



# Tax Policy Decisions and the California Economy

## CalTax<sup>SM</sup> Research Bulletin

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**A**t its best, government allows people to thrive – to become whole through justice, grow with education, receive dignity through services and achieve a better quality of life. To finance these important endeavors, governments must impose taxes.

However, the tax structure can have negative impacts on the economy. For example, increasing taxes on goods will reduce purchases by consumers and businesses, which in turn will result in less economic activity and less revenue for government.

Taxes also may be structured in a way that creates a greater proportional burden on businesses or consumers, such as through taxing business inputs. This sends negative signals to entrepreneurs and innovators that may discourage them from coming to California, impairing the state's ability to compete for high-paying jobs.

A healthy economy provides the most robust and stable revenue. That is why policy makers have attempted to use the tax code to stimulate the economy and draw business to California. They do so with tax policies that address equity and efficiency, or that influence behavior.

Many of these policies are referred to by government officials as “tax expenditures.” California law defines a “tax expenditure” as any “credit, deduction, exclusion, exemption, or any

other tax benefit as provided for by the state.”<sup>1</sup> In sum, a “tax expenditure” occurs when the state diverts from a normative tax system to provide an exception in how taxes are applied, resulting in a tax reduction.

However, such tax policies enable California's taxpayers and economy to

thrive by removing inequalities in the tax structure, motivating innovators, and encouraging employers to hire more people – resulting in a strong, vibrant economy.

This report provides an overview of how tax policies, including “tax expenditures,” can and do encourage economic growth and employment in California. ■

## KEY FINDINGS

- **Good tax policy improves the economy and provides equity among taxpayers.** Tax incentives can be designed to create a better climate for entrepreneurs, innovators and job seekers. Other tax policies can be effective tools for providing equity to taxpayers.
- **Tax policy affects taxpayers' behavior.** A historical overview of tax reductions and incentives shows that taxpayers' behavior is affected when tax policy is developed with specific goals.
- **The “tax expenditure” label should not be viewed as a reflection of the value or worthiness of the underlying policy.** If California did not deviate from what is considered “normative” taxation, it would have a highly regressive, uncompetitive tax structure.
- **Static revenue estimates do not account for the significant value of additional jobs.** Policymakers should consider both the tangible and intangible impacts that tax policy has on the economy.

## WHAT IS A “TAX EXPENDITURE”?

The intended goal of tax credits, deductions, exclusions, exemptions and other tax policies – also known as “tax expenditures” – is to remove inequalities in the tax structure, improve tax administration and provide tax reductions for specific policy purposes.<sup>2</sup>

A common misperception is that taxpayers are abusing the tax code through various “loopholes” or by lobbying for certain “tax breaks.”<sup>3</sup> Such labels placed on tax reductions are misdirected. Demands to repeal certain tax laws often are made without an understanding of the rationale and intent of the policy.

Legislative Analyst Mac Taylor, the nonpartisan fiscal advisor to the California Legislature, recently told the Senate Revenue and Taxation Committee: “I want to stress that tax expenditures are not loopholes. ... These are done intentionally – they’re appropriate to do. You wouldn’t call giving aid to someone – giving health benefits – a ‘loophole.’ A loophole is really something that’s unintended, an ambiguous provision that someone kind of takes advantage of. These are not loopholes.”<sup>4</sup>

In other words, “tax expenditures” are as the law allows and are intended, not outside of the law or an abuse of it as is a “loophole.” Labeling a tax policy as a “tax expenditure” is simply the use of a neutral term to indicate a departure from normative tax treatment – such a label is not a reflection of the value or worthiness of the underlying policy.

The term “tax expenditure” was coined by Harvard economist Stanley Surrey, who served as assistant secretary of the U.S. Treasury in the 1960s. The term itself is a misnomer, since no government funds are directly expended to pay for the

“expenditures.” The term “tax expenditure” is now commonly used to describe a policy decision not to tax something. For example, the sales tax exemption for food is considered a “tax expenditure.”

When designing the state’s tax structure, policymakers make deliberate decisions about what they want to tax and what they do not want to tax.

If California did not choose to deviate from what is considered to be “normative” tax practice, the state government would not allow income tax deductions for Social Security benefits, charitable donations, medical and dental expenses, or retirement benefits given to employees, and would apply sales tax to prescription drugs, prosthetic limbs, meals served at hospitals, periodical subscriptions, and many other purchases. The state doesn’t tax these things, nor should it.

The virtue of tax policy is that it allows policymakers to develop a tax structure to meet the needs of the people. California’s tax structure, developed by elected representatives and the people via the initiative process, represents a set of values. The decision not to tax is not a “loophole.” It is a conscious decision enacted with the intent to effect a specific policy goal, and thereby enhance the tax code and/or economic policy of the state.

### **REVENUE ESTIMATES CAN BE INCOMPLETE**

When measuring the impact that tax policies have on the economy, it is important to review both the dynamic and static impacts. California uses a static method of estimating the revenue impact

that a “tax expenditure” will have on the economy, which means that the only factor included is how much revenue will be lost.

A more accurate approach is to conduct a sound dynamic analysis that considers both tangible and intangible factors. Tax policies that create a more favorable business climate or more equitable tax code have an intangible impact that cannot be easily measured, but should not be ignored.

A September 2010 report by the Rose Institute highlights how a dynamic analysis is more complete. The report notes: “State tax rates influence where companies locate their production or distribution facilities, where they expand or contract their activities, make investments, and where they expand or contract their work force. The economic and fiscal impact of tax provisions are best studied using econometric models of the economy that take into account the behavioral changes brought about by those provisions.”<sup>5</sup>

When the Department of Finance, Board of Equalization or Franchise Tax Board analyzes legislation, there does not appear to be any reconciliation between the projected estimates presented to the Legislature and the actual fiscal impact of legislation once the policy is implemented. In May 2010, Assemblyman Warren Furutani proposed changing the law to require tax agencies to publish an annual report showing whether an agency is able to make good on its promise to bring in more revenue if they hire more staff.<sup>6</sup> He explained that there is a need for more accountability and transparency from tax agencies when they provide their estimates. While his proposal was never melded into the final budget package, a similar proposal could highlight when an estimate by a tax agency is “rosy” or when an estimate is on target. ■

## STATE DATA ON “TAX EXPENDITURES”

Since 1971, the California Department of Finance has been required to report to the Legislature on the total number of “tax expenditures” utilized. The annual list includes comprehensive descriptions of “tax expenditures” above \$5 million, as well as information on whether the “expenditure” has a sunset date, the legislative intent, and other details.<sup>7</sup>

The 2009-10 report estimated that “tax expenditures” amounted to \$28.8 billion for individual and joint personal income tax filers, \$8.5 billion in sales and use tax exemptions,

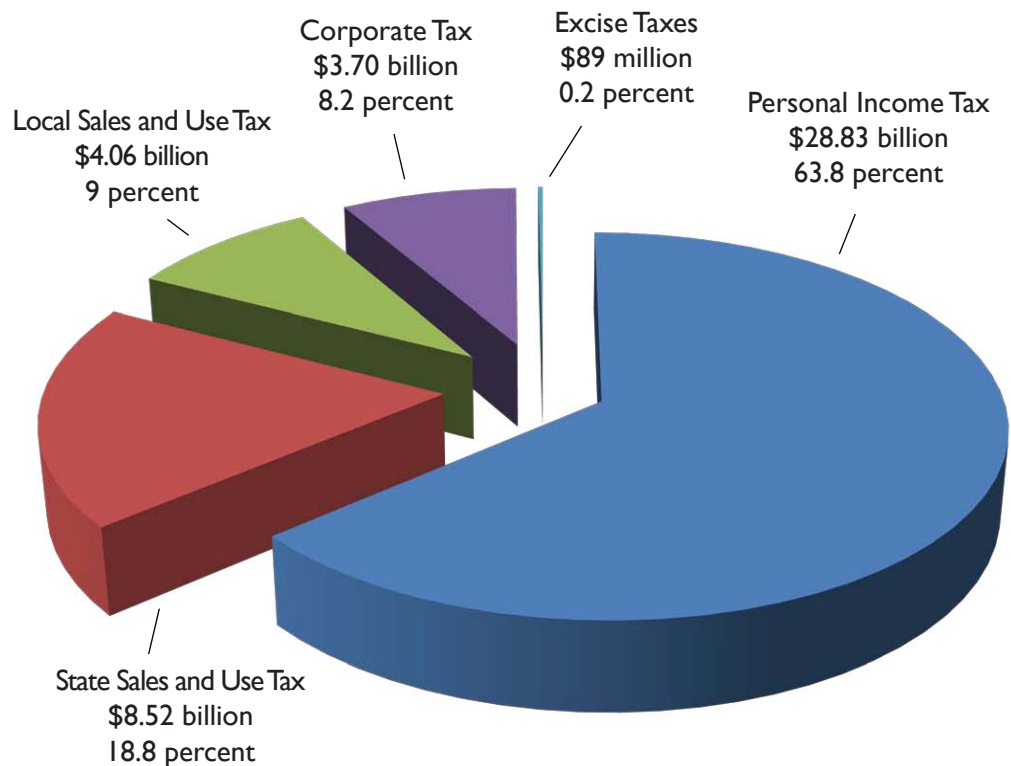
and \$3.7 billion for businesses filing corporate tax returns. Included in those totals: homeowners were able to keep \$4.8 billion by deducting interest accumulated from their home mortgages; individuals who shopped for groceries saved \$6.1 billion because sales tax was not charged on food; and businesses that chose to be innovative and spend money on research and development in California were able to keep \$945 million to allow them to continue to reinvest in this state.<sup>8</sup>

Other “tax expenditures” not

identified in the Department of Finance report include several property tax exemptions: disabled veterans saved \$31.2 million; \$170.7 million was saved on property held by public and private colleges and universities; and \$703.25 million was saved for cemeteries, property leased to government, libraries, low-valued property, and other properties.<sup>9</sup> As shown in the table on page 4, there are many tax expenditures included in the tax code that have been applied broadly, and each has a specific purpose. ■

### Department of Finance Breakdown of Tax Credits, Deductions, Exemptions, Incentives & Related Policies

The Department of Finance reports that California taxpayers benefit from more than \$45 billion in tax incentives, exemptions, deductions, and other related tax policies – personal income tax filers receive almost two-thirds of that total. The report is based on static estimates that do not account for job creation, or how the policies will impact other sectors of the economy.



Source: California Department of Finance estimates from its 2009-10 “Tax Expenditure Report.”

# STATE DATA ON “TAX EXPENDITURES”

## Selected Tax Policies, 2009-10

Type of Tax	Title	Description	Amount
Sales & Use	Food Products Exemption	Sales of food for human consumption. Does not include prepared food or food consumed at the seller’s facilities.	\$4 billion state; \$2.07 billion local
Personal Income	Home Mortgage Interest Deduction	Interest from acquiring, constructing, improving or refinancing principal and one other residence may be deducted.	\$4.8 billion
Personal Income	Exclusion of Employer Pension Contributions	Employer contributions to a qualified retirement plan are excluded from an employee’s income tax.	\$4.1 billion
Personal Income	Exclusion of Employer Contributions to Health Plans	Contributions by employers to provide accident and health benefits are excluded from an employee’s income.	\$3.8 billion
Sales & Use	Gas, Electricity, Water and Steam	Gas, electricity and water delivered through main lines are exempt from tax. Gas delivered to homes also is exempt.	\$2.02 billion state; \$1.04 billion local
Sales & Use	Prescription Medicines	Prescribed medicine distributed by a registered pharmacist is not taxed. Includes orthotics, prosthetic devices and parts.	\$1.55 billion state; \$800 million local
Personal Income	Charitable Donations	A deduction for contributions to qualifying non-profits.	\$1.5 billion
Corporate	Net Operating Loss Carryover Provisions	A net operating loss exists when business expenses surpass income within a single tax year. The state’s net operating loss deduction allows a business to counterbalance or deduct one tax year’s losses from another tax year’s net income.	\$1.5 billion*
Corporate	Single Sales Factor Election	Allows businesses to elect to use a tax formula based on 100 percent of sales in California, beginning Jan. 1, 2011.	\$950 million estimated for 2011-12
Corporate	Research and Development Tax Credit	Businesses are allowed a credit for increased qualified research in California.	\$945 million
Property	Other Charitable Properties	Includes cemeteries, historical aircraft, free museums and libraries, property leased to government and low-valued property.	\$703.25 million
Personal Income	Medical and Dental Expenses Deduction	Itemized deduction is allowed for qualified medical and dental expenses by the taxpayer, spouse and dependents.	\$360 million
Corporate	Hiring Credit	\$3,000 tax credit for hiring full-time employees.	\$330 million
Corporate	Film Tax Credit	Tax credit to taxpayers who produce a motion picture in, or relocate a TV series to, California. Capped at \$100 million.	\$70 million estimated for 2011-12

Sources: California Department of Finance estimates from the agency’s 2009-10 “Tax Expenditure Report”; California Board of Equalization Annual Report, 2008-09. The figure for “Other Charitable Properties” was calculated by multiplying the properties’ assessed value by the property tax rate of 1.1 percent.

\*This figure represents the estimate provided by the Franchise Tax Board. In an analysis of Proposition 24 of 2010, the Legislative Analyst’s Office provided a much different figure. For a possible explanation of why the revenue estimates are different, see page 2. Also, the Department of Finance does not include the net operating loss in the annual “Tax Expenditure Report” because the department considers this deduction a tax policy that provides equity to taxpayers.

# CATEGORIES OF TAX INCENTIVES AND REDUCTIONS

**T**ax policy offers lawmakers an opportunity to further a particular policy goal and improve tax administration. Tax policies can improve equity in the tax code, influence behavior, or revitalize a depressed economy or struggling industry.

## TAX POLICIES THAT PROMOTE EQUITY

The sales tax exemption for food is one example of a tax policy that was enacted specifically to promote equity for taxpayers. California's sales tax is imposed on retailers that sell tangible goods or products.<sup>10</sup> In 1933, when the sales tax was enacted, it also applied to food sold for consumption. Since many businesses chose to pass the tax on to consumers, taxpayers were negatively impacted – particularly those with less disposable income. A static percentage tax on the sale of a gallon of milk would cost low-income taxpayers as much as high-income taxpayers. Since food is essential, many taxpayers believed this tax was unjust.

When famed author and Democratic candidate Upton Sinclair ran for governor in 1934, one of his EPIC (End Poverty in California) campaign pledges was to repeal the sales tax. He told voters that the tax was “forced through the Legislature by a nasty bit of treachery.” Recognizing that practically, the tax couldn't be repealed immediately, he said: “We may have to start by repealing the sales tax on food,

which would relieve about one-third of the burden.”<sup>11</sup>

In a detailed evaluation of California's sales and use tax, University of California at Los Angeles economist Dr. Harold M. Somers stated: “One of the basic precepts governing taxation is that a given tax should be assessed according to the taxpayer's ability to pay.”<sup>12</sup> In the case of the sales tax on food, many lower- and middle-income taxpayers were significantly burdened. In response to the problems with this tax, on July 1, 1935, the Legislature

*“One of the basic precepts governing taxation is that a given tax should be assessed according to the taxpayer's ability to pay.”*

- Dr. Harold M. Somers, University of California, Los Angeles  
California Interim Committee on Revenue and Taxation  
A Major Tax Study, 1963-1965

established one of the early “tax expenditures” by exempting food from the sales tax. This exemption was cemented into the state constitution by Proposition 163 of 1992.<sup>13</sup>

Similarly, California's sales tax exemption on prescription drugs is a tax policy designed to improve equity. Registered pharmacies are exempt from collecting and submitting the sales tax on prescription medicines, orthotics, prosthetic devices and associated parts. Taxing the ill or elderly would fall disproportionately on individuals with health problems

who may not be able to earn a steady income due to their illness, and on seniors living on fixed incomes.

Tax policies also can promote fairness among business taxpayers. The net operating loss deduction prevents taxpayers with cyclical incomes from paying more in tax than those with steady incomes. It thus allows a business to remain competitive when the economy slows, or when the business is not profitable.

A net operating loss occurs when a business' expenses exceed its

income within a single tax year. By claiming the NOL deduction, a business can offset its losses by deducting one tax year's losses from another tax year's profits. For example, a farmer may have a very productive growing season one year, but the

next year could be less productive if the weather or lack of water affects his or her crops. Or an inventor may reap the rewards of an invention in one year, but could have several continuous years where he or she loses money.

The NOL tax policy levels the playing field by helping to reduce taxes in prosperous years so the taxpayer with cyclical income pays no more in tax than someone with steady income. (See the next page for an illustration of how the net operating loss deduction works.)

# CATEGORIES OF TAX INCENTIVES AND REDUCTIONS

## TAX POLICIES THAT INFLUENCE BEHAVIOR

Often, tax policies are enacted to influence taxpayers' behavior by offering tax incentives. This practice of providing tax incentives for certain behaviors is not new. When European settlers arrived in

New England, they adopted the English tradition of granting tax incentives to various industries that produced a particular good or product – the earliest incentive in the United States was a tax incentive in the colony of Massachusetts in 1640 to spur production of linen, wool or cotton clothing.<sup>14</sup>

Interestingly, the earliest tax policy

specifically designed to influence behavior in California was in the form of a tax increase – in 1850, the new state enacted a \$20-a-month tax on foreign miners, designed to drive them out of gold-mining jobs.<sup>15</sup>

Whether modifying behavior through the tax code is good or bad policy depends on the objectives sought and an

## Without Net Operating Loss Deductions, Two Businesses Can Have the Same Profits, but Different Tax Liabilities

In the illustration below, Chuck's Restaurant maintains its profitability over four years, while Maria's Building Company loses money in three of the four years. Maria's business, like other construction companies, profits during construction booms, but is less

profitable when growth slows.

Despite Maria's losses, both she and Chuck are able to earn the same amount of total profits. But because Maria earns more in one of the four years, she pays more taxes.

The net operating loss deduction provides equity for taxpayers by giving struggling or cyclical

businesses the ability to deduct prior-year losses against a current tax liability. With the NOL, both businesses pay the same amount in taxes. This tax policy resolves an inequity in the tax structure that arises when businesses have losses or profits during different cycles.



Chuck's Restaurant

	Year 1	Year 2	Year 3	Year 4	Cumulative Taxes Without NOL		Cumulative Taxes With NOL	
<b>Profits:</b>	+\$1,000	+\$1,000	+\$1,000	+\$1,000	Gross Profits:	\$4,000	Chuck had a positive taxable income for each of the four years and his losses were deductible in each year with or without a NOL deduction.	
<b>Losses:</b>	-\$300	-\$300	-\$300	-\$300	Total Losses:	\$1,200		
<b>Taxable Income:</b>	= \$700	= \$700	= \$700	= \$700	(Total losses are deductible) Taxable Income: \$2,800			
<b>Corp. Tax:</b>	x 10%	x 10%	x 10%	x 10%	Corporate Tax: x 10%			
<b>TOTAL:</b>	= 70	= 70	= 70	= 70	<b>TOTAL:</b>	= \$280		



Maria's Building Company

	Year 1	Year 2	Year 3	Year 4	Cumulative Taxes Without NOL		Cumulative Taxes With NOL	
<b>Profits</b>	\$0	\$0	\$0	+\$4,000	Gross Profits:	\$4,000	Gross Profits:	\$4,000
<b>Losses</b>	-\$400	-\$400	-\$400	\$0	Total Losses:	\$1,200	Total Losses:	\$1,200
<b>Taxable Income</b>	\$0	\$0	\$0	\$4,000	(Total losses are not deductible) Taxable Income: \$4,000		(Total losses are deductible) Taxable Income: \$2,800	
<b>Corp. Tax</b>	x 10%	x 10%	x 10%	x 10%	Corporate Tax: x 10%		Corporate Tax: x 10%	
<b>TOTAL</b>	= \$0	= \$0	= \$0	= \$400	<b>TOTAL</b>	= \$400	<b>TOTAL</b>	= \$280

Note: A four-year time period and 10 percent tax rate were chosen for illustration purposes only.

# CATEGORIES OF TAX INCENTIVES AND REDUCTIONS

individual's point of view.

Leslie E. Carbert, a former state planning officer at the Department of Finance, wrote that a "judicious" selection of pre-designed tax incentives can help influence behavior. He stated that "selective exemptions are to be admired as tools of planning only if a clear set of priorities has been established and only if it can be demonstrated that the response of the private sector is likely to be such as to lead society towards these consensus goals."<sup>16</sup>

California's first significant behavior-modifying tax credit from the modern era was enacted in 1976. With California in the midst of an energy crisis, Senator Alquist sponsored legislation to offer taxpayers a credit for solar projects.<sup>17</sup> This tax policy encouraged taxpayers to install solar panels on their property.

Later, tax credits would be used to increase consumer spending on low-emission vehicles, such as the \$5,000 tax credit that can be claimed by consumers who purchase a zero-emission or plug-in hybrid motor vehicle. Such tax credits and exemptions have become increasingly popular.

Another recent example of a tax policy that influenced behavior is the homebuyer

tax credit. As the subprime mortgage crisis took hold in 2007, many homeowners were forced into foreclosure, inundating the market with properties for sale and slowing construction of new homes to a crawl. To encourage homebuying, California lawmakers adopted a tax credit for new home purchases and first-time homebuyers.

Taxpayers responded to the tax credit, and it proved to effectively stimulate a depressed sector of the economy, motivating individuals to purchase homes they otherwise would not have purchased.<sup>18</sup> By July 2010, the tax credit offered by the state and federal governments had run dry, leading to a decrease in home sales.<sup>19</sup> Without the tax credit influencing individuals, fewer taxpayers were motivated to purchase homes.

## TAX POLICIES THAT ENCOURAGE ECONOMIC GROWTH

Tax policy also can be used to address declining economic activity in an industry, or to promote a healthy, vibrant economy that will generate more tax revenue to fund government services.

Recent tax policy proposals have

sought to change how California taxes business purchases. Many economists agree that taxing business inputs is an unwise tax policy. Stanford Law School Professor Joseph Bankman puts it more directly, recently telling the Senate Revenue and Taxation Committee that taxing business inputs is "stupid."<sup>20</sup>

According to a study by the Council on State Taxation, a sales tax on business purchases leads to tax pyramiding and double taxation.<sup>21</sup> The theory behind the sales tax is that it is imposed on the final point of sale. Yet, many businesses are taxed on equipment and machinery they purchase to use in the manufacturing process. The products they produce are then taxed when sold for retail, so the final product has multiple layers of taxation that go into the cost.

Tax policy can be developed in a way that removes tax pyramiding by exempting certain business purchases. Recently, a push has been made by some lawmakers to provide manufacturers with a sales tax exemption on manufacturing equipment, which would remove barriers that businesses currently face when investing in new machinery in California.<sup>22</sup> The policy goal behind this push is to bring manufacturing jobs back to the state.

For nearly a century, California was a global leader in manufacturing, but during the last 10 years, the state lost more than 390,000 manufacturing jobs.<sup>23</sup> While these job losses occurred during the national manufacturing recession, the Milken Institute points out that California lost manufacturing jobs at a faster pace than the nation as a whole, and California never regained its competitive advantage

*"If the U.S. doesn't get serious, China's going to own the (solar manufacturing) industry. Here, we're way behind. We're still messing around with energy bills. We need to get serious, to get capital spending flowing, to get the government truly behind it, to get focused."*

- David Miller, spokesman for Applied Materials, Inc.  
Interview with the *San Francisco Chronicle*  
October 2, 2009

## CATEGORIES OF TAX INCENTIVES AND REDUCTIONS

over other comparable states. The loss of manufacturing jobs has a widespread impact. For example, the *San Francisco Chronicle* reported that the mid-2010 closure of the New United Motor Manufacturing Inc. (NUMMI) plant in Fremont impacted approximately 2,000 workers in Bay Area companies that supplied parts for cars built at the plant, in addition to the 4,700 NUMMI workers who lost their jobs.<sup>24</sup>

Had California maintained its manufacturing base since 2000, approximately 476,000 jobs would have been preserved. Also, had these jobs remained in California, one estimate projects that an additional 1.65 million jobs in other industries could have been generated.<sup>25</sup>

In a 95-page overview of California's manufacturing climate, the Milken Institute found that one way California can grow its manufacturing base is by improving its tax structure. The report concluded: "Overall, California's incentives, particularly in regard to manufacturing, are lacking in four fundamental ways: 1.) The incentives and the agencies administering them at the federal, state, and local levels are not coordinated, which means more administrative overhead

and less strategic focus. 2.) What the state is offering ... are standard, garden-variety incentives on par with most other states. 3.) The incentives provided are not robust enough to efficiently counter the overall tax burden, onerous regulatory climate, and other structural challenges. 4.) California is the only one among its peers to lack a comprehensive, long-term economic strategy."<sup>26</sup>

To regain lost manufacturing jobs, California's policymakers can use tax policy decisions to attract investment and innovation through tax exemptions, credits and incentives.

One tax policy that encourages businesses to invest in California is the research and development (R&D) tax credit. The R&D tax credit can be claimed by taxpayers that perform "qualified research" in California and meet certain eligibility requirements. This tax policy encourages investment in research, which leads to greater economic growth. The Legislative Analyst's Office notes that the intent behind the R&D tax credit in 1986

was to conform to federal legislation, and the credit subsequently was expanded to reflect "concerns regarding the state's business climate, and a desire to attract economic activity perceived as being conducive to high growth."<sup>27</sup>

Together, the state and federal

*Had California maintained its manufacturing base since 2000, approximately 476,000 jobs would have been preserved, and more than 1.65 million jobs would have been impacted.*

research tax credits have helped California retain its leadership in innovation, particularly when California is competing for investments with China, Japan, Hong Kong, Singapore, the European Union and others.

In a survey of California-based high-tech firms, researchers from the University of California at Berkeley found that along with manufacturing, research and development is one of the first functions to be outsourced to other states, or sent to foreign countries.<sup>28</sup> The report concluded that it is important for California to promote innovation and R&D.

To ensure that California continues to value the importance of research and development, the R&D tax credit is a useful policy tool to stave off domestic and foreign attempts to lure innovation out of the state. ■

For a close look at how tax policies can encourage economic growth, the next two sections provide a deeper look at two tax policy decisions – California's single sales factor election and the film tax credit.

*"There is no longer an incentive for the investor with the elimination of California's investment tax credit. We know in other states those incentives exist and we're absolutely of the belief that there is a payback to the state if we can bring back the investment tax credit."*

– Patricia Salas-Pineda, New United Motor Manufacturing Inc. (NUMMI) Address to the California Manufacturers and Technology Association Statewide Manufacturing Summit, 2005. (In April 2010, NUMMI closed its Fremont plant and laid off 4,700 workers. It is now partnering with Tesla to make electric cars there, after the state agreed to abate sales tax on Tesla's manufacturing equipment.)

# TAX POLICIES THAT GROW THE ECONOMY: THE SINGLE SALES FACTOR ELECTION

California uses a multi-factor method for “apportionment” to determine how to tax the profits of a multi-state business. In calculating the corporate income of a company, the state uses a formula based on a business’ property, payroll and sales in California.

Like other states, California found that by requiring property and payroll as factors in the equation, there was a disincentive for businesses to invest in new or existing California facilities, or to hire new California workers and give raises to current California employees. Increasing these factors caused businesses to pay more tax in California. Effective in 2011, the Legislature revised the corporate tax by adopting the elective single sales factor. The elective single sales factor, which allows businesses to determine California’s share of taxable income solely

according to California sales, is intended to reduce unemployment and encourage businesses to invest in California.

## EVOLUTION OF CALIFORNIA’S CORPORATE TAX

One of the significant developments in California’s corporate tax was the three-factor income “apportionment” method. The legislation that made the change, AB 11 of 1966, was carried by Assemblyman Nick Petris, and is known as the Uniform Division of Income for Tax Purposes Act (UDITPA).<sup>29</sup> The theory behind the act was that the three-factor “apportionment” method accounted for a corporation’s activities through property (representing capital), payroll (representing labor) and a sales factor (representing the market

presence of a business).<sup>30</sup> California adopted a modification to the three-factor formula in 1993 to double-weight the sales factor for most industries (for details on how California’s corporate tax is calculated, see the chart below).

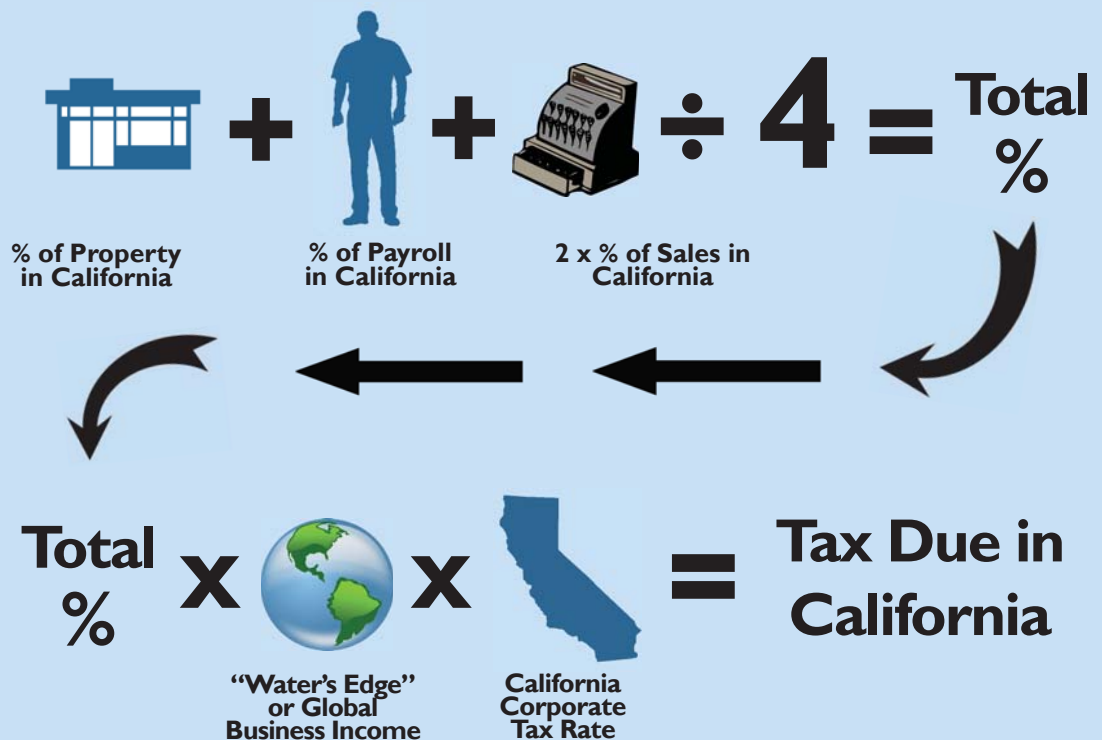
Recently, a number of states have switched from a multi-factor approach to rely more heavily on a business’ sales. When the single sales factor is used, only the sales made by a business are used to calculate the business’ corporate tax. Economists believe that by adopting a single sales factor, a state gives businesses an incentive to grow and hire more workers within the state.<sup>31</sup>

## CORPORATE TAX REVISIONS

California joined a growing number of other states recently by revising its

## Business Taxation: The Multi-Factor Method

Under California’s multi-factor corporate tax formula, a business’ tax is calculated by adding the percentage of the total value of its property in California, percentage of total California payroll and two times its percentage of sales in California, and dividing by four. The resulting percentage is multiplied by its “water’s edge” or global business income to determine how much income in California is subject to state taxes. Under this approach, if a business increases its sales, gives an employee a raise, hires someone, or expands in California, it will pay higher taxes.



## TAX POLICIES THAT GROW THE ECONOMY: THE SINGLE SALES FACTOR ELECTION

corporate tax to allow taxpayers to utilize a single sales factor apportionment formula, effective January 1, 2011 (for more information, see the chart below). Furthermore, California's use of an elective single sales factor ensures that the revisions to the tax policy will not disadvantage some businesses, while enriching others. Of the 46 states that tax a corporation's income, 24 (including California) have moved away from a formula that penalizes employers for job creation and expansion.<sup>32</sup>

Professor Charles Swenson, an economist at the University of Southern California, analyzed data from Georgia, Louisiana, New York, Oregon and Wisconsin, and, using this data as a benchmark, estimated that California's single sales factor apportionment formula could increase the number of jobs in California by 144,000 in the next two years. Based on this estimate, the state could gain \$411 million from additional state sales and personal income tax revenue in several years.<sup>33</sup> Other economists also have concluded that the elective single sales factor will increase economic activity and boost state revenues.

The Legislative Analyst's Office recently

reported that adoption of the single sales factor would generate a "small but noticeable increase in economic activity," because manufacturing activity will increase and businesses will be more likely to invest in facilities and equipment in California.<sup>34</sup>

Excluding property from the formula eliminates a tax "penalty" on adding capital facilities in California (for an example, see the chart on page 11). Also, when payroll is excluded from the corporate tax formula, a business' corporate taxes will not increase when it hires more Californians or rewards an employee with a raise. In addition, without a single sales factor election in California, excluding the payroll and property factors, California effectively encourages taxpayers to invest in other states, since less tax is imposed in California when investments are made in those other states.

Other studies also have found that the single sales factor can increase economic activity in the state. The LAO concluded that the single sales factor was a good principle, and noted that if California continues to mandate the multi-factor

apportionment, California's businesses will be put at a competitive disadvantage.

During a legislative hearing, Andrea Jackson, a representative from Genentech, said the South San Francisco-based biotechnology firm's recent decision to expand in Oregon was based solely on Oregon's single sales corporate tax formula. She said: "Like it or not, tax policy does invoke different behaviors from people and it encourages or discourages behavior. We didn't look at any state to site this facility that did not have a single sales factor. Our tax liability in Oregon remains the same because our sales remain the same there." She explained that her business' corporate tax liability in California was reduced after its Oregon facility was built, as a result of California's multi-factor corporate tax. Ms. Jackson continued: "It seems perverse that California actually paid us to build a facility in Oregon. We're a home-grown California company. We prefer to grow here if we can, but we've gotten to the point where we're large enough that it just doesn't pencil out."<sup>35</sup>

Businesses that will benefit from

### Business Taxation: The Single Sales Factor Election

Under a single sales factor election formula, a business' taxes are calculated by the percentage of sales a business has in California multiplied by the total "water's edge" or global business income. Once a total is calculated, it is multiplied by the corporate tax rate to determine how much tax is owed. Unlike under a multi-factor formula, a business does not pay more taxes if it hires workers or expands in California.



% of Sales in California

X



"Water's Edge" or Global Business Income

X



California Corporate Tax Rate

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**Tax Due in California**

## **TAX POLICIES THAT GROW THE ECONOMY: THE SINGLE SALES FACTOR ELECTION**

the single sales factor election have a significant physical presence in California. For example, if an incorporated business has two locations, one in Needles, California, and another in Flagstaff, Arizona, that business is considered a multi-state corporation. Arizona has a corporate tax rate of 6.968 percent and calculates the tax using a multi-factor approach. If the

business wants to expand by constructing a distribution center and hiring workers to staff the facility, California's single sales factor election would make the Golden State a better location for the expansion. While California has a higher corporate tax rate, at 8.84 percent, the business would not pay any additional corporate taxes by merely hiring California workers

or by purchasing property in California, because the only factor determining tax liability would be the percentage of sales the company makes to people in California.

The single sales factor election is an example of how tax policy, when tailored with a specific objective, can provide California businesses with a competitive edge, and can encourage job creation. ■

### **The Multi-Factor Corporate Tax Penalizes In-State Hiring**

**T**he multi-factor corporate tax formula effectively encourages businesses to hire workers outside California. Under the multi-factor formula, businesses pay more taxes when they hire additional workers or reward an employee with a raise. In the illustration below, Nina's Solar Panel Factory hires 1,250 new employees and pays each employee \$80,000 annually. Under the multi-factor formula, Nina faces higher taxes when hiring in California and lower taxes when hiring out of state. Alternatively, an elective single sales factor allows Nina to hire more California workers while remaining competitive.

#### **What Happens When Nina's Solar Panel Factory Hires New Employees?**

Various Factors	Multi-Factor Corporate Tax*	Multi-Factor Corporate Tax When Nina Hires Employees in California*	Multi-Factor Corporate Tax When Nina Hires Employees Outside of California*	Single Sales Factor Corporate Tax When Nina Hires Employees in California	Single Sales Factor Corporate Tax When Nina Hires Employees Outside of California
CA Property	\$400	\$400	\$400	\$400	\$400
A Property Outside CA	\$400	\$400	\$400	\$400	\$400
Percent of Property in CA	50%	50%	50%	50%	50%
California Payroll	\$100	\$200	\$100	\$200	\$100
B Payroll Outside CA	\$100	\$100	\$200	\$100	\$200
Percent of Payroll in CA	50%	66.67%	33.33%	66.67%	33.33%
California Sales	\$100	\$100	\$100	\$100	\$100
C Sales Outside CA	\$400	\$400	\$400	\$400	\$400
Percent of Sales in CA	20%	20%	20%	20%	20%
Percentage of Income Subject to Tax in CA	35%	39.17%	30.83%	20%	20%
Water's Edge Taxable Income	\$100	\$100	\$100	\$100	\$100
CA Income Subject to Tax	\$35	\$39	\$31	\$20	\$20
Corporate Tax Rate	8.84%	8.84%	8.84%	8.84%	8.84%
<b>Tax Due in California</b>	<b>\$3.09</b>	<b>\$3.45</b>	<b>\$2.74</b>	<b>\$1.77</b>	<b>\$1.77</b>

Dollar amounts in millions. \*Sales in California are double-weighted.

# TAX POLICIES THAT GROW THE ECONOMY: THE FILM TAX CREDIT

After Cecil B. DeMille shot the first major motion picture in Hollywood, the film industry boomed and California became home to film production. By the late 2000s, however, filming in the Golden State had declined – from 272 productions in 2000, down to just 160 in 2008.<sup>36</sup> With fewer films, television shows, commercials and music video productions in California the entertainment industry was hit hard.

Using tax policy to bolster California's film industry and provide jobs to individuals who rely on film production, California's Legislature adopted the state's film tax credit. The goal of the policy was to make California competitive compared to other states and countries that have been luring production out of California with various tax incentives.

## RUNAWAY PRODUCTION

Long-term investment by other states and countries in film tax credits has cost California tens of thousands of jobs over the past decade. When another state or country attracts a film production, the Tax Foundation says that California loses out, noting: "Jobs created in New Mexico are offset by those destroyed in California."<sup>37</sup>

California's film tax credit, authored by Assemblyman Paul Krekorian in 2009, covers 20 percent of the costs for productions with budgets up to \$75 million and 25 percent of the costs for independent films with budgets up to \$10 million.<sup>38</sup> California's tax credit, dubbed by some as the "Ugly Betty" bill,<sup>39</sup> came after the popular ABC comedy left Hollywood

to take advantage of New York's 35 percent film tax credit – adding to the list of what industry insiders call "runaway productions."

Since 2000, an increase in tax incentives offered by other states and Canada has correspondingly matched the decline in the number of productions shot in California.<sup>40</sup> Declining production in California doesn't just mean that more actors and actresses are unemployed – less in-state production means there is less work for truck drivers, restaurant employees, retail employees, real estate agents and many others who rely on economic activity created by the entertainment industry.

If California had retained the 40 percent share of the entertainment jobs in North America that it had a decade ago, 10,600 jobs would have been preserved by 2008, and the additional economic impact created by the

entertainment industry would have led to an additional 25,500 jobs in other areas.<sup>41</sup>

## IMPACT OF THE FILM TAX CREDIT

After enacting tax credits, California began to see increased in-state film production. As of July, feature film production in Los Angeles County alone had increased 11.5 percent in the second quarter of 2010, compared to the same time period the previous year. Industry groups said the credit was "wholly responsible for driving the increase in feature filming."<sup>42</sup>

During the second year that the credit was in existence, the California Film Commission, the agency responsible for distributing the credit, received applications for more projects than it could fund. While the commission was

## How the Film Tax Credit Works

Filmmakers apply for a tax credit to reduce their income and/or sales and use taxes. All eligible productions must film 75 percent of their production days or production budget in California. Beginning in fiscal year 2009-10 through 2013-14, a total of \$100 million in tax credits are available for eligible applicants.

Productions eligible to receive a 20 percent tax credit include: feature films with a budget of \$1 million or more, up to \$75 million; a miniseries with a budget of \$500,000 or more; or a new cable television series with a budget of \$1 million or more.

Productions eligible to receive a 25 percent tax credit include: a television series that had all of its prior seasons filmed outside of California, or an "independent film" – one made by a production company that is not publicly traded – with a budget of \$1 million to \$10 million.

## **TAX POLICIES THAT GROW THE ECONOMY: THE FILM TAX CREDIT**

able to fund 30 productions that will begin shooting in California by late 2010, the commission's director told the *Los Angeles Times* on August 17, 2010 that more than 50 film productions likely will leave California to shoot in places like "Louisiana, London, New York and Texas."<sup>43</sup>

As indicated by the uptick in California productions following the enactment of the tax credit, the state has attracted more investment and created additional employment opportunities. The Tax Foundation noted that California's tax credit, "coupled with proximity

to Hollywood infrastructure, is likely to overwhelm what other states can reasonably offer in the near future."<sup>44</sup>

The film tax credit is an example of how tax policy can be used to encourage businesses to stay or locate in California despite an economic downturn. ■

### Major Motion Pictures Shot Outside of California

Film	Release Date	State/Country	Available Tax Credit
The Blind Side	2009	Georgia	20 percent across-the-board tax credit on a minimum investment of \$500,000, plus additional incentives.
The Curious Case of Benjamin Button	2008	Louisiana	30 percent transferable credit for total in-state expenditures. 5 percent labor tax credit on the payroll of Louisiana residents. Tax credits are fully transferable and have no limits.
The Dark Knight	2008	Illinois	30 percent tax credit on expenditures, including post-production. Additional 15 percent tax credit on salaries of individuals who live in an economically disadvantaged area. The credit has no sunset date.
Gran Torino	2008	Michigan	Refundable tax credit of up to 42 percent of the amount of a production company's expenditures.
Juno	2007	Vancouver, Canada	33 percent tax credit on qualified British Columbia labor expenses.
Leatherheads	2008	North and South Carolina	NC: 25 percent tax credit on purchases of goods and services, not to exceed \$7.5 million. SC: 20 percent cash rebate on wages, 10 percent credit for out-of-state employee wages, and 30 percent cash rebate for in-state expenditures.
Marley & Me	2008	Pennsylvania and Florida	PA: 25 percent tax credit for films productions that spend 60 percent of their budget in the state; applies to feature and TV productions intended for national audience. FL: 22 percent tax credit for film, TV and commercials.
300	2006	Montreal, Canada	25 percent cash-back on all expenses. 20 percent bonus on all CGI and Green screen shots, applicable on extended eligible labor. No minimum spending, no caps.
Terminator Salvation	2009	New Mexico	25 percent tax rebate on all direct production expenditures, applies to feature and independent films, television, regional and national commercials, documentaries, video games and post-production.
Up in the Air	2009	Missouri and elsewhere	35 percent tax credit for in-state production.

Source: Milken Institute "Film Flight: Lost Production and Its Economic Impact on California." For specific data and eligibility requirements on the film tax incentives, contact the National Conference of State Legislatures, the British Columbia Film Office, and the Quebec Film and Television Council.

## CONCLUSIONS

Judicious tax policies are appropriate and necessary in California's tax structure. Tax incentives have created growth for California's economy, helped make the tax structure more equitable, and allowed individuals and businesses to compete in a global economy.

A healthy economy is one of the best sources of new and growing government tax revenue. At times when California's businesses are unable to compete in domestic and global markets, tax policies

such as the research and development tax credit and exemptions of business inputs can encourage economic growth in California.

When measuring the impact of various tax policies, policymakers should not use a static model that fails to account for the value of additional direct and indirect jobs and other factors. Intangible factors, such as the business climate, the health of a particular industry, incentives being

offered by other states and countries, and other indirect impacts, also should be considered.

Tax policy can create a healthy economy and also can help policymakers and the state achieve certain objectives.

Since tax policies change behavior, policymakers can couple certain tax incentives to specific objectives. Forty years ago, it was unheard of for homes to have solar panels on their roofs. With an objective of having homeowners invest in clean technology, policymakers influenced taxpayers' behavior with tax credits. Similar tax policies can be applied to business hiring, investment in low-income communities, start-up business costs, and other objectives.

Critics of some tax policies often characterize them as "loopholes," ignoring that the tax policies were designed to achieve certain goals. Even the term "tax expenditure" doesn't aptly describe how tax credits, deductions, exclusions, exemptions and other tax policies are deliberate decisions made by elected officials and the voters to create a tax structure that promotes equity and builds a better business climate. ■

This report was prepared by the California Taxpayers Association, a non-partisan, non-profit organization founded in 1926 to protect taxpayers from unnecessary taxes and to promote government efficiency. CalTax provides information to its members and the public through research on significant tax and spending issues in the legislative, executive and judicial branches of government.

For more information on public finance and taxation in California, or to become a member of CalTax, visit [www.caltax.org](http://www.caltax.org).

Research Analyst | Robert Gutierrez

### What Taxpayers Are Saying

*"At the moment, business has not been good – as you know how the economy is. I'd like to keep those few employees that I still have; or still remain in business. I don't think raising taxes is the answer. ... I think other solutions can be used to help small business rather than hurt small business."*

– Ray Lazo, owner of North American Phone and Computer  
Interview, September 2009

*"People ask whether Intel will invest in capital or research, but that's the wrong question. It's not whether, but where. It's not a coincidence that Intel invested \$2.7 billion in California after the implementation of the 6 percent Manufacturers Investment Credit."*

– Ray Rossi, Intel Corporation  
Discussion at the California Manufacturers and Technology Association  
Statewide Manufacturing Summit, 2005

*"Colorado passed this tax credit, and it's a pretty generous tax credit. It's 100 percent of the reason that we're thinking about going there. Colorado is actually not that great a market [for our product]. It's not in the top 20 markets for hybrid [vehicles]. There's probably more hybrids in San Francisco than in Colorado. ... But tax credits motivate us, and actually California is just the opposite in this matter."*

- Daniel Sherwood, Co-founder of 3Prong Power Inc.  
Interview with the *Denver Business Journal*, June 2010

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