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BUDGET PROJECT

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UNKEPT PROMISES:
CALIFORNIA'S MANUFACTURERS' INVESTMENT TAX CREDIT

In 1993, lobbyists for California's manufacturers introduced a measure that would have eliminated the state's sales tax on manufacturing equipment. The state had lost over 260,000 manufacturing jobs during the recession of the early 1990s and proponents argued that tax relief was needed to retain and expand manufacturing employment in California. The price tag of the sales tax exemption was high – an estimated $1.2 billion per year – and the state faced an $11.3 billion deficit.[1] After months of negotiation, the Legislature agreed to establish an investment tax credit for investments in manufacturing equipment and certain facilities.

This report examines the Manufacturers' Investment Tax Credit (MIC), its costs, and trends in manufacturing employment since the credit's creation. These questions and their answers are particularly timely. Under current law, the MIC sunsets if manufacturing employment fails to reach specified targets. While the Employment Development Department (EDD) has not provided the required report on manufacturing employment as of January 1, 2003, publicly available data suggests that employment failed to reach the target. Thus, under current law, the credit should cease to exist effective January 1, 2004. Governor Davis has proposed extending the MIC with modest revisions as part of his 2003-04 Budget. This report finds that:

- Only a very small fraction (9.1 percent) of the state's manufacturing corporations claimed the MIC in 2000.

- Corporations that do claim the credit use it to avoid a large share of their California income tax liability. In 2000, corporations claiming the credit used it to reduce their tax liability by an average of 58 percent. Forty percent of the corporations claiming the credit reduced their tax liability by at least 75 percent.

- Manufacturing employment has fallen far short of the promises made by the credit's proponents. Proponents argued that the credit would result in the addition of over 358,000 manufacturing jobs between 1993 and 2002; in fact, average annual employment in manufacturing has declined by 54,000 since the credit's creation.

- The state's largest corporations use most of the MIC. In 2000, 326 corporations with total receipts in excess of $1 billion claimed 69.5 percent ($285 million) of the credits claimed. These large corporations claimed an average credit more than 10 times larger ($874,233 in 2000) than the average credit claimed by all corporations claiming the credit ($82,645) and more than 100 times larger than the average credit claimed by sole proprietors ($7,628).

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What Is the MIC?

The Manufacturers' Investment Credit (MIC) is a tax credit for businesses that purchase specified manufacturing equipment. The 1993 measure creating the MIC, SB 671 (Alquist, Chapter 881) also allowed certain new businesses to claim a sales tax exemption for the state's portion of the sales and use tax. While the credit was originally limited to manufacturers, recent decisions of the state's Board of Equalization have broadened the range of firms eligible to claim the credit, as well as the range of investments qualifying for credits. The Save Mart decision, for example, extended eligibility for the MIC to bakeries located within grocery stores.

The MIC reduced state tax revenues by $458 million in 2000, while the sales and use tax exemption cost an estimated $7.9 million in 2002.

Few of the State's Manufacturers Use the MIC

Contrary to perceptions, the MIC is used by a very small share of the state's manufacturing corporations. In 2000, only 4,021 (9.1 percent) of the state's 44,207 corporate manufacturing taxpayers claimed the MIC. An additional 895 non-manufacturing corporations also claimed the credit. The number of corporations claiming the MIC has remained relatively constant since its implementation in 1995 (Figure 1).

Figure 1

Most of California's Manufacturing Corporations Do Not Claim the MIC

Manufacturing Corporations Claiming the MIC as a Percentage of All Corporate Manufacturers
Tax Year 2000

Source: Franchise Tax Board

In 2000, 6,164 firms filing as personal income taxpayers also claimed the MIC. While more personal income taxpayers than corporate taxpayers claimed the MIC, personal income tax filers, on average, claimed smaller credits. In 2000, the average credit claimed by corporate MIC users was $82,645 (Table 1). The average MIC claimed by a personal income filer was $7,628.

Table 1
Who Claims the MIC Tax Year 2000

Total Receipts	Number of Corporations	MIC Used ($ in Millions)	Percent of Corporations Claiming MIC	Percent of MIC Claimed	Average Claim Per Corporation
Under $1 Million	205	$2	4.1%	0.5%	$9,756
$1 - $5 Million	1,670	$5	33.7%	1.2%	$2,994
$5 - $10 Million	925	$6	18.6%	1.5%	$6,486
$10 - $50 Million	1,135	$25	22.9%	6.1%	$22,026
$50 - $100 Million	232	$12	4.7%	2.9%	$51,724
$100 - $250 Million	214	$19	4.3%	4.6%	$88,785
$250 - $500 Million	132	$20	2.7%	4.9%	$151,515
$500 - $1 Billion	122	$36	2.5%	8.8%	$295,082
One Billion Plus	326	$285	6.6%	69.5%	$874,233
TOTAL	**4,961**	**$410**	**100.0%**	**100.0%**	**$82,645**
	Number of Taxpayers	**MIC Used ($ in Millions)**			**Average Claim Per Taxpayer**
Personal Income Tax Filers	6,164	$47.0			$7,628

Source: Franchise Tax Board

THE MIC: THE PROMISE AND THE REALITY

Advocates for the MIC made aggressive claims in arguing for its implementation. Supporters released a study claiming that the credit would spur creation of 358,386 new manufacturing jobs between 1993 and 2002.[2] In fact, between 1993 and 2002, average annual manufacturing employment has declined by 54,000, rather than increased (Figure 2).[3]

DATA SUGGEST THAT THE MIC FAILS TO MEET STATUTORY TARGET

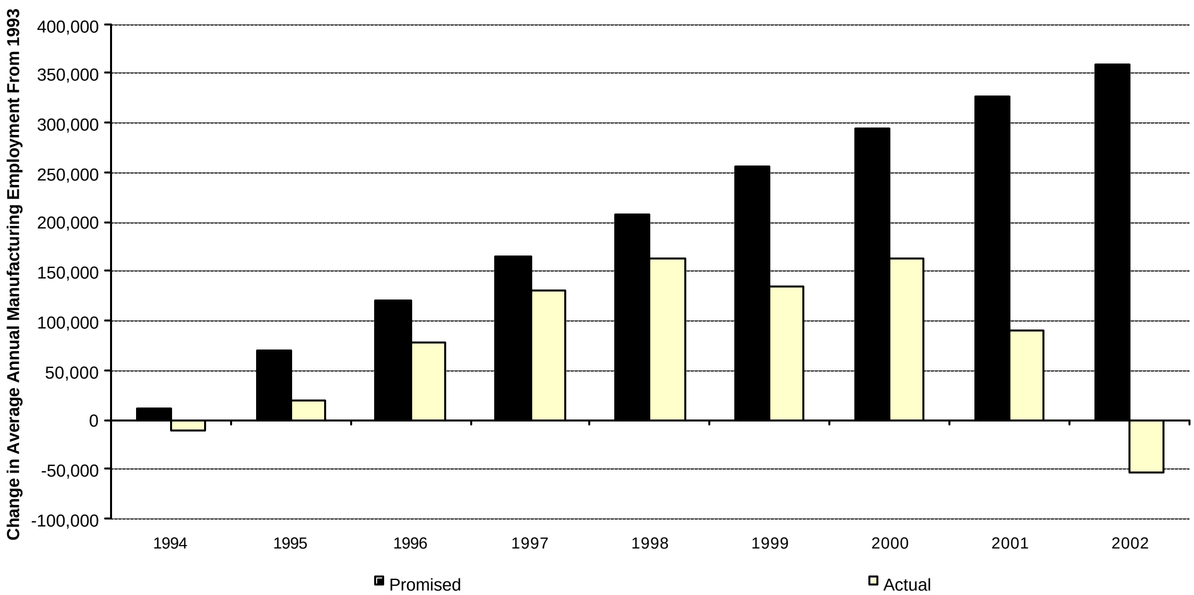
In order to provide a minimal standard of accountability, the state law states that the MIC will:

> "cease to be operative on January 1, 2001, or on January 1 of the earliest year thereafter, if the total employment in this state, as determined by the Employment Development Department on the preceding January 1, does not exceed by 100,000 jobs the total employment in this state on January 1, 1994."[4]

The EDD has not released the required report estimating employment as of January 1, 2003, citing technical difficulties relating to the shift to a new system for classifying industry employment, employment data from December 2002 strongly suggest that the credit has failed to meet the statutory employment target and thus should sunset on January 1, 2004. However, using a method consistent with that used by the EDD, the state lost 11,450 manufacturing jobs between January 1, 1994 and January 1, 2003.[5] Updated average annual employment figures show that average manufacturing employment (excluding aerospace) in 2002 was just 5,000 higher than that in 1993.[6]

Figure 2

Job Growth Has Consistently Lagged Proponents' Promises



Source: AUS Consultants and Employment Development Department

Most of the MIC Goes to Very Large Corporations

While a number of small corporations claim the MIC, most of the credits claimed go to the state's largest corporations. Corporations with total receipts under $5 million accounted for 37.8 percent of the corporations claiming the MIC, but only 1.7 percent ($7 million) of the total credits claimed by corporations in 2000 (Table 1). In contrast, the 6.6 percent of credit users with total receipts of over $1 billion claimed 69.5 percent ($285 million) of the credits used in 2000.

Moreover, the average credit used by large firms far exceeds that claimed by smaller firms. Corporations with receipts under $5 million claimed an average 2000 credit of $3,733, while the largest firms – those with receipts over $1 billion – claimed an average credit of $874,233.

Who Uses the MIC?

Between 1995 and 2000, electronics manufacturing corporations claimed the largest share of the MIC (31.2 percent). "Other" manufacturing corporations claimed 29.0 percent. Oil and gas companies claimed 13.2 percent of the total credits claimed during the same period. MIC use by electronics firms increased between 1995 and 2000, while oil company usage peaked at $105 million in 1996 as refineries retooled to meet clean air standards.

Does MIC Use Correspond to Increased Employment?

Since such a small percent of the state's manufacturers claim the MIC, it would be inappropriate to attribute employment trends to the availability of the credit. State law does not require firms claiming the credit to report employment levels. Thus, it is impossible to determine whether firms claiming the credit are adding more jobs than similar firms that do not claim the credit, or whether they are shedding more jobs than firms that do not claim the credit.

Table 2 Tax Credits Not Necessarily Linked to Job Growth	Change in Average Annual Employment, 1993-2002	Total Claimed, 1995-2000 (in 000s)	Percent of Total Claimed	Credits Per Change in Employment
Food and Kindred Products	(5,400)	$170,280	8.2%	$(31,533)
Chemicals and Allied Products (excl. Drugs)	(3,400)	$63,071	3.0%	$(18,550)
Drugs	12,100	$91,129	4.4%	$7,531
Oil and Gas Refining and Related Industries	(6,100)	$275,327	13.2%	$(45,136)
Electrical and Electronic Equipment	(22,900)	$651,498	31.2%	$(28,450)
Other Manufacturing	(28,300)	$605,683	29.0%	$(21,402)
Other		$230,556	11.0%	
Total Manufacturing	(54,000)	$2,087,545	100.0%	$(38,658)

Source: Franchise Tax Board and Employment Development Department

Employment has declined since the creation of the MIC in some sectors that have used a significant share of the total credits claimed (Table 2). Oil and related industry employment, for example, has dropped steadily since 1993. Chemical and allied employment, excluding drug companies, dropped between 1993 and 1996 and remains far below pre-MIC levels. Electronics employment, on the other hand, rose between 1993 and 2000 and has subsequently declined.

Many Corporations Use the MIC to Avoid a Majority of Their Tax Liability

Over half the corporations that claimed the MIC in 2000 used it to avoid over half of their tax liability. Forty percent of the firms claiming the credit used it to avoid at least three-quarters of their tax liability. According to the Franchise Tax Board, the MIC was responsible for an average reduction in tax liability of 58 percent in 2000.[7]

Conclusion

The MIC has failed to deliver on proponents' promises of manufacturing job growth. Instead, the MIC provides a substantial tax cut to relatively few of the state's manufacturers. Moreover, the credit has been expanded beyond the credit's initial purposes, with a substantial fraction of the credit going to businesses that are not primarily manufacturers. California can ill-afford to continue programs that fail to achieve their stated goals.

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the California Budget Project is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's web site at www.cbp.org.

ENDNOTES

[1] Assembly Revenue and Taxation Committee, *Analysis of AB 1313* (May 17, 1993) and Senate Office of Research, *An Overview of the Budget Solution for 1993-94* (July 1, 1993).
[2] AUS Consultants (September 8, 1993). The AUS study also predicted the addition of 3,946 related construction jobs.
[3] Employment Development Department, Labor Market Information Division, *Industry Employment & Labor Force - by Annual Average* (Updated March 10, 2003) downloaded from www.calmis.cahwnet.gov / file / indhist / cal$haw.xls on March 15, 2003.
[4] SB 671 (Alquist, Chapter 881 of 1993). This measure defined "total employment" as the total employment in the manufacturing sector, excluding aerospace employment.
[5] It is important to note that the data for the two times are not strictly comparable. This method averages monthly employment for December and January of the two respective periods.
[6] The Employment Development Department has ceased to publish a consistent time series of monthly employment data. Currently available monthly data for 2001 and 2002 are not consistent with available data for prior years.
[7] Economic and Statistical Research Bureau, Franchise Tax Board, *Manufacturer's Investment Credit Presented to Assembly Revenue and Taxation Committee* (February 3, 2003).