Tax Expenditure Reform Bill

"Tax expenditures" is a term of art for tax credits, exemptions, deductions and other special tax breaks or incentives. They are called expenditures because they have the same effect as on-budget subsidies or rebates. Tax expenditures are forgone revenues that would otherwise be available to balance the state budget, an issue of particular importance in tight budget years. According to the Legislative Analyst's Office (LAO), tax expenditures result in state General Fund revenue reductions of more than $30 billion each year.

League positions say tax expenditures should be in the interest of the general public and not just a specific group, provide benefits that significantly outweigh the increased burden to others, and contribute to tax equity. We have long advocated regular review and justification of existing tax breaks by the legislature.

Last year we supported a bill by Assemblymember Mark Ridley-Thomas that would have required the Department of Finance to make an annual tax expenditure report to the legislature that included a description of current tax expenditures, their original intent, the number and type of taxpayers that benefit from each, and an estimate of the revenue loss to the state. The report was intended to give the legislature a basis for evaluating existing tax expenditures against other pressing state needs.

That bill passed the legislature but was vetoed by the Governor on the grounds that the Department of Finance did not have access to adequate information needed to provide the "dynamic analyses" of tax expenditures called for by the bill. A dynamic revenue analysis is a method of evaluation based on estimates of the probable behavioral responses to the tax expenditure by taxpayers, businesses, and others. (As one can imagine, the assumptions used in such a model can greatly influence the results.)

The bill has been changed to meet the Governor's objections and reintroduced as AB 168 (Ridley-Thomas), strongly supported by the LWVC. It now requires reports from the Franchise Tax Board and the Board of Equalization that would provide the necessary information. The reports would be limited to revenue losses from tax expenditures in excess of $10 million.

Each year beginning in 2007, the Department of Finance would be required to submit a tax expenditure report in conjunction with the Governor's budget. The LAO would be required to review the reports and make recommendations to the legislature on tax expenditures that should be modified or repealed.

Tax breaks are not all bad. They can function as a carrot that may work to produce public benefits more efficiently than the stick of regulation or the creation of new government programs. Many, however, never produce predicted results for the public good and stay in place with no serious review.

The impact on the state General Fund of the major kinds of tax relief enacted since 1997-98 has risen from $174 million in 1997-98 to nearly $7 billion in 2005-06. Regular evaluation of tax expenditures would be a significant reform of the budget process. It is past time to begin.