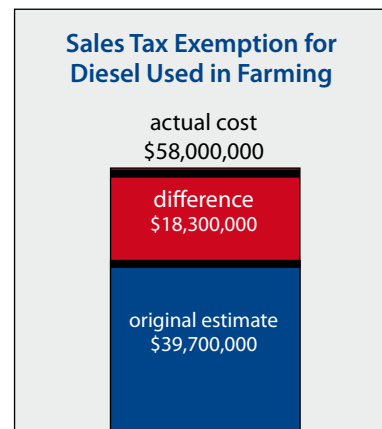
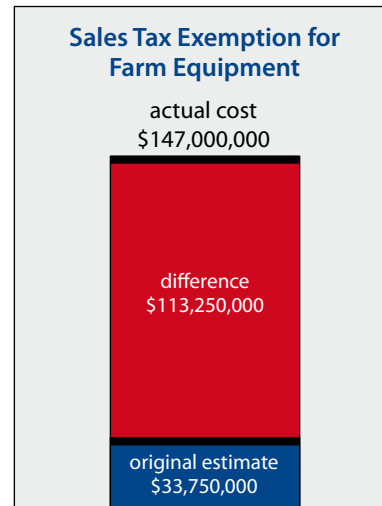
It didn’t work out that way. Several months after the Legislature approved the sales tax exemptions, the Board of Equalization decided that the one for diesel fuel should extend to food processors’ delivery of their final product to customers.

“For example, a processor that turns tomatoes into paste will be exempt for the diesel it uses to haul paste to the ketchup manufacturer,” The Fresno Bee reported in January 2002.

The Board of Equalization took the action despite a letter from then-Finance Director Tim Gage arguing that the liberal interpretation of the tax break was not what the Legislature and governor intended.

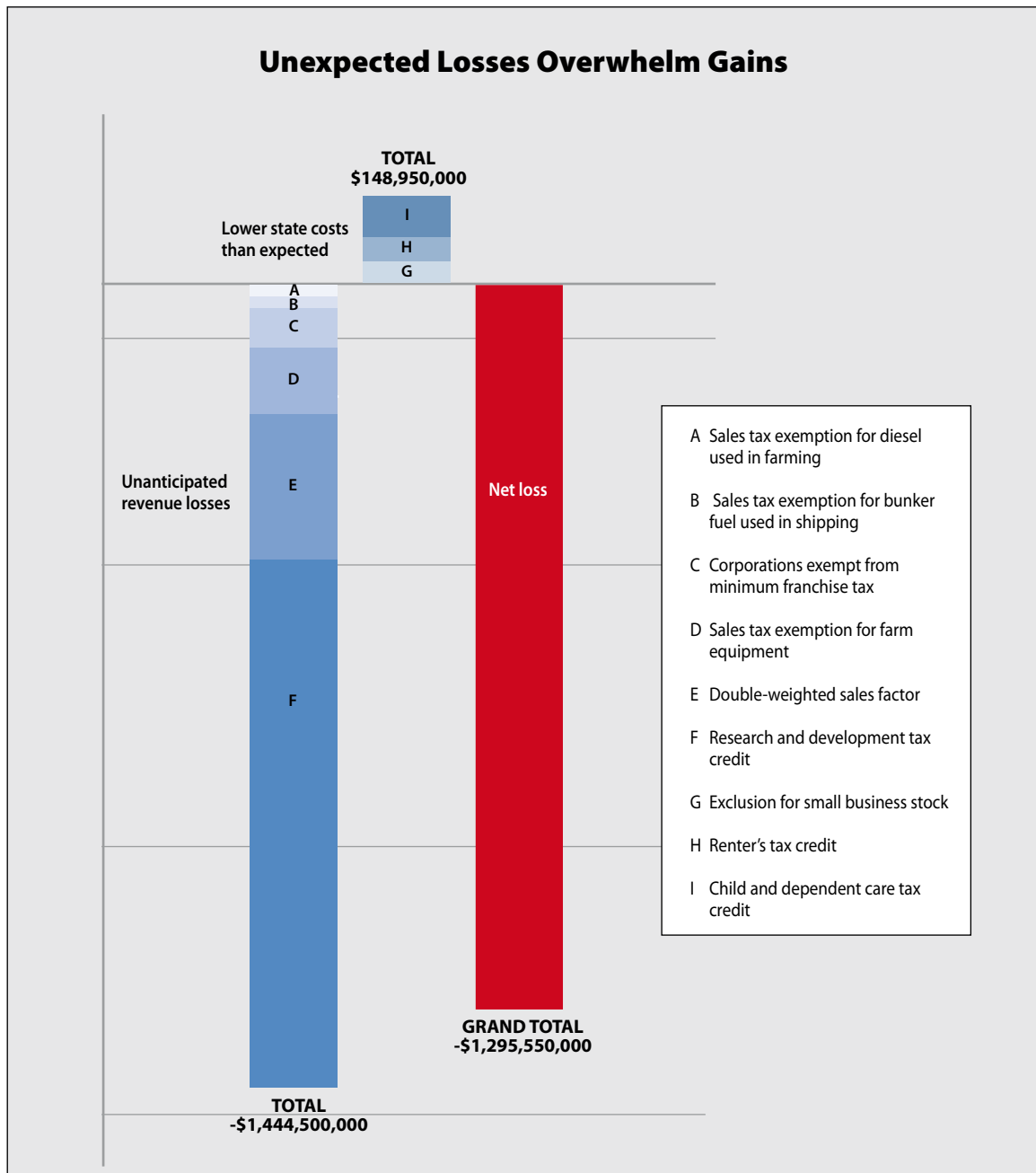
At the same time, the Board of Equalization expanded the types of farm equipment that would qualify for the exemption to include fixed structures such as greenhouses, poultry houses and milking barns. Together, the board’s decisions were expected to double the value of the tax expenditure – from \$50 million a year to \$100 million. In fact, by the 2010-11 fiscal year, the two tax breaks combined were costing the state almost exactly double that increased amount - \$205 million. That’s \$132 million more than the original estimates.

In 2008, the Legislative Analyst recommended ending the farm equipment exemption, as well as two others that targeted specific industries.



“As a general tax policy...we believe that all industries should be treated similarly, and it is not clear that these particular industries are more deserving of tax exemptions than a variety of other industries in the state,” the LAO wrote.

The tax break, however, remains on the books.



California Set the Standard for Tax Expenditure Reports, but Fails to Integrate Them into Systematic Reviews

Tax expenditures are a major component of most states' economic development strategies. A 2002 report by the California Budget Project found that more than two-thirds of the money California spends on economic development every year is in the form of tax breaks.

The California Department of Finance estimates the revenue foregone because of tax expenditures at more than \$41 billion in the 2009-10 fiscal year. The Legislative Analyst's Office pegged the overall cost at closer to \$50 billion.

A growing number of states publish annual tax expenditure reports. The reports summarize information such as the amount of revenue foregone, the types of taxpayers who benefit, and whether the tax measures are meeting their stated goals. For more than a decade, California has been considered a leader in the field. It publishes two tax expenditure reports, one by the Franchise Tax Board and the other by the Department of Finance. The Franchise Tax Board report has been cited as a model in attempting to analyze whether tax expenditures are sensible public policy.

But the institutional response to the reports falls short of what's done in a handful of other states. The tax expenditure reports are not considered as part of the overall budget. And there is no mechanism or routine process for tax expenditures that have been identified as obsolete to be considered for elimination. In addition, unlike a few other states, California makes no effort to model the overall economic impact of tax expenditures.

Despite Extensive Reporting, Intent of Tax Expenditures Often Unknown

The Department of Finance has been publishing tax expenditure reports since 1971. Legislation in 2006 required more extensive reporting on each tax expenditure. For those costing more than \$5 million a year, the

report must state the statutory authority, a description of legislative intent, and the sunset date, if any. The law also requires the report to describe the beneficiaries of the tax credit, estimate the lost revenue and the number of taxpayers who benefit, and list any comparable federal tax breaks. The report must be published no later than September 15.

The Franchise Tax Board has been issuing its tax expenditure reports since 2003. They cover only personal income tax and corporate tax under the board's jurisdiction, not sales tax or other levies. The reports include some of the same material as the Department of Finance's, including descriptions, estimates of foregone revenue, and number of tax returns affected. They provide more detail about the types and size of businesses that benefit, and a discussion of whether the tax break makes sense as public policy. The reports are published in December.

Estimating tax revenue losses is complex. This is especially true when the data cannot be gleaned from tax returns. Credits and deductions, by definition, are reported. But for tax exemptions, which are not included on a tax return, analysts must often turn to complex modeling. The Department of Finance and Franchise Tax Board sometimes come up with different numbers - partly a function of the different timing of the two reports and partly the result of the uncertainty inherent in making such estimates.

In many cases, it is hard to discern the original purpose of the tax expenditure. Of the 82 tax expenditures included in its 2009-2010 report, the Department of Finance was able to list legislative intent for only 12. For the remaining 70, it found that the purpose was "not specified."

In 1999, the Legislative Analyst's Office ran up against the same problem in its own overview of tax expenditure programs, which it refers to as TEPs.

"The specific purpose or rationale for creating individual TEPs, particularly those established many years ago, is not always known with certainty," the LAO wrote. While the rationale can be inferred from the nature of the tax expenditure, the LAO found, "in some cases the original rationale for the TEP no longer applies, and the program has simply continued due to inaction or taxpayer opposition to its elimination."

When the original purpose is unknown, it's impossible for the state to measure whether the tax expenditure is working as intended.

State Often Lacks Data to Assess Effectiveness

Even when the intent is known, challenges remain. The reports by the Franchise Tax Board discuss public policy implications of tax expenditures. But the discussions often fail to reach definitive conclusions because the necessary data cannot be obtained. Most often, the unknowns stem from the difficulty of figuring out how taxpayers would have behaved absent the credit.

Consider the example of the Natural Heritage Preservation Credit, which is meant to encourage taxpayers to donate land for conservation. For the tax credit to be considered successful, it would have to induce conservation of land that otherwise would be developed, according to the tax board report. If the land would never have been built up anyway, the credit amounts to a windfall for taxpayers.

The tax board can't answer the question because it doesn't know what motivated the taxpayers who donated land. "It is not known if any of the... lands would have been developed in the absence of this credit," the report states.

This data isn't easy to get. In its 2008 report, the LAO described the challenges. One was simply getting solid estimates of how much a tax expenditure costs the state. Second, "Measuring whether TEPs are effective and cost-efficient in achieving their objectives is even more difficult, due to problems in identifying their direct impacts and the behavioral effects they can produce," the report stated.

Some States Try to Model Economic Effects

A few states have gone beyond measuring the direct impact of tax expenditures to model the overall effect on their economies. These dynamic analyses go beyond the question of whether a tax preference created jobs or caused more land to be donated for conservation. They consider the effects of foregone revenue in reduced government spending or increased taxes for other taxpayers, as well as the ripple effects in the economy of increasing the desired behavior. A tax credit that is supposed to create more jobs, for instance, might leave the government with less money, causing it to eliminate jobs or raise taxes to make up for the lost revenue. At the same time, jobs that were created by the tax expenditure might stimulate the economy in other ways, because those new workers would buy goods and use services, increasing government revenues.

This kind of approach is the most challenging of all, according to the 2008 LAO report.

“Conducting full-blown dynamic analyses for TEPs is even harder,” the report states, “due to modeling difficulties and knowing how the revenue to fund them would have otherwise been used.”

Yet, dynamic modeling was recommended by an influential study for the Department of Commerce more than a decade ago and a few states are attempting it.

The 1999 study, *Evaluating Business Development Incentives*, concluded from existing research that those who analyze business incentives, including tax expenditures, should consider opportunity costs – that is, what do governments give up when they create tax preferences? Analysts should also take into account spillover effects from intervening in the economy by giving one type of taxpayer a preference.

Connecticut has attempted to follow some of these recommendations. A law that went into effect last year requires the state’s Department of Economic and Community Development to do a report every three years to assess the economic and fiscal impact of tax expenditures intended to promote economic growth. The report considers three scenarios for each tax break. In the first, only 20 percent of the activity the state was encouraging happened as the result of the tax expenditure. The second assumes half occurred in response to the tax break, the third that it all did. In each case, the report took into account the reduced government spending resulting from giving up revenue. It assumed that tax expenditures reduced corporations’ cost of capital, making new projects more feasible. The author used standard economic modeling software not specifically designed for assessing tax breaks.

The first report, issued in December, found that several tax incentive programs “have negative or very limited positive impacts.” It recommended that these programs, along with others that were not being used very much, be eliminated. A few others had significant positive impacts, the report found.

This year, the state of Washington, which has been at the forefront of evaluating tax expenditures, passed a law allowing its Joint Legislative Audit and Review Committee to use an economic impact analysis in its annual reviews. The analysis will be based on an economic model developed by the state in 2002.

Washington officials acknowledge that dynamic modeling is tricky. It takes money, time and staff, said Mary Welsh, a research analyst with the audit committee. The assumptions that go into the model are open to challenge by those who stand to lose if the tax expenditure is eliminated.

The same would likely be true in California. Parties with interests in the outcome would probably challenge analysts' decisions about which parameters to include in the model, Chamberlain said. "It would not be an easy task," he said.

Another concern is that such models only work with changes to the economy that are big enough to result in measurable impacts. "In some cases, the changes are so small, the impact they have on the economy would be imperceptible," Chamberlain said.

The Department of Finance was required by law to do dynamic revenue estimates from 1994 to 2000, when the law expired.

Tax Expenditures not Considered Alongside Budget

Despite the thoroughness of California's tax expenditure reports, their value is limited by their lack of integration into the overall budget process.

As long ago as 1995, the National Conference of State Legislatures, a bipartisan technical assistance organization for state policymakers, recommended that states consider tax expenditures as part of the traditional budget.

"Such tax expenditures are the fiscal equivalent of a state expenditure for the same purpose," the report stated, "but only the beneficiaries of tax expenditures tend to remember their existence. They are not subjected to the examination that formal budget items regularly encounter. Comprehensive budget review should include them."

John Mikesell, a nationally recognized economist from Indiana University, takes the same position.

"If the tax expenditure budget is to improve fiscal discipline, efficiency and allocation, its information should be provided with the direct expenditure portion of the full budget," he wrote in the November 2010 edition of *State Tax Notes Magazine*. "A tax expenditure budget, outside that fiscal decision system, delivered according to some other schedule, is almost certainly only a footnote..."

A few states have taken this advice and consider tax expenditure budgets alongside their traditional budgets. California is not among them.

In fact, the state has no standard process for reviewing the efficacy of tax expenditures and deciding whether to continue them. The Legislative Analyst's Office noted this lack in a 1999 report.

“One key problem is that TEP review or approval is not now part of any regular process,” the LAO reported. “Most TEP discussions occur in policy committees and generally take place when TEPs are created or renewed. No procedure currently is in place in California (or any other state for that matter) to periodically review or approve as part of the budget process existing TEPs that do not have a sunset date.”

Twelve years later, the LAO’s statement about other states is no longer accurate - some states do examine tax expenditures alongside their regular budgets. A few others have created or are considering special entities to recommend what tax expenditures should be continued.

As in other matters related to tax expenditures, Washington state has been in the vanguard. In 2006, its Legislature mandated periodic reviews of tax preferences to determine if they should be ended or modified. A citizen commission schedules tax preference reviews, holds public hearings and comments on the reviews. The reviews themselves are done by the staff of the Joint Legislative Audit and Review Committee, part of the Legislature. Each tax preference must be reviewed every ten years. Depending on the amount of foregone revenue, the tax expenditures are subject to either a full review, an expedited review or an expedited light review.

In several cases, the Legislature has gone along with the committee’s recommendation to allow tax expenditures with sunset dates to expire. In a few cases, the committee suggested getting rid of permanent tax preferences. So far, the Legislature has not agreed.

Other states have similar processes in place or are considering them. A February 2011 report by the Minnesota Department of Revenue calls for a Tax Expenditure Commission patterned on the Washington state example. The commission would set priorities for tax expenditure reviews and recommend changes. The primary evaluation work would be done by the Department of Revenue, which has access to non-public tax information, and other state agencies. The commission would oversee the evaluation of 12 tax expenditures a year at an estimated cost of \$1.2 million.

Recommendations

Tax expenditures have become a fixture on California's fiscal landscape, resistant to change. Tax preferences can be approved by a majority vote, but require a two-thirds supermajority to rescind – a so-called “one-way ratchet.” Eliminating tax expenditures that cost far more than expected or have not proved their worth may be a long shot in the current political climate.

Still, the creation of a more thorough system for evaluating tax expenditures would provide information that could influence future fiscal debates and allow policymakers to assure that tax dollars are leading to effective public policy.

With that in mind, the Senate Office of Oversight and Outcomes recommends the following:

- The Legislature should consider the creation of a commission charged with reviewing existing tax expenditures each year, as is now done in the state of Washington. The commission would select tax expenditures for review based on criteria established by the Legislature, such as the impact on state revenues, the number of years the statute has been on the books or other factors. Individual analyses could be performed by legislative staff or experts at the state's tax boards or the Department of Finance.
- For tax expenditures with no stated legislative purpose, the Legislature should consider reviewing the preference and adding language to statute clarifying their goals. Tax preferences whose public purposes cannot be discerned or are not longer relevant should be referred to the commission for possible revocation.
- For major tax expenditures that result in foregone revenues above a certain threshold, analysts may want to revisit the use of a dynamic revenue model. Although such a model has proven costly and time-consuming in the past, a pared down version may be valuable in assessing the effect of reduced government spending or increased taxes and multiplier effects that may lead to secondary job creation and higher state tax revenues.

- The Legislature should require the Franchise Tax Board and the Department of Finance, in their annual reports, to list estimated costs of tax expenditures upon inception alongside figures for actual foregone revenue. The side-by-side comparison will give legislators and other policymakers a quick snapshot of which tax expenditures are costing more than envisioned, which may lead to investigations of the reasons and amended statutes to control unintended uses of tax preferences.

Methodology

The oversight office set out to determine whether estimates of lost revenue when tax expenditures were approved turned out to be accurate. We examined tax expenditures that became law starting in 1990 or later, listed in an annual tax expenditure report by the Department of Finance. Only those tax expenditures whose first full-year costs were greater than \$20 million were examined. The research and development credit was also analyzed, even though it was first approved three years prior to 1990, because many significant tax expenditure law changes in the past two decades have involved that credit.

For a variety of reasons, some tax expenditures were not included in the analysis. The exclusion of capital gains on sale of the primary residence was not analyzed because the costs of that tax expenditure could not be disentangled from losses that resulted from an earlier tax break that it replaced. The oversight office does not have access to data that would show how much the earlier version would have cost, and the differential between the two.

An expanded tax break involving income from individual retirement accounts was left out because the effects of the new code could not be distinguished from earlier IRA provisions. The manufacturer's investment credit was not part of the analysis because it was one of the few California tax expenditures whose continuation was tied to economic performance. It failed to meet those goals and was repealed in 2004. A tax credit for teachers was suspended two years after it became law, leaving too little data for a meaningful analysis. Some recent tax breaks were not included because the total revenue loss is capped, or they went into effect too recently for cost estimates to have been made.

For the remaining ten tax expenditures, the oversight office consulted Governor's Chaptered Bill Files in the State Archives to find estimated revenue losses and discussion of policy intent. Depending on the nature of the tax expenditure, we then applied a growth factor to estimate the expected foregone revenue beyond the years included in the bill analysis. For the research and development credit and the double-weighted sales factor, for instance, we used the growth in gross state product. For

the renter's credit, we used U.S. Census estimates for the number of households in California that rent. For the exemption from the minimum franchise tax for the first two years of a new business, we used fluctuations in the annual number of incorporations.

The expected revenue losses were then compared to actual foregone revenue listed in annual tax expenditure reports by the Franchise Tax Board and the Department of Finance. When there were disagreements between the two, we used the tax board's number because it is generated later in the fiscal year with more up-to-date information. The Franchise Tax Board does not estimate foregone revenue from sales tax expenditures, so in those cases, we used estimates from the Department of Finance.

For the section on tax expenditure reports, we reviewed reports from other states and interviewed officials in some states about how they compiled data and the challenges they faced. We also consulted general studies and articles about tax expenditure reports, all of which are listed in the References section that follows.

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