This document contains links that are color coded in blue, red and green. When you click on a color-coded link, you are taken to another location within the document.

In table one and two, clicking on a blue link, takes you to the detailed description of that tax expenditure in the text. Clicking on a red link, takes you to table three, that groups tax expenditures by topic.

In table three, clicking on a blue link takes you back to a revenue summary table (table one if the tax expenditure is nonconformity, table two, otherwise). For tax expenditures that are listed in more than one category, clicking on a green link, takes you to the next category where this tax expenditure is listed.

In the text, clicking on a blue link takes you back to a revenue summary table (table one if the tax expenditure is nonconformity, table two, otherwise).

California Income Tax Expenditures

Compendium of Individual Provisions

September 2003

California Franchise Tax Board

Economic and Statistical Research Bureau

INCOME TAX EXPENDITURES
Compendium of Individual Provisions

This report was prepared in the Economics and Statistical Research Bureau of the California Franchise Tax Board, under the direction of Phil Spilberg. The principal authors of the report were Allen Prohofsky and Jay Chamberlain. Primary research on the tax expenditures was conducted by Bagher Modjtahedi, Hoang Nguyen, Luyen Pham, and Allen Prohofsky. George Ramsey and Larry Gilbert developed much of the data used in the statistical analyses of the expenditure items. John Pavlasky and Jeff Garnier of the Legislative Services Bureau and Geoff Way and Debra Peterson, along with other attorneys in the Legal Division provided review support for the analyses of the expenditure items. Phil Spilberg, Jerry Mountjoy, Lori Alexander, Karin Fowler, and Helena Creed provided helpful comments in the review of this report.

CALIFORNIA INCOME TAX EXPENDITURES
COMPENDIUM OF INDIVIDUAL PROVISIONS

Final Report

Table Of Contents

		Page
OVERVIEW		
Figure 1 Estimates of State Revenue Loss for Non-Conformity Items		**i**
Figure 2 Estimates of State Revenue Loss for Conformity Items		**iii**
Figure 3 Tax Expenditures by Topic		**vii**
SECTION I	**THE CONCEPT OF TAX EXPENDITURES**	**1**
I.1.	**Tax Expenditures are Deviations from Normal Tax Law**	**1**
	Normal Tax Law	**1**
I.2.	**Consideration Involved in the Adoption and Retention of Tax Expenditures**	**2**
	Policy Motivations	**3**
	Equity	**3**
	Behavioral Incentives	**3**
	Administrative Issues	**4**
	Constitutional Issues	**4**
	Conformity	**4**
	Other Administrative Issues	**5**
	Disadvantages of Tax Expenditures	**6**
	Increases in General Tax Rates	**6**
	Complexity of the Tax Code	**6**
	Undesirable Behavioral Effects	**6**
	Windfalls	**7**
	Reduced Policy Flexibility	**7**
	Alternatives to Tax Expenditures	**7**
I.3.	**Conceptual Summary**	**9**
SECTION II	**ANALYSIS OF TAX EXPENDITURES**	**11**
	NON-CONFORMITY ITEMS	**12**
	Exclusion of Social Security Benefits	**12**
	Dependent Exemption Credit in Excess of Personal Exemption Credit	**14**
	Research and Development Expenses Credit	**15**
	Manufacturing Investment Credit	**19**

CALIFORNIA INCOME TAX EXPENDITURES
COMPENDIUM OF INDIVIDUAL PROVISIONS

Final Report

Table Of Contents

	Page
Water's-Edge Election	21
Exclusion of Interest on Federal Government Obligations	23
Special Treatment for Economically-Depressed Areas	24
Employer Credits – Hiring Credit and Sales and Use Tax Credit	24
Taxes Paid by EZ Employees	25
Income from Investments in Economically Depressed Areas	26
Business Expense Deduction for Activities within Economically Depressed Areas	27
Child and Dependent Care Expenses Credit	28
Teacher Retention Credit	29
Double-Weighted Sales Apportionment Formula	31
Senior Exemption Credit	33
Renter's Credit	35
Exclusion of Unemployment Insurance Benefits	36
Exclusion of Capital Gains on Small Business Stock	38
Joint Strike Fighter Property and Wage Credits	39
Exclusion of State Lottery Winnings	40
Low-Income Rental Housing Expenses Credit	41
Credit Union Treatment	43
Limited Partnership Investment Source Rules	44
Natural Heritage Preservation Credit	45
Casualty Loss Deduction	45
Employer Childcare Credits	47
Solar Energy Systems Credit	50
Long-Term Care Credit	52
Blind Exemption Credit	53
Child Adoption Expenses Credit	54
Enhanced Oil Recovery Costs Credit	55
Joint Custody Head-of-Household Credit	56
Qualified Senior Head-of-Household Credit	57
Disability Access Expenditure Credit	58
Community Development Financial Institution Credit	60
Rice Straw Credit	61
Dependent Parent Credit	62

CALIFORNIA INCOME TAX EXPENDITURES
COMPENDIUM OF INDIVIDUAL PROVISIONS

Final Report

Table Of Contents

	Page
Transportation of Donated Agricultural Products Credit	63
Prison Inmate Labor Costs Credit	64
Farmworker Housing Costs Credit	65
CONFORMITY ITEMS	66
Mortgage Interest Deduction	67
Exclusion of Employer Contributions to Pension Plans	69
Exclusion of Employer Contributions to Accident And Health Plans	70
Basis Step-up on Inherited Property	71
Charitable Contribution Deduction	72
Exclusion of Proceeds from Life Insurance and Annuity Contracts	75
Real Property Tax Deduction	75
Exclusion of Capital Gains on the Sale of a Principal Residence	77
Employee Business and Miscellaneous Expense Deduction	78
Head-of-Household and Qualifying Widower Filing Status	80
Exclusion of Benefits Provided Under Cafeteria Plans	81
Depreciation Amounts Beyond Economic Depreciation	82
Individual Retirement Accounts	83
Exclusion of Compensation for Injuries or Sickness	84
Self-Employed Retirement Plans	85
Exclusion of Miscellaneous Fringe Benefits	86
Exclusion of Transportation Related Fringe Benefits	87
Medical and Dental Expense Deduction	87
Tax-Exempt Status for Qualifying Corporations	89
Accelerated Depreciation of Research and Experimental Costs	89
Personal Property and Other Tax Deduction	91
Exclusion of Employer Contributions for Life Insurance	92
Self-Employed Health Insurance Premium Deduction	93
Exclusion of Scholarships, Fellowships, and Grants	94

CALIFORNIA INCOME TAX EXPENDITURES
COMPENDIUM OF INDIVIDUAL PROVISIONS

Final Report

Table Of Contents

	Page
Exclusion of Meals and Lodging Furnished by an Employer	94
Exclusion of Foster Care Payments	95
Exclusion of Employee Child and Dependent Care Benefits	96
Percentage Resource Depletion Allowance	97
Moving Expense Deduction	98
Exclusion of Employer-Provided Education Assistance	99
Expensing of Agricultural Costs for Soil or Water Conservation and Prevention of Erosion	100
Student Loan Interest Deduction	101
Exclusion of Income Earned on Section 529 Plans	102
Amortization of Reforestation Expenditures	102
Employee Stock Ownership Plans	103
Expensing of Circulation Costs of Periodicals	104
Energy Policy Act of 1992	104
Medical Savings Account Deduction	105
Reserve Allowance for Bad Debts Deduction	106
Exclusion of Recycled or Redeemed Beverage Container Redemption Payments	106
Exclusion of Earnings on Coverdale Education Individual Savings Accounts	107

Overview

This report on California tax expenditures was prepared by the staff of the Franchise Tax Board in response to a request from Carole Migden, Member of the Franchise Tax Board and Chairperson of the State Board of Equalization. The report only considers tax expenditures in the California Corporation Tax and the California Personal Income Tax. It begins with a discussion of the concept of tax expenditures, covering a number of definitional and policy issues common to tax expenditures. The report then presents expenditure-specific analysis of tax expenditures items that are currently part of the California income tax system. The analysis of specific expenditures is organized by first classifying expenditures according to whether or not they conform to provisions of federal tax law, then ranking them according to their impact on state revenue. Figure 1 provides a list of all the non-conformity expenditure items, the cost of each expenditure, and the page number on which the expenditure write-up can be found. Figure 2 provides the same information for conformity expenditure items. Figure 3 provides a listing of tax expenditures by policy goal.

Figure One

Income Tax Expenditures
Compendium of Individual Provisions

Estimates of State Revenue Loss for Non-Conformity Items
(In Millions)

Item Number	Page	Non-Conformity Items	Calender Year 2001	Fiscal Year 2001/02	Fiscal Year 2002/03	Fiscal Year 2003/04
1	12	Exclusion of Social Security Benefits	$1,000	1,000	1,000	1,000
2	14	Dependent Exemption Credit in Excess of Personal Exemption Credit	814	835	835	865
3	15	Research and Development Expenses Credit	445	455	560	519
4	19	Manufacturing Investment Credit	358	375	425	403
5	21	Water's-Edge Election	350	360	360	400
6	23	Exclusion of Interest on Federal Government Obligations	202	205	210	215
7	24	Special Treatment for Economically Depressed Areas	200	205	215	225
8	28	Child and Dependent Care Expenses Credit	178	180	180	180
9	29	Teacher Retention Credit	166	165	5	180
10	31	Double-Weighted Sales Apportionment Formula	128	130	130	130
11	33	Senior Exemption Credit	103	105	105	105
12	35	Renter's Credit	93	95	98	101
13	36	Exclusion of Unemployment Insurance Benefits	74	75	82	76
14	38	Exclusion of Capital Gains on Small Business Stock	45	45	50	53
15	39	Joint Strike Fighter Property and Wage Credits	0	0	11	39
16	40	Exclusion of State Lottery Winnings	36	37	39	41
17	41	Low-Income Rental Housing Expenses Credit	20	25	30	38
18	43	Credit Union Treatment	10	10	10	10
19	44	Limited Partnership Investment Source Rules	10	10	10	10

Figure One

Income Tax Expenditures
Compendium of Individual Provisions

Estimates of State Revenue Loss for Non-Conformity Items
(In Millions)

Item Number	Page	Non-Conformity Items	Calender Year 2001	Fiscal Year 2001/02	Fiscal Year 2002/03	Fiscal Year 2003/04
20	45	Natural Heritage Preservation Credit	8	8	8	14
21	45	Casualty Loss Deduction	6	6	6	6
22	47	Employer Childcare Credits	4	5	5	5
23	50	Solar Energy Systems Credit	3	3	6	10
24	52	Long-Term Care Credit	2	2	2	2
25	53	Blind Exemption Credit	2	2	2	2
26	54	Child Adoption Expenses Credit	1	1	2	3
27	55	Enhanced Oil Recovery Costs Credit	1	1	1	1
28	56	Joint Custody Head-of-Household Credit	1	1	1	1
29	57	Qualified Senior Head-of-Household Credit	Minor	Minor	Minor	Minor
30	58	Disability Access Expenditure Credit	Minor	Minor	Minor	Minor
31	60	Community Development Financial Institution Credit	Minor	Minor	Minor	Minor
32	61	Rice Straw Credit	Minor	Minor	Minor	Minor
33	62	Dependent Parent Credit	Minor	Minor	Minor	Minor
34	63	Transportation of Donated Agricultural Products Credit	Minor	Minor	Minor	Minor
35	64	Prison Inmate Labor Costs Credit	Minor	Minor	Minor	Minor
36	65	Farmworker Housing Costs Credit	Minor	Minor	Minor	Minor

Figure Two

Income Tax Expenditures
Compendium of Individual Provisions

Estimates of State Revenue Loss for Conformity Items
(In Millions)

Item Number	Page	Conformity Items	Calender Year 2001	Fiscal Year 2001/02	Fiscal Year 2002/03	Fiscal Year 2003/04
1	67	Mortgage Interest Deduction	3,675	4,100	4,600	4,800
2	69	Exclusion of Employer Contributions to Pension Plans	3,169	3,250	3,090	3,500
3	70	Exclusion of Employer Contributions to Accident and Health Plans	2,535	2,600	2,950	3,150
4	71	Basis Step-up on Inherited Property	1,346	1,380	1,410	1,520
5	72	Charitable Contribution Deduction	1,108	1,136	1,136	1,198
6	75	Exclusion of Proceeds from Life Insurance and Annuity Contracts	853	875	890	910
7	75	Real Property Tax Deduction	808	829	867	915
8	77	Exclusion of Capital Gains on the Sale of a Principal Residence	659	700	750	800
9	78	Employee Business and Miscellaneous Expense Deduction	610	626	668	705
10	80	Head-of-Household and Qualifying Widower Filing Status	554	568	582	597
11	81	Exclusion of Benefits Provided Under Cafeteria Plans	410	420	520	550
12	82	Depreciation Amounts Beyond Economic Depreciation	398	408	420	430
13	83	Individual Retirement Accounts	385	395	420	450
14	84	Exclusion of Compensation for Injuries or Sickness	215	220	225	230
15	85	Self-Employed Retirement Plans	210	215	220	225
16	86	Exclusion of Miscellaneous Fringe Benefits	205	210	220	230
17	87	Exclusion of Transportation Related Fringe Benefits	150	150	150	150
18	87	Medical and Dental Expense Deduction	122	125	125	115
19	89	Tax-Exempt Status for Qualifying Corporations	117	120	125	125

Figure Two

Income Tax Expenditures
Compendium of Individual Provisions

Estimates of State Revenue Loss for Conformity Items
(In Millions)

Item Number	Page	Conformity Items	Calender Year 2001	Fiscal Year 2001/02	Fiscal Year 2002/03	Fiscal Year 2003/04
20	89	Accelerated Depreciation of Research and Experimental Costs	100	103	106	108
21	91	Personal Property and Other Tax Deduction	92	0	0	122
22	92	Exclusion of Employer Contributions for Life Insurance	83	85	89	93
23	93	Self-Employed Health Insurance Premium Deduction	50	75	115	140
24	94	Exclusion of Scholarships, Fellowships, and Grants	47	48	52	56
25	94	Exclusion of Meals and Lodging Furnished by an Employer	29	30	33	33
26	95	Exclusion of Foster Care Payments	22	22	22	22
27	96	Exclusion of Employee Child and Dependent Care Benefits	21	22	30	30
28	97	Percentage Resource Depletion Allowance	21	21	21	21
29	98	Moving Expense Deduction	21	21	21	21
30	99	Exclusion of Employer-Provided Education Assistance	17	17	17	17
31	100	Expensing of Agricultural Costs for Soil or Water Conservation and Prevention of Erosion	12	12	12	12
32	101	Student Loan Interest Deduction	11	15	16	17
33	102	Exclusion of Income Earned on Section 529 Plans	7	9	11	12
34	102	Amortization of Reforestation Expenditures	7	7	7	7
35	103	Employee Stock Ownership Plans	4	4	4	4
36	104	Expensing of Circulation Costs for Periodicals	4	4	4	4
37	104	Energy Policy Act of 1992	2	2	2	2

Figure Two

Income Tax Expenditures
Compendium of Individual Provisions

Estimates of State Revenue Loss for Conformity Items
(In Millions)

Item Number	Page	Conformity Items	Calender Year 2001	Fiscal Year 2001/02	Fiscal Year 2002/03	Fiscal Year 2003/04
38	105	Medical Savings Account Deduction	1	1	1	1
39	106	Reserve Allowance for Bad Debts Deduction	1	1	1	1
40	106	Exclusion of Recycled or Redeemed Beverage Container Redemption Payments	1	1	1	1
41	107	Exclusion of Earnings on Coverdale Education Individual Savings Accounts	Minor	Minor	1	1

Figure 3
Tax Expenditures by Topic

Topic	Item	Page
1. Expenditures Benefiting Children		
A. Bolstering Income for Families		
1. Dependent Exemption Credit in Excess of Personal Exemption Credit	N 2	14
2. Exclusion of Foster Care Payments	C 26	95
3. Head-of-Household and Qualifying Widower Filing Status	C 10	80
4. Joint Custody Head-of-Household Credit	N 28	56
5. Qualified Senior Head-of-Household Credit	N 29	57
B. Assistance for Non-Biological Parents		
1. Child Adoption Expenses Credit	N 26	54
2. Exclusion of Foster Care Payments	C 26	95
3. Qualified Senior Head-of-Household Credit	N 29	57
C. Subsidizing Single Parents		
1. Head-of-Household and Qualifying Widower Filing Status	C 10	80
D. Child Care Subsidies		
1. Employer Childcare Credits	N 22	47
2. Exclusion of Employee Child and Dependent Care Benefits	C 27	96
3. Child and Dependent Care Expenses Credit	N 8	28
2. Expenditures for Education		
A. Saving for College		
1. Exclusion of Earnings on Coverdale Education Individual Savings Accounts	C 41	107
2. Exclusion of Income Earned on Section 529 Plans	C 33	102
B. 3rd Party Funding for Education		
1. Exclusion of Scholarships, Fellowships, and Grants	C 24	94
2. Exclusion of Employer-Provided Education Assistance	C 30	99
3. Student Loan Interest Deduction	C 32	101
C. Encouraging Teaching		
1. Teacher Retention Credit	N 9	29
3. Expenditures Benefiting the Elderly		
A. Income Subsidies		
1. Exclusion of Social Security Benefits	N 1	12
2. Senior Exemption Credit	N 11	33
B. Subsidies for Care of the Elderly		
1. Dependent Parent Credit	N 33	62
2. Head-of-Household and Qualifying Widower Filing Status	C 10	80
C. Subsidies for Elderly with Dependents		
1. Qualified Senior Head-of-Household Credit	N 29	57

Note: The N in the item column designates this expenditure item as a non-conformity item. The C in the item column designates this expenditure item as a conformity item

Figure 3
Tax Expenditures by Topic

Topic	Item	Page
4. Expenditures for Modifying the Environment		
A. Land and Water Conservation		
1. Expensing of Agricultural Costs for Soil or Water Conservation and Prevention of Erosion	C 31	100
2. Amortization of Reforestation Expenditures	C 34	102
3. Natural Heritage Preservation Credit	N 20	45
4. Exclusion of Recycled or Redeemed Beverage Container Redemption Payments	C 40	106
B. Promoting Energy Conservation		
1. Solar Energy Systems Credit	N 23	50
2. Energy Policy Act of 1992	C 37	104
C. Reducing Air Pollution		
1. Rice Straw Credit	N 32	61
2. Energy Policy Act of 1992	C 37	104
5. Expenditures Facilitating Employment		
A. Benefits for Employees Requiring Childcare		
1. Employer Childcare Credits	N 22	47
2. Exclusion of Employee Child and Dependent Care Benefits	C 27	96
3. Child and Dependent Care Expenses Credit	N 8	28
B. Transportation Subsidies		
1. Exclusion of Transportation Related Fringe Benefits	C 17	87
2. Moving Expense Deduction	C 29	98
C. Benefits for Specific Industries		
1. Farmworker Housing Costs Credit	N 36	65
2. Teacher Retention Credit	N 9	29
D. Benefits for Targeted Disadvantaged Populations		
1. Special Treatment for Economically Depressed Areas	N 7	24
2. Prison Inmate Labor Costs Credit	N 35	64
6. Expenditures for Health Care		
A. Insurance Purchase Subsidies		
1. Exclusion of Employer Contributions to Accident and Health Plans	C 3	70
2. Self-Employed Health Insurance Premium Deduction	C 23	93
3. Exclusion of Benefits Provided Under Cafeteria Plans	C 11	81
B. Other Medical Expense Prepayment Subsidies		
1. Medical Savings Account Deduction	C 38	105
C. Benefits for Taxpayers Who Have Incurred Major Health-Related Expenses		
1. Medical and Dental Expense Deduction	C 18	87
2. Exclusion of Compensation for Injuries or Sickness	C 14	84

Note: The N in the item column designates this expenditure item as a non-conformity item. The C in the item column designates this expenditure item as a conformity item

Figure 3
Tax Expenditures by Topic

Topic	Item	Page
D. Benefits for Assistance Providers		
1. Long-Term Care Credit	N 24	52
2. Disability Access Expenditure Credit	N 30	58
E. Benefits for Specific Medical Problems60		
1. Blind Exemption Credit	N 25	53
7. Expenditures for Housing		
A. Benefits for Homeowners		
1. Mortgage Interest Deduction	C 1	67
2. Exclusion of Capital Gains on the Sale of a Principal Residence	C 8	77
3. Real Property Tax Deduction	C 7	75
B. Benefits for Rental Housing		
1. Renter's Credit	N 12	35
2. Low-Income Rental Housing Expenses Credit	N 17	41
8. Expenditures Related to Finance		
A. Rules for Alternative Business Ownership Structures		
1. Limited Partnership Investment Source Rules	N 19	44
2. Credit Union Treatment	N 18	43
3. Employee Stock Ownership Plans	C 35	103
B. Special Rules for Banking		
1. Reserve Allowance for Bad Debts Deduction	C 39	106
2. Credit Union Treatment	N 18	43
3. Community Development Financial Institution Credit	N 31	60
C. Financing Small Businesses		
1. Exclusion of Capital Gains on Small Business Stock	N 14	38
9. Expenditures for Business Investments		
A. Depreciation		
1. Depreciation Amounts Beyond Economic Depreciation	C 12	82
2. Accelerated Depreciation of Research & Experimental Costs	C 20	89
B. Research and Development		
1. Accelerated Depreciation of Research & Experimental Costs	C 20	89
2. Research and Development Expenses Credit	N 3	15
C. Equipment and Infrastructure		
1. Manufacturing Investment Credit	N 4	19
2. Disability Access Expenditure Credit	N 30	58
3. Joint Strike Fighter Property and Wage Credits	N 15	39
4. Enhanced Oil Recovery Costs Credit	N 27	55

Note: The N in the item column designates this expenditure item as a non-conformity item. The C in the item column designates this expenditure item as a conformity item

Figure 3
Tax Expenditures by Topic

Topic	Item	Page
D. Subsidies for the Petroleum Industry		
1. Enhanced Oil Recovery Costs Credit	N 27	55
2. Percentage Resource Depletion Allowance	C 28	97
E. Subsidies for Other Specific Industries		
1. Joint Strike Fighter Property and Wage Credits	N 15	39
2. Expensing of Circulation Costs for Periodicals	C 36	104
3. Low-Income Rental Housing Expenses Credit	N 17	41
F. Subsidies for Investments in Targeted Locations		
1. Special Treatment for Economically Depressed Areas	N 7	24
2. Community Development Financial Institution Credit	N 31	60
G. Preferential Treatment for Small Businesses		
1. Exclusion of Capital Gains on Small Business Stock	N 14	38
2. Reserve Allowance for Bad Debts Deduction	C 39	106
10. Expenditures for Employer Provided Benefits		
A. Insurance		
1. Exclusion of Employer Contributions to Accident and Health Plans	C 3	70
2. Self-Employed Health Insurance Premium Deduction	C 23	93
3. Exclusion of Employer Contributions for Life Insurance	C 22	92
4. Exclusion of Benefits Provided Under Cafeteria Plans	C 11	81
B. Pension Plans		
1. Exclusion of Employer Contributions to Pensions Plans	C 2	69
2. Self-Employed Retirement Plans	C 15	85
C. Transportation Subsidies		
1. Exclusion of Transportation Related Fringe Benefits	C 17	87
2. Moving Expense Deduction	C 29	98
3. Employee Business and Miscellaneous Expense Deduction	C 9	78
4. Exclusion of Miscellaneous Fringe Benefits	C 16	86
D. Childcare Benefits		
1. Exclusion of Employee Child and Dependent Care Benefits	C 27	96
2. Exclusion of Benefits Provided Under Cafeteria Plans	C 11	81
E. Employee Housing		
1. Exclusion of Meals and Lodging Furnished by an Employer	C 25	94
2. Farmworker Housing Costs Credit	N 36	65
F. Other Employer Provided Benefits		
1. Exclusion of Employer-Provided Education Assistance	C 30	99
2. Employee Business and Miscellaneous Expense Deduction	C 9	78
3. Exclusion of Miscellaneous Fringe Benefits	C 16	86
11. Expenditures Encouraging Savings		
A. For Retirement		
1. Individual Retirement Accounts	C 13	83
2. Exclusion of Employer Contributions to Pensions Plans	C 2	69

Note: The N in the item column designates this expenditure item as a non-conformity item. The C in the item column designates this expenditure item as a conformity item

Figure 3
Tax Expenditures by Topic

Topic	Item	Page
3. Self-Employed Retirement Plans	C 15	85
B. For Medical Expenses		
1. Medical Savings Account Deduction	C 38	105
C. For College		
1. Exclusion of Earnings on Coverdale Education Individual Savings Accounts	C 41	107
2. Exclusion of Income Earned on Section 529 Plans	C 33	102
12. Expenditures for Capital Gains		
1.Basis Step-Up on Inherited Property	C 4	71
2. Exclusion of Capital Gains on the Sale of a Principal Residence	C 8	77
3. Exclusion of Capital Gains on Small Business Stock	N 14	38
13. Expenditures for Government Programs		
A. Expanded Benefits for Payments Received		
1. Exclusion of Interest on Federal Government Obligations	N 6	23
2. Exclusion of Unemployment Insurance Benefits	N 13	36
3. Exclusion of State Lottery Winnings	N 16	40
4. Exclusion of Scholarships, Fellowships, and Grants	C 24	94
B. Compensation for Non-Income Taxes		
1. Real Property Tax Deduction	C 7	75
2. Personal Property and Other Tax Deduction	C 21	91
14. Expenditures for Catastrophes		
A. Life Insurance		
1. Exclusion of Proceeds from Life Insurance and Annuity Contracts	C 6	75
2. Exclusion of Employer Contributions for Life Insurance	C 22	92
B. Other Catastrophes		
1. Casualty Loss Deduction	N 21	45
15. Expenditures Related to the Definition of Corporate Income		
A. General Structure of Corporate Taxation		
1. Water's-Edge Election	N 5	21
2. Double-Weighted Sales Apportionment Formula	N 10	31
B. Nonprofit Activities		
1. Charitable Contribution Deduction	C 5	72
2. Tax-Exempt Status for Qualifying Corporations	C 19	89
3. Transportation of Donated Agricultural Products Credit	N 34	63
4. Credit Union Treatment	N 18	43

Note: The N in the item column designates this expenditure item as a non-conformity item. The C in the item column designates this expenditure item as a conformity item

Section I: The Concept of Tax Expenditures

1. Tax Expenditures are Deviations from Normal Tax Law

Tax expenditures, as defined by federal law, are "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[1] According to the federal Joint Committee on Taxation (JCT), the legislative history of this congressional act indicates that tax expenditures are to be defined with respect to a "normal income tax structure."[2] This same concept of provisions of the tax code that reduce tax relative to normal tax law can be applied to California tax law. The concept of normal California tax law will be explored below.

The term *tax expenditures* alludes to the fact that the policy objectives supported by these tax provisions could be achieved by other means. Rather than reducing beneficiaries' taxes, the Legislature could, for example, establish direct expenditure programs to allocate money toward its policy goals.

Normal Tax Law

Conceptually, a broad definition of income should be used in determining the normal tax law against which tax expenditures are to be measured. Using the broadest possible definition of income generally makes for sound tax policy, because the broader the base, the lower the tax rate needed to achieve a desired level of revenues; and lower tax rates produce fewer economic distortions.

Following the JCT methodology, this report assumes that the existing tax rate structure is part of normal tax law, even though the tax rates vary for different levels of income. The JCT methodology includes the zero percent tax bracket as part of normal Personal Income Tax (PIT) Law. The zero bracket is the amount of income that a taxpayer can earn and still owe no taxes. It is defined by the presence of one personal exemption for each taxpayer and one for each dependent, plus the standard deduction. These items of normal tax law are not classified as tax expenditures. Itemized deductions that are not necessary for the generation of income are considered to be tax expenditures,[3] but only to the extent that they exceed the standard deduction. Most other tax benefits to individual taxpayers are considered tax expenditures.

Some difficult issues arise in the definition of normal income for businesses. Businesses routinely invest in property and equipment that lasts for a long time. These costs should be depreciated; i.e., the tax deductions for these investments should be spread out over

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[1] Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), Sec. 3(3).
[2] Much of the discussion that follows is taken from *Estimates of Federal Tax Expenditures for Fiscal Years 2003 – 2007*, prepared for the Committee on Ways and Means and the Committee on Finance by the Joint Committee on Taxation, December 19, 2002, USGPO, 2002.
[3] Deductions that are necessary for the generation of income include those for investments and for employee business expenses.

the useful life of the investment. The JCT generally considers a method for doing this known as straight-line depreciation (Internal Revenue Code Section 168[g]) to represent normal tax law. Alternatives that provide more favorable treatment of capital expenses, including accelerated depreciation, expensing, and investment tax credits, are considered tax expenditures. The JCT also assumes that normal tax law requires the accrual method of accounting, use of the "economic performance" standard for testing whether liabilities are deductible, and requires a general concept of matching income and expenses. Provisions not satisfying these three standards are considered tax expenditures. The JCT considers net operating loss carrybacks and carryforwards to be part of normal tax law.

Provisions in the tax code that generate less favorable treatment than normal tax law (as defined above) are not considered to be tax expenditures. Similarly, the Alternative Minimum Tax (AMT) and passive activity loss rules, which reduce the value of many other tax expenditures, are not considered to be tax expenditures. The JCT does, however, consider the interaction of AMT and passive loss rules in its computation of the costs of other tax expenditures.

2. Considerations Involved in the Adoption and Retention of Tax Expenditures

While each individual tax expenditure has its own set of reasons for coming into existence (many of which will be explored in the next section of this report), a number of policy considerations are common to many tax expenditures.

There are two primary policy motivations for adopting tax expenditures. The first is to move towards a more equitable tax system by providing relief to a group of taxpayers who are facing a monetary cost due to their circumstances in life. The second is to provide incentives for taxpayers to alter their behavior.

In addition to these policy goals, decisions to adopt certain tax expenditures may also be driven by administrative concerns. These concerns may include restrictions imposed by the federal government, the desire to keep state tax law in conformity with federal tax law, and other miscellaneous administrative issues.

Proper analysis of tax expenditure policies must consider their potential adverse effects in addition to their desirable effects. The most common concerns arising from the use of tax expenditures are that they:

- May necessitate an increase in tax rates (or, alternatively, a cut in expenditures);
- Complicate the tax code;
- May induce undesirable behavioral reactions from taxpayers;
- May provide expensive windfalls to some taxpayers without furthering the intended policy goals;
- Reduce policy flexibility.

Finally, a complete analysis of the desirability of a particular tax expenditure requires a consideration of possible policy alternatives for achieving the same goal. These alternatives include:

- Reducing general tax rates;
- Government mandates;
- Direct government regulations;
- Direct expenditures;
- Modified tax expenditures.

In the balance of this section, we will explore these considerations in more detail.

Policy Motivations

Equity

A number of tax expenditures are designed to provide tax relief to taxpayers who face monetary costs that are unusual to taxpayers as a whole. Benefits of this type are available to any taxpayer whose circumstances in life fall into the designated category. One example of this is the additional exemption of income for taxpayers (or their spouses) who are blind. The rationale for this type of tax expenditure is to levy tax on an accurate measure of a taxpayer's economic well-being. Under certain circumstances, other issues besides the dollar amount of income earned, marital status, number of dependents, and standard deduction must be considered to accurately measure a taxpayer's economic well-being.

Behavioral Incentives

Many tax expenditures are designed to provide taxpayers with incentives to modify their behavior in a manner deemed by the Legislature to be desirable. These types of expenditures necessarily move the tax system away from the theoretically desirable goal of neutrality. Neutrality is the concept that a tax system should have as little impact on the allocation of resources as possible. In other words, under a neutral tax system, economic agents should make the same decisions that they would be making if there were no tax system and their decisions were motivated solely by the incentives provided by the "free market."

Deviations from neutrality are not necessarily bad policies. Most economists would argue that there are many examples of neutral outcomes that are not optimal. For example, when deciding whether to carpool or drive to work alone, a taxpayer may consider such things as the cost of gas, the wear and tear on her car, the mental stress of driving, along with the hassle of coordinating her schedule with other commuters and having to depend on those other commuters. It is possible, and perhaps likely, that she will not sufficiently take into account the benefits that she is providing to others who commute along her commute route when she carpools; to whit: one less car. In so doing, it is possible that the decision she reaches will not be optimal. She will consider all of the

private costs and benefits of carpooling but will (most likely) insufficiently consider the public costs and benefits. As such, a decision to carpool will be made less often than would be socially optimal. Thus, a credit for carpooling will allow the person making the decision to reap some of the social benefit of carpooling. This will increase the likelihood of a choice being made for carpooling. In such a situation, if the net social benefit from carpooling is positive, the fact that the tax system alters private decisions (or violates tax neutrality) is actually good. Policymakers must be careful, however, to ensure both that tax incentives induce desired behaviors and that they do not induce too much of the desired behaviors.[4]

The effectiveness of behavioral incentives depends on what economists refer to as "price elasticities." Each tax preference reduces the relative price of the favored activity (e.g., in the above example, the credit lowers slightly the cost to the taxpayer of commuting via carpool). Just as some department store sales are more successful than others, a small drop in after-tax prices will sometimes cause many taxpayers to alter their behavior, but other times it will not. The elasticity is the magnitude of the behavioral reaction to a particular change in prices.

Administrative Issues

Federal Preclusion

Some tax expenditures were established by federal mandate. An example of this is the requirement that California exclude from income interest earned on federal savings bonds. This is important because California does not have the authority to modify tax expenditures imposed by the federal government.

Conformity

Many California tax expenditures are identical to provisions found in federal tax law. Conformity to certain federal tax provisions can reduce complexity by allowing taxpayers to use the same calculations for both their federal and their state tax returns. It also reduces administrative costs by enabling California to rely on information exchanges with the IRS to verify substantial portions of Californians' tax returns without developing more expensive independent audit capacity.[5]

The costs of ending conformity between California and federal tax law would be particularly high for any tax expenditures that take the form of exclusions that are not currently reported on tax forms. For example, one tax expenditure on which California conforms to federal practice is the exclusion of employer contributions to pension plans

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[4] In the Carpool Credit example, suppose that we need 10,000 new carpools to relieve congestion and pollution. It would be inefficient to set the credit so high that 50,000 new carpools are formed.

[5] Another benefit of conformity, that is psychological rather than economically substantive, is that taxpayers may feel entitled to all deductions and exclusions available in federal tax law. Even if a tax expenditure is not justifiable on policy grounds, taxpayers may feel that it is unfair for state taxable income to be greater than federal taxable income.

from income. If California eliminated this tax expenditure, employers would need to develop systems for reporting the amount of these contributions made on behalf of each individual taxpayer both to the taxpayer and to the Franchise Tax Board (FTB). Taxpayers would need to be educated to include this extra information on their California tax returns. The FTB would have to modify tax forms to include this item in income and develop an audit system for collecting contribution information from employers and matching this data to individual tax returns.

The costs of ending conformity with federal tax law would be lower for many tax expenditures that involve adjustments to income, such as deductions, that are already reported on tax forms. For example, if California wanted to eliminate the deduction for medical and dental expenses, all that would be required would be to instruct taxpayers to find this deduction on their federal tax return and include it in their adjustments to income for California purposes. FTB would also have to develop a method for verifying that the taxpayer included the appropriate information from their federal return on their California return.

Conformity is not a valid justification for the existence of state tax credits, even those whose calculation conforms to federal law. This is because California could simply eliminate any credit and there would be no increase in compliance costs. Therefore, while it is good policy for state credits that are granted for the same activities or circumstances as similar federal credits to adopt the federal calculations for the amount of income or activity to be credited, there is no reason to argue for the adoption or retention of a credit solely on conformity grounds. The choice of whether a credit should be retained can be made solely on the policy merits of the credit itself, without consideration of conformity.

Other Administrative Issues

Conceptually, the income tax base should include many types of imputed income in addition to income received through cash transfers. An example is the implicit income from owner-occupied housing. To see why, consider two houses identical in every way, except that the first is a rental and the second is owner-occupied. The owner of the first house provides something of value to the renters. In return the renters pay rent. This rent is taxable income to the landlord. The occupants of the second house receive the same benefits (the use of an identical house) as the occupants of the first house. Conceptually, the difference between the rent that they should have paid and the rent they actually paid (zero) is a benefit that ought to be included in taxable income. This could be done by calculating the income that the owners of the second house would have earned if someone else were renting that house and include that in their income. As a practical matter, of course, this calculation would be extremely difficult, so we often choose not to tax imputed income. In fact, it would be so difficult that the JCT describes this problem as an "administrative necessity" and does not report it as a tax expenditure.

Another area in which administrative practicality plays a large role is capital gains. Conceptually, capital gains taxes should be levied on an accrual, rather than a realization,

basis. That is to say that, theoretically, taxpayers should include in income the amount by which their investments have appreciated during the tax year. For many investments, it is difficult to determine the value of this appreciation in years in which the asset is not sold. It is much simpler, therefore, to wait until the asset is sold and tax the entire amount of appreciation since purchase at one time. Since investors will not report all of their gains in any year in which they do not sell all of their assets, this system generates tax expenditures.

Disadvantages of Tax Expenditures.

Increases in General Tax Rates

By definition, tax expenditures are deviations from normal tax law that reduce the amount of tax paid by the affected taxpayer. If a government has a fixed level of revenue that it must raise in order to fund its programs and operations, any revenue forgone through tax expenditures must be raised elsewhere in the tax system. This means that the government must either find a new source of revenue or raise rates for some taxes already in existence. Since raising tax rates generally is bad for the economy, tax expenditures should not be adopted, unless their benefits outweigh the costs to the economy from compensating tax increases. For example, if we eliminated one large PIT tax expenditure, the mortgage interest deduction, we could lower PIT tax rates by about 13 percent across the board and still raise the same amount of revenue. Similarly, if we eliminate the two largest corporate tax credits, the R&D Credit and the Manufacturer's Investment Credit, we could lower the corporate tax rate by approximately 15 percent and still raise the same amount of revenue.

Complexity of the Tax Code

Many tax expenditures increase the complexity of the tax code. Each deduction and credit requires its own calculation. The additional computational complexity is exacerbated by interactions with the Alternative Minimum Tax (AMT). The AMT prevents certain taxpayers from claiming all of their deductions and credits in the current year. Thus, a taxpayers may be required to make not one, but three, new calculations – one for the tax expenditure itself, one for the AMT, and a third in the future tax year in which they apply their carryover AMT credit. In addition to the calculations themselves, many tax expenditures require the generation and retention of copious paperwork in order to prove their validity at audit. Each provision also necessitates additional training and workload for tax auditors. These administrative considerations could potentially outweigh the benefits of some of the less valuable tax expenditures.

Undesirable Behavioral Effects

As was noted above, tax expenditures are often adopted because the Legislature hopes that their incentives will alter the behavior of taxpayers. This, of course, runs counter to a general principle of tax policy called neutrality. This tenet holds that it usually causes inefficient distortions to the economy when different activities face different taxes. In the

case of tax expenditures, we know that the Legislature is trying to compensate for what it perceives as a failure of the free market to provide sufficient incentives for certain activities, so these distortions may be justified. It is very difficult to know, however, if a tax expenditure has been calibrated properly for achieving its desired goal. For example, if a tax credit intended to encourage additional investments of a specific type is set too high, the credit may have the effect of diverting investment from other projects that would be more beneficial to the economy. Another possibility is that a tax expenditure may be adopted on the equity grounds, to offset some cost peculiar to a particular group of taxpayers, but it may also induce behavioral changes. For example, credits for childcare could induce taxpayers to have additional children.

Windfalls

Tax expenditures are a very blunt policy instrument. They are available to broadly defined groups of taxpayers. For this reason, they often provide generous rewards to taxpayers without furthering the policy goals for which they were intended. These windfalls are most noticeable with tax expenditures whose primary motive is to provide behavioral incentives. For example, Enterprise Zone (EZ) Credits may be claimed by taxpayers who would have operated their businesses in the EZs, even in the absence of the credits, not just by those who expanded or relocated their businesses in response to the credit.

The presence of windfalls can dramatically increase the costs of a tax expenditure relative to its benefits. For example, suppose that an investment credit of 10 percent induces a 10 percent increase in private investments. A firm that previously invested $100 now invests $110. The firm claims a credit of $11 ($110 x 10 percent). In this example, the government has paid $11 to generate $10 of benefits.

Reduced Policy Flexibility

We have argued above that tax expenditures are analogous to direct government expenditures. However, the two types of expenditures are treated differently under the Constitution of the State of California. If the Legislature decides that a direct expenditure has not worked out as planned, or has become obsolete, it may be amended or revoked with a simple majority vote. By contrast, it requires a two-thirds vote of the Legislature to undo a failed or obsolete tax expenditure. This supermajority requirement may make it more difficult to amend or abandon tax expenditures that fail to accomplish their policy goals.

Alternatives to Tax Expenditures

There are a variety of other policy instruments available for achieving the policy goals underlying various tax incentives. The next section of this report discusses a number of relevant policy alternatives for specific tax expenditures. Here we describe the broad categories into which these alternatives may be classified.

One alternative that may be considered for any tax expenditure whose goal is to improve the economy in general would be to eliminate the tax expenditure and instead reduce tax rates.

For tax expenditures aimed at spurring investment in specific activities, industries, or geographic locations, alternatives include direct government loans, or direct government loan guarantees or rate subsidies in support of the desired class of projects.

Some policy objectives can be achieved through government mandates, requiring businesses to participate in achieving certain policy goals. For example, the Low-Income Housing Expenses Credit could be replaced with requirements that lenders or developers divert a portion of their economic activity to the low-income market.

Many tax expenditures could be replaced with direct government regulations. This is particularly true for tax expenditures that aim to encourage taxpayers to meet certain environmental objectives. For example, the government could strictly limit the amount of rice straw that could be burnt each year, rather than encourage alternative uses for rice straw through the Rice Straw Credit.

Almost any tax expenditure program could simply be replaced with a direct expenditure program. This is most obvious in the case of credits. For example, instead of offering a Solar Systems Credit, California could make direct payments, equivalent to the tax savings available under the credit, to individuals who purchase and install solar systems. Replacing credits that are not refundable with a direct expenditure program would likely require an increase in the program cost to the state equal to the amount of credits that taxpayers were unable to claim because of the nonrefundability constraint.

Other forms of tax expenditures can also be replaced with direct expenditures, but may be more difficult to administer. For example, the itemized deduction for medical and dental expenses in excess of 7.5 percent of Adjusted Gross Income (AGI) could be replaced with direct payments to individuals with these expenses. The administrative problem is that the value of this deduction may vary across taxpayers, even if the amount of their deduction is the same. Suppose two taxpayers each are entitled to a deduction of $2,000 for these expenses. Taxpayer A is in the 6 percent marginal tax bracket, so her tax savings is $120. Taxpayer B is in the 4 percent tax bracket, so he saves $80. Any direct expenditure that provides the same benefit to these two individuals (on the grounds that they had identical qualifying expenses) would result in a redistribution of income relative to the current deduction. A program that attempted to replicate the impact of the deduction by granting different benefits to people based on their income could be more difficult to administer.

Another general administrative problem with direct expenditures is that losses from fraud may be greater with direct expenditures than with tax expenditures (other than refundable credits). This is because the number of fraudulent claims for a tax expenditure is limited to the number of taxpayers with tax to reduce. With direct expenditures, on the other

hand, people without tax to reduce can apply fraudulently for the benefit, and individuals are more likely to be able to submit multiple claims for the same benefit.

Finally, we note that some tax expenditures could be altered to more precisely achieve their policy goals at lower cost. For example, if the primary goal of the mortgage interest deduction is to increase the percentage of taxpayers who own their own home, it might make more sense to give a large tax credit to taxpayers who are purchasing their first home, rather than the current deduction that is most valuable to taxpayers who already own homes, but are moving to much bigger and more expensive ones.

3. Conceptual Summary

In general, the best tax systems apply low tax rates to a broad tax base. There are, however, some public policy objectives that can be achieved by violating this principle. When elements of the tax base receive preferential treatment, we refer to the treatment as a tax expenditure. The most common types of tax expenditures are:

- Exclusions of certain types of income from tax.
- Deductions from income.
- Tax credits.

Reasons for granting tax expenditures include the desire to offset monetary costs faced by certain classes of taxpayers and the desire to provide incentives to alter taxpayer behavior. Other issues that should to be considered when deciding whether to adopt or retain a tax expenditure are federal limitations on state tax systems, conformity issues, and administrative simplicity.

Adverse consequences of tax expenditures include:

- Higher tax rates on income not receiving preferential treatment.
- Increases in the complexity of the tax code.
- Undesirable behavioral responses by taxpayers taking advantage of preferential treatments.
- Windfall payments from the government to taxpayers who would have undertaken desired activities even in the absence of tax incentives.
- Reduce policy flexibility.

There are potentially many good reasons for using tax expenditures within a tax system. However, careful thought should be given by policymakers to the reason(s) why the tax expenditure is needed and the potential adverse consequences of adopting or retaining the tax expenditure. The pros and cons of each tax expenditure should be weighed as carefully as the pros and cons of any regular government expenditure program.

Section II: Analysis of Tax Expenditures

This section provides more in-depth analysis of many of the tax expenditures that are currently part of California income tax law.

The analysis below presents estimates of the number of taxpayers benefiting from and of the revenue cost of each tax expenditure. For several, more significant tax expenditures, we also present a distributional analysis of the taxpayers claiming the tax expenditure. It should be noted that the tax expenditure estimates are more reliable for some expenditure items than for others. The most reliable estimates are for credits. For these tax expenditures, we present actual amounts of credit claimed in 2001. Estimates for deductions are also generally reliable, since deductions must be reported on tax returns. And since the amount of deduction claimed by each taxpayer is known, we can calculate, for each taxpayer in our statistical sample, how much tax they would have owed if the deduction was not available.

The revenue effects of exclusions and exemptions, on the other hand, are very difficult to estimate. We often do not have data on the actual amount of potential income that taxpayers are not required to report, so we cannot simulate the effects of these tax expenditures directly from tax data. As a result, these estimates are less reliable. The estimates presented are static in nature; i.e., they do not consider any changes that might occur in the overall performance of the California economy if the tax expenditure were removed. We also note that tax expenditures may interact with each other; therefore, it cannot be assumed that the revenue effect of removing two tax expenditures would simply be the sum of the effects of removing each tax expenditure individually.

Finally, we stress the importance of understanding the difference between a tax expenditure estimate and an estimate of the revenue impact of repealing a tax expenditure item. Conceptually, a tax expenditure estimate considers the difference in revenue of two tax systems; one in which the item has always been in place, and one in which the item has never been in place. A revenue estimate of the repeal of an expenditure item, on the other hand, measures the impact of changing from a system with the expenditure item to a system without the expenditure item *at a particular point in time*. These concepts are different and, as a result, estimates of the impact of an expenditure item can be dramatically different depending upon which of the two concepts the estimate is based.

For many expenditure items the difference between these two estimates will be minimal or even nil. For example, the estimates of the exclusion of social security from taxable income would be the same for a tax expenditure estimate and for a repeal revenue estimate. On the other hand, the estimate for the basis step-up for inherited capital gains will differ dramatically between a tax expenditure estimate and a legislative repeal estimate. The reason is that, if the basis step-up is repealed, the repeal would only apply to those assets inherited after the effective data of the legislation. If property is inherited, it may be sold the year it is inherited, the next year, the after that, or any other year after that (or potentially never). Thus, in the first year, the repeal would be effective only for the inherited assets that were inherited in that year and sold in that year. In the second

year for which the repeal is effective, both assets inherited and sold in that year, and assets inherited in the prior year and sold in that year would be effective. Therefore, while in the first year only one "vintage" of inherited assets will be affected, in the second year two "vintages" of in inherited assets will be affected.[6] In each subsequent year an additional vintage of inherited assets will be added to the group of effected assets. Thus, the revenue estimate for repeal would show steady growth over the first several years. For the tax expenditure concept, however, we would estimate the impact if all inherited property that was sold in a particular year did not have the basis step-up, regardless of when it was inherited. Thus, our tax expenditure estimate of the basis step-up is $1.3 billion, while the estimated revenue gain from repeal of the basis step-up is only $2 million.

Following the revenue estimate for each tax expenditure is an overview of policy considerations that may be relevant to that tax expenditure. This overview includes a brief summary of the intent of the tax expenditure, some discussion of the conditions under which the tax expenditure should be viewed as a successful policy tool and, where appropriate, a discussion of potential policy alternatives for achieving the tax expenditure's policy goal.

NON-CONFORMITY ITEMS

1. Exclusion of Social Security Benefits

Description:
This provides an exclusion from gross income for payments received from Social Security.

Amount:
The amount of Social Security income that was reported on federal income tax returns that was excluded from California PIT returns in tax year 2001 was $10.4 billion. However, a large portion of Social Security income, particularly for low and middle-income taxpayers, is also excluded from federal income tax returns. The total amount of Social Security income excluded from PIT returns is unknown. We estimate the tax impact of this exclusion of Social Security income that is reported on federal tax returns to be $655 million. We estimate the total impact of the exclusion of Social Security income to be about $1 billion in tax year 2001.

Number of Tax Returns Affected:
In tax year 2001, 1.2 million Personal Income Tax returns excluded Social Security income that had been reported on their federal tax returns from their California PIT return. The number of taxpayers who had Social Security income but were not required to report it on either their federal or California returns is not known.

[6] Vintage, in this sense, refers to all the assets inherited in a particular year.

Distribution:

Impact of Exclusion of that Portion of Social Security Income that is Reported on Federal Tax Returns: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Exclusion (Thousands of Returns)	Amount of Exclusion Claimed (Millions of Dollars)	Tax Impact of Exclusion (Millions of Dollars)
Less Than $10,000	15.9	127.1	0.1
$10,000 to $19,999	40.9	133.9	1.3
$20,000 to $49,999	614.2	3,996.3	156.0
$50,000 to $99,999	326.1	3,833.0	263.1
$100,000 to $199,999	108.9	1,502.8	155.9
More Than $199,999	50.1	813.0	79.1
Total	1,156.0	10,406.0	655.5

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The primary goal of this exclusion is to reduce the tax liability of Social Security recipients. The exclusion is successful in achieving this purpose.

Social Security is a vehicle for two types of income flows; pension savings and poverty relief. When Social Security first came into existence, the poverty rate for seniors was substantially higher than the overall poverty rate in this country. One goal of the Social Security system is to ensure a minimum level of income support for all participants. To achieve this goal, Social Security payments are more generous than contributions for many low-income participants. To the extent that Social Security payments represent poverty relief, it makes sense to exclude these payments from income, just as other types of welfare payments are excluded from income.

Social Security payments also contain a pension plan component that should not be viewed as poverty relief, but rather as a return on contributions invested in the Social Security system. It would be appropriate tax policy for the pension plan component of Social Security payments to receive the same tax treatment as other pension income. The comparison between Social Security and other pension plans is complicated by the split contribution system used by Social Security. Some Social Security contributions are made by employers and are not taxed. Other contributions are made by employees from after-tax income. It would, therefore, be appropriate to exclude from income benefits equal to the amount of contributions that have already been taxed. Other Social Security benefits ought to be included in income, however. Since they are not, the exclusion of Social Security from AGI has a negative impact on horizontal equity. Consider two taxpayers, both receiving $40,000 this year. One earns $40,000 in investment interest. The other earns $20,000 in interest and receives $20,000 from Social Security. With California's current treatment of Social Security benefits, the first taxpayer will have to

pay tax on the full amount of the $40,000 of wages, while the other taxpayer will only pay tax on the $20,000 of interest received.

One potential problem that is eliminated by this exclusion is that the taxation of Social Security benefits may dissuade some recipients from seeking or retaining employment. This is because the inclusion of social security benefits would push employed recipients into higher marginal tax brackets, reducing the incentive for them to work.

2. Dependent Exemption Credit in Excess of Personal Exemption Credit

Description:
This program allows taxpayers a nonrefundable credit for each of their dependents. In 2002, the credit was $251 per dependent. Using the definition of tax expenditure discussed in Section 1 of this report, only the part of the dependent exemption credit that is greater than the personal exemption credit is considered a tax expenditure. In 2002, the personal exemption credit was $80. The credit phases out for taxpayers whose federal AGI reaches certain thresholds. In 2002, the AGI thresholds were $265,589 for joint filers, $199,192 for heads of household, and $132,793 for married filing separately. The phase-out provisions regarding the dependent exemption credit for high-income taxpayers and the requirements for nonresident taxpayers are the same as those for the personal exemption credit.

Amount:
In tax year 2001, the amount of credits applied (above the personal exemption amount per credit) was $814 million.

Number of Tax Returns Affected:
In tax year 2001, the additional dependent credit amount affected 3.1 million Personal Income Tax returns.

Distributional Analysis:

Amount of Dependent Exemption Credit Greater than the Personal Exemption Credit: 2001		
Adjusted Gross Income Class	Number of Returns Reporting Credit (Thousands of Returns)	Amount of Credit Claimed (Millions of Dollars)
Less Than $10,000	0.4	0.1
$10,000 to $19,999	12.4	1.2
$20,000 to $49,999	960.9	176.1
$50,000 to $99,999	1,356.4	420.8
$100,000 to $199,999	593.8	181.2
More Than $199,999	130.2	34.8
Total	3,054.1	814.2

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The purpose of this program is to reduce the tax liability for taxpayers with dependents. The rationale for this is that the financial responsibilities incurred by taxpayers with dependents reduce the ability of these taxpayers to pay taxes. Prior to 1999, the dependent exemption credit was equal to the personal exemption credit. The credit was increased to more accurately reflect, in the calculation of a taxpayer's tax burden, the reduction in that taxpayer's ability to pay taxes because of the financial responsibilities associated with having dependents. The extent to which the part of the dependent exemption credit that is greater than the personal exemption credit properly compensates taxpayers for the increased financial responsibilities of dependents is unknown.

The federal government offers a dependent deduction rather than a credit. Because of California's highly progressive tax rate structure, however, a credit provides more tax benefit than a deduction to lower-income taxpayers.

The dependent exemption credit is successful in reducing the tax liability of taxpayers with dependents.

3. Research and Development (R&D) Expenses Credit

Description:
This provision allows taxpayers to claim a credit for a portion of their incremental R&D expenses. Incremental expenses are calculated as increases in the ratio of a taxpayer's current-year R&D expenses to gross sales relative to a four-year base period. The credit is equal to 15 percent of qualified incremental R&D expenses, and 25 percent of qualified incremental "basic" R&D expenses. Basic R&D is research conducted at qualified universities or scientific research organizations. Since 1998, California has allowed

taxpayers to elect an alternative formula for calculating their R&D Credit based upon a relative percentage of the Federal Alternative Incremental Credit amount (as adjusted for the difference in the California and federal credit percentages). Once made, the alternative formula election is binding for all future years.

Amount:
In tax year 2001, the amount of credits applied was $20 million under PIT, and $425 million under the Corporate Tax.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 2,050 PIT returns and 1,596 Corporate Tax returns.

Distributional Analysis:
The tables below present information on the distribution of R&D Credits by size of firm and by industry. Firms with gross receipts greater than $1 billion account for only 6 percent of returns claiming the R&D credit, but 63 percent of credits used. The Manufacturing sector accounts for 50 percent of the number of returns and 58 percent of the amount of R&D Credit applied. Within this sector, electrical and electronic equipment claimed the largest amount of R&D Credit, accounting for 23 percent of returns and 39 percent of R&D credit applied.

Distribution of Research and Development Credit Used by Size of Gross Receipts: 2001

Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Above $1 billion	94	266.9	6%	63%
$500 million - $1 billion	48	48.1	3%	11%
$100 - $500 million	102	53.4	6%	13%
$50 - $100 million	70	10.8	4%	3%
$10 - $ 50 million	242	31.7	15%	7%
Below $10 million	1029	11.9	64%	3%
Unknown	11	2.3	1%	1%
Total	1,596	425.0	100%	100%

Source: 2001 Corporate Tax Sample and Credit Samples
Detail may not add to total due to rounding

Research and Development Credits Applied by Industrial Subsector: 2001				
Industrial Subsector	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Food and Kindred Products	15	0.7	1%	0%
Chemicals and Allied Products	36	9.2	2%	2%
Pharmaceuticals	45	56.9	3%	13%
Electrical and Electronic Equipment	371	165.7	23%	39%
Other Manufacturing	435	80.8	27%	19%
Other	694	111.7	43%	26%
Total	1,596	425.0	100%	100%

Source: 2001 Corporate Tax Sample
Detail may not add to total due to rounding

Discussion:
The California R&D Credit is a credit that normally is taken in conjunction with the Federal Research Credit. The calculation of the amount of research expenses creditable in California generally conforms to the calculation for federal purposes, with the exception that the California credit only applies to research activities conducted in California.

At the federal level, there are two reasons to want to encourage R&D. The first is that without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities;" i.e., benefits to people other than the person doing the R&D. The federal R&D Credit reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity. Since state R&D Credits also reduce the after-tax cost of R&D, they too will induce an increase in the overall level of R&D spending. The second purpose of the Federal R&D Credit is to encourage taxpayers to do their R&D in the United States, rather than in another country.

Since the structure of the California R&D Credit generally conforms to that of the federal credit, the California credit will produce both of these same effects. It will contribute to an overall increase in the amount of R&D activity, and it will encourage R&D activity to be undertaken in California. Because California's contribution to total R&D spending is smaller than the federal government's contribution, the first effect -- global increases in R&D activity -- is somewhat less important to state policy than to federal policy. The second effect -- regional competition -- is a relatively more important motivator for state policy. This is because it may be easier for some R&D firms to move their activity to another state than it would be for them to move it to another country, and many states besides California also offer R&D Credit. Therefore, California credit may be necessary

for the state to remain competitive with these other states in attracting and maintaining research business activity.

Both effects of the California R&D Credit, the increase in the overall amount of R&D activity, and the increase in the proportion of this activity that takes place in California must be considered in evaluating the success of the California R&D Credit. The desirability of the increase in overall R&D activity is dependent on the level of the federal R&D Credit (and credits offered by other states and countries). If the federal credit is too low, the added R&D incentives provided by states collectively could generate productive additional R&D activity. Alternatively, if the federal credit has already induced optimal levels of R&D, any increases in overall R&D spending induced by additional state credits will be inefficient and hurt overall economic performance. It is not known whether the federal R&D Credit is currently set at the optimal level.

The R&D Credit may be viewed as successfully maintaining the competitiveness of the California R&D industry only if R&D activity is undertaken in California that would not have been undertaken here in the absence of the credit. The amount of R&D activity that would not have taken place in California in the absence of the credit is unknown. Credits granted for R&D that would have occurred even in the absence of the credit may be considered a windfall.

There are two possible benefits to attracting the R&D business to California. The first is the addition of the R&D jobs themselves. If this were the only benefit, the R&D industry should be singled out for this special benefit only if jobs in this industry are substantially more desirable than jobs in other industries in the state. The second potential benefit from bringing R&D to California is that other California businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many California businesses, not just those receiving this credit, will gain an advantage over their rivals in other states. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and costlessly. The advantage to California may come through something economists call *economies of agglomeration. Economies of agglomeration* are defined as "a reduction in production costs that results when firms in the same or related industries locate near one another."

Thus, for example, if the R&D credit encourages some pharmaceutical companies to locate their research facilities in an area of California, that will, likewise, encourage the growth of pharmaceutical research support firms (such as material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, chemical engineers) to be attracted to that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silcon Valley and motion pictures in Hollywood are two obvious examples). However, there are many factors that contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which

the California R&D credit has actually encouraged the development or growth of any agglomeration economies is not known.

We also note that less than one-third of this credit is actually available to reduce tax in the year that it is generated. The inability to use the credit (because of a lack of tax to reduce) undoubtedly reduces the incentive provided by the existence of the credit.

4. Manufacturers' Investment Credit (MIC)

Description:
This program allows corporate taxpayers in specified manufacturing industries to claim a tax credit equal to six percent of the qualified costs incurred in the construction, acquisition, or lease of qualified property in California. Qualified costs include capitalized amounts of investment used to acquire or construct qualified property on which sales or use tax has been paid and capitalized labor costs associated with the construction or installation of qualified property. Qualified property includes generally depreciable tangible personal property and computer software used in manufacturing, research, pollution control, recycling, and related activities.

Amount:
In tax year 2001, the amount of credits applied was $38 million under PIT, and $320 million under the Corporate Tax.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 3,800 PIT returns and 4,278 Corporate Tax returns.

Distributional Analysis:
The tables below present information on the distribution of MIC credits by size of firm and by industry. Firms with gross receipts greater than $1 billion account for only five percent of returns with MIC credits, but 67 percent of the credits claimed. Electrical and electronic equipment is the largest group taking advantage of MIC credit, accounting for 13 percent of returns and 42 percent of MIC credit applied.

Distribution of Manufacturer's Investment Credit Used by Size of Gross Receipts: 2000				
Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Above $1 billion	196	211.7	5%	66%
$500 million - $1 billion	77	27.8	2%	9%
$100 - $500 million	302	30.4	7%	10%
$50 - $100 million	223	8.8	5%	3%
$10 - $ 50 million	1,007	29.1	24%	9%
Below $10 million	2,411	10.6	56%	3%
Unknown	62	1.2	1%	0%
Total	4,278	319.6	100%	100%

Source: 2000 Corporate Tax Sample and Credit Samples
Detail may not add to total due to rounding

Manufacturer's Investment Credits Applied by Industrial Subsector: 2000				
Industrial Subsector	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Food and Kindred Products	365	32.7	9%	10%
Chemicals and Allied Products	308	9.4	7%	3%
Pharmaceuticals	18	37.5	0%	12%
Oil and Gas Refining and Related Industries	14	27.7	0%	9%
Electrical and Electronic Equipment	361	116.8	8%	37%
Other Manufacturing	2,398	71.7	56%	22%
Other	814	23.8	19%	7%
Total	4,278	319.6	100%	100%

Source: 2000 Corporate Tax Sample
Detail may not add to total due to rounding

Discussion:
Although not truly a sales tax exemption, the MIC is still generally structured as a partial reimbursement of sales tax paid in the form of an income or franchise tax credit. The California legislative record is silent on the intent of this credit. The sponsors of the legislation state that its purpose is to address a significant loss of manufacturing jobs during the early 1990's and to improve California's business climate for manufacturers. The sponsors also note that, of the 45 states with a sales tax in 1993, 36 of those states provided at least a partial exemption from the sales tax for the purchase of manufacturing equipment. The MIC legislation was enacted in part to place California on a more competitive basis with these other states.

There is an economic justification underlying the sales tax exemptions available in 36 other states. In a pure sales tax system, only final consumption goods should be taxed. To charge sales tax on the purchase of a machine used to manufacture an item and again on the entire purchase price of the item when it is sold to the consumer results in inefficient double taxation.[7] Of course, the primary benefit of eliminating this double taxation is that it usually leads to an expansion of manufacturing employment and output.

It is very difficult to determine if the MIC has achieved its desired intent. If the purpose was to create new, sustainable manufacturing jobs, cursory analysis of the available date would suggest the credit has failed. Based upon numbers provided by the Employment Development Department, the number of California manufacturing jobs (excluding the aerospace industry) from January 1993 to January 2003 actually decreased by 11,450 jobs (January 1, 1994 – 1,524,350 to January 1, 2003 – 1,512,900). However, it is not known what the change in the number of manufacturing jobs would have been in the absence of the MIC. It should also be noted that the creation of the MIC appears to have been received positively as a sign of an improvement in the business climate for California manufacturers, based upon news articles and publications after the enactment of the credit.

If this credit is viewed solely as an effort to relieve double sales taxation, the credit is successful, but only to the extent that it is used. Because many taxpayers do not owe enough tax to use all of their nonrefundable credit, about two thirds of MIC credits cannot be used in the year they are generated. Therefore, this credit is not fully successful in achieving this goal. Conceptually, it would be much more straightforward to exempt these purchases from sales tax rather than to provide an income tax credit approximately equal to the sales tax already paid.

If the only intent of the credit is to make California more competitive, any credit claimed for investments that would have been made even without the credit is windfall. The proportion of credited investments that would have been made in the absence of this credit is unknown.

5. Water's-Edge Election

Description:
This program allows unitary multinational corporations the option to compute 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

[7] Economists consider this type of double taxation to be inefficient because the sales tax is not levied equally across all types of goods. In particular, goods that have a higher percentage of intermediate goods involved in their manufacture and distribution will have a higher overall sales tax rate. These differences in overall sales tax rates raise the price of goods that incorporate taxable intermediates. This may distort consumer choices; thus, these taxes may cause inefficiencies in the economy.

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.

Amount:
For tax year 2001, we estimate the tax revenue loss due to this legislation to be about $350 million.

Number of Tax Returns Affected:
In the 2001 tax year, 5,714 corporations elected to file on a water's-edge combined report basis. Of these, 5,303 were apportioning corporations and the rest were non-apportioning. There are a total of about 46,000 apportioning corporations. It is not known how many of these have foreign operations.

Distributional Analysis:
FTB data indicate that multinational corporations of various industry and sizes elected to file their tax returns on a water's-edge basis. Large corporations, however, benefit the most from this program. In 1998, corporations with gross receipts greater than $1 billion accounted for only seven percent of the water's-edge returns but 87 percent of the estimated water's-edge tax benefit.

Discussion:
The standard method used by California to estimate the income earned in California for multistate and multinational corporations is the worldwide unitary method. Under this method, corporations combine their income from all operations and apportion that income to California using a formula that is based upon the portion of a corporation's worldwide sales, property and payroll that are attributable to California. As an alternative, California allows corporations to elect water's-edge. The water's-edge method generally mirrors the worldwide method, but excludes foreign corporations; i.e., it considers only income from United States operations, and it apportions this income according to the portion of a corporation's United States sales, property and payroll that are attributable to California.

Corporations choose to elect water's-edge for a variety of reasons. Some choose water's-edge because it reduces their tax liability, others because it reduces filling complexity, and others – this group is largely composed of foreign parents – because they do not want to provide to California financial detail on their foreign operations.

The water's-edge provisions were enacted in response to concerns that the use of the worldwide combined reporting accounting method to determine the amount of income of multinational corporate groups may improperly attribute income to California. Worldwide combined reporting was ruled to be constitutionally permissible, however, by the United States Supreme Court in 1983 (Container Corporation of America v. Franchise Tax Board, 463 U.S. 159) for United States-based businesses and in 1994 to non-United States-based businesses (Barclays Bank PLC v. Franchise Tax Board 512 US 289).

Individual corporations often have very different tax liabilities under the two reporting methods. Some will owe more under worldwide combination than under water's-edge, and others will owe less. Under the elective system, many corporations will choose whichever method reduces their tax liability. The total tax collected under the elective system will, therefore, be less than would be collected under either pure system. It is the election aspect of the water's-edge election that generates a tax expenditure. If all California corporations were required to use the same filing method, regardless of whether worldwide combination or water's edge was chosen as the method, we would not consider it to be a tax expenditure.

6. Exclusion of Interest on Federal Government Obligations

Description:
Interest earned on debt issued by the federal government is exempt from income.

Amount:
In tax year 2001, the amount of federal obligation interest excluded from PIT returns was $3.1 billion. The tax impact of this exclusion was $202 million.

Number of Tax Returns Affected:
In tax year 2001, this exclusion affected 337 thousand Personal Income Tax returns.

Distributional Analysis:

Impact of Exclusion of Federal Obligation Interest: 2001

Adjusted Gross Income Class	Number of Returns Reporting Exclusion (Thousands of Returns)	Amount of Exclusion Claimed (Millions of Dollars)	Tax Impact of Exclusion (Millions of Dollars)
Less Than $10,000	28.8	326.1	5.3
$10,000 to $19,999	26.9	148.6	3.7
$20,000 to $49,999	82.0	333.8	25.1
$50,000 to $99,999	96.3	427.0	27.5
$100,000 to $199,999	58.8	410.3	31.8
More Than $199,999	43.8	1,485.7	109.0
Total	336.6	3,131.5	202.5

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
States are prohibited by federal statute from taxing interest income from federal debt obligations.

7. Special Tax Treatments for Economically Depressed Areas

California has several economic incentives designed to improve the economic situation of particular types of individuals and particular areas of the state. These programs include:

- Enterprise Zones (EZs).
- Targeted Tax Areas (TTAs).
- Manufacturing Enhancement Areas (MEAs).

Because many of the incentives available are the same for each of the area types listed above, we have consolidated the discussion of the main benefits available in these areas. There are five tax expenditures available

- A hiring credit.
- A credit for sales tax paid on certain investments.
- A credit for taxes paid by enterprise zone employees.
- A business expense deduction.
- Exclusions for certain income received from investments in these areas.

Of these benefits, only the hiring credit is available in MEAs.[8]

Employer Credits – Hiring Credit and Sales and Use Tax Credit

Description:
Most of the designated areas provide both a hiring credit and a credit for sales and use tax payments. These two credits will be discussed in combination here, as the data are not generally available for the two credits separately.

Taxpayers can claim a credit for a portion of the wages paid to qualified "disadvantaged individuals" employed in a designated area. Generally, qualified individuals are those who were unemployed or economically disadvantaged prior to the date of hiring. The available tax credit is 50 percent of the wages paid during the first year, 40 percent for the second year, 30 percent for the third year, 20 percent for the fourth year, and 10 percent for the fifth year. The credit is limited to 150 percent of the minimum wage per employee (202 percent for certain workers in the Long Beach EZ). Credit claimed under this program is limited to the tax attributable to income from the designated area.

Employers in economically depressed areas can receive an income tax credit for the amount of sales and use taxes paid on the certain purchases of machinery or parts. Credit is limited to the tax on income attributable to the depressed area.

[8] There is also a more generous treatment of Net Operating Losses allowed for businesses active in zones. However, Net Operating Loss treatment is not considered a tax expenditure and so is not considered here.

Amount:
In tax year 2001, credits of $120 million were claimed on Corporate Tax returns and $49 million in credits were claimed on PIT returns.

Number of Tax Returns Affected:
In tax year 2001, 1,607 Corporate Tax returns and 2,580 PIT returns claimed this credit.

Discussion:
The purpose of the hiring credit is twofold. It is intended both to encourage business activity in general in designated, depressed areas of the state and also to encourage employment for designated classes of individuals.

This program will be considered successful if it creates new jobs. If the program simply moves jobs from other parts of California into the economically depressed area, it may be considered successful either, (1) if policymakers view jobs in depressed areas as more valuable than jobs in other parts of the state, or (2) if the spillover benefits to the economy from job creation are greater in depressed areas than in the area they would otherwise have been made. For any jobs that would have been created irrespective of this credit, this provision represents a windfall gain to the taxpayer. We have no way of knowing the affect of this credit on the relative proportions of jobs that would have been created in the depressed area anyway, the number that would have been created elsewhere in the state, or the number that would not have been created at all.

The purpose of the sales and use tax credit is to stimulate economic activity in depressed areas by lowering the cost of capital.

Similarly to the hiring credit, this program will be considered successful if it generates new business activity. If the program simply moves business investments from other parts of California into the economically depressed area, it may be considered successful either, (1) if policymakers view investment in depressed areas as more valuable than investment in other parts of the state, or (2) if the spillover benefits to the economy from investment are greater in depressed areas than in the area they would otherwise have been made. For any investments that would have been made anyhow, this provision represents a windfall gain to the taxpayer. We have no way of knowing the affect of this credit on the relative proportions of investments that would have been created in the depressed area anyway, the number that would have been created elsewhere in the state, or the number that would not have been created at all.

Taxes Paid by EZ Employees

Description:
Enterprise Zone employees can receive an income tax credit of five percent of their "qualified wages," up to a maximum of 150 percent of the minimum wage. The credit is reduced by nine cents for each $1 in wages in excess of "qualified wages." The credit is nonrefundable, and unused portions may not be carried forward.

Amount:
In tax year 2001, less than $100,000 of this credit was claimed on PIT returns.

Number of Tax Returns Affected:
In tax year 2001, this credit was claimed on about 250 Personal Income Tax returns.

Discussion:
The primary purpose of this credit is to stimulate economic activity by subsidizing wages. The presence of this credit enables workers to accept lower base wages. This, in turn, lowers businesses' operating costs, which may lead to increased economic activity.

This program will be considered successful if it creates new jobs. If the program simply moves jobs from other parts of California into the economically depressed area, it may be considered successful either, (1) if policymakers view jobs in depressed areas as more valuable than jobs in other parts of the state, or (2) if the spillover benefits to the economy from job creation are greater in depressed areas than in the area they would otherwise have been made. For any jobs that would have been created anyhow, this provision represents a windfall gain either to the employee or to the employer. The windfall accrues to the employer if the worker's base wage is lowered by the amount of the credit. Windfall accrues to the employee if wages do not drop that far (which will happen if the employee would have worked for the minimum wage even without this credit). The number of affected jobs that would have been created even without the credit is not known.

Income from Investments in Economically Depressed Areas

Description:
This provision allows taxpayers to exclude from their gross income the net interest received from certain investments or loans to businesses located in economically depressed areas.

Amount:
We estimate that, in tax year 2001, this program resulted in a Corporation Tax revenue loss of $30 million. This estimate is based on a total of $442 million of deductions claimed by corporate taxpayers. The data to determine the revenue impact or the amount of deductions claimed by PIT returns are not available.

Number of Tax Returns Affected:
In tax year 2001, 122 Corporate Tax returns reported this deduction. Data on the number of PIT returns with this deduction is not available.

Discussion:
The purpose of this credit is to stimulate economic activity in depressed areas by lowering the cost of capital.

This program will be considered successful if it generates new business activity. If the program simply moves business investments from other parts of California into the economically depressed area, it may be considered successful either, (1) if policymakers view investment in depressed areas as more valuable than investment in other parts of the state, or (2) if the spillover benefits to the economy from investment are greater in depressed areas than in the area they would otherwise have been made. For any investments that would have been made anyhow, this provision represents a windfall gain to the taxpayer. The relative proportions of investments that would have been created in the depressed area anyway, would have been created elsewhere in the state, and would not have been created at all are not known.

Business Expense Deduction for Activities within Economically Depressed Areas

Description:
Businesses located in economically depressed areas are allowed to expense part of the costs of business equipment beyond normal Internal Revenue Code Section 179 expensing limits. Depending on the number of years that a zone has been designated, businesses are allowed larger expensing limits than generally allowed under state PIT and Corporation Tax Law.

Amount:
In tax year 2001, we estimate that this program resulted in a revenue loss of $200 thousand. This estimate is based on a total of $3.9 million of deductions claimed by corporate taxpayers. The data to determine the revenue impact or the amount of deductions claimed by PIT returns are not available.

Number of Tax Returns Affected:
In tax year 2001, 247 Corporate Tax returns reported this deduction. Data on the number of PIT returns with this deduction are not available.

Discussion:
The primary purpose of this deduction is to stimulate economic activity by allowing accelerated deductions related to capital equipment. The presence of this provision increases the rate of return on capital equipment in economically depressed areas by accelerating the deductions that can be made against the costs of the equipment. This increase in the rate of return can encourage business to invest beyond a level at which they would normally invest.

This program will be considered successful if it encourages new investment in the economically depressed area. If the program simply moves investment from other parts of California into the economically depressed area, it may be considered successful either: (1) if policymakers view investments (or, more generally, economic activity) in depressed areas as more valuable than investments in other parts of the state, or (2) if the spillover benefits to the economy from additional investment are greater in depressed areas than in the area they would otherwise have been made. For any investment that would have been taken place anyhow, this provision represents a windfall gain either to

the business. The amount of investment that would have taken place even without this program is not known.

8. Child and Dependent Care Expenses Credit

Description:
This credit is equal to a percentage of a parallel federal credit for taxpayers with dependents who pay for child or dependent care in order to work. The credit applies to up to $2,400 in expenses for one child or $4,800 in expenses for two or more children. The California credit is calculated as a percentage of federal qualified expenses. This percentage decreases as income increases and is eliminated for taxpayers with AGI greater than $100,000. The maximum available credit (for families with at least two children) ranges from $907 for AGI less than $1,000, to $403 for AGI $70,000 - $100,000. This credit is refundable; thus, it is available even to Californians with no tax liability.

Amount:
In tax year 2001, the amount of credits applied was $178 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 619,073 Personal Income Tax returns.

Distribution of Credit:

Child and Dependent Care Refundable Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit (Thousands of Returns)	Amount of Credit Claimed (Millions of Dollars)
Less Than $10,000	15.6	5.6
$10,000 to $19,999	55.2	21.7
$20,000 to $49,999	287.8	91.4
$50,000 to $69,999	122.7	30.7
$70,000 to $99,999	137.1	28.0
$100,000 to $199,999	0.7	0.1
More Than $199,999	0.1	0.0
Total	619.1	177.5

Source: 2001 Personal Income Tax Sample
Detail may not add to total due to rounding

Discussion:
The purpose of this credit is to defray expenses incurred by people who must pay for child or dependent care so that they can be gainfully employed or to seek employment. This credit provides this relief by offsetting a portion of the cost of childcare for working taxpayers. Childcare expenses are a necessary part of working for many people. After

subtracting out the childcare expenses, an employee who has childcare expenses has less income remaining than does another employee who earns the same salary. The Child and Dependent Care Credit is intended to make the tax burden of the employee with the childcare expenses reflective of his net (after childcare expenses) rather than gross pay.

This credit successfully achieves its goal of assisting workers with their child and dependent care costs.

This credit could potentially induce two types of behavioral changes in taxpayers. The first is that some taxpayers who would not have chosen to seek employment if they had to bear the full burden of their child or dependent care may now choose to seek employment. The other is that some working taxpayers who, if the credit did not exist, would have made informal arrangements for child or dependent care, may now choose paid child or dependent care.

9. Teacher Retention Credit

The Teacher Retention Credit provides a nonrefundable credit to credentialed teachers who are teaching in kindergarten through 12th grade in a qualified educational institution located in California. This credit was first available for tax year 2000. The credit increases from $250 for teachers with four or five years of service to a maximum of $1,500 for teachers with 20 years of service. The credit is suspended for the 2002 tax year.

Amount:
In tax year 2001, the amount of credits applied was $166 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 214,850 Personal Income Tax returns.

Distributional Analysis:

Teacher Retention Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit (Thousands of Returns	Amount of Credit Claimed (Millions of Dollars)
Less Than $10,000	0.0	0.0
$10,000 to $19,999	0.4	0.0
$20,000 to $49,999	25.8	8.6
$50,000 to $99,999	113.8	77.5
$100,000 to $199,999	67.9	73.0
$200,000 to $499,999	6.3	6.3
$500,000 to $999,999	0.5	0.4
More Than $1,000,000	0.1	0.1
Total	214.9	165.9

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The stated purpose of this program is to encourage California teachers to remain in the profession.

To be successful, this credit must increase the average length of teaching careers. The program has not been in place long enough to know if it has any effect on career length. To the extent that teachers who would have taught even if the credit were not available claim the credit, it can be considered a windfall.

The structure of the credit may not be optimal for achieving its goal. In particular, the largest turnover in the teaching profession appears to be for inexperienced teachers. However, this credit and, therefore, the incentive to continue teaching, is largest for the most experienced teachers; i.e., those that have already demonstrated a commitment to staying in the profession.

The effectiveness of this credit to teachers may be limited to the extent that, over time, the benefits from the credit are negotiated away by their employers. Economic theory suggests that future contract negotiations should result in close to the same level of total teacher compensation as they would have in the absence of the credit. In other words, future pay raises for teachers may be reduced by the amount of the credit. To the extent this happens, the benefit of the credit will flow to the school district rather than the teachers.

An alternative justification that has been suggested for this credit is that it compensates teachers for out-of-pocket expenses incurred for classroom supplies. Under this justification, only credits claimed in excess of actual expenses incurred are windfall. Here, too, the credit may be structured poorly. Experienced teachers may be able to use

some classroom supplies accumulated from previous school years. Therefore, we would expect new teachers – those receiving the smallest credit – to incur the greatest out-of-pocket expenses.

An obvious policy alternative would be to increase state funding for teacher salaries to a level sufficient to ensure satisfactory retention levels.

10. Double-Weighted Sales Apportionment Formula

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 sale factors. Prior to January 1, 1993, California applied a 3-factor formula in which the payroll, property, and sales factors were equally weighted. After January 1, 1993, California adopted a 4-factor formula in which the sales factor is double-weighted. Corporations engaged in qualified agricultural, extractive, and financial business activities are exempted from the 4-factor formula, and must continue using the 3-factor formula to apportion their worldwide income.

Amount:
We estimate the average annual revenue loss over the tax years 1999, 2000, and 2001 to be $128 million.

Number of Tax Returns Affected:
In tax year 2001, 45,532 corporate tax returns apportioned their worldwide income to California. About 1,486 corporate returns used the 3-factor apportionment formula. The remaining 44,046 corporate returns used 4-factor apportionment formula.

Distributional Analysis:
This program does not affect corporations in the agricultural, extractive, and financial industry. Of the remaining corporations, those in the manufacturing and services are most affected by this program. Manufacturing corporations accounted for about 20 percent of all apportioning returns, but enjoyed 63 percent of the total benefit of this program in 2001. Corporations in the services sector accounted for nearly 34 percent of all apportioning returns, but enjoyed only 14 percent of the total benefit. Manufacturing corporations accounted for about 20 percent of all apportioning returns but enjoyed 63 percent of the total benefit of this program in 2001.

Distribution of Impact of Double-Weighted Sales Factor by Size of Gross Receipts: Average 1999-2001				
Size of Gross Receipts	Returns and Tax Impact		Percent of Total	
	Returns	Tax Impact ($ Millions)	Returns	Tax Impact
Above $1 billion	1,135	95.6	2%	75%
$500 million - $1 billion	798	10.4	2%	8%
$100 - $500 million	3,717	15.4	8%	12%
$50 - $100 million	2,858	3.1	6%	2%
$10 - $ 50 million	11,742	0.1	25%	0%
Below $10 million	20,050	1.4	43%	1%
Unknown	6,513	1.7	14%	1%
Total	46,813	127.7	100%	100%

Source: 1999,2000, and 2001 Corporate Tax Sample and Credit Samples
Detail may not add to total due to rounding

Distribution of Impact of Double-Weighted Sales Factor by Industrial Subsector: Average 1999-2001				
Industrial Subsector	Returns and Tax Impact		Percent of Total	
	Returns	Tax Impact ($ Millions)	Returns	Tax Impact
Agriculture	534	-	1%	0%
Extraction	186	-	0%	0%
Bank/Finance	662	-	1%	0%
Construction	2,343	1.0	5%	1%
Manufacture	9,706	75.3	21%	59%
Trade	8,683	2.2	19%	2%
Services	15,244	22.5	33%	18%
Real Estate	6,315	11.5	13%	9%
Transportation, Communications, and Utilities	2,935	15.5	6%	12%
Other	205	(0.4)	0%	0%
Total	46,813	127.7	100%	100%

Source: 1999,2000, and 2001 Corporate Tax Sample and Credit Samples
Detail may not add to total due to rounding

Discussion:
The Uniform Division of Income for Tax Purpose Act (UDITPA) provides for the use of an equally-weighted, 3-factor formula to apportion income between states. At one time, over half the states subscribed to the UDITPA formula. Under the Multistate Tax Compact, taxpayers can elect to use the UDIPTA formula or the state's formula to assign income. In the last decade, many states have switched to an apportionment formula that

uses the traditional three factors (tangible property, payroll, and sales), but weights the sales factor at least twice the value of the other two factors.

The purpose of the double-weighted sales factor is to encourage businesses to locate productive activities in California. It does this by reducing taxes for corporations whose payroll and property factors are larger than their sales factors and increasing taxes for corporations whose sales factors are larger than the other two. Thus, it provides an incentive for firms to produce things in California and sell them elsewhere. This incentive could result in increased investment or employment in California.

On the one hand, higher taxes for businesses with large sales factors may result in either higher consumer prices or in the unavailability of certain goods and services in California.

On the other hand, the double-weighted sales factor increases the tax corporations must pay when they sell goods or services in California. Corporations view this tax increase as an increase in production costs and will often pass the costs through to consumers in the form of higher consumer prices. In extreme cases, where corporations are unable to pass along these costs, they may choose not to make certain goods and services available in California.

This program could be considered successful if the benefits from induced increases in investment and employment in California outweigh any additional costs to California consumers. It is not known how much investment or employment currently located in California would have occurred in the absence of this program. Nor is it known if this program has affected either consumer prices or the availability of goods in California.

11. Senior Exemption Credit

Description:
This program provides taxpayers over the age of 65 with an additional personal exemption credit. The credit is indexed annually for inflation. In 2002, the credit was $80, or $160 for joint filers if both were over age 65.

Amount:
In tax year 2001, the amount of credits applied was $103 million.

Number of Tax Returns Affected:
In tax year 2001, this credit was claimed on 1.1 million Personal Income Tax returns.

Distributional Analysis:

Senior Exemption Credit: 2001		
Adjusted Gross Income Class	Number of Returns Reporting Credit (Thousands of Returns)	Amount of Credit Claimed (Millions of Dollars)
Less Than $10,000	0.0	0.0
$10,000 to $19,999	137.4	8.3
$20,000 to $49,999	505.3	47.7
$50,000 to $99,999	283.8	31.7
$100,000 to $199,999	114.8	12.8
More Than $199,999	21.5	2.2
Total	1,063.0	102.7

2000 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This credit provides hardship relief on the grounds that taxpayers over age 65 are believed to have higher medical and personal costs than other taxpayers. This credit is similar to a provision of federal law that allows an additional deduction from adjusted gross income for this group of taxpayers. The amount of the federal deduction for 2002 was $1,150 for single filers and $1,800 for joint filers, both of whom are over the age of 65.

This credit is effective in reducing the tax liability of taxpayers over age 65.

This credit is available to all taxpayers over age 65, even if they have no extraordinary expenses. To the extent that this credit is intended to offset medical expenses, it may be unnecessary in light of other available benefits, including the itemized deduction for medical expenses and direct government expenditures and provisions for medical care for the elderly.[9] Furthermore, other, nonelderly, taxpayers can also face circumstances in which they have higher medical or other personal costs. If the credit is intended to offset certain medical and other personal costs, it would be more equitable and more efficient to target the credit to all those who face these higher costs, regardless of whether or not they are elderly. However, it is possible that the costs of targeting the credit with greater specificity could outweigh any equity and efficiency benefits that would accrue.

[9] It could be argued that the itemized deduction for medical expenses is not useful for many elderly taxpayers: either because they do not itemize, or because taxpayers are only allowed to deduct medical expenses greater than 7.5% of AGI. While this is true for elderly taxpayers, it is also true for many nonelderly taxpayers. This point, thus, argues for a more specific credit for all taxpayers with medical expenses, rather than a generic credit for all elderly taxpayers.

12. Renter's Credit

Description:
This program provides for a credit to low-income taxpayers who rent their primary residence. The amount of the credit is $60 for single filers with income no more than $28,429 and $120 for joint filers with income not exceeding $56,858. Since 1999, the credit has been nonrefundable.

Amount:
In tax year 2001, the amount of credits applied was $93.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 1.3 million Personal Income Tax returns.

Distribution of Credit:

Renter's Credit: 2001		
Adjusted Gross Income Class	Number of Returns Reporting Credit (Thousands of Returns)	Amount of Credit Claimed (Millions of Dollars)
Less Than $10,000	24.3	0.7
$10,000 to $19,999	409.1	20.3
$20,000 to $49,999	774.5	62.9
$50,000 to $69,999	79.1	9.1
More than $70,000	-	-
Total	1,286.9	93.1

Source: 2001 Personal Income Tax Sample
Detail may not add to total due to rounding

Discussion:
The intent of this credit is to counteract a perceived inequity between renters and homeowners. The credit was originally enacted in 1972 as part of a comprehensive property tax reform program. That program allowed for an increase in the Homeowner's Property Tax Exemption that reduces the property tax on owner-occupied property. In contrast, rental property is not eligible for the homeowner's exemption. The Renter's Credit was enacted as a means of "equalizing" property taxes between renter and the homeowner by providing a benefit directly to the renter. This credit was increased significantly in 1979, shortly after Proposition 13 was passed. It was thought that owners of real property were receiving a benefit from Proposition 13, but that renters received no benefit.

The extent to which this credit realizes its objective depends on both the nature of the homeowner's benefit it is intended to parallel and on conditions in the rental market. The

credit is more likely to be justifiable if it is intended to be the renters' counterpart to the homeowner's exemption than if it is intended to as an expansion of Proposition 13. This is because rental property does benefit from Proposition 13. If the rental market is favorable to renters, landlords may be forced to pass on their savings from Proposition 13 in the form of lower rents. In this case, the Renter's Credit is unnecessary. Since rental property is not eligible for the homeowner's exemption, however, there is no savings to pass along; so the credit may be justified as matching the homeowner's exemption.

This credit may also fail to achieve its objective if conditions in the rental market are favorable to landlords. This is because, under these market conditions, landlords may be able to increase rents by an amount equal to the value of the renter's credit, leaving no benefit to the renters.

Two other aspects of this credit may be worth noting. One is that the benefits from the homeowner's exemption and Proposition 13 are the same, regardless of the taxpayer's filing status. It is not clear why, if the Renter's Credit is intended to mimic these provisions, the credit is twice as large for joint filers as for single filers. The second interesting policy note is that this credit, by helping renters, offers an inducement to rent. Although relatively small, this inducement works against the numerous government policies encouraging people to purchase houses rather than rent.

13. Exclusion of Unemployment Insurance Benefits

Description:
This provides an exclusion from gross income for benefits received under the state's unemployment insurance program. For privately-provided unemployment compensation, benefits up to the amount of prior contributions are not taxable, but benefits that exceed prior contributions are taxable. By contrast, no government-provided unemployment benefits are taxable, whether they exceed previous contributions or not.

Amount:
In tax year 2001, the amount of unemployment income excluded from PIT returns was $2,705 million. The tax impact of this exclusion was $73.6 million.

Number of Tax Returns Affected:
In tax year 2000, this exclusion affected 1,082 thousand Personal Income Tax returns.

Distribution:

Impact of Exclusion of Unemployment Compensation: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Exclusion (Thousands of Returns)	Amount of Exclusion Claimed (Millions of Dollars)	Tax Impact of Exclusion (Millions of Dollars)
Less Than $10,000	181.9	500.3	0.0
$10,000 to $19,999	259.4	629.5	5.5
$20,000 to $49,999	361.4	896.5	21.5
$50,000 to $99,999	199.2	474.9	28.5
$100,000 to $199,999	67.8	171.3	15.1
More Than $199,999	11.8	32.4	3.1
Total	1,081.5	2,704.9	73.6

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The goal of this program is to reduce the taxes paid by taxpayers who have lost their job and have received unemployment benefits. Paying taxes on such benefits creates an additional financial burden for the unemployed at a time when they are already suffering financially as a result of a reduction in income.

The exclusion of unemployment benefits from AGI has a negative impact on horizontal equity. Consider two families, both receiving $40,000 this year. One earns $40,000 in wages. The other has one employed spouse who earns $30,000 and another who is unemployed and receives unemployment compensation of $10,000 per year. With California's current treatment of unemployment benefits, the first family will have to pay tax on the full amount of the $40,000 of wages, while the other family will only pay tax on the $30,000 of earned income. Another concern is that this program may create a disincentive for certain unemployed persons to seek jobs, since it reduces the after-tax cost of their unemployment. This incentive may be more relevant for unemployed spouses of moderate-to-high-income taxpayers, since their need for employment may not be that urgent as compared to those of lower-income individuals.

An additional benefit of this exemption is that it acts as a built-in stabilizer for the economy during times of high unemployment. As unemployment increases and the share of Personal Income made up by unemployment compensation increases, the effective tax rate on Personal Income will fall. The expenditure of these benefits by their recipients will tend to encourage economic growth.

It is not clear why privately-provided and government-provided unemployment compensation should receive different tax treatment.

14. Exclusion of Capital Gains on Small Business Stock

Description:
This program excludes from taxable income of PIT taxpayers 50 percent of the gains from the sale of qualified small business stock. For a married couple filing a joint return, the exclusion amount is limited to the greater of either $10 million, or ten times the stock's basis. The limit is smaller for singles and married couples filing separate returns. This exclusion generally conforms to a similar federal exclusion except that for California purposes, 1) 80 percent of the corporation's payroll must be attributable to California, and 2) for substantially all of the taxpayer's holding period, 80 percent of the corporations assets have to be used in the active conduct of a trade or business in California.

Amount:
We estimate that this program costs the state about $45 million annually.

Number of Tax Returns Affected:
The number of PIT taxpayers excluding gains under this provision is not known, because taxpayers are not required to identify themselves as taking this exclusion.

Discussion:
The purpose of this program is to encourage long-term investment in new and small California C corporations in the manufacturing sector.

There is a widespread belief that small businesses in general, and certain industries in particular, need extra support from the government. The reasoning underlying this belief is not always clear, however. Some argue that small businesses and industries face a capital shortage due to insufficient or inaccurate information, or an aversion to perceived high-risk ventures. Thus, investors may be reluctant to invest in small businesses, or may require greater rates of return, because they do not have sufficient information regarding the credit-worthiness of businesses with no established track record. Others argue simply that a subsidy is necessary for small business start-ups and expansions to be viable. And some supporters take the view that small businesses are worthy of special support, perhaps because they may be more labor intensive than larger businesses, or because small businesses tend to be a substantial source of product development and innovation.

Economists differ, and empirical evidence is inconclusive, regarding the validity of some of the claims regarding the positive aspects of small business activities or the existence of capital shortage for this sector. Even if the justifications given for the program are accurate, there may exist alternative ways to assist small business enterprise.

This program can be considered successful if it increases the number of successful new California firms. It is counterproductive if this incentive attracts new investment to these industries but the newly formed concerns fail. For exclusions claimed by firms that would have succeeded even in the absence of this tax break, the exclusion is a windfall. The number of existing business that would have failed without this exclusion is not

known, but the weak overall performance of the targeted sectors of the California economy in recent years suggests that the program may not be as effective as was hoped.

Other policy approaches might be better suited for assisting small businesses. Since this benefit can be claimed only after a business has succeeded for at least five years, it seems unlikely to have a substantial impact on the liquidity of newly formed businesses. Direct loan guarantees or subsidies would be much more likely to induce new business formation. It is also unclear why owners of small C-corporations should receive more favorable tax treatment than owners of other small businesses.

15. Joint Strike Fighter Property and Wage Credits

Description:
The Joint Strike Fighter (JSF) is a new fighter plane. California offers two credits to JSF contractors and subcontractors who reduce their bids on JSF contracts by the amount of the credits. One credit is a credit to employers equal to 10 percent of the cost of certain investments made as part of a contract for production of the JSF or its components. The second credit is a credit to employers for certain wages paid to employees working in California on the JSF project. The credit is equal to 50 percent of wages up to 1½ times the minimum wage for the first year of employment. The credit percentage is reduced by 10 percent each subsequent year of employment.

Amount:
Due to delays in the JSF program, no credits had been claimed as of the 2001 tax year. We estimate, however, that the revenue impact of the JSF will be approximately $39 for fiscal year 2003-4.

Number of Tax Returns Affected:
Because no credits have yet been claimed, the number of taxpayers who will claim this credit is not known.

Discussion:
The purpose of this credit is to provide an incentive to the federal government to select contractors, and for the contractors to choose subcontractors, that will perform their work on the JSF project in California.

To be considered effective, this credit must increase the number of contracts (including subcontracts) on the JSF project that are awarded to firms that will undertake their JSF work in California. The extent to which the credit will be incorporated into bids for JSF contracts is not yet known. Furthermore, even if any contracts that have been or will be awarded include this credit, it will not be known if the California contractor would have lost its contract to a non-California competitor in the absence of the credit.

It should be noted that if, as required by statute, the credit is passed through to the purchaser, the direct benefit from this credit will accrue to the purchaser rather than to the

taxpayers that actually claim the credit. There is, however, an administrative burden placed on the taxpayer claiming the credit.

One factor that may be inhibiting contractors from incorporating this credit in their bids is that it is nonrefundable. Therefore, taxpayers risk not being able to claim the credit after they have received a contract at a reduced price. This is particularly likely in the case of the property credit. Most property eligible for the JSF property credit is also eligible for the Manufacturer's Investment Credit. These investments may also qualify for Enterprise Zone Credits. Taxpayers who can claim these other credits are less likely to have sufficient tax liability to use their JSF credits.

16. Exclusion of State Lottery Winnings

Description:
Under this provision, winnings from the California State Lottery are exempt from gross income.

Amount:
In tax year 2001, the amount of exempt income was approximately $244.4 million. We estimate the tax impact of that exclusion at $36.0 million.

Number of Tax Returns Affected:
In tax year 2000, 8.3 thousand California PIT returns reported lottery income on their federal tax returns and excluded the income from their PIT returns.

Distributional Analysis:

Impact of Exclusion of Lottery Winnings: 2001

Adjusted Gross Income Class	Number of Returns Reporting Exclusion (Thousands of Returns)	Amount of Exclusion Claimed (Millions of Dollars)	Tax Impact of Exclusion (Millions of Dollars)
Less Than $10,000	1.3	71.4	8.4
$10,000 to $19,999	1.2	3.7	2.2
$20,000 to $49,999	2.1	42.2	5.7
$50,000 to $99,999	1.9	49.6	7.5
$100,000 to $199,999	1.7	76.8	12.1
More Than $199,999	0.2	0.6	0.3
Total	8.3	244.4	36.2

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The California State Lottery was established by Proposition 37, the California State Lottery Act of 1984. The Act prohibits California from taxing winnings from the

California State Lottery. This exemption for winnings from the California State Lottery differs from federal treatment of lottery winnings and from California treatment of other gambling winnings. State lottery winnings are subject to federal income taxation, to the extent that they exceed lottery-wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses.

The purpose of this exemption is to encourage sales of California State Lottery tickets. This is considered desirable because a portion (34 percent) of lottery sales is used to fund education programs. Lottery proceeds account for only two percent of education expenditures, however.

To be considered effective, this exemption must increase lottery sales by at least three times the amount of forgone revenue. This is because only one-third of the revenue from lottery sales goes to education programs. The rest goes to prizes and administrative expenses. Therefore, the loss of funds to education programs will be only one-third of the decrease in lottery sales attributable to making them taxable. By contrast, in the absence of this exemption, all of the revenue raised from taxes on lottery income could be directed to education. The extent to which lottery sales might decrease if this exemption were removed is not known.

Additionally, it is not clear whether the funds that are contributed to public education from the lottery ultimately affect the amount of money spent on education. Although lottery funds are earmarked for education, there is nothing to keep those who are setting funding levels for education from considering the amount of earmarked funds as part of the total funding level. That is, if the State Legislature decides that the appropriate amount of money to devote to public education is $28 billion, and it knows that $1 billion is earmarked from the lottery, it can just adjust the contribution from the General Fund to $27 billion. However, with the adoption by California of Proposition 98 in 1988, it could become more difficult to shift lottery funds from education to other uses. Proposition 98 set minimum funding levels for education, independent of lottery funds. Thus, if Proposition 98 funding limits are binding (that is, if the state is not funding education above the minimum levels specified by Proposition 98), the lottery funds would truly be augmenting the state's funding of education. However, when the state is contributing more to education than is required by the Proposition 98 minimums (as it has for the last several budgets), it is possible and, one might argue, reasonable for legislators to consider the amount contributed by the lottery when determining the amount of the General Fund contribution to public education.

17. Low-Income Rental Housing Expenses Credit

Description:
This is a tax credit provided 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.

Amount:
In tax year 2001, the amount of credits applied was $20 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 1,093 Personal Income Tax returns and 55 Corporation Tax returns.

Distributional Analysis:

Low-Income Rental Housing Expenses Credit (PIT)		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	*	*
$10,000 to $19,999	32*	2.1*
$20,000 to $49,999	292	116.8
$50,000 to $99,999	361	332.5
$100,000 to $199,999	223	406.9
More Than $199,999	185	497.8
Total	1,093	1,356.0

* Fewer than 3 taxpayers have AGI less than $10,000. To preserve confidentiality, the data for taxpayers with AGI less than $10,000 has been included with the data for AGI between $10,000 and $20,000.
Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Distribution of Low-Income Rental Housing Expenses Credit Applied by Corporations By Size of Gross Receipts: 2001				
Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Above $500 million	3	4.5	5%	24%
$100 - $500 million	9	10.3	16%	54%
$50 - $100 million	3	1.2	5%	7%
$10 - $ 50 million	14	1.8	25%	10%
Below $10 million	26	1.2	47%	6%
Total	55	19.0	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Distribution of Low-Income Rental Housing Expenses Credit Applied by Corporations by Industry 2001				
Industry	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Finance and Insurance	36	17.5	65%	92%
Real Estate	6	0.04	11%	0.2%
Other	13	1.5	24%	8%
Total	55	19.0	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Discussion:
The purpose of this tax credit is to increase the supply of affordable rental housing units in California available to low-income households. It encourages production of affordable rental housing by subsidizing investments in qualified projects.

This program supplements a parallel federal tax credit. Under the federal program, the amount of money available for each state is capped at the same per capita funding level ($1.75 per state resident in 2002). California elected to supplement this credit, because the costs of housing in California are higher than average.

The program can be considered successful if it leads to increased production of affordable rental housing. For qualified units that would have been constructed even in the absence of this credit, the credit is a windfall. The proportion of qualified units that would not have been constructed in the absence of this credit is not known.

Policy alternatives to this credit could include vouchers that low-income households could use toward making rental payments for housing priced at market levels or alternative tax benefits to developers, such as expensing of costs for building qualified low-income housing units.

18. Credit Union Treatment

Description:
Credit unions are exempt from state income and franchise tax. Since credit unions are nonprofit, membership organizations, only their "nonmember" income (items 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.

Amount:
We estimate the revenue cost of this exemption for state-chartered credit to be approximately $10 million per year.

Number of Tax Returns Affected:
There are 198 state-chartered credit unions and 382 federally-chartered credit unions in California.

Discussion:
The purpose of this tax exemption is to provide financial relief to institutions that provide low-cost financial and other services to their members.

There are two types of credit unions, state-chartered and federally-chartered. California is prohibited by the federal government from taxing federally-chartered credit unions. (They are not subject to federal income tax either.) Extending this exemption to state-chartered credit unions places state-chartered credit unions in the same position as federally-chartered credit unions. In the absence of this exemption, some state-chartered credit unions may have opted to change their charter to federal to obtain the tax-exempt status.

To be considered successful, this provision must either increase the number of credit unions or enable these institutions to increase their banking activities. It is not known whether any of these institutions would not exist or would have curtailed their activities in the absence of this exemption.

Originally, credit union membership and business activities were narrowly limited. Over time, however, the number of credit union members and the scope of credit union activity have greatly expanded. This expansion has increased the frequency with which credit unions compete directly with commercial financial institutions. The tax advantages accruing to credit unions may enable them to attract some customers from commercial financial institutions.

19. Limited Partnership Investment Source Rules

Description:
Under this program, the dividends, interest, or gains and losses from qualified investment securities of members of limited partnerships are exempted from taxation if they reside outside California, and their only contact with this state is through a security dealer, broker, or an investment advisor located in the state. Qualified investment securities include, but are not limited to, stocks, bonds, and mortgage-based or asset-backed securities.

Amount:
We estimate his program to cost the state $10 million per year.

Discussion:
The purpose of this provision is to encourage nonresident investors to use California investment services. Prior to passage of this exemption, nonresident members of limited partnerships were deemed "doing business" in California and were taxed on their security investment income if the investments had been made through a California dealer or broker. The securities industry argued that these tax rules placed the California

investment services industry in a competitive disadvantage vis-à-vis their competitors in states that granted this exemption.

This provision can be considered successful if it increases the amount of nonresident security investments made through California brokers and if the economic value to California of these investments exceeds the value of the forgone revenue. It is not known how much current investment qualifying for this exemption would have taken place elsewhere if this exemption did not exist.

20. Natural Heritage Preservation Credit

Description:
The Natural Heritage Preservation Tax Credit provides a nonrefundable credit to taxpayers who donate property for conservation purposes. The amount of the tax credit equals 55 percent of the fair market value of the donated real property. Property donations must be approved by the California Wildlife Conservation Board. Total credits are limited to $100 million annually and will be available for fiscal years 2000-2001 through 2004-2005.

Amount:
In tax year 2001, the amount of credits applied was $8 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 51 Personal Income Tax returns and on fewer than three Corporation Tax returns.

Discussion:
The purpose of this program is to encourage donations of qualified lands and water for permanent preservation.

To be considered successful, this credit must induce preservation of land that would have been developed in the absence of this credit. Any credits granted for land that would never have been developed anyway are a windfall to the recipient. It is not known if any credited lands would have been developed in the absence of this credit.

Policy alternatives could include: purchasing lands for conservation directly, increasing zoning restrictions on development, or increasing the costs of development through increased regulatory burdens on development techniques or environmental impacts.

21. Casualty Loss Deduction

Description:
This program allows taxpayers to 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, fire, storms, earthquakes, vandalism, theft, etc. Casualty losses are limited to nonbusiness losses that are greater than $100 per loss and to cases where the sum of all casualty losses during a

particular year is greater than 10 percent of federal adjusted gross income. This deduction is the same as the federal casualty loss deduction, except that it may only be claimed for losses sustained in California.

Amount:
In tax year 2001, PIT taxpayers claimed $174 million in casualty loss deductions, lowering their taxes by about $5 million. The amount of Corporation Tax casualty loss deductions in 2000 was much smaller, with a tax reduction amount of about $1 million.

Number of Tax Returns Affected:
In tax year 2000, 12 thousand PIT taxpayers claimed casualty loss deductions.

Distribution:

Impact of Casualty Loss Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	0.0	3.1	0.0
$10,000 to $19,999	1.6	3.3	0.0
$20,000 to $49,999	6.8	21.6	0.8
$50,000 to $99,999	2.4	8.8	0.6
$100,000 to $199,999	0.7	80.9	0.7
More Than $199,999	0.4	56.2	2.9
Total	11.8	173.9	5.0

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This program is designed to provide tax relief to taxpayers who face sudden, unexpected, or unusual large losses. The rationale for this program is that taxpayers who suffer a large loss should, for equity considerations, be allowed to reduce their taxable income by the amount of the loss. For example, if there are two taxpayers who earned $100,000 and one taxpayer suffered a $40,000 casualty loss due to a flood, while the other did not, equity considerations would suggest that the taxpayer with the loss should pay less tax. This program is effective at reducing the tax liability for taxpayers who claim the deduction, as long as they have sufficient income to offset. However, its effectiveness is limited to the extent that only taxpayers who itemize their deductions can get any benefit. Additionally, if a taxpayer's loss is larger than his income, he does not get any benefit from the loss in the current year, and the excess loss does not generate a loss carryforward that can be used in subsequent years. It is also not clear why the deduction should be limited to casualty losses in California. If a California taxpayer suffers a loss of property in another state, his ability to pay may be just as negatively affected as if the loss of the property had been in California.

An additional concern with this deduction is that, by providing relief to uninsured or underinsured losses, government indirectly discourages the purchases of home and property insurance.

Policy alternatives include providing direct relief assistance or emergency loans or subsidizing relief organizations that perform these services.

22. Employer Childcare Credits

Description:
California provides two credits for employers that provide childcare services for their employees. One credit is equal to 30 percent of the costs paid or incurred for contribution to a qualified care plan for employees' dependents under the age of 12. This credit is limited to $360 for each contribution. The second credit is a 30 percent credit for startup expenses of establishing a childcare program in California, constructing a childcare facility, or costs for childcare information and referral services. This credit is limited to $50,000 per year. Taxpayers must reduce their cost basis in facilities by the amount of credit claimed. They may opt for depreciation instead of the childcare program start-up credit.

Amount:
In tax year 2001, the amount of credits applied was $3.6 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 4,786 Personal Income Tax returns and 146 Corporation Tax returns.

Distributional Analysis:

Employer Childcare Credit (PIT)		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	*	*
$10,000 to $19,999	17*	1.8*
$20,000 to $49,999	358	81.8
$50,000 to $99,999	2,053	783.8
$100,000 to $199,999	1,570	711.5
$200,000 to $999,999	734	345.9
More Than $999,999	54	90.1
Total	4,786	2,015.6

* Fewer than three taxpayers have AGI less than $10,000. To preserve confidentiality, the data for taxpayers with AGI less than $10,000 has been included with the data for AGI between $10,000 and $20,000.
Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Employer Childcare Credit Applied (Corp) by Size of Gross Receipts 2001				
Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Thousands)	Returns	Credit Applied
Above $100 million	12	930.4	8%	68%
$10 - $100 million	12	479.6	8%	14%
$1 - $10 million	25	131.8	17%	4%
$100,000 - $1 million	41	41.6	28%	3%
Below $100,000	56	39.1	38%	2%
Total	146	1,622.5	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Employer Childcare Credit Applied (Corp) by Industry 2001				
Industry	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Thousands)	Returns	Credit Applied
Manufacturing	19	329.8	13%	20%
Wholesale & Retail	23	54.0	16%	3%
Professional Services	48	165.0	33%	10%
FIRE	17	185.6	12%	11%
Health Care	14	51.3	10%	3%
Other	25	836.9	17%	52%
Total	146	1,622.5	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Discussion:
The purpose of these credits is to increase the access to childcare for workers. They do this by encouraging employers to subsidize childcare for their employees. The childcare contribution credit encourages employers to directly subsidize their employees' childcare costs. The childcare construction credit provides an indirect subsidy by encouraging the construction of new childcare facilities. Construction of worksite childcare facilities may provide additional benefits to workers in that such childcare may be more conveniently accessed than offsite childcare.

There are two alternative possible justifications for the existence of these credits. One is that decreasing the costs, or increasing the availability, of childcare may encourage some individuals, who otherwise would not have, to seek and accept employment and, particularly in the case of onsite childcare, may reduce turnover for current employees. Under this rationale, the program would be considered successful if it increases employment of workers who require childcare in order to work. To the extent that employees would have found childcare in the absence of these subsidies, or to the extent that employers would still have constructed childcare facilities or would have contributed as much to childcare in the absence of these credits, they are a windfall. The number of childcare facilities that would not have been built in the absence of the construction credit is not known, and the level of employer contributions to childcare plans in the absence of these credits is not known.

Alternatively, these credits may be viewed as restoring equity between taxpayers who must pay childcare expenses in order to be employed and those who do not have to. To achieve this goal, they do not need to increase the availability of childcare or the number of workers using childcare; they help further this goal if they lower the cost of childcare for employees. To the extent that employers would have contributed to childcare in the absence of these credits, they are still a windfall.

It should also be noted that, if employers fund their increased contributions to childcare by reducing other forms of employee compensation, the credits may result in a redistribution of wealth from employees without children in subsidized care to employees with children in subsidized care, rather than a net increase in employee welfare. While it may be reasonable for the government to attempt to achieve equity between taxpayers by providing tax relief for those with employment-related childcare expenses, it is not clear why the government should encourage employers to favor one group of employees (those with childcare expenses) over other groups.

23. Solar Energy Systems Credit

Description:
This is a credit for the purchase and installation of solar energy systems installed on California property. Beginning in 2003, the credit will also apply to the purchase and installation of wind energy systems. The credit is equal to the lesser of 15 percent (after December 31, 2003, 7.5 percent) of the purchase and installation cost minus the value of any government incentive payments, or $4.5 per rated watt of the generating capacity of the system. The system must be used primarily to generate electricity for the taxpayer, must be certified by the State Energy Resources Conservation and Development Commission, can have peak generating capacity of no more than 200 kilowatts, and must be installed with a five-year warranty against breakdown or undue degradation. The credit will sunset in 2006.

Amount:
In tax year 2001, the amount of credits applied was $2.7 million.

Number of Tax Returns Affected:

In tax year 2001, credits were applied on 1,597 Personal Income Tax returns and 4 Corporation Tax returns.

Distributional Analysis:

Solar Systems Credit (PIT)		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	*	*
$10,000 to $19,999	23*	2.1*
$20,000 to $49,999	230	105.5
$50,000 to $99,999	554	665.2
$100,000 to $199,999	487	919.7
$200,000 to $499,999	226	631.7
$500,000 to $999,999	49	171.5
More Than $999,999	28	149.0
Total	1,597	2,644.6

* Fewer than three taxpayers have AGI less than $10,000. To preserve confidentiality, the data for taxpayers with AGI less than $10,000 has been included with the data for AGI between $10,000 and $20,000.
Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The purpose of this credit is to encourage investment in solar- and wind-based energy systems. By replacing fossil fuel systems, solar- and wind-based systems improve air quality and reduce dependence on oil imports. Solar energy systems may be particularly useful for replacing "peak load" generators (that often are among the worst air polluters), since solar systems generate the most energy on warm sunny days when electricity demand is generally the highest. An additional benefit to alternative energy generating equipment is that it is often located at the place that the electricity will be consumed, reducing the need for transmission and distribution infrastructure.

This program can be considered successful if it leads to an increase in installations of solar and wind generating capacity. Additional benefits will accrue if the new installations spur innovations or generate economies of scale that reduce the cost of alternative energy sources relative to fossil fuel sources. Credits claimed for alternative energy projects that would have been undertaken even in the absence of the credit are a windfall to the taxpayers receiving them. It is not known how many projects receiving this credit would not have been undertaken in the absence of this credit.

24. Long-Term Care Credit

Description:
The Long-Term Care Credit programs provide a nonrefundable credit to eligible taxpayers with adjusted gross income less than $100,000, who provide long-term care to family members. The credit is $500 for each individual receiving care from the taxpayer. Individuals receiving care must suffer from a chronic disability and require substantial assistance due to a loss of functional capacity. Credit can only be claimed for care of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer.

Amount:
In tax year 2001, the amount of credits applied was $2.3 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 5,198 Personal Income Tax returns.

Distributional Analysis:

Long-Term Care Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	4	0.1
$10,000 to $19,999	82	9.4
$20,000 to $49,999	1,737	524.3
$50,000 to $99,999	3,375	1,734.6
More Than $99,999	0	0
Total	5,198	2,268.9

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The purpose of this credit is to provide hardship relief to taxpayers for nondeductible expenses incurred caring for family members with chronic or serious illness, or disability. In many cases, the taxpayer cannot claim a dependent exemption credit or head of household filing status for the individual, because the individual has other income or maintains a separate residence.

The credit is successful in providing tax relief to the target population to the extent that they are aware of and take advantage of the credit. It is not known how many taxpayers would benefit from the credit but do not avail themselves of the credit.

This credit may enable some individuals to improve their quality of life by receiving medical care in a private rather than in an institutional setting.

A policy alternative would be increased direct government subsidies for medical expenses.

25. Blind Exemption Credit

Description:
This program allows a taxpayer to claim an additional personal exemption tax credit if either the taxpayer or the taxpayer's spouse is blind (two credits may be claimed if both are blind). The amount of this credit (which is indexed annually for inflation based on the California Consumer Price Index) was $79 in 2001.

Amount:
In tax year 2001, the amount of credits applied was $1.5 million.

Number of Tax Returns Affected:
In tax year 2001, 19.1 thousand returns claimed this credit.

Distributional Analysis:

Blind Exemption Credit: 2001		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	1,622	128
$10,000 to $19,999	2,786	220
$20,000 to $49,999	6,829	540
$50,000 to $99,999	5,243	414
$100,000 to $199,999	2,386	188
More Than $199,999	245	19
Total	19,111	1,509

Source: 20010 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This exemption is intended to compensate taxpayers who have increased expenses because they are blind.

Federal law provides an additional deduction from Adjusted Gross Income (AGI) for blind taxpayers who do not itemize their deductions. In 2002, the amount of this deduction is $900 for married taxpayers (whether filing separately or jointly) and

surviving spouses and $1,150 for single taxpayers and head of household filers. The federal deduction is more consistent with the concept that income spent on blindness related expenses should not be considered in calculating an individual's ability to pay taxes. Because of California's highly progressive tax rate structure, a credit provides more tax benefit than a deduction to lower-income taxpayers.

This credit is effective at reducing the tax liability of blind taxpayers. It is unclear why the legislature believes that the blind require assistance of this sort more than do taxpayers with other types of disabilities, or why a taxpayer should receive the credit if their spouse is blind, but not if another dependent is blind. As with all similar credits, a direct expenditure program to benefit the blind would be an alternative to this credit.

26. Child Adoption Expenses Credit

Description:
Under this program, a taxpayer is allowed a credit equal to 50 percent of the specified costs paid or incurred for the adoption of a United States citizen or legal resident minor child who was in the custody of a state or county public agency. The costs must be directly related to adoption to be qualified for the credit. The eligible costs include such items as the travel expenses related to adoption and fees paid to adoption agencies and the Department of Social Services. The credit is limited to $2,500 per child. Unused credits may be carried over to following years until used.

Amount:
In tax year 2001, the amount of credits applied was $1.5 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 1,550 Personal Income Tax returns.

Distributional Analysis:

Child Adoption Expenses Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	0	0
$10,000 to $19,999	*	*
$20,000 to $49,999	195*	47.5*
$50,000 to $99,999	846	675.1
$100,000 to $199,999	419	577.7
More Than $199,999	90	188.3
Total	1,550	1,488.6

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The primary purpose of this credit is to encourage the adoption of children who are in the custody of a government agency. Adoption reduces the costs to the state of caring for the adopted children, and usually provides adopted children a healthier and more stable environment to live in. The program can be considered successful if it leads to an increase in the number of such adoptions. The number of adoptions that would not have occurred in the absence of this credit is not known. A secondary purpose of this credit is to provide relief for the hardships created by the expense of the adoption procedure. The credit is effective in achieving this purpose, except for those who adopt children who are not wards of the state.

The federal government provides a similar adoption credit.

27. Enhanced Oil Recovery Costs Credit

Description:
This allows certain independent oil producers a nonrefundable credit equal to five percent of the qualified enhanced oil recovery costs for projects located in California. Taxpayers who are retailers of oil or natural gas or who are refiners of crude oil whose daily output exceeds 50,000 barrels are not eligible for the credit. Except for the geographic limitation, the California credit is generally available for the same activities as the parallel federal 15 percent credit.

Amount:
In tax year 2001, the amount of credits applied was $0.9 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 71 Personal Income Tax returns and 10 Corporation Tax returns.

Discussion:
The primary purpose of this credit is to increase the use of qualified oil and gas recovery technologies. In general, these technologies are more expensive than other oil and gas technologies, but increase the amount of oil and gas produced by a particular oil and gas field. One benefit of this increased production is a decreased reliance on oil and gas imports. A secondary purpose of this credit is to provide independent producers a competitive advantage relative to integrated oil and gas companies.

The increased use of these technologies is only desirable if free market incentives plus the 15 percent federal credit are insufficient to induce use of the optimal amount of these technologies. For this to be the case, enhanced recovery must produce 'externalities,' benefits to society that cannot be captured by the business that generates them. The externality that one may argue arises in this case comes from a reduction in the importation of foreign oil. Depending on foreign sources for oil (particularly when those foreign sources are politically unstable or unsavory) increases the risk of dramatic fluctuations in the supply and the price of oil. These fluctuations may be very damaging to the economy. They may also induce dangerous foreign policy entanglements.

The purpose of this credit will be achieved if the credit induces increased use of qualified recovery technologies. Credits claimed for recovery operations that would have been undertaken even in the absence of this credit are windfalls. The amount of qualified activity that would not have been undertaken in the absence of this credit is not known. Since the externalities justifying this credit are national rather than specific to California, it is not clear why California should be offering this credit.

The second purpose will be achieved if it increases the market share of independent oil and gas recovery firms. While it is clear that this credit offers the independent firms a competitive advantage in this area, it is not known if market shares would be different in the absence of this credit. Nor is it obvious why California would want to increase independent producers' share of the oil recovery industry.

States often provide add-on credits to federal credits in order to encourage businesses to locate activity in their state rather than another state. Because existing oil and gas fields cannot be moved to another state, however, this credit seems unlikely to reap any benefits of this sort.

28. Joint Custody Head-of-Household Credit

Description:
This credit is for divorced or separated individuals who incur significant costs to maintain a home for a dependent for part of the year. Individuals who provide the principal residence for the dependent and, therefore, qualify for the "head-of-household filing status would not qualify for this credit.

The amount of the credit is the lesser of (1) 30 percent of a taxpayer's net tax, and (2) a maximum amount determined annually ($315 in 2001). To qualify for the credit, a taxpayer must:

- Provide at least 50 percent of the cost of maintaining the principal residence of the dependent for at least 146 days but no more than 219 days of the tax year, and
- Either:
  (1) Be divorced or legally separated from the child's other parent and use the single filing status or
  (2) Live apart from their spouse and file under married filing separately status.

A taxpayer who maintains the principal residence of the dependent for more than 219 days a year qualifies for the head-of-household status that is more advantageous.

Amount:
In tax year 2001, the amount of credits applied was $0.7 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 2,802 Personal Income Tax Returns.

Distributional Analysis:

Joint Custody Head-of-Household Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	12	0.1
$10,000 to $19,999	194	7.1
$20,000 to $49,999	1,309	282.5
$50,000 to $99,999	1,006	309.5
$100,000 to $199,999	237	73.5
More Than $199,999	44	13.8
Total	2,802	686.4

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The intent of the tax credit is to provide financial relief to taxpayers who are divorced or separated, have custody of their children for a significant portion of the year, and do not qualify to file under a head-of-household filing status. The head-of-household filing status is generally allowed to parents (single, divorced, or separated) whose children live with them for more than half the year. To compensate for the expenses borne by taxpayers on behalf of their dependents, the head-of-household status provides for lower tax rates than does the single filing status. Where parents have a joint custody agreement, providing for equal shared custody, it is common that neither will qualify for head-of-household filing status; thus, they must compute their tax at the higher single status tax rate. This credit recognizes that taxpayers whose children live with them for part of a year have greater expenditures than (otherwise similarly situated) taxpayers with no children, but lower expenditures than taxpayers whose children live with them for more than half of the year. This credit, therefore, allows these taxpayers some relief, but not as much as if the children were living with them for the period of time required to qualify for the more favorable head-of-household tax rates. This credit is successful in reducing the tax liability of taxpayers with joint custody arrangements.

29. Qualified Senior Head-of-Household Credit

Description:
This program allows qualified taxpayers 65 years or older to claim a credit equal to two percent of taxable income. Qualified taxpayers are those who qualified for head-of-household status in at least one of the two preceding tax years, but no longer qualify because the qualifying individual that they supported has died. This credit was limited to taxpayers with adjusted gross income of not more than $52,941 in 2002. The maximum credit available in 2002 was $979. The AGI and credit limits are adjusted annually for inflation.

Amount:
In tax year 2001, the amount of credits applied was $0.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 457 Personal Income Tax returns.

Distributional Analysis:

Qualified Senior Head-of -Household Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	4	0.03
$10,000 to $19,999	71	7.5
$20,000 to $49,999	373	132.7
$50,000 to $99,999	9	5.4
More Than $99,999	0	0
Total	457	145.9

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
This credit is designed to provide tax relief to low-income seniors who qualified for head–of-household filing status because they provided a household for a qualifying individual (generally a dependent relative, but not a spouse) who died during one of the two preceding years. Presumably, most of the taxpayer's expenses from the care of the qualifying individual ended soon after the qualifying individual's death, so it is not clear why these taxpayers require relief for two additional years. There are very few qualified taxpayers with incomes between the zero tax threshold and the income limit for this credit.

30. Disability Access Expenditure Credit

Description:
The Disabled Access Expenditure Credit allows small businesses taxpayers to deduct 50 percent of up to the first $250 of eligible expenditures for providing access to disabled persons. To qualify for the credit, the business must have earned less than one million dollars in gross receipts in the previous year and employ no more than 30 full-time employees.

Amount:
In tax year 2001, the amount of credits applied was $0.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 918 Personal Income Tax returns and 192 Corporation Tax returns.

Distribution:

Disabled Access Expenditure Credit (PIT)		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	0	0
$10,000 to $19,999	14	0.8
$20,000 to $49,999	112	10.1
$50,000 to $99,999	218	22.9
$100,000 to $199,999	274	23.6
$200,000 to $499,999	199	16.2
$500,000 to $999,999	67	5.5
More Than $999,999	34	2.2
Total	918	81.4

Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Disabled Access Expenditure Credit Applied (Corp) by Size of Gross Receipts 2001				
Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Thousands)	Returns	Credit Applied
Above $500,000	11	0.5	6%	4%
$100,000 - $500,000	75	4.4	39%	29%
Below $100,000	106	10.4	55%	68%
Total	192	15.3	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Disabled Access Expenditure Credit Applied (Corp) by Industry 2001				
Industry	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Thousands)	Returns	Credit Applied
Food Services	13	1.0	7%	6%
Health Care	134	10.7	70%	70%
Real Estate	14	1.2	7%	8%
Other	31	2.4	16%	16%
Total	192	15.3	100%	100%

Source: 2001 Business Entity Tax System extract
Detail may not add to total due to rounding

Discussion:
The purpose of this program is to provide tax relief to taxpayers for their qualified expenditures incurred in complying with the federal Americans with Disability Act. This program complements a federal tax credit for 50 percent of qualified expenditures exceeding $250 and up to $10,250. The program is successful at directing resources to the targeted uses, but, since the credit is nonrefundable, it is successful only to the extent that taxpayers have tax liability to offset.

An obvious alternative to this credit would be to have the state partially or fully subsidize the cost of disabled access retrofits.

31. Community Development Financial Institutions Credit

Description:
This is a 20 percent credit for the amount of each "qualified investment" in a "community development financial institution" (CDFI). A qualified investment is a deposit or loan that does not earn interest, or an equity investment, that is equal to or greater than $50,000 and is made for a minimum duration of 60 months. A CDFI is a private financial institution located in California and certified by the California Organized Investment Network (COIN) that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

Amount:
In tax year 2001, the amount of credits applied was $0.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on seven Personal Income Tax and fewer than three Corporation Tax returns.

Discussion:
The purpose of this credit is to increase investment in certain economically disadvantaged communities.

Most investments that qualify for this credit also qualify for the federal New Markets Tax Credit. The federal credit is five percent of qualified contributions in each of the first three years and six percent in each of the fourth through seventh years.

This program will be considered successful if it generates new investment activity in targeted communities. For any investments that would have been made anyhow, this provision represents a windfall gain to the taxpayer. The portion of investments receiving this credit that would not have been made in its absence is not known.

Another state program whose goals are very similar to the goals of this credit is the deduction available for loans made to economically depressed areas, including enterprise zones and targeted tax areas.

A policy alternative would be direct government funding of community development financial institutions.

32. Rice Straw Credit

Description:
The Rice Straw Credit gives a credit worth $15 per ton to taxpayers who purchase California-grown rice straw and use the rice straw for some purpose other than burning. To qualify for the credit, taxpayers must receive certification from the California Department of Food and Agriculture that they did purchase the rice straw and use it in a approved manner. Credits are limited to $400,000 per year and are granted on a "first-come, first-served" basis. Taxpayers who are related to rice straw growers are not eligible for the credit. Rice straw purchases after 2007 will not be eligible for the credit.

Amount:
In tax year 2001, the amount of credits applied was $0.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 60 Personal Income Tax returns and six Corporate Tax Returns

Discussion:
The purpose of this credit is to encourage the development of alternatives to rice burning. It is generally believed that the burning of rice straw produces adverse aesthetic and health consequences. This credit is one of several state programs (see below) attempting to mitigate the effects of rice straw burning by encouraging the development of economically viable uses for rice straw. The purpose of this credit is not to eliminate burning by purchasing all available rice straw. The Department of Food and Agriculture notes that, "The ceiling placed on this tax credit will only address approximately one

percent to two percent of the available straw, but may provide enough incentive for private concerns to develop economical uses of rice straw."

To be considered effective, this credit must induce new uses for rice straw or increase volumes of rice straw used for existing purposes, rather than simply pay rice straw consumers for existing uses. The proportion of credited alternative rice straw projects that would not have been undertaken in the absence of this credit is not known.

There are at least three other state programs with the same objective as the rice straw credit. One is the Rice Straw Utilization Grant Program. This program is also administered by the Department of Food and Agriculture. It provides grants of not less than $20 per ton and not more than $300,000 per project for the development of off-field uses of rice straw. In 2001, DFA made grants of $1.79 million to eight projects from a pool of 15 applicants. According to DFA, "Projects must demonstrate environmental benefits and the ability to assist in developing a market for rice straw not dependent on government assistance." This grant program provides larger incentives than the rice straw credit. Additionally, the grant program has a screening program, which the credit does not have, that is intended to locate recipients with a greater likelihood of success in developing economically viable alternatives to rice straw burning. It seems likely that the grant program is more effective than the credit, based simply on the dollar amount of expenditure. However, the credit may still be effective as an additional incentive. Furthermore, due to the cost of maintaining the state bureaucracy necessary to implement the expenditure program, the credit may be more cost effective.

The other two state grant programs that may contribute to a reduction in rice straw burning are the Agricultural Biomass Utilization Account (administered by DFA) that provides up to $20 per ton of rice straw used, and the Agricultural Biomass-to Energy Incentive Grant Program (administered by Technology, Trade, and Commerce) that provides $10 per ton for purchases by qualified biomass facilities.

Another policy alternative available for achieving the goal of reduced rice straw burning is directly regulating the amount of rice straw burning. This option could be more effective in meeting the policy objective of reduced burning, but may impose disposal costs on Californians currently burning rice straw.

33. Dependent Parent Credit

Description:
This credit is available to a taxpayer, 1) whose status is married, filing separately, 2) who lives apart from his or her spouse for the last half of the tax year, and 3) covers more than half of the cost of maintaining a household (not necessarily the taxpayer's) which was the principal home of a dependent mother or father for the year. The credit equals of 30 percent of the taxpayer's net tax and was limited in 2002 to $320.

Amount:
In tax year 2001, the amount of credits applied was $0.1 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 298 Personal Income Tax returns.

Distribution:

Dependent Parent Credit		
Adjusted Gross Income Class	Number of Returns Reporting Credit	Amount of Credit Claimed (Thousands of Dollars)
Less Than $10,000	*	*
$10,000 to $19,999	8*	0.3*
$20,000 to $49,999	126	26.3
$50,000 to $99,999	125	38.5
$100,000 to $199,999	33	10.4
More Than $199,999	6	1.9
Total	298	77.3

* Fewer than three taxpayers have AGI less than $10,000. To preserve confidentiality, the data for taxpayers with AGI less than $10,000 has been included with the data for AGI between $10,000 and $20,000.
Source: 2001 Personal Income Tax Credit Master File
Detail may not add to total due to rounding

Discussion:
The purpose of this credit is to provide relief for certain taxpayers who bear the burden of maintaining a residence for his or her parent(s), but do not qualify for other forms of tax relief such as head-of-household filing status. The credit is successful at directing resources to its target group. A policy alternative would be direct housing subsidies for the qualifying dependent.

34. Transportation of Donated Agricultural Products Credit

Description:
This program provides a tax credit for 50 percent of transportation costs paid or incurred by a taxpayer that are related to the transportation of agricultural products donated to a nonprofit, charitable organization.

Amount:
In tax year 2001, the amount of credits applied was $0.03 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on 26 Personal Income Tax returns.

Discussion:
The purpose of this program is to encourage taxpayers to donate the transportation of, or incur the costs for transporting, agricultural products to charitable organizations. The underlying rationale is that charitable organizations are providing a socially beneficial service by distributing agricultural products to needy individuals, and that this service is worthy of indirect state support. By partially offsetting the costs of transporting the agricultural products, the program encourages more taxpayers to donate or incur the costs of transporting these products. Thus, more agricultural products may reach charitable organizations than otherwise would without the incentive.

In the absence of this credit, the value of the donated transportation would still be tax deductible. It is unclear why transportation of agricultural products should be treated more favorably than other charitable contributions.

To be considered effective, this credit must increase the amount of agricultural product donated to charitable organizations. It is not known whether this credit increases agricultural donations to charitable organizations.

Policy alternatives include increases in targeted aid, i.e. food stamps, to disadvantaged individuals and government grants to charitable institutions providing food assistance.

35. Prison Inmate Labor Costs Credit

Description:
This program allows employers a tax credit equal to ten percent of the wages they pay to state prison inmates employed in a joint-venture program between the taxpayer and the California Department of Corrections. This program was enacted by Proposition 139 in 1990.

Amount:
In tax year 2001, the amount of credits applied was $0.02 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on ten Personal Income Tax returns and fewer than three Corporation Tax returns.

Discussion:
The purpose of this credit is to increase the number of inmates hired under joint-venture programs. It is hoped that this employment will enhance prospects for the inmates' employment once they are released from prison and reduce recidivism. In addition to the potential benefit to the rehabilitation of the inmate, part of the wages earned by inmates is used in a socially beneficial way – either to pay taxes, pay for prison room and board, pay restitution to crime victims, or to provide support for the inmate's family.

In order to be effective, this program must increase the number of inmates employed in joint-venture programs. The joint-venture programs must enable inmates to acquire

better employment after release from prison or reduce recidivism rates. It is not known how many inmates in this program would not have been hired in the absence of this credit or how employment in this program affects employment after release. Studies have found that employment of inmates does improve post-release employment prospects and reduce recidivism.

Other California programs that also contribute to the goal of meaningful employment for released prisoners include support services provided to inmates after release and a variety of employment training programs and hiring incentives that are not targeted specifically at inmates. For example, some released inmates may qualify for the Enterprise Zone Hiring Credit that provides incentives (50 percent of wages up to 1½ times the minimum wage in the first year, phased out over five years) to employers who hire disadvantaged workers. It is not known whether pre- or post-release programs are more effective in achieving the goal of increasing the employability of inmates.

36. Farmworker Housing Costs Credit

Description:
This program provides a tax credit to any farmer who constructs, improves, or donates farmworker housing. The credit equals the lesser of, (1) 50 percent of the cost of building, repairing, or donating the farmworker housing, and (2) the amount certified by the California Tax Credit Allocation Committee. To be eligible for the credit, the housing must meet certain criteria and the taxpayer must enter into an agreement with the committee to build or donate the house. The credit will be available in the year when the housing is completed and occupied.

A similar credit is available to lenders who provide low-interest loans for farmworker housing construction and repair. The amount of the credit is equal to the difference between the market interest rate and the rate charged by the lender.

Amount:
In tax year 2001, the amount of credits applied was less than $0.01 million.

Number of Tax Returns Affected:
In tax year 2001, credits were applied on five Personal Income Tax returns.

Discussion:
The purpose of the credit is to encourage farm owners to provide housing for their employees.

Historically, many farmworkers have been unable to procure housing that most people would consider to be of minimal acceptable quality. Because of the itinerant nature of much farmwork, dormitory-style housing is generally considered the most efficient means of providing them with minimally acceptable housing. However, this type of housing does not qualify for the Low-Income Housing Credit. The Farmworker Housing Credit is a response to this gap in the coverage of the Low-Income Housing Credit.

The program can be considered successful if it increases the amount of housing available for farmworkers. Credits claimed for housing investments that would have been made even in the absence of the credit would be considered windfall. The amount of housing that would not have been built in the absence of this credit is not known; but judging from the small number of credits claimed on tax returns, the credit does not seem to have a strong incentive effect.

A policy alternative to this credit would be to expand the Low-Income Housing Credit.

CONFORMITY TAX EXPENDITURE ITEMS

The next section of this report discusses tax expenditures for which California law generally conforms to federal law. At first glance, it may appear that since the federal government is already providing these tax benefits, there is no reason for the state to provide additional benefits. In fact, however, conformity can be justified for many tax expenditures. For example, it makes sense for the state to conform to tax expenditures, such as the deduction for medical and dental expenses, that are designed to provide hardship relief to a class of taxpayers. This is because the condition that impedes the taxpayer's capacity for paying federal taxes will also impede their ability to pay state taxes.

The analysis of conformity is more complicated for tax expenditures whose primary purpose is to provide incentives to alter taxpayer behavior. State level behavioral incentives have two effects. The first is they encourage more of the tax-favored behavior. For example, the state level tax preferences for Individual Retirement Accounts will increases in contributions to these accounts. Whether or not this is a good thing depends on whether the federal government has already provided an optimal incentive for this behavior. If the federal incentive is not strong enough to induce the optimal level of contributions to these accounts, the additional state incentive will encourage a more productive allocation of savings. If, on the other hand, the federal incentive by itself stimulated sufficient savings, additional state incentives will cause too much savings in these accounts, leading to economic inefficiencies.

The second effect of state level behavioral incentives is to encourage taxpayers to engage in tax-favored activities in California. For example, special treatment of research and development expenditures may induce firms to conduct research in California rather than elsewhere. Again, depending on other factors in the economy, this may be beneficial to California, or it may cause an inefficient distortion of investment decisions.

Conformity also reduces the administrative burden for both taxpayers and the state. The reduction in administrative costs is much greater, however, for some tax expenditures than for others. In general, administrative savings are greater for exclusions and exemptions than for deductions. This is because exclusions often make record keeping entirely unnecessary. For example, since miscellaneous fringe benefits are excluded from income, employers do not need to report to the employee or to the state how much of these benefits they provide, employees do not need to track the value of these benefits,

and the state does not have to audit the level of these benefits received. The reduction in administrative burden is much less for deductions, since deduction amounts must still be tracked and verified. For most deductions, in fact, deconforming from federal law would require only an adjustment (such as California currently has for backing out the deduction for state income tax) to back out the deduction claimed for federal purposes from the calculation of income taxable in California.

1. Mortgage Interest Expenses Deduction

Description:
This provision allows a taxpayer to deduct qualified mortgage interest expenses from income. Qualified mortgage interest includes mortgage interest incurred in acquiring, constructing, substantially improving, or refinancing the principal residence of the taxpayer and one other residence (i.e., vacation home) as well as interest on home-equity borrowing, secured by the residence. This deduction is only available to taxpayers who itemize their deductions.

For purchasing, constructing or improving a home, only interest paid on the first one million dollars borrowed ($500,000 for married individuals filing separate returns) may be deducted. On home-equity loans, interest on the first $100,000 borrowed ($50,000 married, filing separately) may be deducted. Home equity loans must be secured by a qualified residence and may not exceed the fair market value of the residence reduced by any outstanding debts incurred in the process of purchasing or constructing the home. Interest on home equity loans is deductible, even if the proceeds are used for personal expenditures.

Home mortgage interest is not deductible in the calculation of the Alternative Minimum Tax (AMT). Thus, taxpayers who owe AMT, and those whose credits are limited by the Tentative Minimum Tax calculation, must defer the benefits from this deduction.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $60.7 billion in mortgage interest deductions, lowering their taxes by about $3.7 billion.

Number of Tax Returns Affected:
In tax year 2001, 3.9 million PIT taxpayers claimed mortgage interest deductions.

Distribution:

Impact of Mortgage Interest Deduction: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	1.6	1,407.7	1.3
$10,000 to $19,999	42.0	1,703.6	4.6
$20,000 to $49,999	791.3	11,754.7	256.5
$50,000 to $99,999	1,781.9	21,308.5	1,288.7
$100,000 to $199,999	928.6	15,606.7	1,418.6
More Than $199,999	334.1	8,910.9	706.0
Total	3,879.5	60,692.1	3,675.7

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The goal of this program is to provide an incentive for home ownership. Many people believe that increasing home ownership is desirable because it promotes neighborhood stability and civic responsibility. It is thought that home ownership can do this by giving individuals a financial stake (i.e., maintaining the value of real property owned) in the quality of the neighborhood.

Whether or not increasing homeownership is a valid goal, most economists believe that the value of this tax break is generally capitalized into the value of housing. In other words, on average, housing prices should fairly quickly increase by the value of the tax savings over the expected period of time for which the house is owned. Therefore, this deduction does not actually make housing more affordable for homeowners. Instead it results in a transfer from the state treasury to people who already owned homes at the time the deduction was granted or, in the case of new construction, to whoever owned the land at the time it becomes obvious that the land will likely be zoned for residential use. In fact, home owners who do not itemize or whose income places them in low rate brackets are likely to find housing less affordable, because they will not receive a tax reduction large enough to offset the increased price of housing. Additionally, if the goal is to encourage home ownership (in the sense that we want more individuals to own homes), there is no reason to extend the benefit to second homes.

Another aspect of this program is that many taxpayers have used the home equity provision to engage in tax-favored borrowing for purposes other than purchasing or

remodeling homes. This is done by taking out unnecessarily large loans on houses instead of taking out non-tax-favored loans for other purposes.[10]

Policy alternatives that may bring this program more in line with its intended objectives include lower limits on the amount of deductible interest or limiting deductions to loans for first-time home purchases.

The reduction or elimination of mortgage interest deductions could harm current homeowners in two ways. First, homeowners who itemize their deductions will lose the value of the tax deductions that they can no longer claim. This problem could be eliminated by "grandfathering," i.e., allowing deductions for a mortgages already existing at the time of the policy change. Grandfathering would enhance fairness by reducing the impact on taxpayers who took on mortgages under the assumption that the deduction would remain in place for the life of their loan. Of course, grandfathering would reduce the revenue gain to the state from this policy reform. Grandfathering would also create a "lock-in" effect that would reduce the efficiency of the housing market. There are two reasons for this. First, since only the current owner can claim the interest deduction, a grandfathered house is more valuable to its current owner than to a prospective buyer. Second, because the grandfathered owner can only claim the interest deduction on his current house, the grandfathered house is more valuable to its owner than another otherwise equally valuable house. Both of these effects will distort economic activity by discouraging home buying and selling (locking owners into their current homes). Our second alternative policy, limiting deductions to first-time home purchasers, would only lock homeowners into their first homes.

The second impact of the proposed policy alternatives on current homeowners is that this policy change will likely reduce home values. We argued above that the mortgage interest deduction is generally capitalized into the value of housing. Removing or reducing the deduction should lower home prices by approximately the value of the eliminated tax benefit. Since most current homeowners purchased their homes after the implementation of the mortgage interest deduction raised housing values, most current homeowners will be unfairly harmed by this reduction in housing values.

However, it should be pointed out that, in the long run, removing the mortgage interest deduction will decrease the inequities arising from tax-driven fluctuations in housing prices. Under the current system, the tax value of the interest deduction changes every time tax rates are changed. Through the capitalization process, any increase (decrease) in statutory tax rates will increase (decrease) housing values, producing windfall gains (losses) to homeowners. Removing the deduction will eliminate these unintended changes to wealth that results whenever tax rates change.

2. Exclusion of Employer Contributions to Pension Plans

Description:
Subject to certain conditions, employers' contributions to qualified retirement plans and simplified employee pension plans are excluded from the gross income of employees. In

[10] Note that, as described above, while the regular PIT tax does not limit the deductibility (other than the overall limit on mortgage indebtedness) of home equity interest, the AMT does. Thus, many taxpayers are effectively prohibited from deducting home equity interest.

addition, the earnings in these pension plans are excluded from income until they are withdrawn from the plan. Employees do, however, have to pay taxes upon withdrawal on the portion of the retirement benefits they receive that were funded by the employer contributions. In 2002, the exclusion was limited to the lesser of $40,000 or 100 percent of earned income for a defined contribution plans, and to the lesser of $90,000 or 100 percent of average earned income (not exceeding $200,000) for the highest three consecutive years of earnings for a defined benefits plan.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $3.2 billion in tax year 2001.

Discussion:
The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent "new" savings rather than savings redirected from other sources is not known.

3. Exclusion of Employer Contributions to Accident and Health Plans

Description:
Under this program, employer contributions to accident and health plans are excluded from the gross income of employees for tax purposes.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $2.5 billion in tax year 2001.

Discussion:
This exemption provides an incentive for employers to include these types of insurance as part the employees' compensation packages. Program supporters argue that this is a desirable social goal, because it provides security to workers, increases productivity, and reduces the need for the government itself to provide accident and health care programs. It is also sometimes argued that taxing non-cash benefits imposes financial hardship on some taxpayers.

By creating large insurance pools, employer-based insurance programs may enhance the efficiency of the insurance market by mitigating a problem known as "adverse selection," which arises because people who know that they are in ill health are more likely than others to purchase health insurance. This drives up the price of insurance and, in turn,

causes more people to forgo insurance. This problem is less likely to arise when employers insure large numbers of people. There are, however, a variety of non-employer-based methods of financing health care that can also overcome the adverse selection problem.

The consensus view of economists is that state and federal programs like this one have contributed significantly to shifting the mix of employee compensation away from wages and salary income in favor of nonmonetary fringe benefits. To the extent that this is true, these programs can result in a misallocation of economic resources.

Another resource allocation problem arises from tying health insurance to employment. There are important advantages from enabling people to maintain continuity in their health insurance for long periods of time. Many people change jobs more frequently than they would like to change health plans. Establishing otherwise identical health insurance plans that are not linked to a person's place of employment would eliminate disruptions and other changes in health coverage caused by job changes (or losses). This provision in the tax code, however, provides a strong incentive to maintain employment-related health plans.

One of the most difficult issues in designing health care policy is determining the optimal level of government support for health insurance. The tax savings provided by this provision lowers the price of health care services. Lower prices will induce people to seek health care services more frequently. When this results in consumers seeking preventative health services in a timely fashion, this can further enhance the efficiency of the health care system. On the other hand, when the price of health services is too low, many people will demand to see doctors when there is no need for them to, reducing the efficiency of the system. The desirability of government subsidies to the price of health care depends on the relative frequency of these two behavioral reactions to the subsidies.

4. Basis Step-up on Inherited Property

Description:
Under this provision, when property is transferred from a decedent to an heir, the basis of the inherited property is adjusted upwards, for tax purposes, to equal its fair market value at the time of the decedent's death. Therefore, any appreciation in the value of the property that occurred prior to the decedent's death is exempted from capital gains taxation.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $1.3 billion in tax year 2001.

Discussion:
The original justification for this exemption was that, since taxpayers had to pay taxes on inherited property, taxing capital gains would constitute double taxation. This concern is

no longer applicable, however, since California removed its taxes on inherited property in 1982.

Another concern is that it is sometimes very difficult for heirs to determine the original basis of the property they are inheriting. Many bequeathed assets are purchased by the deceased years prior to the year of inheritance. The heir may not know when the asset was purchased. This makes it very difficult to determine the asset's basis. (Of course, recent improvements in record-keeping technology and increases in the percentage of assets held in major financial institutions should, over time, reduce the relative importance of this problem). One imperfect solution to this problem would be to provided a safe harbor basis. For example, taxpayers could be allowed to claim a basis equal to 50 percent of the sales price if they have no documentation to prove otherwise.

5. Charitable Contribution Deduction

Description:
This provision allows taxpayers to deduct cash from income and specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. For Personal Income Tax (PIT) taxpayers, the itemized deduction is generally limited to 50 percent of adjusted gross income (AGI). Excess contributions generally may be carried forward to future tax years for up to five years. This deduction is only available to taxpayer's who itemize their deductions.

When taxpayers make qualified donations of appreciated property, the capital gains on the appreciated property is exempt from taxation.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $18.3 billion in charitable contribution deductions, lowering their taxes by about $1.1 billion.

Number of Tax Returns Affected:
In tax year 2001, 5.1 million PIT taxpayers claimed a charitable contribution deduction.

Distribution:

Impact of Charitable Contribution Deduction: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	102.3	138.1	0.3
$10,000 to $19,999	225.0	375.2	0.8
$20,000 to $49,999	1,427.0	2,661.9	64.6
$50,000 to $99,999	2,021.5	4,744.1	274.3
$100,000 to $199,999	1,017.4	3,626.7	314.7
More Than $199,999	350.2	6,728.6	454.1
Total	5,143.4	18,274.6	1,108.7

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The purpose of this program is to provide an incentive for taxpayers to make contributions to qualifying charitable organizations. The original justification for the charitable contribution deduction at the federal level grew out of a concern that high-income taxpayers (the only individuals subject to the income tax in its early years) would have less income to contribute to charities because of the federal income tax. It was believed that charitable organizations would suffer substantial declines in income without the deduction.

The underlying reason for supporting charitable organizations is that charitable organizations provide services that benefit society as a whole. One potential problem with this rationale is that charitable organizations often work at cross-purposes with other charitable organizations. For example, some charitable organizations might work to stop the development of certain portions of land, whereas other charitable organizations work to protect the rights of landowners to develop that same land. Also, much of what religious organizations do is at cross-purposes from other religious organizations. Likewise, most churches (as well as synagogues, mosques, and temples) adhere to certain doctrines and work, with a greater or lesser degree of vigor, to promote the view that those doctrines are correct. How can two sets of services that contradict each other both provide a benefit to society? There are several ways to view this. One is that society benefits from most services provided by charitable organizations. While society doesn't benefit from all the services provided by charitable organizations (such as offsetting legal advocacy) they benefit from the majority of the services or, at least, from a large enough

portion of the services that it justifies the subsidy. In other words, the government may not want to subsidize all the activities of charitable organizations, but it believes that there would be a greater harm done by attempting to distinguish which activities of charitable organizations are socially beneficial and which are not.

It also may be the case that the advocacy done by charitable organizations, even when it contradicts the advocacy done by other charitable organizations, is considered healthy in the sense that it encourages competition of different political, social, and religious ideas. Just as a free market for goods can weed out inefficient producers, a free market for ideas can weed out those ideas that have insufficient efficacy or substance.[11] Finally, it may be the case that involvement in charitable organizations is considered to make the contributor a better citizen, apart from the contribution. That is, just the fact that a person aligns himself with an organization (as evidenced through a contribution) may provide that individual with an impetus to act as a better citizen (obey laws, pay taxes, treat others civilly). One possible way this could happen is by causing the individual to feel that he has a stake in at least some aspect of the community.

Given that there is at least the appearance of an externality (benefit to society beyond the benefit realized by the giver and the receiver of the contribution) associated with charitable contributions, it is useful to ask how effective this preferential treatment for charitable contributions has been for encouraging contributions. Using reasonable estimates of the responsiveness of charitable contributions to the rate of tax suggests that, if California were to repeal the deductibility of charitable contributions, contributions would drop by five to ten percent.

Even if there is a valid purpose for government to subsidize some contributions to charities, much of what falls under the guise of charitable contributions could be more accurately characterized as club dues. Those "club dues" are spent largely for the benefit of the dues paying members. For example, when the local Little League builds new diamonds, buys new equipment, or pays into the national organization, the majority of the benefits of those expenditures accrue to the members of the Little League. The same could be said for most charitable organizations including religious organizations such as churches, synagogues, mosques, and temples. If the reason government subsidizes charitable organizations is the belief that club membership in itself makes people better citizens, there is no real problem with allowing the deductibility of club dues as charitable giving. However, if the justification for subsidizing charitable organizations is that they do good deeds for others outside their own organization, then the subsidy for that part of the dues that is expended internally is not well spent. The charitable contribution deduction is only available to itemizers. Since a greater percentage of high-income taxpayers itemize, limiting this deduction to itemizers tends to treat low-income taxpayers less favorably than high-income taxpayers. Conceptually, a portion of the standard deduction is intended to account for charitable contributions by non-itemizers. Nonetheless, if a taxpayer who is taking the standard deduction makes larger

[11] Of course, the argument against this reasoning is that, if we want a free marketplace for the exchange of ideas, why does the government need to be involved in subsidizing the exchange of ideas.

contributions to a charity than another non-itemizing taxpayer, the first taxpayer will get no tax benefit from the additional contribution.

The exemption of capital gains on donated appreciated property increases the tax savings from these donations. This should increase the amount of donations to charity. To the extent that donations would have been made even if capital gains on donations were not excluded, this represents a windfall. Furthermore, this provision creates inequities between taxpayers who use different methods to make equivalent charitable donations. This occurs because some taxpayers have appreciated property to donate and others do not, therefore, some taxpayers will receive a greater tax benefit than others making the same size charitable donation.

6. Exclusion of Proceeds from Life Insurance and Annuity Contracts

Description:
These provisions allow taxpayers to exclude proceeds received from life insurance policies of a deceased person from their gross income. If the proceeds are received in circumstances other than death, only the actual investment portion of the proceeds is excludable from gross income. In case of proceeds received as installments, the interest component of such proceeds must be included in the taxpayer's gross income.

Also, the insured who receives "living benefits" from a life insurance policy upon having a catastrophic or life-threatening illness or condition is allowed to exclude the proceeds from gross income. In such a case, the policy owner can trade the right to receive death benefits under the policy for a compensation amount less than the death benefits (a viatical settlement) and still exclude the amounts received from gross income.

Amount:
We estimate this program to have cost the state $853 million in tax year 2001.

Discussion:
The purpose of this program is to provide tax relief for those who receive benefits as designated beneficiaries in the life insurance policies of the deceased persons. The rationale for this program is that beneficiaries often face economic hardships due to the loss of income and/or services provided by the deceased and, thus, need an additional benefit.

Alternative policy would be to address the specific financial hardships involved, rather than to favor life insurance as a vehicle for financing them; e.g., the government could provide direct expenditures for items such as funeral expenses or for childcare for children who lose a parent. Direct expenditures could be provided to all who are in need, not just to those who receive life insurance (and, hence, are less likely to be severely financially distressed).

7. Real Property Tax Deduction

Description:
Taxpayers can deduct from gross income taxes paid to local, state, or foreign governments on real property.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $13.4 billion in real property tax deductions, lowering their taxes by about $808 million.

Number of Tax Returns Affected:
In tax year 2001, 4.9 million PIT taxpayers claimed a real property tax deduction.

Distribution:

Impact of Real Property Tax Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	141.4	329.1	0.4
$10,000 to $19,999	237.5	415.6	0.6
$20,000 to $49,999	1,311.5	2,399.2	53.2
$50,000 to $99,999	1,871.7	4,207.1	268.2
$100,000 to $199,999	966.6	3,396.9	297.6
More Than $199,999	341.7	2,626.0	187.9
Total	4,870.3	13,373.8	807.9

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This deduction most likely grew out of a view of fiscal federalism that higher level governments should not interfere in, but in fact should encourage, the revenue-generating efforts of lower-level governments. Thus the federal government encouraged lower level governments to levy sales, property, and income taxes by allowing a deduction for the amount of these taxes paid. The State of California conformed to this approach partly because of the inherent benefits of conformity, and partly to encourage revenue generation by county and city governments. For a variety of reasons (often arising from actions by parties with very different motivations), California has moved away from this independence approach to fiscal federalism to one in which much of the revenue of local jurisdictions is actually raised by the state and then distributed out to the jurisdictions. As

such, the original motivation for this deduction may no longer be relevant.[12] However, as is the case on the expenditure side of the budget, if a tax benefit is available for a long enough period of time it comes to be viewed as an entitlement. As such there is likely little political will, relative to the political cost, of removing this benefit.

This deduction also has the effect, like the mortgage interest deduction, of subsidizing the cost of purchasing or maintaining property. Most economists believe, however, that any such subsidies are generally capitalized into the price of the property, i.e., the price is increased by approximately the value of the tax savings, so that the purchaser is no better off than they would be without the deduction.

Finally, this deduction has the side benefit of offsetting some of the inequities caused by Proposition 13. Under Proposition 13, in which property values can only be adjusted 2% per year, unless the property is sold, homeowners who hold onto their homes for long periods of time during inflationary periods can be paying dramatically less in property taxes than their newly-arrived neighbor who is living in a comparable home. This deduction would partially offset this deduction by giving the person paying the higher property tax a larger deduction.

8. Exclusion of Capital Gains on the Sale of Principal Residence

Description:
Under this provision, the gain realized on the sale or exchange of a principal residence, up to $250,000 for single income tax filers and $500,000 for joint filers, is excluded from taxation. The property must have been used as a principal residence in two of the previous five years. Taxpayers who do not meet the ownership and use requirements may still qualify for a reduced exclusion amount, if they can show that the sale or exchange is by reason of a change in employment, health or, in some cases, unforeseen circumstances. The exclusion can be applied multiple times during a taxpayer's life, but only to one sale or exchange every two years.

This provision of California law conforms to federal law, except that, under California law, Peace Corp volunteers are exempted from the two-year occupancy condition.

Amount:
We estimate this program to have cost the state $659 million in tax year 2001.

Discussion:
In the absence of this provision, the capital gains generated by sales of houses would receive the same tax treatment as other types of capital gains.

There are a number of reasons why many taxpayers would view this as unfair. Part of this opposition stems from the psychology of housing sales. Housing sales are often

[12] Note that the deduction for sales tax was repealed at the federal level in the Tax Reform Act of 1986. California conformed to this repeal in 1987.

traumatic experiences even without tax considerations. The gains from housing sales are often very large relative to the seller's other income, so the tax due if housing sales were treated like other gains may appear unfairly large relative to the taxpayer's non-gain income. This feeling is exacerbated by the fact that, because the income tax is progressive, fully taxing gains on housing sales would push many taxpayers into a higher tax bracket. Another psychological complication arises from the fact that most sellers of houses purchase another house at approximately the same time as the sale of the first house. When a taxpayer moves to a more expensive house, they generally feel as though they have taken on a new financial burden, not as though they have generated a capital gain. Finally, many people argue that all capital gains should be excluded from income, not just gains on housing sales. The exclusion of capital gains on sales of residences is an effective response to the perceived injustice of fully taxing these capital gains.

This provision encourages people to buy and sell houses more often. Many sellers of primary residences purchase another house at approximately the same time that they sell their house. Some homeowners would choose to stay in their original house, rather than sell it and buy a new one, if they had to pay capital gains on the sale of their first house. This "lock-in" effect would reduce the efficiency of the housing market.

The exclusion also increases the rate of return on investments in housing. This should increase the amount of investment in the housing sector. This may result in an increase in the number of people who own their own home or, as most economists believe, the value of the tax break may be capitalized in the value of housing; i.e., on average, housing prices are increased by the value of the tax break, so houses are not more affordable than they would be in the absence of this exclusion.

A policy alternative would be to tax capital gains on houses the same as other capital gains. A more refined policy would allow the capital gain to be rolled over when a more expensive house is purchased at approximately the same time as the gain-generating sale. This would solve the lock-in problem in which taxpayer's opt not to sell and buy houses, because the tax on the sale deprives them of resources necessary for the purchase of the next house.

9. Employee Business and Miscellaneous Expense Deduction

Description:
A taxpayer is allowed to deduct from gross income a portion of certain unreimbursed, business-related expenses. These include business expenses such as travel, meals, entertainment, and lodging, as well as miscellaneous expenses related to producing or collecting taxable income; management, conservation, or maintenance of income-producing property; and tax return preparation fees.

Currently, 50 percent of meals and entertainment expenses can be deducted provided that they exceed two percent of the taxpayer's federal AGI.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $11.6 billion in employee business and miscellaneous expense deductions, lowering their taxes by about $610 million.

Number of Tax Returns Affected:
In tax year 2001, 1.9 million PIT taxpayers claimed an employee business and miscellaneous expense deduction.

Distribution:

Impact of Employee Business and Miscellaneous Expense Deduction: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	76.4	182.0	0.2
$10,000 to $19,999	95.1	327.5	1.8
$20,000 to $49,999	576.1	2,597.1	71.7
$50,000 to $99,999	799.0	4,060.6	235.3
$100,000 to $199,999	323.1	2,369.4	190.7
More Than $199,999	74.5	2,152.0	110.4
Total	1,944.3	11,688.6	610.0

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The expenses covered by this provision are expenses that employees must incur in order to earn income. In our income tax system, large and unusual expenses that generate income are normally deductible. The types of expenses that qualify for this deduction are expenses, such as for business travel, that are often reimbursed by employers. This provision, therefore, works toward restoring equity between otherwise similar taxpayers some of whose employers reimburse these expenses and others whose employers do not reimburse them. It also creates equity between employees who are not reimbursed for their work-related expenses and the self-employed.

The two percent floor on expenses limits this benefit to employees who incur significant business related expenses. The floor simplifies the administration of the program.

The 50 percent limitation of meals and entertainment was imposed because it was felt that many taxpayers were incurring expenditures that exceeded the legitimate business purpose of the tax favored activity. For example, there may be a valid business reason for a lunch expense. Often, the business purpose could be served by meeting at a $10 per

person restaurant. The participants may, however, opt to go to lunch at a $30 per person restaurant. Conceptually, in this case, the first $10 per person should be deductible, but the remainder of the cost should be viewed as personal entertainment. The 50 percent rule is an administratively feasible method of addressing this problem.

Policy alternatives could include changes in the types of expenses that qualify for this deduction or changes in the two percent threshold for claiming the deduction. If this deduction were removed, it is possible that employers would feel pressure to either begin reimbursing their employees for these expenses or increase wages to compensate for the increased tax bill.

10. Head-of-Household and Qualifying Widow(er) Filing Status

Description:
Under the head-of-household program, taxpayers who provide a home for a qualifying relative are eligible for a lower tax rate than is available to single persons or to married persons filing separate returns. The program provides tax relief to heads-of-households who are single, or married but living apart.

To claim the head-of-household filing status, a taxpayer must provide the principal home of the qualifying relative for more than one-half of the year. In addition, the taxpayer must pay more than half of the cost of maintaining that household. Single taxpayers who provide the main home for their unmarried child or grandchild can still qualify for head-of-household filing status, even if they are not entitled to a Dependent Exemption Credit for the child or grandchild. For example, if a single custodial parent has moved into the home of her widowed father, the father would qualify as a head-of-household. Otherwise, the taxpayer must be entitled to a Dependent Exemption Credit for the relative to be qualified.

A qualifying widow(er) is a taxpayer whose spouse died within two years prior to the taxable year involved and has not remarried, and who provides the main home for a child for whom the taxpayer is entitled to a dependent exemption credit. Qualifying widow(er)s may claim a larger personal exemption in addition to the lower tax rates provided to heads-of households.

Amount:
In tax year 2001, PIT taxpayers reduced tax liability by $554 million, because of the special treatment afforded head-of-household and qualifying widow(er) filers.

Number of Tax Returns Affected:
In tax year 2001, 1.9 million PIT taxpayers filed as head-of-household, while only about 6,000 taxpayers filed as qualifying widow(er).

Distribution:

Impact of Special Treatment for Head-of-Household and Qualifying Widow(er) Filers: 2001		
Adjusted Gross Income Class	Number of Returns Filing as Head-of-Household or Surviving Spouse (Thousands of Returns)	Tax Impact of Treatment (Millions of Dollars)
Less Than $10,000	257	0.0
$10,000 to $19,999	546	1.0
$20,000 to $49,999	903	276.3
$50,000 to $99,999	227	223.0
$100,000 to $199,999	31	43.1
More Than $199,999	9	10.7
Total	1,972	554.1

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The basic structure of the income tax includes a zero percent bracket, in which the first dollars earned each year by a taxpayer are not taxed. The zero bracket is intended to recognize that a certain amount of income is vital for procuring life's basic needs. As a family increases in size, it becomes more costly to feed, house and clothe them. The zero bracket, therefore, increases with the size of the family. For prototypical families, when a family increases in size from one member to two members, the taxpayer files a joint return instead of a single return. The joint return provides for a much larger zero bracket than the single return. Subsequent increases in family size (e.g., from two members to three) increase the zero bracket only by allowing an additional dependent credit. Prior to the recent increases in the dependent credit, the tax savings from adding another type of dependent was much smaller than the savings from adding a spouse. Allowing head-of-household status is consistent with the view that addition of any second member to a household, whether or not the second member is a spouse, generates a substantial increase in the most basic financial needs of the household by providing less traditional two-member households with the same tax benefit level as traditional two-member households.

This favorable treatment extended to surviving widow(er)s is intended to partially compensate the widow(er) for potential loss of income. This provision generates inequities between qualifying taxpayers and other taxpayers with the same income.

11. Exclusion of Benefits Provided Under Cafeteria Plans

Description:
This program allows taxpayer to exclude qualified benefits received from cafeteria plans from gross income. Cafeteria plans are packages offered by employers that provide a choice of qualified benefits or monetary compensation. Qualified benefits may include accident and health coverage, group-term life insurance coverage, or child and dependent care benefits. Qualified benefits do not include deferred compensation except for certain plans maintained by educational institutions. If the taxpayer prefers monetary compensation to qualified benefits, the monetary compensation must be included in gross income subject to taxation.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $410 million in tax year 2001.

Discussion:
For the most part, the benefits (health insurance, life insurance) that can be provided on a tax-free basis through cafeteria plans, can be offered on a tax-free basis without a cafeteria plan. The benefit of the cafeteria plan is that it allows employers to offer choices to their employees so that each employee can better tailor the benefits they receive to match their particular needs. In so doing, this provision is likely to encourage non-wage compensation over wage compensation. Whether or not this is a desirable policy goal depends on the desirability of subsidizing the underlying forms of non-wage compensation (health insurance, life insurance, childcare). For more analyses of these issues, see the relevant sections of this report. It is not know by how much the tax treatment of cafeteria plans has increased the provision of non-wage forms of compensation.

12. Depreciation Amounts Beyond Economic Depreciation

Description:
This program allows taxpayers to deduct depreciation in excess of economic depreciation on qualified physical assets. California PIT Law conforms to the federal depreciation rules under the Modified Accelerated Cost Recovery System (MACRS) and to the rules on Section 179 expensing as of January 1, 2001 (California has not, as of this writing, conformed to the most recent federal expansion of Section 179). California PIT Law does not conform to the temporary bonus depreciation rules adopted by the federal government in 2002 and expanded in 2003. The expensing and depreciation rules are set up to provide accelerated depreciation. California corporate taxpayers, however, are not allowed to follow federal depreciation rules and must use depreciation schedules that approximate actual economic depreciation.

Amount:
We estimate this program to have cost the state $398 million in tax year 2001.

Discussion:
Over time, the value of old business assets decreases. Conceptually, business should be allowed, each year, to deduct from income the amount by which the value of these assets has decreased (e.g., their economic depreciation). By allowing more rapid tax write-offs of the cost of equipment, taxpayers are allowed to recover the costs of their investments more quickly. This increases the rate of return on the depreciable property. The purpose of this program is to provide an incentive for taxpayers to invest in qualified assets such as equipment and buildings by increasing the rate of return on these investments. It is thought that these investments will spur general economic growth both by augmenting the capital infrastructure of the economy and by stimulating demand for investment goods. It is not know by how much this provision for PIT taxpayers has increased investment in depreciable property, nor the impact of any increased investment on the level of economic output for the state.

It has also been argued that, for some assets, accelerated depreciation compensates taxpayers for the failure of the tax code to update the depreciable basis of property to reflect inflation over time. A counter argument to this, however, is that no other sources of capital income (such as interest or capital gains) are allowed to adjust their reported earnings downward to reflect the impact of inflation.

Accelerated depreciation will tend to benefit certain types of investment over others. As such, accelerated depreciation can have a distortionary impact on the economy and lead to inefficiencies.

Another problem with current California law is that it provides more favorable treatment to businesses subject to the Personal Income Tax Law than for similar businesses subject to the Corporate Franchise Tax Law. This unequal treatment is distortionary and leads to inefficiencies.

13. Individual Retirement Accounts

Description:
There are two types of Individual Retirement Accounts (IRAs), traditional IRAs and Roth IRAs. This provision allows taxpayers to deduct from income (subject to the limits described below) contributions to traditional IRAs. Also, earnings in traditional IRAs are excluded from income until they are distributed to the taxpayer. For Roth IRAs, contributions are not deductible. Earnings in Roth IRAs are excluded from income. Distributions from Roth IRAs are also excluded from income provided that the account has been open at least five years, and the recipient is at least 59 ½ years old.

The yearly maximum contribution to IRAs is the lesser of $3,000 or 100 percent of the individual's compensation for individuals less than 50 years old. The maximum dollar amount for individuals 50 years old or older is $3,500. Married joint-return filers may

contribute to each spouse's IRA even if one spouse receives little or no compensation. The total combined contributions to IRAs for joint-filers may not exceed the lesser of $6,000 ($6,500 if only one spouse is 50 years old or older or $7,000 if both spouses are 50 years old or older) or their combined compensation. If the taxpayer is enrolled in a retirement plan sponsored by their employer, the amount of contributions to traditional IRAs that may be deducted is reduced if the taxpayer's AGI is greater than $40,000 for single filers, $60,000 for married joint-return filers, and $0 for married filing separately. The deduction is eliminated when AGI exceeds $50,000 for single filers, $70,000 for married joint-return filers and $10,000 for married filing separately. If a joint-filing taxpayer is not covered by an employer's plan, but their spouse is, the deduction phases out for AGI between $150,000 and $160,000. The yearly limit for contributions to Roth IRAs is phased out for single taxpayers with AGI between $95,000 and $110,000, for joint filers with AGI between $150,000 and $160,000.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $385 million in tax year 2001.

Discussion:
The purpose of this program is to provide an incentive for taxpayers to save for retirement.

Tax relief is provided in two ways. Some relief is provided by deferral of taxes on this income. Additional relief is provided to taxpayers whose marginal tax rates are lower in retirement when withdrawals are taken than they were when the taxpayer was working. The value of these benefits has been reduced by recent reductions at the federal level in the tax rate on long-term capital gains on investments held in fully taxable accounts.

The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent "new" savings rather than savings redirected from other sources is not known.

14. Exclusion of Compensation for Injuries and Sickness

Description:
This provision allows taxpayers to exclude from income the compensation received from workers' compensation, accident insurance, and health insurance for their physical injuries and physical sickness. The exclusion applies whether the compensation is awarded by court order or whether the taxpayer receives the award in lump sum or installments payments. In addition, reimbursement by the employer for expenses

incurred for the care of an employee, the employee's spouse, or the employee's dependents is not subject to taxation. Punitive damages, however, are taxable, since they are amounts in excess of what is necessary to "make the taxpayer whole." Disability benefits received under state statutes are excludable, but reimbursements for medical expenses claimed as income tax deductions in prior years are not.

Amount:
We estimate this program to have cost the state $215 million in tax year 2001.

Discussion:
The purpose of this program is to provide tax relief to qualified taxpayers who suffer economic hardship resulting from injuries or sickness. There are two types of hardship that may be addressed by these insurance programs. The first is loss of income when the injury or sickness prevents a person from working. The second is direct expenses (primarily medical) arising from the injury or sickness.

In the first case, if the replacement income from the insurance is equal to the income lost due to injury or sickness, this exclusion creates inequities. This happens because a taxpayer who receives insurance payments will have a higher after-tax income than another taxpayer who earned an identical income prior to the first taxpayer's injury. In this case, the insurance income should be taxed as if it were regular income. If, on the other hand, insurance payments are less than or equal to the after tax income that the taxpayer would have had in the absence of the injury, the exclusion works to restore equity between these taxpayers.

To the extent that this deduction compensates taxpayers for direct expenses related to their injury or sickness, it creates inequities between taxpayers receiving deductible compensation and others who suffer the same injuries or illnesses but receive no tax break. Furthermore, because this is an exclusion, the actual benefit conferred is greater for taxpayers in higher income brackets, even though those people may be more able to withstand the financial hardship caused by the injury or sickness. A policy alternative would be direct government expenditures for the medical and other related expenses.

15. Self-Employed Retirement Plans

Description:
This provision allows taxpayers to deduct from income contributions to a self-employed retirement plan. The deduction claimed for California purposes must be the same as the deduction claimed for federal purposes. In 2002, the deduction was limited to the lesser of $40,000, or 100 percent of earned income for a defined contribution plans, and to the lesser of $90,000, or 100 percent of average earned income (not exceeding $200,000) for the highest three consecutive years of earnings for a defined benefits plan. Income generated by these accounts is also excluded from taxation until the assets are withdrawn from the account.

Amount:
We estimate this program to have cost the state $210 million in tax year 2001.

Discussion:
The purpose of this program is to provide an incentive for self-employed taxpayers to save for retirement. They are given the same type of tax deferral as provided for individuals covered under employer-established retirement programs. Since contributions to employer-provided pension plans are excluded from income, it is equitable to provide a similar benefit to self-employed individuals.

The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent "new" savings rather than savings redirected from other sources is not known.

16. Exclusion of Miscellaneous Fringe Benefits

Description:
Under this program, employees receive tax exemption for certain fringe benefits paid by their employers. These benefits include, (1) free special services provided to employees (such as free stand-by flights provided by airlines to their employees); (2) employee discounts for the purchase of company products; (3) use of company equipment (such a company car); and (4) "de minimis" fringe benefits (such as personal use of an employer's computer equipment or the use of on-premise gymnasium facilities).

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $205 million in tax year 2001.

Discussion:
The rationale for the tax relief depends on the type of the benefit. For example, in the case of the use of gymnasium facilities, the argument has been that using such facilities improves the health, morale, and productivity of employees; therefore, this expense can be viewed as a business investment. In other cases, such as personal use of company equipment, the administrative difficulty of measuring the value of the private benefits of the use of the equipment (business use of the equipment should not be taxed) for tax purposes is the primary justification.

This exemption increases the value, to employees, of these miscellaneous fringe benefits relative to wages. Therefore, this exemption will tend to encourage the provision of compensation in the form of miscellaneous benefits. The extent to which this exemption

increases the amount of these benefits given to employees is not known. Repeal of these exemptions would likely result in significant administrative and compliance costs.

17. Exclusion of Transportation Related Fringe Benefits

Description:
This provision allows employees to exclude qualified compensation for employer-provided transportation benefits from income. These benefits may include up to $175 per month for parking, $65 per month for transit passes, and all expenses for ridesharing programs. The exclusion is limited to the fair market value of the benefits received. These provisions of California law generally conform to federal law, except that in California law the exclusion for ridesharing is more generous. For federal purposes, the ridesharing exclusion is limited to $65 per month, whereas, for California, the exclusion is unlimited.

Amount:
We estimate this program to have cost the state $150 million in tax year 2001.

Discussion:
There is no obvious policy reason for the exclusion of employer-provided parking benefits.

Favorable tax treatment for mass transit and ridesharing can be justified on the grounds that encouraging alternative forms of transportation may reduce congestion and air pollution.

The purpose of the more generous California exclusion for ridesharing is to encourage ridesharing. To the extent that ridesharing reduces the number of cars on California roads (especially if the reductions occur during commute time), both roadway congestion and air pollution will be reduced.

This program will be considered successful if it increases ridesharing. It is not known how many taxpayers currently utilizing ridesharing programs would not be if this provision did not exist. The reduction in congestion from subsidized ridesharing programs could encourage some people to choose to live further from their jobs and undertake longer commutes, thus reducing the gains from the ridesharing program.

18. Medical And Dental Expense Deduction

Description:
This provision allows taxpayers to claim a deduction for qualified medical and dental expenses incurred on behalf of the taxpayer, the taxpayer's spouse, and/or the taxpayer's dependents. Only expenditures that exceed 7.5 percent of federal adjusted gross income

and not covered by other means such as insurance are deductible. The deduction is available only to taxpayers who itemize their deductions.

Qualifying medical and dental expenses include payments for prevention, diagnosis, cure, mitigation, and treatment of disease, prescription drugs, or nonprescription insulin, certain related travel and lodging costs, and qualified long-term care and its insurance premiums.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $5.4 billion in allowed medical and dental expense deductions, lowering their taxes by about $122 million.

Number of Tax Returns Affected:
In tax year 2001, .9 million PIT taxpayers claimed a medical and dental expense deductions deduction.

Distribution:

Impact of Medical and Dental Expense Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	121.8	708.5	1.0
$10,000 to $19,999	138.3	831.3	0.9
$20,000 to $49,999	402.5	2,249.7	26.5
$50,000 to $99,999	204.3	1,048.3	49.4
$100,000 to $199,999	42.5	447.1	30.6
More Than $199,999	5.8	149.9	13.8
Total	915.2	5,434.9	122.1

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This program is intended to mitigate hardships faced by taxpayers who incur very large medical expenses.

The tax benefit from this deduction is greater for taxpayers who are in higher tax brackets, even though those taxpayers would seemingly be more able to absorb large medical expenses. Also, this benefit is available only to taxpayers who itemize their deductions. An alternative policy that would address these issues would be to replace the deduction with either a credit or direct government compensation for medical expenses.

Another possible concern arising from this deduction is that, by shifting a portion of medical expenses to other taxpayers, it may discourage some people from purchasing optimal levels of medical insurance.

19. Tax Exempt Status for Qualifying Corporations

Description:
This program allows qualifying nonprofit and charitable organizations to be exempt from corporate franchise and income taxes. Qualifying corporations may include religious, charitable, educational, and scientific organizations, as well as certain homeowner organizations, civic and business organizations, and credit unions.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $117 million in tax year 2001.

Discussion:
The purpose of this program is to provide tax relief to organizations that are involved in nonprofit and charitable activities and for qualified membership organizations. The justification for this program is that these organizations are providing beneficial services to society and, therefore, should be indirectly supported by the government. These qualifying organizations, however, are still subject to taxes for income derived from activities unrelated to their tax-exempt status.

For additional analysis of the desirability of governmental support for charitable organizations, see the discussion of Item 5 above.

20. Accelerated Depreciation of Research and Experimental Costs

Description:
The provision allows taxpayers to deduct qualifying research or experimental expenditures more rapidly than the economic life of these investments.

Amount:
We estimate this program to have cost the state $100 million in tax year 2001.

Discussion:
This purpose of this program is to provide an incentive for taxpayers to undertake research and experimental projects.

There are two reasons to want to encourage R&D. The first is that, without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities;" i.e., benefits to people other than the person doing the R&D. Accelerated depreciation of R&D reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity.

The second reason for favorable treatment of R&D expenditures is to encourage taxpayers to do their R&D in the United States, rather than in another country. There are two possible benefits to attracting the R&D business. The first is the addition of the R&D jobs themselves. If this were the only benefit, however, the R&D industry should not be singled out for this special benefit unless R&D jobs are substantially more desirable than other jobs. The second potential benefit from attracting R&D is that other businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many local businesses, not just those receiving this incentive, will gain an advantage over their rivals in other countries. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and costlessly. The advantage may come through something economists call *economies of agglomeration. Economies of agglomeration* is defined as "a reduction in production costs that results when firms in the same or related industries locate near one another."

Thus, for example, if the accelerated depreciation of R&D encourages some pharmaceutical companies to locate their research facilities in an area of California, that will, likewise, encourage the growth of pharmaceutical research support firms (such as material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, and chemical engineers) in that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silicon Valley and motion pictures in Hollywood are two obvious examples). However, there are many factors that contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which the accelerated depreciation of R&D has actually encouraged the development or growth of any agglomeration economies is not known.

It is also possible for the government to provide too large an incentive for R&D. If this happens, investment will be diverted from other more productive uses to relatively inefficient R&D activities. This could hurt overall economic performance.

Other government policies supporting R&D activity include direct government grants and fellowships, indirect government support such as support for educational and other research institutions, and other tax policies such as the R&D credit (see item 3 of the non-conformity items). It is not known whether the overall level of federal support for R&D is optimal.

For R&D projects that taxpayers would have undertaken even in the absence of this provision, accelerated depreciation may be considered a windfall. The amount of R&D activity that would not have taken place if R&D accelerated depreciation was not available is not known.

21. Personal Property and Other Tax Deduction

Description:
Under this program, taxpayers can deduct from gross income taxes on personal property paid to local and state governments. The distinction between real and personal property is that the personal property is mobile. The most common such tax is the Vehicle License Fee. Household items such as furniture and appliances are exempt from personal property taxes. City license fees, import or custom duties paid to federal customs officers, liquor or alcoholic beverage license fees, and other business, privilege or excise taxes are also deductible under this program.

These provisions of California law conform to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $1.1 billion in personal property tax deductions, lowering their taxes by about $92 million.

Number of Tax Returns Affected:
In tax year 2001, 2.8 million PIT taxpayers claimed a personal property tax deduction.

Distribution:

Impact of Personal Property Tax Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	67.3	17.9	0.1
$10,000 to $19,999	115.0	26.6	0.1
$20,000 to $49,999	699.1	244.6	6.2
$50,000 to $99,999	1,045.4	403.1	34.3
$100,000 to $199,999	653.4	283.9	34.1
More Than $199,999	246.8	147.6	17.6
Total	2,827.0	1,123.8	92.4

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
This deduction most likely grew out of a view of fiscal federalism that higher level governments should not interfere in, but in fact should encourage, the revenue-generating efforts of lower-level governments. Thus the federal government encouraged lower level governments to levy sales, property, and income taxes by allowing a deduction for the amount of these taxes paid. The State of California conformed to this approach partly because of the inherent benefits of conformity, and partly to encourage revenue generation by county and city governments. For a variety of reasons (often arising from

actions by parties with very different motivations), California has moved away from this independence approach to fiscal federalism to one in which much of the revenue of local jurisdictions is actually raised by the state and then distributed out to the jurisdictions. As such, the original motivation for this deduction may no longer be relevant. However, as is the case on the expenditure side of the budget, if a tax benefit is available for a long enough period of time it comes to be viewed as an entitlement. As such there is likely little political will, relative to the political cost, of removing this benefit.

Because it lowers taxes on personal property, this deduction may encourage the purchase of such property. The consumer response to the reduction in taxes may be particularly sensitive for automobiles because of the generally high level of political awareness of taxes on automobiles. However, it is likely, although not as likely as it is for home ownership subsidies, that any subsidies for car ownership are generally capitalized into the price of the car, i.e., the price is increased by approximately the value of the tax savings, so that the purchaser is no better off than they would be without the deduction.

22. Exclusion of Employer Contributions for Life Insurance

Description:
Under this program, 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 the employee's coverage.
The exemption does not apply when the beneficiary is an employer or a charitable organization, or to the cost of any group-term life insurance provided under a qualified pension or profit-sharing plan.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $83 million in tax year 2001.

Discussion:
This program intends to provide an incentive for employers and employees to incorporate life insurance in compensation packages.

The program results in horizontal inequity. The self-employed and those employees who buy their own life insurance without receiving any contributions from their employers do not receive such a tax relief.

Higher-income taxpayers benefit from this program more than the lower-income taxpayers, because these taxpayers are more likely to be covered by these benefits and because they have higher marginal income tax rates so that a dollar of exemption results in a greater amount of tax break.

23. Self-Employed Health Insurance Premium Deduction

Description:
This provision allows self-employed taxpayers to deduct from income premiums paid for health insurance policies that they buy 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. The deduction can be taken regardless of whether or not the taxpayer itemizes deductions.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $.9 billion in self-employed health insurance premium deduction, lowering their taxes by about $50 million.

Number of Tax Returns Affected:
In tax year 2001, .5 million PIT taxpayers claimed a self-employed health insurance premium deduction.

Distribution:

Impact of Self-Employed Health Insurance Premium Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	47.5	72.1	0.0
$10,000 to $19,999	56.2	81.9	0.8
$20,000 to $49,999	129.0	236.3	5.0
$50,000 to $99,999	107.6	217.8	13.8
$100,000 to $199,999	71.8	171.0	16.3
More Than $199,999	49.9	164.3	14.1
Total	462.2	943.5	50.0

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The purpose of this program is to provide an incentive for self-employed taxpayers to obtain health insurance for themselves and their families. The justification for this program is that self-employed taxpayers should receive the same benefit as that received by taxpayers who work as employees. Since contributions to employer-provided health insurance plans are excluded from income, it is equitable to provide a similar benefit to self-employed individuals. This justification suggests that the deduction should not be limited to the net income of the taxpayer's trade or business, because taxpayers who are

not self-employed may exclude employer-provided premiums even if the employer is losing money. However, such an extension would substantially increase the cost to the state.

For a discussion of the desirability of providing a tax incentive to link health insurance to employment, see discussion in item 3 of the conformity items.

24. Exclusion of Scholarships, Fellowships, and Grants

Description:
This provision allows taxpayers to exclude from income any qualifying scholarships, fellowships, and tuition grants received and used for qualified educational expenses at an educational institution. Qualified expenses include tuition, enrollment fees, books, supplies, and equipment. The exclusion also applies to incidental expenses such as travel, research, clerical assistance, and equipment.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $56 million in tax year 2001.

Discussion:
This program provides an incentive for taxpayers to pursue education. This may be sound public policy if society as a whole benefits from increases in the number of individuals pursuing higher education. It is not known, however, how many students would forgo these educational pursuits in the absence of this exclusion. In fact, since many colleges calibrate student aid levels to the financial needs of their students, the colleges might increase aid levels for the neediest students if the exclusion was removed. It may not, therefore, be possible to assess the overall impact of this exclusion without studying the entire higher education funding system. This system includes both direct government subsidies to educational institutions, government-backed student loans, and other tax preferences such as the exclusion of savings in education IRAs (see item 41 of conformity items) and Section 529 plans (see Item 33), the exclusion for employer-provided educational expenses (see Item 30), and federal education credits (Hope Credits, Lifetime Learning Credits).

Prior to 1954, these items were included in income unless the taxpayer could demonstrate that the funds constituted a gift. Some observers argued that it was inequitable to tax some students, but not others, on their expenses.

25. Exclusion of Meals and Lodging Provided by Employer

Description:

Under this provision, the value of meals and lodging provided by an employer (other than the military) to an employee, spouse, or dependent is excluded from the gross income of

the employee. The meals and lodging must be provided at the employer's place of business and for the convenience of the employer. Moreover, accepting the employer-provided lodging by the employee must be a precondition for the employment.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $29 million in tax year 2001.

Discussion:
This program provides tax relief to taxpayers who are required to eat or stay at the employer's place of business in order to fulfill the requirements of the job. Examples are firefighters and other emergency services personnel, live-in housekeepers, and resident apartment managers.

Many employees maintain their own residence, independent of the employer-provided residence (e.g., firefighters spending some nights at home and some at the station). In these cases, the value as a residence of employer-provide lodging to the employee would essentially be zero, and it makes sense not to tax the employee on the nominal value of the residence. In other cases (e.g., live-in apartment managers), the employer-provided residence is also the employee's primary residence. Since these employees are saving the cost of independent housing, they are receiving a benefit that conceptually should be treated as income.

If total compensation received by the employee is reduced by an amount equal to the value of this tax savings, the government is subsidizing employers who provide meals and lodging. The program may, therefore, provide an incentive for employers and employees to rely more than they otherwise would on nonwage compensation, since the after-tax value of a dollar of this form of nonwage income is greater than that of a dollar of regular taxable wage income. The extent to which compensation packages are altered because of this incentive is not known.

A policy alternative would be to establish rules to distinguish whether the employer is providing the employee's primary residence or a secondary residence, and allow the exclusion only for secondary residences.

26. Exclusion of Foster Care Payments

Description:
Under this provision, taxpayers are allowed to exclude from income the payments they receive 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. The foster child must live in the taxpayer's home for the exclusion to apply.

Also excluded from income of foster parents are the supplemental "difficulty-of-care payments" paid by the state or a tax-exempt child-placement agency. These are

additional payments to compensate the foster parents for the care of a foster child with a physical, mental, or emotional handicap.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $22 million in tax year 2001.

Discussion:
The rationale for this program is to provide incentives for taxpayers to care for foster children. Allowing foster care payments to be nontaxable increases the value of the payments to the recipients. Because of the progressivity of the tax rate structure, the increase in the value of payments is greater for high-income taxpayers than for low-income taxpayers. If this tax preference were removed, the state could increase foster care payments to restore the average value of payments to foster parents. If it did, then the net effect on state revenues would be minimal, but there would be some redistribution of resources from high-income to low-income foster parents.

27. Exclusion of Employee Child and Dependent Care Benefits

Description:
This provision allows taxpayers to exclude from income benefits from qualified employer-sponsored payroll deduction programs for child and dependent care services. The exclusion is also available to self-employed individuals and partners of a partnership. The exclusion is limited to the lowest of $5,000 per year ($2,500 for married filing separately), the amount of the taxpayer's earned income, or the amount of the taxpayer's spouse's earned income.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $21 million in tax year 2001.

Discussion:
The purpose of this exclusion is to defray expenses incurred by people who must pay for child or dependent care so that they can be gainfully employed or to seek employment. This exclusion provides this relief by allowing working taxpayers to pay for childcare with pre-tax rather than post-tax dollars, thereby reducing the cost of childcare by the amount of tax not paid on those dollars. Childcare expenses are a necessary part of working for many people. After subtracting out the childcare expenses, an employee who has childcare expenses has less income remaining than does another employee who earns the same salary. The child and dependent care benefits are intended to make the tax burden of the employee with the childcare expenses reflective of his net (after childcare expenses) rather than gross pay.

This program successfully achieves its goal of assisting workers with their child and dependent care costs.

This exclusion could potentially induce two types of behavioral changes in taxpayers. The first is that some taxpayers who would not have chosen to seek employment if they had to bear the full burden of their child or dependent care may now choose to seek employment. The other is that some working taxpayers who, if the exclusion did not exist, would have made informal arrangements for child or dependent care may now choose paid child or dependent care.

This exclusion is similar to, but for many taxpayers more generous than, the Child and Dependent Care Tax Credit.

28. Percentage Resource Depletion Allowance Deduction

Description:
This provision allows taxpayers to deduct from income a fixed percentage for resource depletion. The percentage depends on the type of resource, and the depletion allowance cannot be more than 50 percent of a taxpayer's related net income prior to the depletion deduction, or more than 100 percent in the case of oil and gas properties.

California conforms to federal tax law regarding the percentage depletion for oil and gas wells, and for geothermal deposits. The depletion rates are limited to 22 percent for regulated domestic natural gas, 10 percent for natural gas from geopressurized brine, 15 percent for domestic crude oil and natural gas from certain independent producers, and 15 percent for geothermal deposits located in U.S.

Amount:
We estimate this program to have cost the state $21 million in tax year 2001.

Discussion:
The purpose of this program is to encourage taxpayers to explore and develop oil, gas, and other mineral resources.

These increases in exploration and development activity are desirable if free market incentives, plus the federal deduction for these activities, are insufficient to induce the optimal level of business activity. There are two possible reasons this could occur. The first is that risk-averse firms may be unwilling to undertake risky and expensive exploration and development projects. This deduction may induce business to undertake more of these projects by increasing the expected rate of return on these projects. The large asset base of the leading natural resource firms, and their ability to diversify their risks through both financial arrangements and their ability to explore and develop multiple resource sites simultaneously, suggest that risk aversion may not be seriously retarding investment in these activities. Of course, if the government provides too great an incentive to engage in risky activity, the primary result will be an increase in this type of risky investment beyond the optimal level.

The second possible reason for government to subsidize these activities is that exploration and development of natural resources may produce 'externalities,' benefits to society that cannot be captured by the business that generates them. The externality that one may argue arises in this case comes from a reduction in the importation of foreign natural resources. Depending on foreign resources (particularly when those foreign sources are politically unstable or unsavory) increases the risk of dramatic fluctuations in the supply and the price of these resources. These fluctuations may be very damaging to the economy. They may also induce dangerous foreign policy entanglements. On the other hand, increased exploration and development of natural resources may also generate 'negative externalities.' For example, resource activities may cause environmental degradation. This imposes costs on all users of the environment, but these additional costs are not borne by the businesses generating them. In this case, government encouragement of these business activities may increase the overall costs to society.

The purpose of this deduction will be achieved if the deduction induces increases in exploration and development. Deductions claimed for activities that would have been undertaken even in the absence of this deduction are windfalls. The amount of qualified activity that would not have been undertaken in the absence of this deduction is not known. Since the externalities justifying this deduction are national rather than specific to California, it is not clear why California should be offering this deduction.

29. Moving Expense Deduction

Description:
This program allows deductions for the portions of qualified moving expenses required to start a new job that are not paid or reimbursed by employers. The deduction is limited to the cost of (1) transportation of household goods and personal effects and (2) travel (including lodging but not meals) to the new residence. That is, the expenses that are directly related to moving to the new location. Where an automobile is used in making the move, a taxpayer may deduct either (1) the actual out-of-pocket expenses incurred (gasoline and oil, but not repairs, depreciation, etc.), or (2) a standard mileage allowance of 12 cents per mile in 2003.

To qualify for the deduction, the move must pass two tests. The *distance* test requires that the distance between the new and old locations must at least be 50 miles. The *time* test requires that the taxpayer be employed in the new job on a full-time basis for at least 39 weeks during the 12 months following the new employment. This requirement for the self-employed is 78 weeks during the 24 months following the start of the new business.

If the employer pays the moving expense either directly or the employee is reimbursed by the employer, that employer payment is an excludable fringe benefit to the employee as long as that expense would have been deductible, if paid directly by the employee rather than the employer.

This provision of California law conforms to federal law.

Amount:
In tax year 2001, PIT taxpayers claimed $446 million in moving expense deductions, lowering their taxes by about $21 million.

Number of Tax Returns Affected:
In tax year 2001, 165 thousand PIT taxpayers claimed a moving expense deduction.

Distribution:

Impact of Moving Expense Deduction: 2001			
Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	3.9	6.3	0.0
$10,000 to $19,999	23.3	28.9	0.6
$20,000 to $49,999	51.7	104.7	4.4
$50,000 to $99,999	55.3	158.2	7.7
$100,000 to $199,999	23.0	96.1	5.4
More Than $199,999	7.8	51.9	2.5
Total	165.1	446.0	20.7

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The rationale behind this tax relief is that moving expenses are expenses that employees must incur in order to earn income. In our system, large and unusual expenses that generate income are normally deductible. This program creates partial parity between two taxpayers, one of whom would start a new job in a distant location while the other's new job is close to home.

In addition, it also is intended to create parity between two employees, where one employee is reimbursed by the employer (or the employer directly pays for the move) and one is not.

30. Exclusion of Employer-Provided Education Assistance

Description:
Taxpayers may exclude from income benefits received from an employer as part of a qualified educational assistance program. Qualified benefits may include tuition, fees, books, supplies and equipment. The exclusion is limited to $5,250 per year.

Amount:
We estimate this program to have cost the state $17 million in tax year 2001.

Discussion:
This provision encourages participation in employer-sponsored educational activities.

For some employees, pursuing certain educational opportunities is a requirement of employment. For these employees, this exclusion may be viewed as similar to the exclusion of employer-provided fringe benefits (see Item 16 of the conformity items). These employees would likely feel that it is unfair to make them pay additional taxes, because they were required by their employer to enroll in educational activities.

For other employees, education funding from an employer may be viewed as similar to the receipt of a scholarship or fellowship (see Item 24 of the conformity items). This exclusion creates equity between these students and other students who receive third-party support for their education. On the other hand, it creates inequity between a student whose education is funded by a qualifying plan and one who receives nonqualified support (i.e., taxable wages) from their employer.

In general, government support for education is desirable if the education creates externalities – benefits to society that are not captured by the person incurring the cost of the activity.

31. Expensing of Agricultural Costs for Soil or Water Conservation and Prevention of Erosion

Description:
This program allows taxpayers to expense qualified costs associated with soil and water conservation, or the prevention of erosion.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $12 million in tax year 2001.

Discussion:
This program is intended to encourage certain types of farming-related investments for the purpose of soil or water conservation, or for the prevention of erosion of land used in farming. Government encouragement for these types of investment may be necessary if these investments generate 'externalities', benefits to the public (in the form of a cleaner environment) that cannot be captured by the taxpayers undertaking the investment.

This program can be considered successful if it induces an increase in qualified investments. To the extent that taxpayers would have undertaken these investments even in the absence of the program, the tax relief given to this group is a windfall. The proportion of qualified investments that would not have been made in the absence of this incentive is not known.

Another potential concern is that some taxpayers might try to portray unqualified investment expenses as qualified investments. Such behavior would result in increased administrative costs to ensure compliance.

An obvious policy alternative would be a direct expenditure program that provided grants to Californians making the desired types of investments. This alternative may be particularly attractive in the case of farming, since many farms operate at a loss and, therefore, may be less responsive to a tax benefit since they have no taxes to reduce.

32. Student Loan Interest Deduction

Description:
Under this program, taxpayers may deduct interest paid on qualified education loans. The deduction is allowed for interest paid on qualified education loans during the first 60 months in which interest payments are required. A qualified education loan is defined as the money that is borrowed to pay for the educational expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer in attending (1) post-secondary educational institutions and certain vocational schools, and (2) institutions conducting internships or residency programs that lead to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Amount:
In tax year 2001, PIT taxpayers claimed $237 million in student loan interest deductions, lowering their taxes by about $11 million.

Number of Tax Returns Affected:
In tax year 2001, 407 thousand PIT taxpayers claimed a student loan interest deduction.

Distribution:

Impact of Student Loan Interest Deduction: 2001

Adjusted Gross Income Class	Number of Returns Reporting Deduction (Thousands of Returns)	Amount of Deduction Claimed (Millions of Dollars)	Tax Impact of Deduction (Millions of Dollars)
Less Than $10,000	30.2	15.9	0.0
$10,000 to $19,999	61.6	29.8	0.3
$20,000 to $49,999	230.8	147.2	1.7
$50,000 to $99,999	83.6	43.3	4.6
$100,000 to $199,999	0.4	0.4	3.1
More Than $199,999	0.1	0.2	1.8
Total	406.7	236.8	11.5

Source: 2001 Personal Income Tax Sample and microsimulation model
Detail may not add to total due to rounding

Discussion:
The goal of this program is to encourage individuals to pursue higher education. The rationale for this program, and many other programs that provide an education subsidy, is that educating individuals provides benefits to society that are not captured by the individual receiving the education. Because of this "externality," the number of people seeking higher education may be less than would be best for society. Therefore, incentives must be provided to increase the number of people pursuing higher education.

The number of students who would not have opted to attend school in the absence of this provision is not known. For students who would have taken out student loans even in the absence of this provision, this exclusion is a windfall.

33. Exclusion of Income Earned on Section 529 Accounts

Description:
Taxpayers may exclude from income earnings of Section 529 educational savings accounts (such as California's Scholarshare program), provided that, upon withdrawal, the money in the accounts is used for qualified educational expenses.

Amount:
We estimate this program to have cost the state $7 million in tax year 2001.

Discussion:
This program provides an incentive for taxpayers to save for their children's post-secondary education by giving favorable tax treatment to earnings on qualified savings.

Some taxpayers would save for their children's post-secondary education even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of education funds that represent "new" savings rather than savings redirected from other sources is not known.

There are a number of other government policies that also work toward the goal of increasing participation in post-secondary education. These include direct government subsidies of colleges and universities, government aid to students for education expenses (fellowships, loans etc.), and federal tax credits for education expenses. The program most similar to Section 529 is the Education IRA (see Item 41 of the conformity items). In some cases, the interactions between these different programs greatly increase the complexity of financial planning for taxpayers expecting to send their children to college.

34. Amortization of Reforestation Expenditures

Description:
Under this program, taxpayers can amortize over seven years up to $10,000 per year of qualifying reforestation expenditures. These expenditures include the direct costs of forestation and reforestation, such as site preparation, seeds, labor, and equipment. This

treatment conforms to federal practice, except that the benefit is limited to reforestation activities located in California.

Amount:
We estimate that this program costs $7 million annually.

Discussion:
The intent of this program is to speed up the reforestation of the depleted timberlands.

For this program to be considered effective, it must increase investment in reforestation activities. Any benefits from this program accruing to investments that would have been undertaken even in the absence of this credit would be a windfall to the taxpayer. The amount of reforestation that would not have taken place in the absence of this credit is not known.

This tax expenditure is economically efficient only if reforestation generates positive externalities – benefits to society that are not captured by the taxpayer making the investment. This policy cannot be justified solely in terms of increased lumber available for harvest. The free market will encourage investment in reforestation sufficient to maximize profits from lumber sales. If, however, society derives additional benefits from reforestation, such as improved air quality or aesthetics, from increases in forest lands, there may be a public interest in supporting reforestation.

A policy alternative would be direct government subsidies of reforestation activities.

35. Employee Stock Ownership Plans (ESOP)

Description:
This provision allows employers that provide employee stock ownership plans a deduction for dividends paid to an ESOP, when those dividends are paid by the ESOP to participants or used to retire ESOP debt. It also allows the deferral of capital gains on the sale of stock to an ESOP, if the proceeds are used to acquire a similar type of security. The deduction is not available to S corporations.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $4 million in tax year 2001.

Discussion:
This deduction provides an incentive for employers to provide their employees with this form of compensation as an option. One justification often provided for encouraging ESOPs is that employees may be more productive if they are part owners of the companies they work for. If, however, employee-owned businesses are more productive than nonemployee-owned businesses, employee-owned businesses should become more prevalent even in the absence of government encouragement. In a truly competitive

market, therefore, the government should not be favoring one form of business ownership over other forms.

36. Expensing of Circulation Costs for Periodicals

Description:
Under this program, a taxpayer can expense the costs of establishing, maintaining, or increasing the circulation of a periodical it publishes, excluding purchases of land or depreciable property. The taxpayer may instead elect to amortize the costs over a period of three years. In the absence of this program, the taxpayer would have to amortize the expenses over the period of time that the expenditure was deemed to generate income.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $4 million in tax year 2001.

Discussion:
This provision encourages periodicals to increase investments related to increasing their circulation. For investments that would have been undertaken even in the absence of this provision, expensing provides a windfall. To the extent that taxpayers redirect funds from other investment activities to circulation related activities, this provision create distortions in the economy that likely are inefficient.

37. Energy Policy Act of 1992

Description:
The Federal Energy Act of 1992 provides various incentives to encourage energy conservation. California has conformed to two components of this program that generate tax expenditures.

a) Treatment of employer-provided transportation benefits. Under this program, large employers (those employing more than 50 employees) in polluted air basins are mandated to provide their employees the option of cash in lieu of parking. The value of either cash or the parking is included in the taxable income of the employee. However, if the cash is used for ridesharing purposes, it is excluded for tax purposes. California also has a stand-alone statute that provides an exclusion from the gross income of an employee for compensation or the fair market value of any other benefits, other than salary or wages, received from an employer for participating in certain ridesharing arrangements.
b) Exclusion of energy conservation subsidies provided by public utilities. Under this program, any subsidy provided to a customer by a public utility for the purchase or installation of energy conservation equipment, such as solar panels, in the customer's residence is excluded from the customer's taxable income. Beginning in 1995, the exclusion was extended to properties that were not dwelling units, but with certain percentage limitations.

Amount:
We estimate this program to have cost the state $2 million in tax year 2001.

Discussion:
These programs are intended to encourage energy conservation and to promote air quality. These policies may be particularly effective if the tax-favored investments generate externalities – benefits to society that are not captured by the person making the investment. In other words, all of the people who benefit from having cleaner air should contribute to the cost of the pollution reducing equipment. The extent to which air quality has improved in response to these incentives is not known.

38. Medical Savings Account Deduction

Description:
This provision allows taxpayers to deduct from income contributions made to Medical Savings Accounts (MSAs). In addition, any earnings accumulated in the Medical Savings Accounts are tax-free, if used for qualified medical expenses.

Contributions include those from both employer 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.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $1 million in tax year 2001.

Discussion:
The purpose of this program is to provide an incentive for taxpayers to save for medical treatment and emergencies.

MSAs are similar to health insurance policies in that an individual makes periodic payments in exchange for a larger return payment in a time of need. Unlike regular insurance policies, however, MSAs do not enable risk sharing. As a result, an individual who incurs a very large medical expense will not be able to cover the entire expense from their MSA. On the other hand, if the individual does not have large expenses, her contributions will not be used for payments to other individuals who do have large medical expenses. Instead, the excess contributions will essentially be converted into another retirement fund account. See Item 2 of the conformity items for a discussion of the desirability of government subsidies for retirement programs.

The tax benefit from this deduction is greater for taxpayers who are in higher tax brackets, even though those taxpayers would seemingly be more able to absorb large medical expenses. An alternative policy that would address these issues would be to replace the deduction with either a credit or direct government compensation for medical expenses.

39. Reserve Allowance for Bad Debts Deduction

Description:
The Reserve Allowance for Bad Debts Deduction program allows financial institutions with assets of less than $500 million to deduct qualified additions to their reserves for losses from bad debts. Financial institutions with assets in excess of $500 million, must deduct debts deducted as they are determined to be worthless. For smaller institutions, the ending balance for the bad debt reserve is determined by a formula, using historical loss ratios for the past five years and the loss ratio and loan balance for the current year. Debts that become uncollectable in the current year are charged against the reserve calculated at the end of the prior year. The taxpayer may then deduct the amount necessary to increase the resulting reserve to the amount calculated for the current year-end.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have cost the state $0.5 million in tax year 2001.

Discussion:
The Securities and Exchange Commission requires financial institutions to maintain prudent reserves for debts that likely will prove to be uncollectable. This provision lowers the cost of maintaining these reserves by allowing financial institutions to deduct increases to these reserves from income. The policy motivation for providing this favorable treatment to small financial institutions but not to large ones is not clear.

40. Exclusion of Recycled or Redeemed Beverage Container Redemption Payments

Description:
This program exempts from gross income any amount received by a consumer for delivering empty beverage containers to a recycling center.

Amount:
We estimate that this program costs the state $1 million annually.

Discussion:
The intent of the program is to encourage recycling of beverage containers, because recycling reduces litter and can conserve resources.

This program may be considered successful if it increases the number of recycled containers. It is not known what proportion of currently recycled containers would not be recycled in the absence of this exemption.

This exemption also simplifies tax administration. The refund for most recyclable containers is 2½ cents. The time and effort required to track and tabulate income earned in 2½ cent increments are likely quite large relative to the amount of revenue generated. The administrative burden would be particularly onerous for recycling centers if they would be required to issue Form 1099s to refund recipients. Also, it could be argued that refunds received by the individual who initially paid the deposit should not be considered income. Distinguishing refunds paid to individuals who paid the deposit from those paid to individuals collecting recyclables for profit would be very difficult.

41. Exclusion of Earnings on Coverdale Education Savings Accounts

Description:
This program allows taxpayers to exclude from income earnings in Coverdale Education Savings Accounts (ESAs, formerly known as Education IRAs) if these earnings are spent on qualified educational expenses. Qualified expenses may be incurred at the elementary, secondary or post-secondary level. The total yearly contributions, from all contributors, to a beneficiary's Coverdale ESA(s) cannot exceed $2,000 per year. Qualified educational expenses include tuition, fees, books, supplies, equipment, and room and board.

The maximum contribution limit is available for taxpayers with modified AGI of up to $190,000 for married joint-return filers and $95,000 for single filers. For joint returns with modified AGI between $190,000 and $220,000 and for single filers with modified AGI between $95,000 and $110,000 the contribution limit is phased out. Contributions to a Coverdale ESA are not deductible.

This provision of California law conforms to federal law.

Amount:
We estimate this program to have had a minor cost to the state in tax year 2001, rising to $1 million in fiscal year 2002/03.

Discussion:
This program provides an incentive for taxpayers to save for their children's post-secondary education by giving favorable tax treatment to earnings on qualified savings.

Some taxpayers would save for their children's post-secondary education even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of education funds that represent "new" savings, rather than savings redirected from other sources is not known.

There are a number of other government policies that also work toward the goal of increasing participation in post-secondary education. These include direct government subsidies of colleges and universities, government aid to students for education expenses (fellowships, loans etc.), and federal tax credits for education expenses. The program most similar to the education IRA is Section 529 (see Item 33 of the conformity items). In some cases, the interactions between these different programs greatly increase the complexity of financial planning for taxpayers expecting to send their children to college.