CALIFORNIA
BUDGET PROJECT

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SIX QUESTIONS TO ASK WHEN EVALUATING TAX POLICY PROPOSALS

Legislators will act on nearly 300 bills modifying the state's tax laws during the current two-year session. Often, the impact and consequences of these measures are not immediately apparent. In response to a number of requests, the California Budget Project offers the following guide to evaluating tax policy proposals.

1. What is the desired outcome or goal of a bill?

Is the purpose of the bill to encourage a particular type of behavior or to provide tax relief? Proposed changes should have clearly defined goals and outcomes. For example, the goal of increasing the dependent tax credit is to provide tax relief for families, not to encourage families to have additional children. The goal of the research and development tax credit is to encourage certain businesses to increase the amount spent on research and development. In order to be effective, bills should have a clear goal and mechanism for achieving that goal.

2. Is the proposed change an effective tool to achieve the desired outcome?

The proposed change should directly and effectively address the desired outcome. For example, a tax credit designed to help low income families purchase health coverage will be of no assistance to a family whose income is so low as to have zero income tax liability. Because of California's high tax thresholds – a family of four with two children did not owe 2000 personal income taxes unless their income exceeded $39,790 – many families pay little or no California income taxes. Similarly, a tax change designed to assist start-up businesses will be of no benefit to a firm that has no net income subject to tax.

3. Is the benefit substantial enough to have the desired outcome?

If the goal of a proposed change is to encourage a desired behavior, the benefit must be substantial enough to encourage the desired outcome. In order to ascertain whether a proposed benefit is substantial enough to impact taxpayers' behavior, it is important to take into account the fact that some state taxes are deductible for federal tax purposes. Individuals can deduct state income and property taxes and vehicle license fees if they itemize deductions on their federal income taxes. Businesses can deduct all of the taxes they pay as ordinary business expenses. Take, for example, a provision exempting construction of a "granny unit" from the property tax. Is a $400 property tax break - worth $288 after accounting for federal deductibility for a taxpayer in the 28 percent federal income tax bracket- sufficient to encourage construction of a $40,000 second unit? Or a deduction for the value of a computer donated to a school? A taxpayer claims a deduction equal to 8.84 percent of the value of the computer. However, after adjusting for federal deductibility, the donation is only worth 5.75 percent of the value of the computer for a business subject to the 35 percent federal corporate income tax rate. Is a $57.50 tax break enough to encourage a business to donate a $1,000 computer?

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4. Does the proposed change reward taxpayers for doing what they would do anyway?

A tax incentive only works as an incentive if it encourages behavior that would not have otherwise occurred. An evaluation of the state's Enterprise Zone program, for example, found that program benefits influenced the expansion and location plans of only one-third of the Enterprise Zone businesses surveyed. Fewer than 20 percent of the businesses surveyed hired additional employees as a result of the hiring credit. The majority of the businesses received benefits for doing exactly what they would have done in the absence of Enterprise Zone incentives.

5. Is the proposed change of equal or higher priority than competing budgetary proposals?

The Congressional Joint Committee on Taxation notes that "Special tax provisions are referred to as tax expenditures because they are considered to be analogous to direct outlay programs. Tax expenditures are most similar to those direct spending programs which have no spending limits, and which are available as entitlements." From a budget standpoint, tax reductions are not "free money." Tax reductions directly compete with amounts available for "on-budget" spending. Because tax reductions are not considered as part of the annual budget process, they are not subject to the same level of scrutiny, review, and trade-offs that govern other spending programs.

Proposed tax reductions should be viewed as a tool for achieving a desired policy goal and balanced against other methods of achieving the same goal, as well as competing policy demands. The revenue loss associated with a tax credit for health expenses incurred by seniors is approximately equal to the cost of extending full scope Medi-Cal coverage to 13,560 seniors. If tax expenditures were considered as part of the annual budget process, the strengths and weaknesses of the two approaches to subsidizing health coverage would be more directly apparent. Without a direct comparison, the trade offs are less apparent.

In many years, there is a direct connection between changes in tax policies and school funding. In years where Proposition 98's "test 3" determines school funding, as much as 60 percent of the cost of a tax reduction comes out of school funding, approximately equal to a $11 per student reduction for each $100 million in revenues foregone.

6. Does the proposed change set a reasonable precedent?

One of the principles of sound tax policy is that similar taxpayers and similar types of behavior should be treated comparably. Proposed changes should be judged by the extent to which they are consistent with existing law and whether they will establish an undesirable precedent in the future. For example, a sales tax exemption for a casing used in animal foods is consistent with the treatment of other materials used to manufacture animal feed. However, a sales tax exemption for books used in college courses could treat the same book differently, depending on the intent of the purchaser, and could be the first step toward a broader sales tax exemption for books, which may or may not be desirable.