STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**01/09/03**	Bill No:	**SB 47**
Tax:	**Sales and Use**	Author:	**Ackerman, et al.**
Board Position:		Related Bills:	**SB 2X (Poochigian)** **AB 122 (Calderon)**

BILL SUMMARY

This bill would, among other things, delete the sunset date for the five percent sales and use tax exemption for new manufacturers' purchases of equipment, thereby extending the partial exemption indefinitely.

ANALYSIS

Current Law

Existing law, Section 6377 of the Sales and Use Tax Law, provides a 5 percent state sales and use tax exemption for purchases of manufacturing equipment. Under the law, this partial exemption is available only to "qualified persons," who include only new trades or businesses that are engaged in those lines of business described in Standard Industrial Codes 2011 to 3999 (manufacturers). The partial exemption applies to the following:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).

- Tangible personal property purchased for use in research and development.

- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.

- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.

This exemption statute contains a sunset provision based on the number of manufacturing jobs in California. Under the current provision, if the number of non-aerospace manufacturing jobs in California has not increased by at least 100,000 above the comparable 1994 number, the exemption will expire. Each year, the Employment Development Department is required to determine the number of non-aerospace manufacturing jobs, and if the number ever falls below 100,000, the exemption will expire on the next January 1.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

Under the Personal Income Tax Law and the Corporation Tax Law, a 6 percent income tax credit on similar property is available to businesses who either do not qualify as a new trade or business under Section 6377, or who would qualify as a new business, but decide to claim the 6% credit rather than the 5% exemption. A similar sunset clause is contained in these laws as well.

Proposed Law

This bill would delete the sunset dates contained in the Sales and Use Tax Law, the Personal Income Tax Law, and the Corporation Tax Law, thereby extending the partial exemption and tax credits for manufacturers indefinitely.

As a tax levy, the bill would become effective immediately upon enactment.

Background

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.

- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.

- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.

- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.

- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.

- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.

- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

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COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. Its purpose is to make permanent the tax incentives available to manufacturers.

2. **Will the exemption/credit ever sunset?** The sunset dates in the statutes were worded in such a way that it had appeared as if they would likely never trigger – according to the Employment Development Department (EDD), by January 1, 1998, manufacturing employment had increased by over 213,000 more than in 1994. However, by January 1, 2002, that employment figured dropped to about 143,900. If the economy declines further, the employment figures could realistically drop lower than the 100,000 mark, which would result in the sunsetting of these provisions.

   The following table prepared by EDD depicts the total employment in manufacturing (excluding the aerospace industries) for the years 1994 through 2002:

TIME PERIOD	TOTAL MANUFACTURING EMPLOYMENT	INCREASE FROM JANUARY 1, 1994
January 1, 1994	1,650,250	N/A
January 1, 1995	1,585,750	35,500
January 1, 1996	1,642,350	92,100
January 1, 1997	1,694,900	144,650
January 1, 1998	1,763,900	213,660
January 1, 1999	1,744,650	184,400
January 1, 2000	1,761,850	211,800
January 1, 2001	1,814,950	264,700
January 1, 2002	1,694,150	143,900

3. **Related legislation.** A bill identical to this measure, SB 2X (Poochigian, et al.), has also been introduced, and AB 122 (Calderon) has been introduced to extend the conditional sunset date until January 1, 2006.

COST ESTIMATE

Enactment of this measure would not impact the Board's administrative costs.

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REVENUE ESTIMATE

Current purchases of qualified equipment as defined in Section 6377 of the Revenue and Taxation Code for 2002 are estimated to be $157.8 million.

Revenue Summary

The revenue impact from exempting $157.8 million from the state sales and use tax is estimated to be:

	Total Purchases	Revenue Loss
State (5.00%)	$157.8 million	$ 7.9 million

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