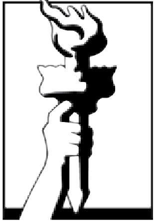

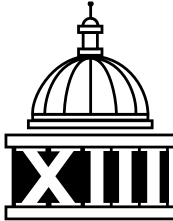

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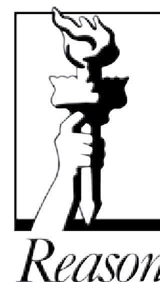
Tax Credits in California:
Economic Growth Engine or Wasteful Corporate Welfare?

By Adam B. Summers with Ankur Chawla

Reason Foundation



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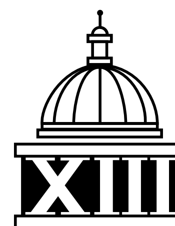

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HJTF advances the interests of taxpayers in the courtroom. Given the high cost of litigation, an ordinary taxpayer is rarely in a position to challenge the validity of an illegal tax levy. In appropriate cases, HJTF provides legal representation without cost to other taxpayer advocacy organizations, homeowners and individual taxpayers where the precedence established confers a broad public benefit to other citizens.

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Executive Summary

Introduction

All states, to some extent, use their tax codes to advance specific policies. Those various policies can be reflected in differing tax rates on individuals, businesses or activities. In addition, tax forebearance, or "tax breaks," can be used to advance policies thought to be beneficial. But such tax breaks tend to be a polarizing topic, with some viewing them as salvation for individuals and businesses suffering from high taxes, while others view them as loopholes or corporate welfare for unscrupulous businessmen. The scandal that erupted when Fremont, CA-based solar cell manufacturer Solyndra declared bankruptcy and defaulted on government-backed debt is a case in point. In addition to the $528 million loss that federal taxpayers took on loan guarantees Solyndra was unable to pay back, the company also received $25 million in California state tax exemptions that ultimately proved to be a waste. This painful lesson did not prevent the legislature from passing, on the last day of the 2012 legislative session, a two-year, $200 million extension of the state's film tax credit, however.

Proponents argue that while cases such as Solyndra are unfortunate, they are a necessary evil that must be tolerated since the benefits of governmental "investing" in certain technologies or industries will, in their view, someday outweigh the costs. Critics cite it as a classic example of government using—and losing—taxpayer dollars to play favorites and advance a political agenda by interfering in the market.

This study looks at certain corporation tax and sales and use tax credits, deductions and exemptions in order to evaluate whether they serve their purpose. The argument offered in support of such tax breaks is that they will improve the lives or livelihoods of certain classes of individuals, businesses or industries. But their costs are frequently ignored. While they may encourage business activity in a certain sector of the economy, this comes at an unseen cost, which is the business activity that would otherwise have taken place in other sectors of the economy. The relevant question then is: does such favorable treatment really result in a net gain to the economy and the state? Or is it a zero-sum game in which politically favored industries benefit at the expense of those without political pull in Sacramento? Or—worse—is it a negative-sum game in which favored interests benefit at the expense of the economy and the state?

Background

The non-partisan California Legislative Analyst's Office (LAO) estimates that the state's tax expenditures cost it about $45 billion in foregone tax revenue during fiscal year 2011–12. This includes roughly $30 billion in personal income tax expenditures, $5 billion in corporate tax expenditures, and $9 billion in sales and use tax expenditures. Moreover, tax breaks tend to result in more tax forebearance "costs" than initially expected. According to a 2011 California Senate Office of Oversight and Outcomes report, "In the 2010–11 fiscal year, the state lost $1.3 billion more than anticipated as a result of major tax breaks . . . passed since 1990." The Office's analysis of 10 tax expenditures whose first-year costs were greater than $20 million found that these tax breaks cost the state $6.3 billion more than expected over a 10-year period.

Many corporate tax breaks and some sales and use tax breaks are intended to improve business activity in certain sectors of the state's economy. But despite the many tax breaks offered by the state, California has one of the worst business climates in the nation.

California has the third-highest unemployment rate in the U.S. at 9.8 percent, behind only Nevada and Rhode Island (both at 10.2 percent). A major reason for this is that many businesses have been leaving California for better climes in recent years. Dun & Bradstreet reports that between January 2007 and October 2010, more than 2,500 employers have left the state, costing California approximately 109,000 jobs.

In its 2009 *Freedom in the 50 States* report, the Mercatus Center at George Mason University ranked California 48th in overall economic and personal liberty, and 47th in both the Fiscal Policy and Regulatory Policy categories. According to the Tax Foundation, the state's 10.6 percent state and local tax burden is the sixth-highest in the nation, and it ranks 48th in terms of its business tax climate. *Chief Executive* magazine's annual survey of hundreds of CEOs on the best and worst states in which to do business determined that, for the eighth year in a row (every year that the survey has been conducted), California's business climate ranked dead last, including by far the worst Taxation and Regulation score of all the states. Indeed, California's tax burden just got significantly heavier with the passage of Proposition 30 in November of 2012. The top marginal

rate on income is now 13.3 percent, by far and away the highest in the country. Current rankings of business climate and tax burden have yet to factor in this recent change in law.

One way to improve the state's business climate would be to lower and simplify the state's tax code by eliminating tax credits. The Franchise Tax Board estimates that if the Research and Development Credit alone were eliminated, the overall corporate tax rate could be reduced by about 14 percent. If some of the other tax breaks discussed in this report were also eliminated—including the Accelerated Depreciation of Research and Experimental Costs, Double-Weighted Sales Factor, Film Credit, Low-Income Housing Credit, Hiring Credit, Percentage Depletion of Mineral and Other Natural Resources, and Expensing of Timber Growing Costs breaks—California could likely reduce its overall corporate tax rate by more than 20 percent.

Economic Growth Engine or Wasteful Corporate Welfare?

The stated goals of California's targeted business tax relief programs are to attract new businesses and jobs and to retain existing businesses and jobs. But while certain businesses or industries may benefit from such policies, we must also look at the cost side of the equation. There are a number of reasons why the negative effects of targeted tax breaks overshadow the positive effects.

The Inefficiency of Targeted Tax Breaks

While proponents of tax breaks tout the benefits of directly or indirectly subsidizing various industries, they often overlook the costs. These include not only the costs of foregone revenue to state coffers, but also the opportunity costs of granting special tax favors when that money might have been spent more efficiently on other pursuits. In propping up some industries by lowering costs through tax breaks, legislators indirectly hurt other industries, which must still pay the higher taxes, leaving them at a competitive disadvantage.

Numerous economic studies have shown that countries with freer markets—with fewer distortions created by arbitrary government intervention—tend to grow more rapidly. The same applies at the state and local level.

By offering special benefits to some, tax breaks substitute one form of economic activity for another. A study by Daniel J. Wilson for the Federal Reserve Bank of San Francisco found that states' research and development tax credits are effective in drawing in R&D dollars to the state but at the same time they reduce R&D expenditures by the same amount in other states, so they do not generate net economic growth. Moreover, since such R&D tax credits are costly to administer and result in R&D allocations that would not otherwise occur, it is reasonable to conclude that, in fact, they are a net drain on the national economy.

Meanwhile, narrowly targeted tax breaks can harm innovation and economic growth. In a free market, businesses have incentives to produce better goods that are less expensive and consume fewer resources. But when markets are distorted through subsidies or tax breaks, innovation is stifled and important new technologies that do not qualify for the tax break are not given a fair chance. To borrow a line from writer Wilton D. Alston, "If the horse-and-buggy manufacturers had been bailed out, we'd probably still be cleaning up behind our transportation."

In addition, narrowly focused tax breaks are inefficient because they subsidize much behavior that would occur anyway. They may help to gain new businesses from other states, or keep existing ones within state borders, but much of the benefits will end up going to businesses that would have operated with or without the incentives, or for activities that companies would have undertaken with or without the incentives.

In Minnesota, the Office of the Legislative Auditor found that approximately 70 percent of the businesses that participated in the state's JOBZ program, an economic development program that offers state and local tax reductions to businesses who locate in or expand in certain zones of the state, would have expanded without any tax breaks at all.

Special-Interest Politics

But if targeted tax breaks are so inefficient, why are they so common? In some instances, the answer is simple: cronyism, or special-interest politics. Elected officials frequently need to get re-elected, and if special interests such as a labor union or industry group has deep pockets and can help them achieve that goal in exchange for some favorable treatment, then the politician will do what needs to be done to preserve his or her job. In other cases, policymakers may be passionately driven by ideology to advance some policy goals that happen to benefit some more than—or at the expense of—others. In both scenarios, however, the politician has substituted his or her own desires for those of the consumer. By contrast, in a free market, business decisions are driven by consumers' wants.

The blame for market tinkering through the tax code does not fall solely on politicians, however. Many businesses and trade groups are only too happy to lobby for special treatment. The tragedy is that the more special-interest deal-making that goes on, the worse it becomes. Once such activity is rewarded, everyone wants a piece of the pie. This encourages companies and trade groups to spend more money on lobbying and less on investments that would result in innovation, thus increasing the economic waste, or "dead weight loss," of the tax breaks.

Targeted Tax Credits vs. Across-the-Board Tax Cuts

As noted above, targeted tax credits and subsidies are inefficient because they sap money away from more productive economic ventures that better satisfy consumers' wants and direct it toward less productive ends. If these tax breaks could be eliminated and replaced with across-the-board tax cuts, California's economy would benefit significantly from more innovation, more economic growth and greater satisfaction of consumers' desires. The only real losers would be the companies currently benefitting from the tax breaks. As it is, special carve-out incentives for some mean higher tax rates for everyone else.

Problems with Data

Tax expenditure programs are notoriously difficult to evaluate because of problems in acquiring reliable data and predicting how businesses and individuals will react to them. Even where good data may be obtained, the methods of analysis used can drastically affect the outcome and conclusions.

Tax policy analysis tends to suffer from the performance of *static analysis*, or the projecting of outcomes based on existing behavior alone. The problem is that when the laws or rules change, people change their behavior accordingly in pursuit of their self-interests. A *dynamic analysis*, by contrast, attempts to ascertain not only the initial, direct effects of a policy change, but also the secondary effects of such a change.

California used to utilize a dynamic economic model for its tax break analyses, but it stopped doing so in 2000. It would seem prudent for California to return to dynamic analyses in order to get a more accurate picture of just how the state's tax break policies are performing and what effects they are having on the state's taxpayers and economy.

Some data problems are inherent to any analysis of the impact of changes in taxes, however, and no economist or government supercomputer will ever be able precisely to predict the changing behavior of tens of millions of individuals and businesses.

Lack of Transparency and Oversight

All the accurate data in the world will do little good if there is a lack of oversight. Even determining what a particular tax break is supposed to achieve can be a challenge. A Department of Finance review of state tax credits concluded that the legislative intent was "not specified" for 70 of the 82 tax expenditures analyzed. Even when the legislative intent is specified, it is subject to change, and the applicability of tax breaks can be broadened by either courts or tax agencies. The efficacy of tax expenditure programs is difficult enough to measure even if their scope were to remain static. If the purpose of such a program cannot be determined or is constantly changing in unintended directions, the difficulty in quantifying the impacts is amplified.

The Worst Offenders: Most Egregious Tax Credits and Exemptions

With the aforementioned arguments in mind, we set out to identify some of the more egregious manipulations of the California tax code. It would be beyond the scope of this study to analyze every tax benefit offered by the state of California to every business or industry, but here we address some of the "low-hanging fruit" that strike us as especially unreasonable.

In deciding which tax breaks are particularly untoward, we considered three primary criteria. Tax credits and exemptions were considered more legitimate when:

1. They are broad-based (not aimed at one or a few cherry-picked businesses or industries, for example);
2. They include a clearly articulated policy goal; and
3. They are not a clear example of government picking winners or losers for ideological or special-interest reasons.

Tax expenditure programs that failed to meet these criteria were considered unreasonable and the worst offenders are included in the list below.

Estimated Foregone California Revenue for Selected Tax Breaks

Tax Break	Estimated General Fund Revenue Loss (Millions of Dollars)		
	FY 2011-12	FY 2012-13	FY 2013-14
Corporation Tax			
Research and Development Credit	1,200	1,200	1,300
Accelerated Depreciation of Research and Experimental Costs	270	320	370
Double-Weighted Sales Factor	210	230	250
Film Credit	160	110	90
Low-Income Housing Credit	60	65	70
Hiring Credit	48	55	60
Percentage Depletion of Mineral and Other Natural Resources	26	27	28
Expensing of Timber Growing Costs	8	8	7
Total	$1,982	$2,015	$2,175
Sales and Use Tax			
Custom Computer Programs	174	188	200
Exemption for Farm Equipment	95	102	109
Fuel Sold to Common Carriers	89	96	102
Water Common Carriers	41	44	47
Diesel Fuel Used in Farming and Processing	33	35	37
Teleproduction and Post Production Equipment	13	14	15
Alternative Energy	12	13	14
Total	$457	$492	$524

Source: State of California, Department of Finance, *Tax Expenditure Report 2011-12*.

Egregious California Tax Breaks

Corporate Tax Breaks:

- Accelerated Depreciation of Research and Experimental Costs
- Double-Weighted Sales Factor (Repealed by voters in November 2012)
- Expensing of Timber Growing Costs
- Film Credit
- Hiring Credit
- Low-Income Housing Credit
- Percentage Depletion of Mineral and Other Resources
- Research and Development Credit

Sales and Use Tax Breaks:

- Aircraft and Component Parts Sales
- Alternative Energy
- Custom Computer Programs
- Diesel Fuel Used in Farming and Processing
- Farm Equipment and Machinery
- Fuel Sold to Common Carriers
- Motion Picture Production Services
- Periodicals
- Printed Advertising
- Teleproduction and Post Production Equipment
- Water Common Carriers

Fuel Tax Breaks:

- Aircraft Jet Fuel Used by Common Carriers
- Fuel Used by Transit Districts and Schools

Property Tax Breaks:

- Computer Programs

Recommendations

In order to reduce the taxation burden on California taxpayers and increase the fairness and sanity of the state's tax codes, policymakers should implement the following reforms.

1. Eliminate special tax treatment wherever possible, particularly in cases where:
   a. The tax break's purpose is not clearly defined;
   b. The tax break is not serving its intended purpose or has outlived its intended purpose;

c. The tax break is narrowly tailored to benefit a specific industry or type of business; or

d. The tax break is clearly an example of the government picking winners or losers for ideological or special-interest reasons.

2. Wherever possible, lower broad tax rates down to tax break levels, rather than raise tax break levels up to broad tax rates.

3. Require a clear statement of purpose and performance measures for each tax break—including existing tax breaks without a clear statement of purpose or relevant performance measures—in order to facilitate evaluations of the impact of tax breaks on taxpayers and the state budget.

4. Eschew static analysis of state tax breaks and return to dynamic analysis of their effects on taxpayers and the state budget.

5. Establish a sunset commission to periodically evaluate tax breaks and other state regulations. A citizen's commission would aid the legislative sunset commission in a way similar to the state of Washington model. Adopt legislation requiring that both existing and future tax breaks must be evaluated every 5 or 10 years. Tax breaks not acted upon within this period would automatically be repealed.

6. Adopt a Base Realignment and Closure (BRAC)-style commission to evaluate existing tax breaks and regulations. The two-thirds supermajority makes it difficult enough to repeal existing tax breaks. This, coupled with the logrolling behavior ("I'll support your tax break if you'll support mine) and the pork-barrel politics (whereby elected officials try to obtain special benefits from the government to bring money into their districts) that occurs in legislative bodies, makes it nearly impossible to eliminate tax breaks. To alleviate the logrolling and pork-barrel problems, the state should establish a commission modeled after the BRAC Commission that has been used at the federal level to divest military bases determined to be unnecessary (yet politically popular with elected officials). Under such a process, an independent panel of taxpayers, perhaps with additional representatives from the Franchise Tax Board, State Board of Equalization and Legislative Analyst's Office, would be appointed to evaluate and recommend tax breaks for elimination. The recommendations, once approved by the governor, would be submitted to the legislature, which would not be allowed to make any amendments and could only vote up or down on the entire package. A simple majority of both houses would be required to approve the recommendations.

Table of Contents

Introduction **1**

Background **2**

Economic Growth Engine or Corporate Welfare? **5**
A. The Inefficiency of Targeted Tax Breaks 5
B. Special-Interest Politics 8
C. Targeted Tax Credits vs. Across-the-Board Tax Cuts 9
D. Problems with Data 10
E. Lack of Transparency and Oversight 11

The Worst Offenders: Most Egregious Tax Credits and Exemptions **13**
A. General Business 16
B. Technology/Computers, Biotechnology/Pharmaceutical and Other Research-Intensive Industries 18
C. Entertainment/Film 20
D. Energy 23
E. Print Media 26
F. Aircraft 26
G. Agriculture 27
H. Minerals, Timber and Other Resources 27
I. (Dis)Honorable Mentions 28

Conclusions and Recommendations **30**
Recommendations 31

Appendix A: California Tax Credits and Exemptions Available **32**

Appendix B: California Film Tax Credits, FY 2009–10 to FY 2012–13 .... **39**

About the Authors **42**

Endnotes **43**

Part 1

Introduction

All states, to some extent, use their tax codes to advance specific policies. Those various policies can be reflected in differing tax rates on individuals, businesses or activities. In addition, tax forebearance, or "tax breaks," can be used to advance policies thought to be beneficial. But such tax breaks tend to be a polarizing topic, with some viewing them as salvation for individuals and businesses suffering from high taxes, while others view them as loopholes or corporate welfare for unscrupulous businessmen. The scandal that erupted when Fremont, CA-based solar cell manufacturer Solyndra declared bankruptcy and defaulted on government-backed debt is a case in point. Many recall the $528 million loss that federal taxpayers took on loan guarantees Solyndra was unable to pay back, but the company also received $25 million in California state tax exemptions. Proponents argue that while such cases are unfortunate, they are a necessary evil that must be tolerated since the benefits of governmental "investing" in certain technologies or industries will, in their view, someday outweigh the costs. Critics cite it as a classic example of government using—and losing—taxpayer dollars to play favorites and advance a political agenda by interfering in the market.

This study looks at certain corporation tax and sales and use tax credits, deductions and exemptions in order to evaluate whether they serve their purpose. The argument offered in support of such tax breaks is that they will improve the lives or livelihoods of certain classes of individuals, businesses or industries. But their costs are frequently ignored. While they may encourage business activity in a certain sector of the economy, this comes at an unseen cost, which is the business activity that would otherwise have taken place in other sectors of the economy. The relevant question then is: does such favorable treatment really result in a net gain to the economy and the state, or is it a zero-sum game in which politically favored industries benefit at the expense of those without political pull in Sacramento, or—worse—is it a negative-sum game in which favored interests benefit at the expense of the economy and the state?

The following sections of this paper are divided into four parts: Part 2 provides an overview of tax credits, exemptions and exclusions in California. Since one main argument advanced in favor of such tax breaks is to improve conditions for business (and thus encourage job and economic growth), this section also takes a look at the state's tax and regulatory climate. Part 3 examines the arguments for and against tax breaks to determine if they are engines of economic growth or merely a form of corporate welfare. Part 4 provides a list and description of the tax breaks we consider to be among the most egregious. Some additional discussion and analysis is provided for the largest or most often discussed ones in the news. Conclusions and recommendations are presented in Part 5.

Part 2

Background

The state of California offers several hundred tax break programs. The rather cheeky term for these programs—one usually employed by interests favoring bigger government—is "tax expenditures."[1] There are three main categories of tax expenditures: personal income taxes, corporate taxes, and sales and use taxes.[2] Examples of personal income tax breaks are the Home Mortgage Interest Deduction, contributions to retirement plans and exclusions of employer contributions to pension and health plans. Corporate tax breaks include the Hiring Credit, Low-Income Housing Credit, Research and Development Credit, and special treatment for certain industries such as the Film Credit program. Sales and use tax breaks include special treatment for products such as food, gas, electricity, water, prescription medicines, alternative energy, periodicals, printed advertising, custom computer programs, and farm equipment and machinery. (See Appendix A for a listing and description of major state tax credits, exemptions and deductions.)

Some tax breaks have a set maximum amount that may not be exceeded in any given year or multiple-year period. These tend to be relatively smaller tax expenditure programs such as the Film Credit and Hiring Credit tax breaks. Most tax breaks are open-ended, however, with the amount determined by the number of eligible individuals, households or businesses who claim them, and the amount each taxpayer is able to claim based on income, sales or other factors.

Tax breaks are like tax increases: once established, they are very difficult to repeal. This is because it only takes a majority of each house in the legislature to approve a tax break bill, but because eliminating a tax break is considered to be a tax increase it takes a two-thirds supermajority to eliminate them.

The non-partisan California Legislative Analyst's Office (LAO) estimates that the state's tax expenditures cost it about $45 billion in foregone tax revenue during fiscal year 2011–12.[3] This includes roughly $30 billion in personal income tax expenditures, $5 billion in corporate tax expenditures, and $9 billion in sales and use tax expenditures.[4]

Moreover, tax breaks tend to result in more tax forbearance "costs" than initially expected. According to a 2011 California Senate Office of Oversight and Outcomes report prepared for the California Senate Rules Committee, "In the 2010–11 fiscal year, the state lost $1.3 billion more than anticipated as a result of major tax breaks . . . passed since 1990."[5] The Office's analysis, which included a review of 10 tax expenditures whose first-year costs were greater than $20 million, found that these tax breaks cost the state $6.3 billion more than expected over a 10-year

period.[6] (Note that California's tax burden just got significantly heavier with the passage of Proposition 30 in November of 2012. The top marginal rate on income is now 13.3 percent, by far and away the highest in the country. Current rankings of business climate and tax burden have yet to factor in this recent change in law.

Many corporate tax breaks and some sales and use tax breaks are intended to improve business activity in certain sectors of the state's economy. But despite the many tax breaks offered by the state, California has one of the worst business climates in the nation. In its 2009 *Freedom in the 50 States* report, the Mercatus Center at George Mason University ranked California 48th in overall economic and personal liberty, and 47th in both the Fiscal Policy and Regulatory Policy categories. According to the Tax Foundation, the state's 10.6 percent state and local tax burden is the sixth-highest in the nation,[7] and it ranks 48th in terms of its business tax climate.[8] (Note that California's tax burden just got significantly heavier with the passage of Proposition 30 in November of 2012. The top marginal rate on income is now 13.3 percent, by far and away the highest in the country. Current rankings of business climate and tax burden have yet to factor in this recent change in law.)

Similarly, *Chief Executive* magazine's annual survey of hundreds of CEOs on the best and worst states in which to do business determined that, for the eighth year in a row (every year that the survey has been conducted), California's business climate ranked dead last,[9] including by far the worst Taxation and Regulation score of all the states.[10] The magazine concluded:

> *California's enduring place of perpetual decline continues in this year's ranking. Once the most attractive business environment, the Golden State appears to slip deeper into the ninth circle of business hell. The economy, which used to outperform the rest of the country, now substantially underperforms. And its status as the most ruinously contentious place to operate remains undisturbed in eight years.*[11]

Among some of the responses of the CEOs surveyed were the following:

- "California continues to head in the wrong direction as its tax policies will drive more businesses and people to relocate in other states. State politicians feel business and commerce are 'necessary evils' that provide the funds to enable pursuit of their misguided agendas."
- "California government is difficult to work with and very bureaucratic. Taxes and regulation are high and unruly."
- "California is begging for businesses to leave its state."
- "California is going in the wrong direction if that's even possible."
- "California is out of control. They have too much government who have nothing better to do than to harass businesses in the state. They need to cut the size of their regulatory bodies in half."

- "California is the worst! They are doing everything possible to drive a business out of their state. If the environment in CA was not so good, they would have lost half of their population."
- "California regulations, taxes and costs will leave only tech, life sciences and entertainment as viable. If you aren't an elitist no room here for the middle or working classes."[12]
- "California's regulation and specifically labor regulation is a job killer. We will be moving our business out of CA and the State will lose 100's of jobs simply due to the poor regulatory environment."
- "California's taxes and ongoing changes for regulations are devastating. One never knows from even day to day what new interpretation of an existing regulation or new regulation will befall you and your small business."[13]

Keep in mind that these are the impressions of business leaders in the state and around the country, and that the above is only a small sampling of the negative comments about California's tax and regulatory climate. One recurring theme is that California's high taxes and voluminous and ever-changing regulations are causing businesses and employees to avoid or leave the state.

> California has the third-highest unemployment rate in the nation.

This is not mere talk or theory. California has the third-highest unemployment rate in the nation, at 9.8 percent, behind only Nevada and Rhode Island (both at 10.2 percent). This is significantly above the national unemployment rate of 7.8 percent, and if you remove California from the equation, the average of the other 49 states is only 7.4 percent.[14] A major reason for this is that many businesses have been leaving California for better climes in recent years. Dun & Bradstreet reports that between January 2007 and October 2010, more than 2,500 employers have left the state, costing the state approximately 109,000 jobs.[15]

Moreover, the pace at which businesses are leaving the state has been increasing. According to Joseph Vranich, principal of business expansion and relocation services company Spectrum Location Solutions, who keeps his own tally of companies who leave the state for better opportunities, on average, a business left California each week in 2009. In 2010 that rate increased to four businesses per week, and in 2011 five businesses left the state every week.[16] This likely helps to explain why California had a net outmigration (more people moving from California to other states than from other states to California) of over 1.4 million between fiscal year 2000–01 and FY 2009–10, with more than 1 million of that coming during just the last five years of this period.[17]

Clearly, California's burdensome tax and regulatory environment has become a major problem. In the next section, we will explore whether or not tax breaks are the solution.

Part 3

Economic Growth Engine or Corporate Welfare?

The stated goals of California's targeted business tax relief programs are to attract new businesses and jobs and to retain existing businesses and jobs. But while certain businesses or industries may benefit from such policies, we must also look at the cost side of the equation. If the costs of such a policy outweigh the benefits, then we must abandon the policy and look for a better alternative, including, but not limited to, broad-based tax relief. There are a number of reasons why the negative effects of targeted tax breaks overshadow the positive effects. We detail some of these reasons below.

A. The Inefficiency of Targeted Tax Breaks

While proponents of tax breaks tout the benefits of directly or indirectly subsidizing various industries, they often overlook the costs. These include not only the costs of foregone revenue to state coffers, but also the opportunity costs of granting special tax favors when that money might have been spent more efficiently on other pursuits.

In propping up some industries by lowering costs through tax breaks, legislators indirectly hurt other industries, which must still pay the higher taxes, leaving them at a competitive disadvantage. Thus, we agree with the Legislative Analyst's Office when it argued in its FY2008–09 budget analysis about the special tax treatment received by farming equipment: "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."[18]

By offering special benefits to some, tax breaks substitute one form of economic activity for another. A study by Daniel J. Wilson for the Federal Reserve Bank of San Francisco found that states' research and development tax credits are effective in drawing in R&D dollars to the state but at the same time they reduce R&D expenditures by the same amount in other states, so they do not generate net economic growth.[19] Moreover, since such R&D tax credits are costly to administer and result in R&D allocations that would not otherwise occur, it is reasonable to conclude that, in fact, they are a net drain on the national economy.

State R&D tax credits were first introduced by Minnesota in 1982 and have since proliferated; by 2006 they had been adopted by 32 states.[20] Like nuclear proliferation and trade restrictions, states without such policies have persuaded themselves—in many cases quite plausibly, as Wilson shows—that they are vulnerable to capital flight. But is the argument that "everyone else is doing it" a sufficient policy justification? The situation is similar to the beggar-thy-neighbor trade restrictions that were introduced by governments in the inter-war period, which had a devastating effect on national economies. Those trade restrictions were finally reversed, slowly, following the development of the General Agreement on Tariffs and Trade—in part because the same vested interests that benefitted domestically from restrictions on imports suffered internationally because of difficulties exporting. In the U.S. context, the tax credits now apply so widely that even many R&D-intensive firms might be better off if they were scrapped and state corporation tax reduced by an amount that kept state revenue neutral.

As for firms that are predominantly in one state because of the tax credits, the United States Supreme Court has previously held that state tax may be in violation of the Commerce Clause of the U.S. Constitution if it "will in its practical operation work discrimination against interstate commerce"[21] by "providing a direct commercial advantage to local business."[22] And Daniel J. Wilson notes that the findings of his study suggest that "state R&D tax credits may indeed 'work discrimination' both in statute and in practice."[23]

"If the horse-and-buggy manufacturers had been bailed out, we'd probably still be cleaning up behind our transportation."

Meanwhile, narrowly targeted tax breaks can harm innovation and economic growth. In a free market, businesses have incentives to produce better goods that are less expensive and consume fewer resources. Think of the progress of common items such as cars, computers and cell phones, and compare them with their counterparts from yesteryear. Economist Joseph Schumpeter called this process "creative destruction."[24] But when markets are distorted through subsidies or tax breaks, there is both less destruction and less creation: important new technologies that do not qualify for the tax break are not given a fair chance. To borrow a line from writer Wilton D. Alston, "If the horse-and-buggy manufacturers had been bailed out, we'd probably still be cleaning up behind our transportation."[25]

Over the past 20 years, study after study has shown the importance of free markets for economic growth—and the dangers of government intervention. For example, in a 1996 study for the Cato Institute and the Fraser Institute, James Gwartney, Robert Lawson and Walter Block analyzed economic data for over 100 nations during a 20-year period and concluded that there is "a very strong relationship between economic freedom and economic growth."[26] In other words, countries with freer markets—with fewer distortions created by arbitrary government intervention—tend to grow more rapidly. They tend to experience more creative destruction. The same applies at the state and local level.

Finally, narrowly focused tax breaks are inefficient because they subsidize much behavior that would occur anyway. They may help to gain new businesses from other states, or keep existing ones within state borders, but much of the benefits will end up going to businesses that would have operated with or without the incentives, or for activities that companies would have undertaken with or without the incentives.

The federal tax credits for electric vehicles are a good case in point. A Congressional Budget Office report concluded that the cost-effectiveness of the government's attempts to use the tax credits to reduce consumer gasoline consumption and reduce greenhouse gas emissions was greatly diminished by the fact that an estimated 70 percent of electric vehicle purchases would have occurred even without the tax credits.[27]

In Minnesota, the Office of the Legislative Auditor found that approximately 70 percent of the businesses that participated in the state's JOBZ program, an economic development program that offers state and local tax reductions to businesses who locate in or expand in certain zones of the state, would have expanded without any tax breaks at all. According to the auditor's February 2008 report,

> *Surveys of JOBZ businesses indicate that about 19 percent of the participants would have expanded to the same extent in Greater Minnesota without JOBZ assistance. In addition, another 50 percent would have expanded to some extent without tax breaks. Furthermore, local governments have approved JOBZ subsidies for businesses that compete with other Greater Minnesota companies for the same Minnesota customers. The increase in employment at subsidized businesses could be offset by job cuts at their competitors.*[28]

In California, a February 2012 UCLA Institute for Research on Labor and Employment (UCLA-IRLE) report on the state's film credits program criticized a 2011 study by the Los Angeles County Economic Development Corporation (LAEDC) for exaggerating the economic benefits of the program. The main reason for the LAEDC study's embellishment was its assumption that all of the productions that ended up receiving the film credit would have left California if not for the state's enticement. However, as the UCLA-IRLE report noted, "while many producers are swayed by the enticement of a tax credit in their production location decision making, the assumption that all productions that do not receive a credit will leave the state and only productions that do receive a credit will stay, is not true."[29] The report observed that in one year 14 productions ended up being filmed despite applying for, but failing to win, the lottery for the state's film credits. Of these 14 productions, five ended up being filmed in California anyway and accounted for 8.4 percent of the total production budgets.[30] Clearly, a significant portion of productions receiving the tax credit would end up filming in California even if the state did not offer any film incentive at all.

B. Special-Interest Politics

But if targeted tax breaks (and direct subsidies) are so inefficient, why are they so common? In some instances, the answer is simple: cronyism, or special-interest politics. Elected officials frequently need to get re-elected, and if special interests such as a labor union or industry group has deep pockets and can help them achieve that goal in exchange for some favorable treatment, then the politician will do what needs to be done to preserve his or her job. In other cases, policymakers may be passionately driven by ideology to advance some policy goals that happen to benefit some more than, or at the expense of, others. In both scenarios, however, the politician has substituted his or her own desires for those of the consumer. By contrast, in a free market, business decisions are driven by consumers' wants.

The blame for special-interest politics should not be laid solely at the feet of politicians, however. Many businesses are more than eager not only to feed at the public trough, but to pressure the politicians to increase (or maintain) the amount of the feed. Some may even threaten to lay off workers or relocate to another district or another state if they do not get the goodies they demand.

Consider the example of Proposition 24, which appeared on the November 2010 state ballot. Prop. 24 would have rolled back three tax breaks valued at up to $1.3 billion per year that were granted as part of a budget deal reached in 2009. The tax breaks allowed:

- Corporations to shift operating losses to prior tax years and to extend the period permitted to shift operating losses to future tax years.
- Corporations to share tax credits with affiliated corporations.
- Multistate businesses to use a sales-based income calculation, rather than a combination property-, payroll- and sales-based income calculation.[31]

(Note that Proposition 39 in 2012 addressed the latter multi-state business "single sales tax" issue.)[32]

Proposition 24 was opposed by many business interests, including pharmaceutical company Genentech, which was the largest donor to the opposition campaign with contributions of just over $1.6 million.[33] The company, and the No on 24 campaign generally, had argued that the tax breaks were needed to stave off job losses, yet shortly after the measure was defeated Genentech announced plans to lay off 840 workers in San Francisco and Vacaville anyway.[34]

Similarly, Comcast won a tax exemptions package in 2010 by threatening to move 150 workers from Livermore, CA to Utah. It donated $94,000 to incumbent legislators, candidates and the Republican Party during the weeks leading up to, and just after, the October 2010 votes on the budget and tax deal. Of this amount, the largest single donation of $20,000 went to the California Republican Party. (GOP legislators had led the push to get the tax deal through).[35] And in September 2011, Governor Jerry Brown attempted to push his California Jobs First Package through the legislature, which would save big cable companies $83 million in tax credits.[36]

Such arrangements are possible because the benefits of the lobbying effort are large relative to the costs of lobbying and are concentrated on a relatively small number of businesses, while the costs to other taxpayers and businesses are dispersed widely, so that any individual taxpayer's share of the cost is so minimal as not to be worth his or her time to become more educated about it or fight it. In other words, it is easier for a small, motivated group to lobby the state legislature for some benefits and then pass the costs off to taxpayers than it is for taxpayers to organize against such deals.

The more special-interest deal-making that goes on, the worse it becomes. Once such activity is rewarded, everyone wants a piece of the pie. This encourages companies and trade groups to spend more money on lobbying and less on investments that would result in innovation, thus increasing the economic waste, or "dead weight loss," of the tax breaks.

The Franchise Tax Board estimates that if the Research and Development Credit alone were eliminated, the overall corporate tax rate could be reduced by about 14 percent, thus improving the business climate for all industries.

C. Targeted Tax Credits vs. Across-the-Board Tax Cuts

As noted above, targeted tax credits and subsidies are inefficient because they sap money away from more productive economic ventures that better satisfy consumers' wants and direct it toward less productive ends. If these tax breaks were eliminated and replaced with across-the-board tax cuts, California's economy would benefit significantly from more innovation, more economic growth, and greater satisfaction of consumers' desires. The only real losers would be the companies currently benefitting from the tax breaks.

The positive economic impact could be very large. The Franchise Tax Board estimates that if the Research and Development Credit alone were eliminated, the overall corporate tax rate could be reduced by about 14 percent, thus improving the business climate for all industries.[37] If some of the other tax breaks discussed in this report were also eliminated—including the Accelerated Depreciation of Research and Experimental Costs, Double-Weighted Sales Factor, Film Credit, Low-Income Housing Credit, Hiring Credit, Percentage Depletion of Mineral and Other Natural Resources, and Expensing of Timber Growing Costs breaks (see Table 1 on page 14)—California could likely reduce its overall corporate tax rate by more than 20 percent.[38]

Given that more economic freedom leads to more economic growth, and that millions of private individuals acting in their own self-interests can manage the economy more efficiently than a handful of politicians, bureaucrats and lobbyists, policymakers should abandon labyrinthine tax codes filled with special carve-out incentives and instead seek to level the playing field and keep

the tax and regulatory burden on all firms as low as possible to allow for maximum economic growth.

D. Problems with Data

Tax expenditure programs are notoriously difficult to evaluate because of problems in acquiring reliable data and predicting how businesses and individuals will react to them. Even where good data may be obtained, the methods of analysis used can drastically affect the outcome and conclusions.

Tax policy analysis in general oftentimes suffers from the performance of *static analysis*, or the projecting of outcomes based on existing behavior alone. The problem is that when the laws or rules change, people change their behavior accordingly in pursuit of their self-interests. In explaining why the cost of tax breaks in California tend to exceed initial projections so significantly, the Senate Office of Oversight and Outcomes noted: "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."[39]

A *dynamic analysis*, by contrast, attempts to ascertain not only the initial, direct effects of a policy change (in this case, the implementation of a new tax break law), but also the secondary effects of such a change. As the famed 19th century French economist and statesman Frédéric Bastiat observed:

> *In the economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause—it is seen. The others unfold in succession—they are not seen: it is well for us if they are foreseen. Between a good and a bad economist this constitutes the whole difference—the one takes account of the visible effect; the other takes account both of the effects which are seen and also of those which it is necessary to foresee. Now this difference is enormous, for it almost always happens that when the immediate consequence is favorable, the ultimate consequences are fatal, and the converse. Hence it follows that the bad economist pursues a small present good, which will be followed by a great evil to come, while the true economist pursues a great good to come, at the risk of a small present evil.*[40]

California used to utilize a dynamic economic model for its tax break analyses, but it stopped doing so in 2000. The Senate Office of Oversight and Outcomes explains how and why some other states rely on dynamic models:

> *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.*[41]

It would seem prudent for California to return to dynamic analyses in order to get a more accurate picture of just how the state's tax break policies are performing and what effects they are having on the state's taxpayers and economy.

Some data problems are inherent to any analysis of the impact of changes in taxes, however, and no economist or government supercomputer will ever be able to precisely predict the changing behavior of tens of millions of individuals and businesses. As the Legislative Analyst's Office reports,

> *For some TEPs [tax expenditure programs], reasonably good data are available regarding the extent of their use, such as for certain PIT [personal income tax] and CT [corporation tax] TEPs that are claimed on tax returns. For other TEPs, however, such as many under the SUT [sales and use tax] and certain PIT and CT exclusions, hard data are more limited and sometimes nonexistent. This includes information about the distribution of their benefits among different categories of taxpayers, like income groups. Measuring whether TEPs are effective and cost-efficient in achieving their objections is even more difficult, due to the lack of hard data, problems in identifying their direct impacts, and uncertainty about the behavioral effects they can produce. Conducting full-blown dynamic analyses for TEPs is even harder, due to modeling difficulties and knowing how the revenues to fund them would have otherwise been used.*
>
> ***TEP Evaluations Are Very Hard to Do.*** *Due to the challenges listed above, policymakers should regard many TEP evaluations with skepticism. Analysis of alternative uses of public funds is difficult and often omitted entirely from such studies. These studies also usually rely on extensive and sometimes subjective assumptions, which, if changed, can produce very different results.*[42]

These challenges are complicated still further by limited legislative review, little control over how much is ultimately claimed in tax breaks, and limited enforcement capabilities (and thus greater opportunities for fraud or tax evasion).[43] Thus, the LAO concludes, skepticism of the purported benefits of targeted tax breaks is justified:

> *Given the problems listed above, we advise the Legislature to approach proposals to adopt, extend, or maintain TEPs with skepticism. As alternatives to TEPs, broad-based tax rates can be maintained or lowered or spending on high-priority programs can be increased. It is rare that the value of TEPs can be demonstrated conclusively compared to these alternate uses of tax dollars.*[44]

E. Lack of Transparency and Oversight

All the accurate data in the world will do little good if there is a lack of oversight. Even determining what a particular tax break is supposed to achieve can be a challenge. According to the

Senate Office of Oversight and Outcomes 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.'"[45] Even when the legislative intent is specified, it is subject to change, and the applicability of tax breaks may be broadened, either by courts or tax agencies.[46] The efficacy of TEPs is difficult enough to measure even if their scope were to remain static. If the purpose of such a program cannot be determined or is constantly changing in unintended directions, the difficulty in quantifying the impacts is amplified.

In addition to requiring new—and even existing—tax breaks to contain a statement of legislative intent and purpose, increased clarity and oversight may be achieved simply by forcing the legislature to periodically reconsider tax breaks (and all forms of regulation, for that matter). The state of Washington performs such a "sunset review" of its tax expenditure programs every 10 years. A citizen's commission was established to schedule reviews and hold public hearings. The actual reviews are performed by the legislature's Joint Legislative Audit and Review Committee.[47]

In August of 2011, the California legislature passed Senate Bill 508, which would have met these data requirement and review objectives, but the bill was vetoed by Governor Jerry Brown.. The bill would have required future tax break legislation to include:

(a) Specific goals, purposes and objectives that the tax credit will achieve.

(b) Detailed performance indicators for the legislature to use when measuring whether the tax credit meets the goals, purposes and objectives stated in the bill.

(c) Data collection requirements to enable the legislature to determine whether the tax credit is meeting, failing to meet, or exceeding those specific goals, purposes and objectives. The requirements shall include the specific data and baseline measurements to be collected and remitted in each year the credit is in effect, in order for the legislature to measure the change in performance indicators, and the specific taxpayers, state agencies or other entities required to collect and remit data.

(d) A requirement that the tax credit shall cease to be operative no later than 10 taxable years after its effective date, and as of January 1 of the year following the end of the operative period is repealed.[48]

In his veto message, Gov. Brown stated: "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."[49]

But the fact is that the legislature does not examine all its bills and programs. Adopting some basic rules to force it to do what it has been unable or unwilling to do thus far could, therefore, bring some much needed clarity, transparency and accountability to the state's tax and regulatory policies.

Part 4

The Worst Offenders: Most Egregious Tax Credits and Exemptions

With the aforementioned arguments in mind, we set out to identify some of the more egregious manipulations of the California tax code. It would be beyond the scope of this study to analyze every tax benefit offered by the state of California to every business or industry, but here we address some of the "low-hanging fruit" that strike us as especially unreasonable.

In deciding which tax breaks are particularly untoward, we considered three primary criteria. Tax credits and exemptions were considered more legitimate when:

1. They are broad-based (not one or a few cherry-picked businesses or industries, for example),
2. They include a clearly articulated policy goal, and
3. They are not a clear example of government picking winners or losers for ideological or special-interest reasons.

Tax expenditure programs that failed these criteria were considered unreasonable and the worst offenders are included in the list below.

Egregious California Tax Breaks

Corporate Tax Breaks:

- Accelerated Depreciation of Research and Experimental Costs
- Double-Weighted Sales Factor (Repealed by voters in November 2012)
- Expensing of Timber Growing Costs
- Film Credit
- Hiring Credit
- Low-Income Housing Credit
- Percentage Depletion of Mineral and Other Resources
- Research and Development Credit

Sales and Use Tax Breaks:

- Aircraft and Component Parts Sales
- Alternative Energy
- Custom Computer Programs
- Diesel Fuel Used in Farming and Processing
- Farm Equipment and Machinery
- Fuel Sold to Common Carriers
- Motion Picture Production Services
- Periodicals
- Printed Advertising
- Teleproduction and Post Production Equipment
- Water Common Carriers

Fuel Tax Breaks:

- Aircraft Jet Fuel Used by Common Carriers
- Fuel Used by Transit Districts and Schools

Table 1: Estimated Foregone California Revenue for Selected Tax Breaks			
Tax Break	Estimated General Fund Revenue Loss ($Millions)		
	FY 2011-12	FY 2012-13	FY 2013-14
Corporation Tax			
Research and Development Credit	1,200	1,200	1,300
Accelerated Depreciation of Research and Experimental Costs	270	320	370
Double-Weighted Sales Factor	210	230	250
Film Credit	160	110	90
Low-Income Housing Credit	60	65	70
Hiring Credit	48	55	60
Percentage Depletion of Mineral and Other Natural Resources	26	27	28
Expensing of Timber Growing Costs	8	8	7
Total	**$1,982**	**$2,015**	**$2,175**
Sales and Use Tax			
Custom Computer Programs	174	188	200
Exemption for Farm Equipment	95	102	109
Fuel Sold to Common Carriers	89	96	102
Water Common Carriers	41	44	47
Diesel Fuel Used in Farming and Processing	33	35	37
Teleproduction and Post Production Equipment	13	14	15
Alternative Energy	12	13	14
Total	**$457**	**$492**	**$524**

Source: State of California, Department of Finance, *Tax Expenditure Report 2011–12*.

A few of the tax breaks included on the list are available for certain business practices in all industries, while the rest tend to be concentrated into the following industries:

- Technology/Computers, Biotechnology/Pharmaceuticals and Other Research-Intensive Industries
- Entertainment/Film
- Energy
- Print Media
- Aircraft
- Agriculture
- Minerals, Timber and Other Resources

The tax breaks on our list are presented below by these categories. Each tax break is identified by the nature of the tax break (corporation tax, sales and use tax, fuel tax or property tax) and accompanied by a description and cost data (where available), courtesy of the California Department of Finance's *Tax Expenditure Report 2011–12*,[50] as well as a brief comment on why it was included in the list and any additional information or analysis.

A. General Business

1. Hiring Credit (Corporation Tax) *Estimated Cost (FY 2012–13):* $55 million

Department of Finance description: Provides that a qualified employer can take a credit against his tax of $3,000 for each increase in qualified full-time employees during the tax year. The total allowable credits for all tax years is $400 million.

Comment: While this tax break is fairly broadly applied, it nonetheless intervenes in a central business practice, namely, the hiring and firing of employees. Businesses must have the freedom to hire and fire employees as they see fit, without coercion or enticement, in order to adapt to changing technology and economic conditions. As *Sacramento Bee* columnist Dan Morain affirmed, "Businesses hire and fire for many reasons, most of them way beyond the control of California's Assembly and Senate."[51]

If that were not enough, enforcement of the Hiring Credit is too difficult a task to perform effectively. It is simply too easy to game the system. This can be done by temporarily hiring an employee, only to lay him or her off after a short period of time, and perhaps even re-hire the same worker in the future to take advantage of the credit again.

2. Low-Income Housing Credit (Corporation Tax) *Estimated Cost (FY 2012–13):* $65 million

Department of Finance description: A tax credit is allowed for a portion of the costs of investing in qualified low-income rental housing. The aggregate amount of the credit is capped, and specific credits are allocated to applicants by the California Tax Credit Allocation Committee. Credits are allocated to developers who, in turn, sell them to investors in exchange for project funding. All projects receiving the California credit must also receive the parallel federal credit.

Comment: As with the Hiring Credit, this is a business practice and condition of employment that should be negotiated between the employer and prospective employee. The Low-Income Housing Credit encourages investment in low-income rental housing, but at what cost? That money could alternately been used for higher wages and benefits, increased research and development, or other investment in the business. The fact that a tax credit was needed to encourage such investment is evidence of the fact that businesses otherwise would have invested that money on other aspects of their businesses that they deemed more appropriate or of a higher priority.

3. Double-Weighted Sales Factor (Corporation Tax) *Estimated Cost (FY 2012–13):* $230 million

Department of Finance description: Corporations with income derived from sources both within and outside California must apportion income using a formula that takes into account payroll, property and sales factors. Prior to January 1, 1993, California applied a three-factor formula in which the payroll, property and sales factors were equally weighted. After that date, California adopted a

formula in which the sales factor is double-weighted. Corporations engaged in qualified agricultural, extractive and financial business activities are exempted from the double-weighted sales formula, and must continue using the equally weighted three-factor formula to apportion their worldwide income.

Comment: This tax break discriminated against out-of-state companies that did business in multiple states, particularly those companies that had a high sales volume in California but few employees or property in the state. Moreover, the impact of the Double-Weighted Sales Factor was clouded by legal issues.

The above description from the Department of Finance pre-dated the November 2012 election wherein Proposition 39 was enacted. The new law means multi-state businesses are no longer able to select the method for determining their state taxable income that is most advantageous for them. Nonetheless, we included this "tax expenditure" in this study, not only for the historical context, but to illustrate the irony and foolishness of California tax policy. Specifically, while Proposition 39 repealed the elective sales tax method of apportionment, it traded this tax break for an equally egregious tax break for green energy. Only in California, we believe, can one tax break favoring specific special interests be "poached" by other special interests seeking their own "tax expenditure"! The following offers some additional historical background on the double-weighted sales factor tax break.

In July 2012 the state's First District Court of Appeals overturned a lower court's decision and ruled in favor of Gillette and a number of other corporate plaintiffs who claimed that the Double-Weighted Sales Factor violated a tax agreement reached by a number of states and caused them to pay $34 million more in taxes than they should have owed over a four-year period.[52] As of this writing, it is unknown if the Franchise Tax Board will appeal the ruling.

In 1974, California enacted the Multistate Tax Compact. The Compact specifies that states are to base their corporate taxes on three equally weighted factors: payroll, sales and property. It was designed to provide greater uniformity of state tax policies and eliminate double taxation for companies that conduct business in more than one state. There are 19 member states to the Compact.

In 1993, California implemented a statute that doubled the weight given to sales within the state, putting out-of-state businesses at a disadvantage by imposing higher taxes on them. At the time, it did not explicitly withdraw from the Multistate Tax Compact, however, which led to the court's decision in favor of the corporate taxpayers. In anticipation of a potential court victory for the taxpayers, in June 2012 the state enacted SB 1015, which repealed the Compact and allowed the state to utilize its own corporate tax formulas.

Most, if not all, of the ancillary legal issues have been rendered moot by the passage of Proposition 39.

B. Technology/Computers, Biotechnology/Pharmaceutical and Other Research-Intensive Industries

1. Research & Development Credit (Corporation Tax) *Estimated Cost (FY 2012–13):* $1.2 billion

Department of Finance description: Businesses are allowed a credit for increased research expenditures over a four-year base period.

Comment: The Research and Development Credit is the largest corporation tax break, with an estimated annual cost of $1.2 billion of foregone revenue to the state. It was enacted in 1987 and included a six-year sunset clause. In 1993 the credit was made permanent, and it has been expanded a number of times since then.[53] The state's Basic Research Credit is equal to 24 percent of expenditures in excess of a calculated base amount for certain types of research performed at independent research institutions and universities. The Qualified Research Credit is equal to 15 percent of expenditures in excess of a calculated base amount for research and development.[54] According to the Legislative Analyst's Office, in order for a taxpayer to qualify for the research credit, the following requirements must be met:

- The research must have qualified as a business deduction.
- The research must have been undertaken to "discover information which is technological in nature."
- The taxpayer must have intended to use the information to develop a new or improved business component.
- The taxpayer must have pursued a "process of experimentation" during substantially all of the research.[55]

Research performed outside of California, research in the areas of social sciences, arts or humanities, market and consumer research and research funded by a grant or contract are not eligible for the credit. The sectors that benefit most from the credit include the computer and peripheral equipment manufacturing, communications equipment manufacturing, semiconductor and other electronic component manufacturing, pharmaceuticals and medicine manufacturing and software publishing industries, with companies from each sector claiming a combined total of at least $100 million a year in credits.[56]

But is this credit even effective? The Franchise Tax Board, Senate Office of Oversight and Outcomes, and Legislative Analyst's Office have all raised questions as to the effectiveness of the Research and Development Credit, citing a lack of data and the fact that much research and development activity would occur anyway in the absence of a tax break.[57] In its December 2011 report on the state's research and development tax credits, the LAO urged getting rid of some or all of the credits: "We recommend that the Legislature consider reducing the credit or phasing it out over time, given the substantial direct revenue losses associated with the program and its uncertain benefits."[58]

Moreover, as the aforementioned Federal Reserve Bank of San Francisco study observed, research and development credits may be able to encourage technology and other research-related businesses to relocate to a state offering such credits, but they are ineffective at generating any net economic growth.[59] In other words, state research and development credits are essentially a zero-sum game.

The Research and Development Credit disproportionately affects businesses in technology and research-intensive industries. Moreover, the credit either subsidizes investment that would have taken place even in the absence of such a credit or redirects investment away from wages and benefits or other business investments. Therefore, we recommend eliminating the credit and using the "savings" to reduce the overall corporate tax rate for all industries.

2. Accelerated Depreciation of Research and Experimental Costs (Corporation Tax)

Estimated Cost (FY 2012–13): $320 million

Department of Finance description: Corporations that meet specified criteria are allowed to elect Subchapter S corporation status for tax purposes. S corporations pay tax on corporate income at a reduced rate of 1.5 percent, except for financial institutions, which are subject to a 3.5 percent rate. S corporations are not subject to the Alternative Minimum Tax but are subject to the applicable corporate minimum tax. Individual shareholders of an S corporation pay personal income taxes on their pro rata share of corporate income.

Comment: As with the Research and Development Credit, the Accelerated Depreciation of Research and Experimental Costs credit disproportionately affects businesses in technology and research-intensive industries. Moreover, the tax break either subsidizes investment that would have taken place even in the absence of such a credit or redirects investment away from wages and benefits or other business investments.

3. Custom Computer Programs (Sales and Use Tax)

Estimated Cost (FY 2012–13): $188 million

Department of Finance description: The transfer of custom computer programs, other than a basic operational program, and separate charges for custom modifications to existing prewritten programs are excluded from the definition of "sale."

Comment: The Custom Computer Programs tax break is the largest sales and use tax break on this list, with an estimated cost of $188 million in foregone revenue to the state. This credit disproportionately benefits a single industry or sector of the state's economy.

4. Computer Programs (Property Tax)

Estimated Cost (FY 2012–13): Over $100 million

Department of Finance description: Computer programs other than basic operational programs that are necessary for the fundamental functioning of the computer are exempt from tax. The storage media for the programs are, however, taxable.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

C. Entertainment/Film

1. Film Credit (Corporation Tax) *Estimated Cost (FY 2012–13):* $110 million

Department of Finance description: Provides a nonrefundable franchise or personal income tax credit to qualified taxpayers who produce a motion picture in California or relocate a television series or independent film to California. The credits are allocated and certified by the California Film Commission. The annual allocation of credits is capped at $100 million.

Comment: The California Film & Television Tax Credit Program, run by the California Film Commission, provides tax credits for film and television productions in California. Signed into law in February 2009, the program was originally given a five-year, $500 million plan. It has since been extended twice. The credit is equal to 20 percent to 25 percent of qualified production expenses, including the salaries of film crew members and the construction costs for building sets. Since there is such high demand for the tax credits, credits for eligible projects are allocated based on a lottery system.

The California Film Commission has the authority to allocate up to $100 million in tax credits each fiscal year that the program is in effect.[60] While $10 million of this amount is reserved for independent productions, the vast majority goes to the major film production studios. As a December 2010 *Sacramento Bee* article relates,

> *California Film Commission records show that of the initial $175 million in tax credits to be doled out for feature films, as much as $120 million will go to movies produced or distributed by Disney, Fox, Viacom, Sony Pictures, NBC-Universal and Comcast, which is taking over NBC-Universal, and their various subsidiaries.*[61]

During the 2011–12 fiscal year, over $121 million in tax credits was used for 51 projects.[62] The last few years have seen the Film Credit utilized by television series such as “Franklin & Bash” and “Rizzoli & Isles,” movies like “Beverly Hills Chihuahua 2,” “Drunk Dial” and “Jackass 3D,” and even big-budget feature films such as “Burlesque,” “Bridesmaids,” “Hop” and “We Bought a Zoo.”

Various groups have issued studies to try to justify the Film Credit. In 2011, the Los Angeles County Economic Development Corporation (LAEDC) released a study, paid for by the Motion Picture Association of America, claiming that the Film Credit generated $3.8 billion in economic activity, supporting 20,000 film-related jobs, during the first two years of the program. In addition, the report asserts that state and local governments received $1.13 in tax revenue for every $1.00 spent on the tax credits.[63] A UCLA Institute for Research on Labor and Employment (UCLA-IRLE) study concluded that these figures were exaggerated, largely because the LAEDC study assumed that all film and television productions that applied for, but did not receive, a tax credit would relocate to another state. The UCLA-IRLE study cautioned that other factors, such as differences in labor costs, were also significant factors in deciding where to shoot a film or television program, and estimated that there was only a small benefit of approximately $1.04 received in state and local tax revenues for every $1.00 spent on the Film Credit program.[64] Yet

even this must be at least offset, and perhaps result in a negative return to the state, when the opportunity costs of alternate uses of funds diverted to the Film Credit are considered.

Indeed, a June 2012 Legislative Analyst's Office evaluation of the Film Credit identified several issues in both the LAEDC and UCLA-IRLE studies that would result in fewer benefits than those claimed in either study, and possibly a *negative* net benefit. These issues include:

- Unknown assumptions embedded in the LAEDC economic models and their failure to consider the benefits of alternate public or private uses of tax credit funds (which could result in the credit program having significantly *less* net benefit than shown in the studies).
- In-state film activity that would occur in California without any tax credit (which results in the credit program having *less* economic and tax net benefit than shown in the LAEDC study).
- In-state economic and employment activity resulting from out-of-state productions (which results in the credit program having *less* net benefit than shown in the studies).
- Crowding out effects (which result in the credit program having *less* net benefit than shown in the studies in at least some years).
- Effects of film-related tourism (which would likely not result in significant changes in net benefits in most years). [Emphases in original][65]

This led the LAO to conclude the following:

> *While the total effects of these issues are impossible to quantify, their combined effects are likely to be negative in any given fiscal year—that is, resulting in the net benefit of the credit program being less than shown in both the LAEDC and UCLA-IRLE studies. . . . [W]e believe it is likely that the state and local tax revenue return would be under $1.00 for every tax credit dollar—perhaps well under $1.00 for every tax credit dollar in many years. In any event, even if the combined state and local tax revenue return is right around $1.00 for every tax credit dollar, the state government's tax revenue return would by definition be less than $1.00 for every tax credit dollar. The credit program, therefore, appears to result in a net decline in state revenues.*[66]

This would not be unusual for state film credits. A December 2010 Center on Budget and Policy Priorities study conducted a literature review of state film incentive studies and found that Arizona, Connecticut, Louisiana, Massachusetts, Michigan and Pennsylvania all lost money on their film subsidy programs, as the economic activity induced by these programs generated merely $0.07 – $0.28 in revenue for every $1.00 spent on the film incentives.[67]

It is certainly true that California is losing film and television industry jobs to states offering even more generous tax incentives. The *Los Angeles Times* reported that just 8 percent of new one-hour network television dramas (two out of 23) are based in Los Angeles this year, down from 50 percent in 2010 and 79 percent in 2005.[68] A July 2010 Milken Institute study estimated that between 1997 and 2008 California lost more than 36,000 film industry jobs and $4.2 billion in

related economic output.[69] This is largely due to the phenomenon known as "runaway production," whereby film and television productions leave the state to locate in states that offer greater benefits.

The vast majority of states are now in on the film credit game.[70] In all, 44 states plus the District of Columbia and Puerto Rico now offer tax incentives for film and television production.[71] Many of these are even more generous than California's program. Louisiana issued $180 million in film tax credits for movie projects alone during fiscal year 2010–11,[72] and New York allocates a whopping $420 million.[73] One state to buck the trend was Iowa, which ended its film incentives program. As a *Wall Street Journal* article relates, "Iowa suspended its incentives after filmmakers were caught in 2009 siphoning cash from the program and charging the state's taxpayers for personal items, including a Range Rover and an iPod. Several people involved were convicted of fraud this year, and the tax breaks haven't been reinstated."[74]

Supporters of the California Film Credit argue that the incentives are needed because the film industry is important to California. While this has historically been true, must it be true for all time, and must taxpayers bribe the industry to keep it this way? The film industry has been a significant component of the state's economy in the past, but as the current trend indicates, it might not be as significant in the future.

Proponents of the film incentives point to the "arms race" among various states to attract film and television productions, and claim that California must "keep up with the Joneses." But this ignores a couple of the points made in the LAO analysis. First, even when productions are filmed in other states it oftentimes generates some economic activity within California nonetheless. As the LAO report explains,

> *Often when a production is made elsewhere, various specialized personnel are brought into those jurisdictions from California, and some categories of work on the project may occur in California even if principal production occurs elsewhere. These types of activities result in direct and indirect expenditures by production participants in the California economy. Thus, even when a production is outside California, some economic activity continues to be generated here.*[75]

Second, the pro-film credit arguments ignore the "crowding out" effect of the credits, in which film staff and industry infrastructure are drawn into productions utilizing film incentives and are thus not available for other productions. In other words, "the films encouraged to remain in California by the credit tie up some workers and facilities that otherwise would be used in other productions. This could defer, reduce, or eliminate altogether the opportunity for those other productions to film here in California."[76]

Moreover, politicians tempted to follow the example of other states should recall the sage parental lesson from their youth: "If your friends jump off a bridge then will you jump too?" If other states wish to subsidize the entertainment industry—or any other industry—then let them, even if it means some film and television jobs end up moving out of state. If California were to eliminate

targeted tax credits like the Film Credit, and instead lower tax rates across the board, many more jobs from many other industries would more than make up for the loss.

Alas, California does not seem to have learned its lesson. In 2011, Governor Jerry Brown signed a one-year, $100 million extension of the tax credit. And on the final day of the 2012 legislative session, the legislature passed another extension for an additional two years and $200 million, which Gov. Brown also signed.

2. Motion Picture Production Services (Sales and Use Tax)

Department of Finance description: Transfers of any qualified motion picture or any interest or rights therein prior to the date that the qualified motion picture is exhibited or broadcast to its general audience and the performance of qualified motion picture production services are not subject to tax.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

3. Teleproduction and Post Production Equipment (Sales and Use Tax)

Estimated Cost (FY 2012–13): $14 million

Department of Finance description: Sales of teleproduction and post production equipment to businesses primarily engaged in teleproduction and post production activities are exempt from the 5 percent state sales and use tax when that property is used 50 percent or more in those activities.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

D. Energy

1. Alternative Energy (Sales and Use Tax)

Estimated Cost (FY 2012–13): $13 million

Department of Finance description: Authorizes the California and Advanced Transportation Financing Authority to approve a sales and use tax exemption on the purchase of tangible personal property that is used for the design, manufacture, production or assembly of advanced transportation technologies or alternative energy products.

Comment: Alternative, or "green," energy is a favorite cause of state politicians, particularly majority-party Democratic legislators. But of all the "investments" that politicians make in private businesses through tax breaks, loan guarantees or direct subsidies, perhaps none are more risky—or, arguably, more wasteful—than those for alternative energy companies. The federal government has become notorious for its investments in alternative energy companies that went on to become bankrupt and lose significant amounts of taxpayer money. Solyndra is the most well-known

example, in which the company lost $528 million of $535 million in loan guarantees when it filed for bankruptcy,[77] but there are many others. Electric-car battery manufacturer Ener1 Inc. lost the $55 million it had received of a $118 million grant from the U.S. Energy Department when it went belly-up,[78] energy storage company Beacon Power Corp. owed $39.1 million on a government-backed loan when it declared bankruptcy,[79] solar panel maker Evergreen Solar Inc. lost $5.3 million of federal stimulus money (through a state grant) when it was forced to close its doors,[80] and Abound Solar, another solar panel manufacturer, lost $70 million before its credit line to $400 million in loan guarantees was cut off.[81]

Such failures do not only impact the federal government, however. As noted previously, the Solyndra bankruptcy also left California taxpayers on the hook for an additional $25 million in state sales tax exemptions, which the company used to buy equipment before it ceased operations.[82] In California, alternative energy "investments" are made by the California Alternative Energy and Advanced Transport Financing Authority (CAEATFA). The Authority finances tax breaks in the form of sales and use tax exclusions to alternative energy firms in fields such as:

- Electric vehicle manufacturing,
- Solar photovoltaic manufacturing,
- Landfill gas capture and production,
- Biogas capture and production (dairies and wastewater treatment plants),
- Demonstration hydrogen fuel production,
- Electric vehicle battery manufacturing, and
- Biomass processing and fuel production.[83]

CAEATFA was established by SB 71 (Padilla) and signed into law by then-Governor Arnold Schwarzenegger on March 24, 2010. Between November 2010 and August 1, 2012, CAEATFA approved financing plans for 45 alternative energy projects. These projects are expected to amass a total of $147 million in sales and use tax exemptions, $41 million of which has already been incurred. The largest award went to Solyndra, for which CAEATFA authorized nearly $35 million in sales and use tax exemptions. More than $25 million of that amount was used before the company infamously filed for Chapter 11 bankruptcy protection. Other top beneficiaries of the SB 71 tax exclusion program include Tesla Motors, Inc. (with anticipated sales and use tax exclusions of $23.7 million), CE Obsidian Energy, LLC ($14.1 million), Nanosolar Inc. ($12.8 million), Stion Corp. ($9.6 million) and Soitec Solar Industries LLC ($8.5 million).[84]

Embarrassment over the Solyndra failure briefly caused State Treasurer Bill Lockyer, head of CAEATFA, to consider suspending the alternative energy program. "In light of recent events," said Lockyer, "we owe it to the taxpayers to see if there is more we can do to make sure we don't give their money to companies headed for a fall or companies that take California's money and run to other states to create jobs."[85] CAEATFA's work would go on undeterred, however, ensuring a high probability of more Solyndras in the future.

2. Diesel Fuel Used in Farming and Processing (Sales and Use Tax) *Estimated Cost (FY 2012–13):* $35 million

Department of Finance description: Sales of diesel fuel are exempt from the 5 percent state sales and use tax when that fuel is consumed during the activities of a farming or food processing business. Farming business includes transporting farm products to the marketplace. (This tax break is also included in the "Agriculture" section below.)

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

3. Fuel Sold to Common Carriers (Sales and Use Tax) *Estimated Cost (FY 2012–13):* $96 million

Department of Finance description: Sales of fuel and petroleum products to air common carriers for international flights are exempt from tax.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

4. Water Common Carriers (Sales and Use Tax) *Estimated Cost (FY 2012–13):* $44 million

Department of Finance description: The sale of fuel and petroleum products is exempt when sold to a water common carrier for immediate shipment outside this state.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

5. Aircraft Jet Fuel Used by Common Carriers (Fuel Tax)

Department of Finance description: Air common carriers engaged in the business of transporting persons or property for compensation under certification of public necessity by the state, national, or any foreign government, persons engaged in the business of constructing or reconstructing aircraft, and the United States armed forces are exempt from the tax on aircraft jet fuel. (This tax break is also included in the "Aircraft" section below.)

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

6. Fuel Used by Transit Districts and Schools (Fuel Tax)

Department of Finance description: Diesel fuel purchased by certain public transit agencies, school districts and common carriers is taxed at a reduced rate of one cent per gallon.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

E. Print Media

1. Periodicals (Sales and Use Tax)

Department of Finance description: Sales of periodicals that appear at stated intervals of at least four times per year but not more than 60 times per year, and their ingredient and component parts are exempt from the sales and use taxes when the periodical is sold by subscription and delivered by mail or common carrier.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

2. Printed Advertising (Sales and Use Tax)

Department of Finance description: Sales of printed material that is substantially advertisements for goods and services are exempt from tax if the material is (1) printed to the special order of the purchaser, (2) mailed or delivered by the seller, the seller's agent, or a mailing house, and (3) delivered to another person at no cost to that person.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

F. Aircraft

1. Aircraft and Component Part Sales (Sales and Use Tax)

Department of Finance description: The sale of aircraft and component parts to common carriers, foreign governments or nonresidents is not subject to tax.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

2. Aircraft Jet Fuel Used by Common Carriers (Fuel Tax)

Department of Finance description: Air common carriers engaged in the business of transporting persons or property for compensation under certification of public necessity by the state, national or any foreign government, persons engaged in the business of constructing or reconstructing aircraft, and the United States armed forces are exempt from the tax on aircraft jet fuel. (This tax break is also included in the "Energy" section above.)

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

G. Agriculture

1. Farm Equipment and Machinery (Sales and Use Tax)

Estimated Cost (FY 2012–13): $102 million

Department of Finance description: Sales of farm equipment, machinery, and their parts are exempt from the 5 percent state sales and use tax when sold to qualified persons engaged in the business of producing and harvesting agricultural products.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

2. Diesel Fuel Used in Farming and Processing (Sales and Use Tax)

Department of Finance description: Sales of diesel fuel are exempt from the 5 percent state sales and use tax when that fuel is consumed during the activities of a farming or food processing business. Farming business includes transporting farm products to the marketplace. (This tax break is also included in the "Energy" section above.)

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

H. Minerals, Timber and Other Resources

1. Percentage Depletion of Mineral and Other Resources (Corporation Tax)

Estimated Cost (FY 2012–13): $27 million

Department of Finance description: Taxpayers may deduct a fixed percentage of gross income for resource depletion, which is generally more than the deduction that would be allowed under the normal cost-depletion method. The percentage depends upon the type of resource, and the depletion allowance cannot be more than 50 percent of the taxpayer's related net income prior to the depletion deduction, or more than 100 percent for oil and gas properties.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

2. Expensing of Timber Growing Costs (Corporation Tax)

Estimated Cost (FY 2012–13): $8 million

Department of Finance description: Expenses of growing timber fall into three categories. Some must be capitalized and recovered through cost depletion as the timber is cut. Some are fully deductible. Others may be used only to offset the proceeds of sale.

- *Capitalized costs:* Preparation of the site including brush removal, cost of seedlings, and labor and tool expense, including depreciation of equipment used in planting, are capital expenditures and are added to the basis of the timber. These costs are recovered under cost depletion as the timber is cut.

- *Fully deductible:* Expenditures incurred for silvicultural practices, such as weeding, cleaning or noncommercial thinning, are currently deductible business expenses. Reforestation expenses (on property located in California) of up to $10,000 on any one timber property may be expensed in any year, and the balance of reforestation expenses above this amount may be amortized for 84 months.
- *Offset proceeds of sale:* The cost of land improvements, such as road grading, ditching and firebreaks, are capitalized into the basis of the land; they are not added to the basis of the timber and are recovered as an offset against the sales proceeds when the land is sold. Expenses related to the sale of the timber must be offset against the sales proceeds.

Comment: This tax break disproportionately benefits a single industry or sector of the state's economy.

I. (Dis)Honorable Mentions

1. Enterprise Zones and Similar Areas (Corporation Tax)

Estimated Cost (FY 2012–13): $600 million

Department of Finance description: Several tax incentives are available for certain types of expenditures or income earned in economically depressed areas of the state. These include areas designated as Enterprise Zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs) and Manufacturing Enhancement Areas (MEAs).

(1) Employers in these areas may be allowed a credit for a portion of the wages paid to qualified individuals.

(2) Employers may be eligible for a credit for the amount of sales and use taxes paid on certain purchases of machinery or parts.

(3) Employees in these designated areas may be eligible for an income tax credit of 5 percent of their qualified wages.

(4) Taxpayers may exclude the net interest from certain investments or loans to businesses in economically distressed areas.

(5) Businesses in designated areas are allowed to expense part of the costs of business equipment beyond normal expensing limits.

Comment: The Enterprise Zones and Similar Areas credit is more broad-based than the narrowly targeted tax breaks above, but while the idea of lowering taxes to encourage economic growth is sound and would benefit the economy, why not just make the entire state of California an enterprise zone and really kick-start the economy?

2. Sales to Government Agencies (Cigarette and Tobacco Products Tax)

Estimated Cost (FY 2012–13): $2 million General Fund + $13 million special fund

Department of Finance description: Sales of cigarettes and tobacco products by or through the United States military exchanges, commissaries, ship's stores, or the United States Veterans' Administration are not subject to the cigarette tax. Deliveries of cigarettes or tobacco products to a veterans' home of this state or a hospital or domiciliary facility of the United States Veterans' Administration for the use of the veterans are also not subject to tax.

Comment: It is unclear what the purpose of this tax break is, since it appears to already be required under federal law. According to the Department of Finance's *Tax Expenditure Report 2011–12*, "The exemption for sales by or through military installations will sunset on the first calendar day beginning more than 60 days after federal law is changed to allow state taxation of military sales."[86]

Part 5

Conclusions and Recommendations

While targeted tax breaks might seem compelling as a means to attract and retain business in an increasingly competitive global economy, they clearly come with risks. Notwithstanding the fact that even fiscal conservatives may be seduced into supporting them—even based on legitimate desires for economic growth—they should be avoided because their distortionary effects on the state's economy are harmful. Crony capitalism that benefits a few undermines the free-market capitalism that benefits the many.

Policymakers must be aware that when they implement policies that favor certain businesses or industries—through the tax code, state spending programs, or regulation—they are necessarily harming other industries. Moreover, in doing so, they diminish economic activity by redirecting capital away from the purposes taxpayers and investors prefer toward less efficient ends based on their own preferences. Besides, the "important" industries of today may not be the important industries of tomorrow.

Of course, special-interest politics tends to play a huge role in tax policy. Government is a poor venture capitalist precisely because the incentives and decision-making involved in spending someone else's money are very different from those involved in spending one's own money. Failures such as Solyndra are testament to this hubris.

To be clear: tax cuts are much needed in California's high-tax, high-regulatory business climate and tax rates should be lowered as much as possible, but the rules should be applied evenly, rather than carving out special benefits for some. As the Franchise Tax Board has noted, the corporate tax rate could be reduced 14 percent without any budgetary impact just by getting rid of the Research and Development Credit. Additionally eliminating other corporate tax breaks—including the Accelerated Depreciation of Research and Experimental Costs, Double-Weighted Sales Factor, Film Credit, Low-Income Housing Credit, Hiring Credit, Percentage Depletion of Mineral and Other Natural Resources, and Expensing of Timber Growing Costs breaks—would allow the state to reduce the overall corporate tax rate by 20 percent or more. Sales and use taxes could similarly be reduced by eliminating tax breaks narrowly targeted to certain industries.

In order to reduce the taxation burden on California taxpayers and increase the fairness and sanity of the state's tax codes, policymakers should implement the following reforms.

Recommendations

1. Eliminate special tax treatment wherever possible, particularly in cases where:
   a) The tax break's purpose is not clearly defined,
   b) The tax break is not serving its intended purpose or has outlived its intended purpose,
   c) The tax break is narrowly tailored to benefit a specific industry or type of business, or
   d) The tax break is clearly an example of the government picking winners or losers for ideological or special-interest reasons.
2. Wherever possible, lower broad tax rates down to tax break levels, rather than raise tax break levels up to broad tax rates.
3. Require a clear statement of purpose and performance measures for each tax break—including existing tax breaks without a clear statement of purpose or relevant performance measures—in order to facilitate evaluations of the impact of tax breaks on taxpayers and the state budget.
4. Eschew static analysis of state tax breaks and return to dynamic analysis of their effects on taxpayers and the state budget.
5. Establish a sunset commission to periodically evaluate tax breaks and other state regulations. A citizen's commission would aid the legislative sunset commission similar to the state of Washington model. Adopt legislation requiring that both existing and future tax breaks must be evaluated every 5 or 10 years. Tax breaks not acted upon within this period would automatically be repealed.
6. Adopt a BRAC-style commission to evaluate existing tax breaks and regulations. The two-thirds supermajority makes it difficult enough to repeal existing tax breaks. This, coupled with the logrolling behavior ("I'll support your tax break if you'll support mine) and the pork-barrel politics (whereby elected officials try to obtain special benefits from the government to bring money into their districts) that occurs in legislative bodies, makes it nearly impossible to eliminate tax breaks. To alleviate the logrolling and pork-barrel problems, the state should establish a commission modeled after the Base Realignment and Closure (BRAC) Commission that has been used at the federal level to divest military bases determined to be unnecessary (yet politically popular with elected officials). Under such a process, an independent panel of taxpayers, perhaps with additional representatives from the Franchise Tax Board, State Board of Equalization and Legislative Analyst's Office, would be appointed to evaluate and recommend tax breaks for elimination. The recommendations, once approved by the governor, would be submitted to the legislature, which would not be allowed to make any amendments and could only vote up or down on the entire package. A simple majority of both houses would be required to approve the recommendations.

Appendix A

Appendix A: California Tax Credits and Exemptions Available

Tax Credit	Description	Statutory Authority
Personal Income Tax		
Home Mortgage Interest Deduction	Taxpayers may generally deduct a limited amount of interest paid or accrued within the taxable year for acquiring, constructing, substantially improving or refinancing their principal and one other residence.	Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 163
Exclusion of Employer Pension Contributions	Employer contributions to qualified retirement plans are generally excluded from employees' income, subject to annual limits.	Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Section 401
Exclusion of Employer Contributions to Health Plans	Contributions by employers to provide accident and health benefits are excluded from the income of employees.	Revenue and Taxation Code Section 17131 in conformity with Internal Revenue Code Section 106
Basis Step-Up on Inherited Property	The basis of property acquired by bequest or inheritance is the fair market value at the date of death. Therefore, appreciation that occurred prior to the death is not taxed.	Revenue and Taxation Code Sections 18031, 18035.6, 18036.6 in conformity with Internal Revenue Code Section 1014
Exclusion of Social Security Benefits	Social Security and federal railroad retirement benefits are not subject to tax.	Revenue and Taxation Code Section 17087
Real Estate, Personal Property and Other Taxes Deduction	Individual taxpayers may deduct certain taxes as an itemized deduction. This includes property taxes, personal property taxes including vehicle license fees, one-half of self-employment taxes and other state, local and foreign taxes relating to a trade or business or property held for the production of income.	Revenue and Taxation Code Sections 17201, 17220, 17222, which conform to Internal Revenue Code Section 164
Charitable Contribution Deduction	A deduction is allowed for cash or certain non-cash contributions to qualifying nonprofit or governmental entities. For personal income taxpayers, the deduction is only available to those who itemize their deductions. The deduction amount is limited depending upon the type of contribution and recipient, but in no case may exceed 50 percent of adjusted gross income. For corporate taxpayers, the limit is 10 percent of taxable income. Contributions in excess of these amounts may be carried forward for up to five years.	Revenue and Taxation Code Sections 17201, 17275.5, 24357-24359.1 in conformity with Internal Revenue Code Section 170
Employee Business and Miscellaneous Expense Deduction	Certain unreimbursed employee expenses, expenses of producing income and other qualifying expenses may be deducted as a miscellaneous itemized deduction. Amounts for meals and entertainment are limited to 50 percent of the expense. The deduction is limited; only the amount in excess of 2 percent of the taxpayer's federal adjusted gross income may be deducted.	Revenue and Taxation Code Sections 17072, 17076, 17201, which generally conform to Internal Revenue Code Sections 62(a), 67, 68, 162, 274
Exclusion of Benefits Provided Under Cafeteria Plans	The value of benefits received from an employer-sponsored cafeteria plan is not subject to tax. Cafeteria plans allow employees to choose between monetary compensation and qualified benefits, such as health insurance, life insurance, and dependent care benefits. If monetary compensation rather than benefits is selected, the amount is subject to tax.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 125
Exclusion of Investment Income on Life Insurance and Annuity Contracts	The proceeds of a life insurance policy of a deceased person are generally excluded from the income of the beneficiary. Amounts received from a "living benefits" contract are also excluded from income, as are certain survivor benefits paid as an annuity to the beneficiary of a public safety officer killed in the line of duty.	Revenue and Taxation Code Sections 17131, 17132.5, 24302, and 24305, which conform to Internal Revenue Code Section 101

Tax Credit	Description	Statutory Authority
Exclusion of Capital Gains on Sale of a Principal Residence	An individual may exclude up to $250,000 of gain realized on the sale of a principal residence. For joint returns, the exclusion is $500,000.	Revenue and Taxation Code Section 17131 and 17152 in conformity with Internal Revenue Code Section 121
Head-of-Household and Qualifying Widow(er) Status	Individuals who provide a home for a qualifying relative are eligible for lower tax rates than are available for single persons or a married person filing separately. A qualifying widow(er) may claim a larger personal exemption in addition to the lower tax rates provided to heads-of-households. A qualifying widow(er) is an individual whose spouse died within the two prior years and has not remarried, and who provides the main home for an eligible dependent.	Revenue and Taxation Code Section 18521, which is in partial conformity with Internal Revenue Code Section 2
Exclusion of Unemployment Insurance Benefits	Benefits received from the state's unemployment insurance program are excluded from income for tax purposes. For privately provided unemployment compensation, benefits up to the amount of prior contributions are not taxable, but benefits in excess of this amount are taxable.	Revenue and Taxation Code Section 17083
Contributions to Self-Employed Retirement Plans	Self-employed persons are allowed a limited deduction when computing adjusted gross income for contributions to a self-employed retirement plan. Income generated by these contributions is also excluded from taxation until the assets are withdrawn.	Revenue and Taxation Code Sections 17501, 17504, 17506, and 17507, which generally conform to Internal Revenue Code Sections 219, 401-404, 408, and 415
Medical and Dental Expenses Deduction	Taxpayers may take an itemized deduction for qualified medical and dental expenses incurred on behalf of the taxpayer, the taxpayer's spouse and/or the taxpayer's dependents. Only unreimbursed expenditures that exceed 7.5 percent of federal adjusted gross income are deductible.	Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 213
Contributions to IRAs Deduction	Taxpayers who receive compensation that is included in gross income and who are under 70-1/2 years of age may be allowed a deduction in computing adjusted gross income for contributions to their Individual Retirement Account (IRA). Earnings in IRAs are excluded from income until they are distributed to the taxpayer.	Revenue and Taxation Code Sections 17201, 17203, 17501, 17504-09, 17551, 17563.5 in conformity to Internal Revenue Code Section 219
Exclusion of Miscellaneous Fringe Benefits	Certain fringe benefits are excluded from the income of the employees who receive them. This includes free special services such as free stand-by flights provided to airline employees, employee discounts for the purchase of company products, use of company equipment such as a company car, and "de minimis" fringe benefits such as the use of a work-site gym.	Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 132
Exemption for Senior Citizens	Individuals over the age of 65 are eligible for an additional personal exemption credit.	Revenue and Taxation Code Sections 17054 and 17054.1
Renters' Credit	Low-income individuals who rent their principal residence are eligible for a credit of $60 if they are single, or $120 if married filing jointly or a head of household. In order to be eligible, the taxpayer's income cannot exceed specified levels.	Revenue and Taxation Code Section 17053.5
Deduction of Health Insurance Paid by Self-Employed	Self-employed individuals are allowed to deduct the cost of premiums paid for health insurance for themselves and their families. The deduction is limited to the taxpayer's net income earned from the trade or business for which the plan was established. This deduction can be taken regardless of whether the taxpayer itemizes his or her deductions.	Revenue and Taxation Code Sections 17201, 17203, 17273, which generally conform to Internal Revenue Code Section 162
Exclusion of Transportation-Related Fringe Benefits	Employees are allowed to exclude qualified compensation for employer-provided transportation benefits from income. These benefits include up to a specified amount for parking, transit passes and ridesharing programs. The exclusion is limited to the fair market value of the benefits received.	Revenue and Taxation Code Sections17090 and 17149, which generally conform to Internal Revenue Code Section 132
Child and Dependent Care Credit	A credit is allowed for a portion of qualifying child or dependent care expenses paid for the purpose of allowing the taxpayer to be gainfully employed. The credit is a percentage of a parallel federal credit. The percentage decreases as income increases and is eliminated for taxpayers with AGI greater than $100,000. Chapter 14, Statutes of 2011 (SB 86) repealed the refundable portion of the Child and Dependent Care credit, effective January 1, 2011.	Revenue and Taxation Code Section 17052.6, which generally conforms to Internal Revenue Code Section 21
Exclusion of Nonresident Military Pay	The military compensation of a person who is not domiciled or taxable in California, but attributable to a resident spouse because of community property laws is exempt from tax.	Revenue and Taxation Code Sections 17140.5
Exclusion of Scholarship/ Fellowship Income	Individuals may exclude from income any qualifying scholarships, fellowships, and tuition grants or reductions they receive that are used for qualified educational expenses.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 117
Exclusion of Employer Contributions to Life Insurance	An employer's contribution to an employee's group term life insurance policy is exempted from the employee's gross income for the first $50,000 of coverage.	Revenue and Taxation Code Section 17081, which conforms to Internal Revenue Code Section 79

Tax Credit	Description	Statutory Authority
Exclusion of Compensation for Injuries or Sickness	Taxpayers may exclude from income the compensation received from workers' compensation, accident insurance, state disability insurance, and health insurance for injuries or illness. This also includes compensatory damages awarded in court settlements for injury or sickness, but not punitive damages. Also, employer reimbursement for expenses incurred for the care of an employee, an employee's spouse or dependents is excluded from tax.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 104
Exclusion of Employee Child Care Benefits	Employees may exclude the amount of child and dependent care benefits received through an employer-sponsored payroll deduction program. The exclusion is the lesser of $5,000 per year, the amount of the taxpayer's earned income, or the amount of the taxpayer's spouse's earned income.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 129
Exclusion of Meals and Lodging Furnished by Employers	The value of meals and lodging furnished by non-military employers to an employee, spouse or dependent is excluded from the income of the employee. The meals and lodging must be provided at the employer's place of business, for the convenience of the employer and a precondition for employment.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 119
Exclusion of State Lottery Winnings	Winnings from the California State Lottery are exempt from tax.	Government Code Section 8880.68
Exclusion for Cancellation of Mortgage Debt	Income from the cancellation of debt (COD) arising from the discharge of a loan for the acquisition, construction, or substantial improvement of the principal residence of an individual taxpayer is generally included in gross income. This provision allows taxpayers to exclude from gross income discharge of a loan from an acquisition debt up to: (a) $250,000 ($125,000 for married filing separate) for discharges that occurred in 2007 and 2008, and (b) $500,000 ($250,000 for married filing separate) for discharges that occur in years 2009 through 2012. The maximum amount of the loan eligible for exclusion is $800,000 ($400,000 married filing separate), and the exclusion is phased-out for discharged loans exceeding those amounts. The COD must occur on or after January 1, 2007 and before January 1, 2013.	Revenue and Taxation Code Section 17144.5, which generally conforms to Section 108 of the Internal Revenue Code
Exclusion of Employer-Provided Educational Assistance	Individuals may exclude from income up to $5,250 of qualified educational assistance contributions made by their employer.	Revenue and Taxation Code Section 17151, which partially conforms to Internal Revenue Code Section 127
Student Loan Interest Deduction	Taxpayers may deduct interest paid on qualified education loans up to a maximum amount. This deduction is phased out for taxpayers above a specified income level.	Revenue and Taxation Code Section 17204, which conforms to Internal Revenue Code Section 221
Exclusion of Housing for Clergy	The rental value of a minister's dwelling is exempt from tax. Also, state-employed members of the clergy may allocate up to 50 percent of their gross salary to either the rental value of a home furnished to them or to the rental allowance paid to them to rent a home.	Revenue and Taxation Code Sections 17131 and 17131.6, which partially conform to Internal Revenue Code Section 107
Medical Savings Account	This provision allows taxpayers to deduct from income contributions made to Medical Savings Accounts (MSAs). In addition, any earnings accumulated in the MSAs are tax-free, if used for qualified medical expenses. Contributions include those from both employers and employees. In general, employer or employee contributions are limited to 65 percent of the annual health insurance deductible for taxpayers with individual insurance coverage and to 75 percent with family coverage. Contributions to and earnings from this account may be withdrawn for medical purposes without penalty or tax. Other withdrawals may be subject to tax as well as penalty.	Revenue and Taxation Code Section 17215, which generally conforms to Internal Revenue Code Section 220.
Housing Credit 2009 New Home Credit	Under the Personal Income Tax Law, a taxpayer is allowed a tax credit equal to the lesser of $10,000 or 5 percent of the purchase price for qualified purchases. In 2009, the credit applied to new-home purchases only. It was available for purchases made on or after March 1, 2009, and before March 1, 2010. The tax credit was capped at $100 million, and this limit was reached on August 31, 2009. The credit must be claimed in equal amounts over three tax years. Unused credits may not be carried forward.	Revenue and Taxation Code Section 17059
Exclusion of Foster Care Payments	Payments received from state and local governments, as well as tax-exempt foster care placement agencies, as reimbursements for the costs of caring for a foster child are excluded from income. The foster child must live in the taxpayer's home for the exclusion to apply.	Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 131
Exclusion of Income Earned on Section 529 (Scholarshare) Plans	Individuals may exclude earnings of Section 529 educational savings accounts (such as California's Scholarshare program) from income, provided that, upon withdrawal, the money from the accounts is used for qualified educational expenses.	Revenue and Taxation Code Section 17140, which conforms to Internal Revenue Code Section 529

Tax Credit	Description	Statutory Authority
Casualty Loss Deduction	Taxpayers may deduct from gross income qualified casualty losses for which they were not compensated by insurance or other means. Casualty losses are losses caused by sudden, unexpected, or unusual events, such as floods, fires, storms, earthquakes, vandalism, theft, etc. Casualty losses are limited to losses that are greater than $100 per loss and where the sum of all casualty losses during a year is greater than 10 percent of federal adjusted gross income.	Revenue and Taxation Code Sections 17131, 17207, and 24347.5, which generally conform to Internal Revenue Code Section 165
Moving Expense Deduction	An above-the-line deduction is allowed for certain unreimbursed moving expenses that are required to start a new job. The deduction is limited to the cost of transportation of household goods and personal effects, and travel (including lodging, but not meals) to the new residence.	Revenue and Taxation Code Sections 17072 and 17076, which conform to Internal Revenue Code Section 217
Exclusion of Capital Gains on Small Business Stock	Fifty percent of the gain from the sale of qualified small business stock that is held for at least five years is excluded from income. For married couples, the exclusion is limited to $10 million or ten times the stock's basis. The limit for single persons is less.	Revenue and Taxation Code Section 18152.5, which partially conforms to Internal Revenue Code Section 1202
Housing Credit 2010 First Time, and New Home Credits	Under the Personal Income Tax Law, a taxpayer is allowed a tax credit equal to the lesser of $10,000 or 5 percent of the purchase price for qualified purchases of single-family residences. The credit must be claimed in equal amounts over three tax years. Unused credits may not be carried forward. In 2010, two credits are available: One for new-home purchases and one for first-time home buyers. The credits apply to purchases made on or after May 1, 2010, and before August 1, 2011. The new-home purchase credit can only be used for enforceable contracts executed on or before December 31, 2010. The credits are capped at $100 million each.	Revenue and Taxation Code Section 17059.1
Limited Partnerships Investment Source Rules	The dividends, interest or gains and losses from qualified investment securities of members of limited partnerships are exempted from taxation if the members reside outside California, and their only contact with this state is through a security dealer, broker or an investment advisor located in this state.	Revenue and Taxation Code Section 17955
Exclusion of Earnings on Coverdell Education Savings Accounts	Allows taxpayers to exclude from income earnings in Coverdell Education Savings Accounts, if these earnings are spent on qualified educational expenses.	Revenue and Taxation Code Section 23712, which conforms to Internal Revenue Code Section 530
Dependent Exemption in Excess of Personal Exemption	A nonrefundable personal exemption credit is allowed for all taxpayers and their dependents. The exemption credit for dependents is over three times greater than the exemption allowed for the taxpayer or their spouse. A temporary reduction of the dependent credit to the level of the personal credit was instituted for the 2009 and 2010 tax years.	Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733
Corporation Tax		
Research and Development Credit	Businesses are allowed a credit for increased research expenditures over a four-year base period.	Revenue and Taxation Code Sections 17052.12 and 23609 in partial conformity with Internal Revenue Code Section 41
Enterprise Zones and Similar Areas	Several tax incentives are available for certain types of expenditures or income earned in economically depressed areas of the state. These include areas designated as Enterprise Zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs), and Manufacturing Enhancement Areas (MEAs). (1) Employers in these areas may be allowed a credit for a portion of the wages paid to qualified individuals. (2) Employers may be eligible for a credit for the amount of sales and use taxes paid on certain purchases of machinery or parts. (3) Employees in these designated areas may be eligible for an income tax credit of 5 percent of their qualified wages. (4) Taxpayers may exclude the net interest from certain investments or loans to businesses in economically distressed areas. (5) Businesses in designated areas are allowed to expense part of the costs of business equipment beyond normal expensing limits.	Chapter 12.8 of the Government Code and Revenue and Taxation Code Sections 17053.33 17053.34, 17053.45, 17053.46, 17053.47, 17053.7, 17053.74, 17053.75, 17268, 17276.2, 23612.2, 23622.7, 23622.8, 23633, 23634, 23645, 23646
Water's Edge Election	Unitary multinational corporations are allowed the option of computing the income attributable to California on the basis of a water's-edge (domestic) combined report, as opposed to a worldwide combined report. Under the water's edge provision, a business may elect to compute its California tax by reference to only the income and factors of a limited number of entities. In general, these entities include United States incorporated entities, the United States activities of foreign incorporated entities, and the activities of various foreign entities that are included in the federal consolidated return. The election is generally for a seven-year period.	Revenue and Taxation Code Sections 25110-25113

Tax Credit	Description	Statutory Authority
Subchapter S Corporations	Corporations that meet specified criteria are allowed to elect Subchapter S corporation status for tax purposes. S corporations pay tax on corporate income at a reduced rate of 1.5 percent, except for financial institutions, which are subject to a 3.5 percent rate. S corporations are not subject to the Alternative Minimum Tax but are subject to the applicable corporate minimum tax. Individual shareholders of an S corporation pay personal income taxes on their pro rata share of corporate income.	Revenue and Taxation Code Sections 17087.5, 18006, and 23800-23813, which partially conform to Internal Revenue Code Sections 1361-1379
Accelerated Depreciation of Research and Experimental Costs	Research and experimental expenditures may be deducted currently, or may be amortized over a 60-month period at the election of the taxpayer.	Revenue and Taxation Code Sections 17201 and 24365, which conform to Internal Revenue Code Sections 59 and 174
Double-Weighted Sales Factor	Corporations with income derived from sources both within and outside California must apportion income using a formula that takes into account payroll, property and sales factors. Prior to January 1, 1993, California applied a three-factor formula in which the payroll, property and sales factors were equally weighted. After that date, California adopted a formula in which the sales factor is double-weighted. Corporations engaged in qualified agricultural, extractive and financial business activities are exempted from the double-weighted sales formula, and must continue using the equally weighted three-factor formula to apportion their worldwide income.	Revenue and Taxation Code Section 25128
Tax-Exempt Status for Qualifying Corporations	A minimum tax of $800 is generally imposed on corporations subject to the corporation franchise tax. However, corporations in their first year of business are generally not subject to the minimum tax.	Revenue and Taxation Code Section 23153
Like-Kind Exchanges	No gain or loss is recognized when business or investment property is exchanged solely for like-kind property. If, as part of the exchange, other (not like-kind) property or money is received, gain is recognized to the extent of the other property and money received, but a loss is not recognized.	Revenue and Taxation Code sections 18031 and 24941, which conform to Internal Revenue Code section 1031
Employee Stock Ownership Plans (ESOP)	Employers that provide employee stock ownership plans are allowed a deduction for dividends paid to an ESOP, when those dividends are paid by the ESOP to participants or are used to retire ESOP debt. Also, capital gains on the sale of stock to an ESOP are deferred if the proceeds are used to acquire a similar type of security.	Revenue and Taxation Code Sections 18042 and 24601-24612, which generally conform to Internal Revenue Code Sections 401-424 and 1042
Low-Income Housing Credit	A tax credit is allowed for a portion of the costs of investing in qualified low-income rental housing. The aggregate amount of the credit is capped, and specific credits are allocated to applicants by the California Tax Credit Allocation Committee. Credits are allocated to developers who, in turn, sell them to investors in exchange for project funding. All projects receiving the California credit must also receive the parallel federal credit.	Revenue and Taxation Code Sections 17058 and 23610.5 in conformity with Internal Revenue Code Section 42
Hiring Credit	Provides that a qualified employer can take a credit against their tax of $3,000 for each increase in qualified full-time employees during the tax year. The total allowable credits for all tax years is $400 million.	Revenue and Taxation Code Sections 17053.80 and 23623
Percentage Depletion of Mineral and Other Resources	Taxpayers may deduct a fixed percentage of gross income for resource depletion, which is generally more than the deduction that would be allowed under the normal cost-depletion method. The percentage depends upon the type of resource, and the depletion allowance cannot be more than 50 percent of the taxpayer's related net income prior to the depletion deduction, or more than 100 percent for oil and gas properties.	Revenue and Taxation Code Sections 17681 and 24831
Expensing of Timber Growing Costs	Expenses of growing timber fall into three categories. Some must be capitalized and recovered through cost depletion as the timber is cut. Some are fully deductible. Others may be used only to offset the proceeds of sale. **A. Capitalized costs**– Preparation of the site including brush removal, cost of seedlings, and labor and tool expense, including depreciation of equipment used in planting, are capital expenditures and are added to the basis of the timber. These costs are recovered under cost depletion as the timber is cut. **B. Fully deductible** – Expenditures incurred for silvicultural practices, such as weeding, cleaning or noncommercial thinning, are currently deductible business expenses. Reforestation expenses (on property located in California) of up to $10,000 on any one timber property may be expensed in any year, and the balance of reforestation expenses above this amount may be amortized for 84 months. **C. Offset proceeds of sale** – The cost of land improvements, such as road grading, ditching and firebreaks, are capitalized into the basis of the land; they are not added to the basis of the timber and are recovered as an offset against the sales proceeds when the land is sold. Expenses related to the sale of the timber must be offset against the sales proceeds.	Revenue and Taxation Code Sections 17201, 17278.5, 17681, 24343, 24373.2, and 24831, which conform to Internal Revenue Code Sections 162, 194, and 611

Tax Credit	Description	Statutory Authority
Credit Union Treatment	Credit unions are exempt from state income and franchise taxes. Since credit unions are nonprofit, membership organizations, only their "nonmember" income (such as investment income on excess deposits or miscellaneous sources of income, such as ATM fees charged to nonmembers) would be taxed in the absence of this exemption.	Revenue and Taxation Code Section 23153
Single Sales Factor Election	An apportioning business that utilizes the four factor formula for allocating net income that includes property, payroll and sales, with sales being double weighted, is allowed to elect to allocate net income for California tax purposes based on a single factor, 100 percent sales, starting with tax years beginning on or after January 1, 2011.	Revenue and Taxation Code Sections 25128.5, 25135, and 25136
Film Credit	Provides a nonrefundable franchise or personal income tax credit to qualified taxpayers who produce a motion picture in California or relocate a television series or independent film to California. The credits are allocated and certified by the California Film Commission. The annual allocation of credits is capped at $100 million.	Revenue and Taxation Code Sections 17053.85 and 23685
Sales and Use Taxes		
Food	Sales of food for human consumption are not generally subject to the sales and use taxes. However, this exemption does not generally include hot prepared food, food sold and consumed at or on the seller's facility, or food sold for consumption where there is an admission charge.	Revenue and Taxation Code Section 6359
Gas, Electricity, and Water	Gas, electricity and water delivered through mains, lines or pipes are exempt from tax. Water sold in bulk quantities of 50 gallons or more and liquefied petroleum gas delivered for use in a residence are also exempt.	Revenue and Taxation Code Section 6353
Prescription Medications	Medicine that is prescribed for a human being and furnished by a registered pharmacist is exempt from tax. This exemption also includes such things as orthotic and prosthetic devices and parts.	Revenue and Taxation Code Sections 6369 and 6369.1
Candy, Confectionery, Snack Foods, Bottled Water	Candy, gum, confectionery, snack foods and bottled water are not subject to the sales and use taxes.	Revenue and Taxation Code Section 6359
Farm Equipment and Machinery	Sales of farm equipment, machinery and their parts are exempt from the 5 percent state sales and use tax when sold to qualified persons engaged in the business of producing and harvesting agricultural products.	Revenue and Taxation Code 6356.5
Fuel Sold to Common Carriers	Sales of fuel and petroleum products to air common carriers for international flights are exempt from tax.	Revenue and Taxation Code Section 6357.5
Rental of Linen Supplies	A person leasing linen supplies and similar articles who furnishes the recurring service of laundering or cleaning such linen supplies is the consumer of the property provided and tax applies to the purchase of the items.	Revenue and Taxation Code Section 6006 and 6010
Custom Computer Programs	The transfer of custom computer programs, other than a basic operational program, and separate charges for custom modifications to existing prewritten programs are excluded from the definition of "sale."	Revenue and Taxation Code 6010.9
Diesel Fuel Used in Farming and Processing	Sales of diesel fuel are exempt from the 5 percent state sales and use tax when that fuel is consumed during the activities of a farming or food processing business. Farming business includes transporting farm products to the marketplace.	Revenue and Taxation Code 6357.1
Water Common Carriers	The sale of fuel and petroleum products is exempt when sold to a water common carrier for immediate shipment outside this state.	Revenue and Taxation Code Section 6385
Teleproduction and Post Production Equipment	Sales of teleproduction and post production equipment to businesses primarily engaged in teleproduction and post production activities are exempt from the 5 percent state sales and use tax when that property is used 50 percent or more in those activities.	Revenue and Taxation Code Section 6378
Treatment of Vending Machine Sales	Sales through vending machines are subject to tax on 33 percent of the sales price. Also, vending machine operators are considered the consumer of food products sold below a specified price through a vending machine.	Revenue and Taxation Code Sections 6359.2 and 6359.4
Alternative Energy	Authorizes the California and Advanced Transportation Financing Authority to approve a sales and use tax exemption on the purchase of tangible personal property that is used for the design, manufacture, production or assembly of advanced transportation technologies or alternative energy products.	Public Resources Code Section 26003
Animal Life, Feed, Seeds, Plants, Fertilizer, Drugs, and Medicines	Sales of animals which are generally used for human food, as well as the feed and drugs used for those animals are exempt from tax. Also, seeds and plants that are normally used for human food and fertilizer for those plants are exempt from tax.	Revenue and Taxation Code Section 6358
Meals Furnished by Institutions	Meals furnished by institutions such as health facilities, residential care facilities for the elderly, drug treatment facilities, community care facilities and alcohol recovery facilities are not subject to tax.	Revenue and Taxation Code Section 6363.6
Aircraft and Component Parts Sales	The sale of aircraft and component parts to common carriers, foreign governments or nonresidents is not subject to tax.	Revenue and Taxation Code Section 6366
Leases of Motion Pictures and Television Films	Leases of motion pictures, animated motion pictures and television films and tapes are not considered sales. The lessor is considered the consumer of such tangible personal property it leases.	Revenue and Taxation Code Section 6006 and 6010

Tax Credit	Description	Statutory Authority
Motion Picture Production Services	Transfers of any qualified motion picture or any interest or rights therein prior to the date that the qualified motion picture is exhibited or broadcast to its general audience and the performance of qualified motion picture production services are not subject to tax.	Revenue and Taxation Code Section 6010.6
Periodicals	Sales of periodicals that appear at stated intervals of at least 4 times per year but not more than 60 times per year, and their ingredient and component parts are exempt from the sales and use taxes when the periodical is sold by subscription and delivered by mail or common carrier.	Revenue and Taxation Code Section 6362.7
Printed Advertising	Sales of printed material that is substantially advertisements for good and services are exempt from tax if the material is (1) printed to the special order of the purchaser, (2) mailed or delivered by the seller, the seller's agent, or a mailing house, and (3) delivered to another person at no cost to that person.	Revenue and Taxation Code 6379.5
Cigarette and Tobacco Tax		
Sales to Government Agencies	Sales of cigarettes and tobacco products by or through the United States military exchanges, commissaries, ship's stores, or the United States Veterans' Administration are not subject to the cigarette tax. Deliveries of cigarettes or tobacco products to a veterans' home of this state or a hospital or domiciliary facility of the United States Veterans' Administration for the use of the veterans are also not subject to tax.	Revenue and Taxation Code Sections 30102 and 30105.5
Fuel Taxes		
Aircraft Jet Fuel Used by Common Carriers	Air common carriers engaged in the business of transporting persons or property for compensation under certification of public necessity by the state, national or any foreign government, persons engaged in the business of constructing or reconstructing aircraft, and the United States armed forces are exempt from the tax on aircraft jet fuel.	Revenue and Taxation Code Section 7389
Fuel Used by Transit Districts and Schools	Diesel fuel purchased by certain public transit agencies, school districts and common carriers is taxed at a reduced rate of one cent per gallon.	Revenue and Taxation Code Sections 8655, 60039, and 60502.2
Property Tax		
Computer Programs	Computer programs other than basic operational programs that are necessary for the fundamental functioning of the computer are exempt from tax. The storage media for the programs are, however, taxable.	Revenue and Taxation Code 995
Fixtures Excluded from the Supplemental Roll	Fixtures that are valued as a separate appraisal unit from the structure on the property are exempt from supplemental property tax assessment. Fixtures are personal property such as equipment that are affixed to and incorporated into real property.	Revenue and Taxation Code Section 75.5

Source: State of California, Department of Finance, *Tax Expenditure Report 2011-12*.

Appendix B

Appendix B: California Film Tax Credits, FY 2009–10 to FY 2012–13

Production Title	Production Company	Production Type	Estimated Tax Credit
FY 2009-2010			
After the Fall	Robigo Limited	Movie of the Week	365,013.00
Amish Grace	Larry A. Thompson Organization, Inc.	Feature Film	314,602.00
Answers to Nothing	Answers to Nothing LLC	Feature Film	368,117.00
Backyard Wedding	Annaburg Limited	Movie of the Week	365,013.00
Bad Teacher	BET Networks	Feature Film	2,355,408.00
Beginners	Beginners Movie LLC	Feature Film	611,045.00
Beverly Hills Chihuahua 2	Tiny But Mighty Productions, Inc.	Feature Film	1,995,622.00
Burlesque	Screen Gems Productions, Inc.	Feature Film	7,225,306.00
Christmas in Beverly Hills	Fast Lane Productions, Inc.	Feature Film	972,565.00
Circle of Eight	Bronson Avenue II, LLC	Feature Film	405,674.00
The Class	Meditrina Limited	Movie of the Week	365,013.00
Dinner for Schmucks	DW Studios Productions LLC	Feature Film	6,285,821.00
Dirty Girl	D. Girl, Inc.	Feature Film	826,292.00
Farewell, Mr. Kringle	Camus Productions, Inc.	Movie of the Week	363,349.00
Faster	CBS Films Productions Inc.	Feature Film	3,816,242.00
Fred	Derf Fil, LLC	Feature Film	229,139.00
The Future	Leopold LLC	Feature Film	529,221.00
The Good Doctor	The Good Doctor LLC	Feature Film	1,162,233.00
Hero Factory	Threshold Animation Studios, Inc.	Movie of the Week	445,318.00
Hirokin	Hirokin Productions LLC	Feature Film	702,502.00
Honey II	MVF Productions, LLC	Feature Film	980,992.00
Important Things with Demetri Martin	Central Productions, LLC	Relocating TV Series	1,340,097.00
Jackass 3D /Jackass 3.5	Superstar Productions USA Inc.	Feature Film	2,037,776.00
Justified – Season 1	Woodridge Productions, Inc.	TV Series (Basic Cable)	4,254,326.00
Let Go	Yeah, Yeah Picture & Sound, LLC	Feature Film	220,794.00
Love Will Keep Us Together	Tecklenburg Limited	Movie of the Week	365,013.00
Max Rose	Lightstream Pictures LLC	Feature Film	1,533,052.00
Men of a Certain Age – Season 1	Turner North Center Productions, Inc.	TV Series (Basic Cable)	2,382,638.00
No Strings Attached	DW Studios Productions LLC	Feature Film	3,471,168.00
Priest	Screen Gems Productions, Inc.	Feature Film	8,349,450.00
Rock the House	Werder Limited	Movie of the Week	363,349.00
Scooby Doo & the Lake Monster	Warner Specialty Productions Inc.	Feature Film	1,595,640.00
Slumdog Virgin	Steinbeck, LLC	Feature Film	299,753.50
The Social Network	Columbia Pictures Industries, Inc.	Feature Film	4,978,982.00
Starstruck	Close to Home Productions, LLC	Movie of the Week	1,252,513.00
Super 8	Paramount Pictures Corporation	Feature Film	10,282,027.00
Terriers	Pacific 2.1 Entertainment Group, Inc.	TV Series (Basic Cable)	4,426,601.00
Untitled Wakbie Project	Tatira 2, LLC	Feature Film	8,257,770.00
Winnie the Pooh	Walt Disney Pictures	Feature Film	2,857,735.00
The Wish List	Latinus Limited	Movie of the Week	362,013.00
You Again	Briarvale Productions, Inc.	Feature Film	3,198,920.00
Fiscal Year 2009-10 Total			**$92,514,104.50**
FY 2010-2011			
10,000 Days	10,000 Days, LLC	Feature Film	248,268.00
A Better Life	Jardinero Productions, LLC	Feature Film	1,768,442.00
Artcraft	Artcraft Productions Inc.	Feature Film	349,099.00
B.G.F.A.D.	WE World Entertainment, LLC	Feature Film	910,365.00

Production Title	Production Company	Production Type	Estimated Tax Credit
Blackout	Aelen Limited	Mini-Series	1,262,520.00
Bridesmaids	So Happy for You Productions, LLC	Feature Film	5,141,743.00
Cinema Verite	Home Box Office, Inc.	Feature Film	2,769,193.00
Crazy Eyes	Crazy Eyes LLC	Feature Film	523,585.00
Crazy Stupid Love	Warner Bros. Pictures, Inc.	Feature Film	5,030,276.00
Disney's Prom	Romp Productions, Inc.	Feature Film	1,430,767.00
Friends with Benefits	Screen Gems Productions, Inc.	Feature Film	3,238,879.00
Hop	UCS Project I, Inc.	Feature Film	11,353,948.00
Horrible Bosses	New Line Productions, Inc.	Feature Film	4,897,314.00
Huge	Almost Home Productions, LLC	TV Series (Basic Cable)	3,992,939.00
In Time (a.k.a. Now)	New Regency Productions, Inc.	Feature Film	6,527,019.00
Larry Crowne	Larry Crowne Production, LLC	Feature Film	3,591,584.00
The Last Godfather	TLG, LLC	Feature Film	1,636,858.00
Love Begins	Zorion Productions, Inc.	Movie of the Week	363,349.00
Love's Resounding Courage	Amora Productions, Inc.	Movie of the Week	363,349.00
Moneyball	Columbia Pictures Industries, Inc.	Feature Film	5,869,304.00
Mulligan	Carlito Productions, Inc.	Movie of the Week	389,957.00
Muppet Movie	Newsub 33 Productions, Inc.	Feature Film	7,308,633.00
Mystery Girl	Serpa Productions	Movie of the Week	363,349.00
Pretty Little Liars – Season 1	Horizon Scripted Television Inc.	TV Series (Basic Cable)	1,994,780.00
Project X	Warner Bros. Pictures, Inc.	Feature Film	2,096,311.00
Red State	Cooper's Dell	Feature Film	1,189,352.00
Rizolli & Isles – Season 1	Horizon Scripted Television Inc.	TV Series (Basic Cable)	2,318,739.00
Terri	Team Terri, LLC	Feature Film	287,349.00
Water for Elephants	Twentieth Century Fox Film Corporation	Feature Film	6,045,843.00
Fiscal Year 2010-11 Total			**$83,263,114.00**
FY 2011-2012			
A Girl and a Gun	All You Need Productions, LLC	Feature Film	1,645,153.00
A Glimpse Inside the Mind of Charles Swan III	American Zoetrope	Feature Film	571,142.00
Annie Kringle's Year Off	Dosten Limited	Movie of the Week	445,760.00
Billion Dollar Movie	Billion Dollar Movie, LLC	Feature Film	91,532.00
Body of Proof – Season 2	FTM Productions, LLC	Relocating TV Series	7,188,036.00
Breaking the Girl	BTG Productions, LLC	Feature Film	191,144.00
Bulletproof Bride	Demetrio Productions, Inc.	Movie of the Week	432,561.00
Carnal Innocence	SC Unit Pictures Nine, Inc.	Movie of the Week	258,401.00
The Christmas Pageant	Humberto Productions, Inc.	Movie of the Week	432,561.00
Cinderbiter	Shademaker Productions, Inc.	Feature Film	9,985,909.00
The Craigslist Killer	Woodridge Productions, Inc.	Movie of the Week	28,716.00
Drive	Drive Film Productions, LLC	Feature Film	2,485,762.00
Drunk Dial	Ten/Four Pictures, LLC	Feature Film	1,454,220.00
Fixing Pete	Morela Productions, Inc.	Movie of the Week	427,440.00
Franklin & Bash – Season 1	Woodridge Productions, Inc.	TV Series (Basic Cable)	915,585.00
The Futurist Congress	Liverpool, Inc.	Feature Film	286,983.00
Gangster Squad	Warner Bros. Pictures, Inc.	Feature Film	11,577,530.00
Glory Daze	Horizon Scripted Television Inc.	TV Series (Basic Cable)	2,799,069.00
It Is What It Is	Red Oods, LLC	Feature Film	853,857.00
J. Edgar	Warner Bros. Pictures, Inc.	Feature Film	4,555,245.00
Jane by Design – Season 1	Almost Home Productions, LLC	TV Series (Basic Cable)	4,078,498.00
Judy Moody and the NOT Bummer Summer	Judy Moody Productions LLC	Feature Film	440,295.00
Just 45 Minutes from Broadway	Just 45 Minutes from Broadway, LLC	Feature Film	268,985.00
Justified – Season 2	Woodridge Productions, Inc.	TV Series (Basic Cable)	4,444,507.00
Knife Fight	Divisadero Pictures, LLC	Feature Film	435,672.00
Lincoln Lawyer	Lincoln Lawyer Productions, LLC	Feature Film	364,175.00
Men of a Certain Age – Season 2	Turner North Center Productions, Inc.	TV Series (Basic Cable)	3,519,973.00
My Mother's Curse	Paramount Pictures Corporation	Feature Film	5,320,103.00
Nine Lives of Chloe King	Almost Home Productions, LLC	TV Series (Basic Cable)	3,970,031.00
Oliver's Ghost	Liberio Productions, Inc.	Movie of the Week	76,653.00
Operation Cupcake	Jellico Productions, Inc.	Movie of the Week	432,561.00

Production Title	Production Company	Production Type	Estimated Tax Credit
Perception – Season 1	FTP Productions, LLC	TV Series (Basic Cable)	5,155,653.00
Pretty Little Liars – Season 2	Horizon Scripted Television Inc.	TV Series (Basic Cable)	6,855,011.00
The Protector – Season 1	FTP Productions, LLC	TV Series (Basic Cable)	3,851,449.00
Rampart	End of Watch, LLC	Feature Film	2,127,660.00
Rites of Passage	Party Killer Films, LLC	Feature Film	195,839.00
Rizzoli & Isles – Season 2	Horizon Scripted Television Inc.	TV Series (Basic Cable)	2,930,454.00
Should've Been Romeo	Should've Been Romeo, Inc.	Feature Film	70,625.00
Sports Camp	Artcraft Productions Inc.	Feature Film	1,491,406.00
Switched at Birth	Almost Home Productions, LLC	TV Series (Basic Cable)	3,834,986.00
Takin' It Back	Elixir Entertainment, Inc.	Feature Film	779,871.00
Taste of Romance	Dransfeld Limited	Movie of the Week	445,760.00
A Thanksgiving Engagement	The Gardeners (JPG), LLC	Movie of the Week	133,700.00
Thin Line (a.k.a. For the Love of Money)	All Cash Productions LLC	Feature Film	116,338.00
This Is 40	Forty Productions LLC	Feature Film	5,829,165.00
Torchwood – Season 1	BBC Worldwide Productions LLC	Relocating TV Series	5,700,100.00
Untitled Hemingway & Gellhorn Project	For Whom Productions, LLC	Movie of the Week	3,300,712.00
We Bought a Zoo	Twentieth Century Fox Film Corporation	Feature Film	7,585,129.00
We Have Your Husband	The Gardeners (JPG), LLC	Feature Film	292,804.00
William and Kate: A Royal Romance	FKPS Company	Movie of the Week	342,767.00
Wrong	Rubber Films, LLC	Feature Film	179,129.00
Fiscal Year 2011-12 Total			**$121,196,617.00**
FY 2012-2013			
Argo	Warner Bros. Pictures, Inc.	Feature Film	6,397,624.00
Bachelorette Party	Bold Films	Feature Film	2,488,360.00
Burt Wonderstone	Warner Bros. Pictures, Inc.	Feature Film	7,460,464.00
City of Redemption	9 Ranked Angels Entertainment, LLC	Feature Film	2,113,165.00
Cyber Planet	Cyber Planet the Movie, LLC	Feature Film	2,388,360.00
Decoding Annie Parker	Decoding Annie Parker LLC	Feature Film	481,659.00
Dunderheads	Paramount Pictures Corporation	Feature Film	4,938,098.00
End of Watch	Sole Productions, LLC	Feature Film	284,222.00
Evidence	Bold Films	Feature Film	185,676.00
Five Lies	Sneak Preview Productions, LLC	Feature Film	533,354.00
Franklin & Bash – Season 2	Woodridge Productions, Inc.	TV Series (Basic Cable)	3,605,912.00
Happytime Murders	The Gardeners (JPG), LLC	Feature Film	1,755,916.00
Insider	The Gardeners (JPG), LLC	Feature Film	193,248.00
It's a Matter of Time	Matter of Time Productions, LLC	Feature Film	3,599,983.00
Justified – Season 3	Woodridge Productions, Inc.	TV Series (Basic Cable)	4,749,639.00
Lords of Salem	Beethoven 5 Films, LLC	Feature Film	637,121.00
Lovelace	Millenium Films, Inc.	Feature Film	1,113,740.00
Low Down	Low Down LLC (Epoch Films, Inc.)	Feature Film	1,134,733.00
Major Crimes Series	Warner Bros. Television	TV Series (Basic Cable)	3,231,334.00
Matchmaker Santa	Potsdam Limited	Movie of the Week	432,561.00
Meddling Mom / Of Two Minds	FKPS Company	Movie of the Week	587,318.00
The Metro Gardeners	Quickborn Limited	Movie of the Week	432,561.00
The Moment	Momentous Development LLC	Feature Film	229,286.00
The Night Crew	Maya Entertainment Inc.	Feature Film	226,508.00
Nina	34 Degrees Corporation	Feature Film	1,154,219.00
Pet Sematary	Paramount Pictures Corporation	Feature Film	5,002,465.00
Think Like a Man	Screen Gems Productions, Inc.	Feature Film	1,424,528.00
To Believe	The Gardeners (JPG), LLC	Feature Film	314,406.00
The To Do List	Summer Break Productions, LLC	Feature Film	329,587.00
Trust Me	Howard Holloway Films LLC	Feature Film	449,426.00
Vocal Chords of Freedom	KMR Films, Inc.	Feature Film	382,618.00
The Wedding Band	Terrapin Productions, Inc.	TV Series (Basic Cable)	2,694,933.00
Fiscal Year 2012-13 Total			**$60,953,024.00**
4-Year Total			$357,926,859.50

Source: California Film Commission

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Endnotes

[1] The term "tax expenditure" is an unfortunate one, since it implies that the taxes the state would expect to receive in the absence of such tax credits or exemptions are legitimately the property of the state, rather than that of the taxpayer. In other words, by granting tax benefits, the state, in its great beneficence, is "spending" money that it is owed, regardless of whether the state should have been entitled to the taxpayers' money in the first place.

[2] There are also a couple of minor categories such as fuel taxes (including breaks for Aircraft Jet Fuel Used by Common Carriers and Fuel Used by Transit Districts and Schools) and state property taxes (including breaks for Computer Programs and Fixtures Excluded from the Supplemental Roll).

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[12] Interestingly, the technology, life sciences and entertainment industries mentioned in the CEO's quote are some of the biggest beneficiaries of California tax breaks. By granting preferential treatment to certain industries such as these, policymakers appear to be trying to protect them and prop them up, while their other actions to overtax and over-regulate are punishing all other industries and driving them out of the state.

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bank and financial S corporations pay 3.5 percent, other S corporations pay 1.5 percent, and the state has a corporate alternative minimum tax rate of 6.65 percent), yielded an estimated rate of about 7 percent, a 21 percent reduction compared to the current rate. In addition, the Franchise Tax Board concluded that eliminating the $1,200,000,000 Research and Development Credit would allow the state to reduce the overall corporate tax rate by 14 percent without any negative effect on revenues. If this ratio is held constant, eliminating the $1,982,000,000 in tax breaks for the eight corporate tax breaks included in Table 1 (including the Research and Development Credit) would translate to a little more than a 23 percent reduction in the overall corporate tax rate. Thus, our estimate of at least a 20 percent reduction in the corporate tax rate seems to be a sound one.

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[45] Hill, "Bleeding Cash," p. 4.

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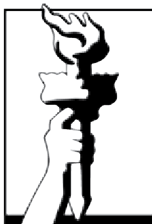

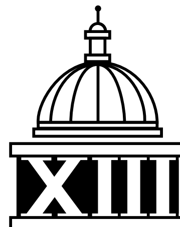

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