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May 25, 1993

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Law and Legislation Committee
Sacramento, California

DIVISIONS:
ACCOUNTING
BUDGET
REVENUE
RISK MANAGEMENT

Honorable Members in Session:

SUBJECT: Conditional Support of Assembly Bill 1313 (W. Brown)

LOCATION AND COUNCIL DISTRICT: All.

RECOMMENDATION:

Staff recommends that the City Council support AB 1313 on the condition that the bill is amended to protect local governments from a loss of direct tax revenues. In addition, it is recommended that the City work to amend AB 1313 in concert with other legislative initiatives by the City to protect the tax base of local governments.

CONTACT PERSON: Bill Farley, Sr. Management Analyst, 264-7730

FOR COMMITTEE MEETING: June 1, 1993

SUMMARY

Assembly Bill 1313 would provide a sales tax exemption for equipment used in the manufacturing process. This sales tax exemption, along with workers compensation and environmental regulation reform, is widely regarded as a top priority on the legislative agenda of the business community.

As currently proposed, the benefits of this bill would not come without a cost to state and local government. The state share of the lost revenue would be approximately \$1.5 billion. We estimate that it could cost the City \$1.0 to \$2.0 million in annual sales tax revenue.

Staff is recommending support of AB 1313 based on the condition that it is amended to protect the tax base of local governments. Conditional support of AB 1313 would be

consistent the City Council's priority to support economic development initiatives - while protecting funding for local services that are essential to local residents.

BACKGROUND

Assembly Bill 1313 would provide a sales tax exemption for equipment used in the manufacturing process. As currently proposed, the state share of the lost revenue would be approximately \$1.5 billion. We estimate that it could cost the City \$1.0 to \$2.0 million in annual sales tax revenue. Proponents of the bill have made claims that the lost revenue will be "made-up" in increases in economic activity.

However, it is not likely that the loss of sales tax revenue to the City (with the bill in its current form) would be offset by new taxes from increased economic activity. Recent modifications to the local government tax base shift most of the property taxes to the state and school districts. Local government would need to reduce services or raise local taxes in order to make up for lost sales tax revenue if AB 1313 became law.

Staff is recommending that the City Council support AB 1313 on the condition that it is amended to protect the tax base of local government. This recommendation, and the suggested amendments are made based on our determination of the value of a sales tax exemption to corporations - compared against the impacts on local government programs.

Business perspective on corporate taxes

In order to develop a general understanding of the value of the sales tax exemption in the corporate decision-making process, staff has reviewed a recent survey conducted in cooperation with the National Association of Corporate Real Estate Executives (NACORE) on the relative value of various site selection criteria. This survey was completed in the last year and measured the value of 28 separate criteria used by corporations in deciding where to expand or relocate office, warehouse, and distribution facilities.

As with virtually all surveys on "business climate" issues, it was not conducted using statistical methods that would provide conclusive evidence on the value of a sales tax exemption on manufacturing equipment. However, the nature of this survey provides valuable insight into the general priorities of several corporations. In this respect, the survey does provide a reasonable set of data upon which to establish general priorities and policies for local economic development initiatives.

Table 1 provides a summary of the site selection factors that were evaluated by NACORE members. Each of the factors was rated on a scale of 1 to 3 (1 meaning not important and 3 meaning very important). Participants in the study owned or leased 24 million square feet of office, manufacturing, distribution, and research and development facilities.

Sales tax on manufacturing equipment (proposed for exemption under AB 1313) falls under the "Corporate and Business Tax" criteria. This factor was ranked tenth among the 28 criteria.

TABLE 1
PREFERRED SITE SELECTION FACTORS
 Survey of the National Association of Corporate Real Estate Executives

Rank	Score	Site Selection Factors
1	2.81	Low lease rates
2	2.48	Access to major freeways
3	2.48	Educated labor force
4	2.47	Low construction costs
5	2.41	Access to primary Consumer markets
6	2.37	Well-developed energy/telecommunication systems
7	2.34	Favorable local government attitude towards business
8	2.28	Low property tax rates
9	2.26	Low crime rates
10	2.18	Low Corporate and Business Tax
11	2.14	Ease of commute
12	2.14	Port/airport
13	2.13	Up-front rent concessions
14	2.13	Cost of living
15	2.12	Housing affordability
16	2.12	Labor relations
17	2.09	Availability of low cost labor
18	2.08	Regional Growth Planning
19	2.03	Availability of job training
20	2.02	Industry specific skills
21	2.02	Recreation/cultural amenities
22	2.01	School systems
23	1.97	Tax relocation incentives
24	1.88	Corporate Headquarters
25	1.86	Personal tax rates
26	1.75	Access to Suppliers
27	1.70	Climate
28	1.54	Access to Rail Transportation

In general terms, it appears from the survey results that the sales tax exemption is an important factor in decisions of corporations to relocate or expand facilities. For manufacturers, this criteria is probably even more important due to the heavy investment required for plant equipment.

It is important to note that "Crime Rate" is rated slightly above "Corporate and Business Tax" in the evaluation. Reducing crime is primarily the responsibility of local government - through police protection, recreation programs, library services, and other activities that support residential communities and neighborhoods.

City perspective on the current crisis in financing local government services

The quality of local government is an important part of a corporate decision to expand or relocate operations in a community. The NACORE survey identified three areas that corporations look at when evaluating a community (ranking of criteria in parentheses):

- Crime rate (#9)
- Cost of living (#14)
- Recreation/cultural amenities (#21)

The City of Sacramento addresses these three areas in programs funded through the annual operating budget. On May 3rd, the City of Sacramento released its proposed operating budget for 1993-94.

The proposed budget is balanced and reflects several difficult decisions the City Council has made to date to reduce the General fund budget by \$30 Million. This reduction was necessary to respond to the down-turn in the local economy, and the State's new policy of permanently shifting property taxes from local governments to school districts and the State's treasury.

The 1993-94 Proposed Budget includes the elimination of 513 positions, a 12% staffing reduction. Included in that number is an 18% reduction in management positions (the Assistant City Manager, 2 Department Heads, 3 Assistant Department Heads, etc) and the net elimination of one City Department (General Services, and Parks and Community Services were eliminated and a Neighborhood Department was created). These actions, which reorganize and flatten our organization, will permanently reduce City costs by \$29 million. In addition, \$1 million in new revenues was approved by the City Council.

These reductions cut the basic services that municipal government is responsible for providing. Examples of cuts we are taking include:

- **72 Sworn Police positions have been cut.** This will reduce our ability to respond to neighborhood traffic complaints, reduce support provided for special events such as demonstrations, eliminate the school crossing guard program, reduce our ability to conduct investigative work, reduce DUI enforcement, and generally reduce flexibility in the department.

- **33 Sworn Fire fighter positions have been cut.** Two fire truck companies will be eliminated and there will be a rotating closure of a third truck company. The number of battalions will be reduced from 4 to 3 which will reduce our ability to coordinate major conflagrations or emergencies.
- **20% of the Parks and Community Services Department has been cut.** Park maintenance will be substantially reduced below acceptable standards.
- **18% of the Library budget has been cut.** Current minimal library hours will be further reduced 10-15%. The book budget will be reduced 26%.
- **20% of Community Group funding has been cut, and in addition, 100% of the funding provided to the Sacramento Symphony has been cut.**

The Council is prepared to take further action this summer to fix the remaining projected \$10 million gap. In addition, the City is faced with additional impacts from shifts in property tax from local governments to the State. The impact to the City from the proposed shift of \$2.6 billion is \$11-\$17 million.

Establishing a balanced approach to AB 1313

In its current form, AB 1313 would create a severe impact on local government revenues. Table 2 outlines these losses in the second column.

The City would automatically lose the local share of the sales tax that is collected from manufacturing equipment. And, it is probable that local governments would be required to absorb the State's share of lost revenue through additional shifts in property taxes. The total direct and indirect loss could total \$7.0 to \$8.0 million.

TABLE 2
AB 1313 FISCAL IMPACT

IMPACTS	CURRENT FORM	PROPOSED AMENDMENTS
Loss in revenue from exemption for manufacturing equipment	\$1.5 Billion	\$750 Million
Direct impact on the City from losing local share of sales tax on manufacturing equipment		
All local governments	\$200 Million	\$0
City of Sacramento	\$1.0 to \$2.0 Million	\$0
Potential impact if State increases property tax shift to make up lost sales tax revenue		
All local governments	\$1.5 Billion	\$750 Million
City of Sacramento	\$7.0 to \$8.0 Million	\$3.5 to \$4.0 Million

AB 1313 can be amended to eliminate adverse fiscal impacts on local governments. Amendments recommended by staff to protect local governments include:

- **Reduce the range of equipment that can be exempted from the sales tax.** It is recommended that the exemptions be limited to \$750 million. This will provide a significant incentive for corporations. And, at the same time it keeps the loss of revenue at a level that can be addressed through other revenue sources.
- **Exclude the local portion of the sales tax from the exemption.** Very few states exempt the entire amount of sales tax on plant equipment. Excluding the local share would result in a 1% sales tax on equipment - a significant improvement over the current rate. And, it would protect local governments from losing an important part of their tax base.
- **Identify alternative revenue sources to offset losses from the sales tax exemption** (continuation of the 1/2 cent sales tax or reduction of other tax expenditures). Unless the state identifies an alternate source of revenue, local governments are the likely candidates to absorb the entire revenue loss through additional shifts in the allocation of property tax (from local government to the state).

Column three of Table 2 illustrates the potential impact of AB 1313 if it is amended to reduce the range of exemptions, and to exclude the local portion of the sales tax from the proposed exemption.

Avoiding any fiscal impact of AB 1313 at the local level is contingent on the State identifying revenue to offset the "tax expenditures" of AB 1313. This could be achieved through extending the 1/2 cent sales tax (\$1.5 Billion in annual revenues) or through reduction of other "tax expenditures" targeted towards corporations.

The amendments to AB 1313 proposed by staff would make the bill "revenue neutral" from the perspective of local government. If AB 1313 were amended as proposed, the State would be simply shifting taxes from businesses to residents - through the continuation of the 1/2 cent sales tax. These amendments would make the tax policies in California similar to other states across the country - while protecting local governments from dramatic reductions in services to existing residents.

FINANCIAL CONSIDERATIONS

AB 1313, as proposed, would reduce the City's annual sales tax revenue from \$1.0 to \$2.0 million. Staff is recommending support of AB 1313 on the condition that it is amended to protect the tax base of local government.

POLICY CONSIDERATIONS

From a state and local perspective, AB 1313 is important to economic development initiatives at all levels of government:

- It would provide important economic incentives to encourage corporations to expand or locate operations in California:
- It would provide a level playing field for all Cities in California working to attract and retain businesses - by reducing the need for producing local incentive packages involving property and sales tax rebates.
- It would send a clear signal that California is starting to address the business climate in our state. Regulatory reform for workers compensation and environmental reviews will both require lengthy deliberations. The sales tax is a quick first step toward improving the business climate.

And as currently proposed, AB 1313 would also hurt local economic development initiatives by impacting the ability of Cities to provide important municipal services.

Staff is recommending several amendments to AB 1313 to balance economic development and local government financing priorities.

Options not recommended by staff

Council has two primary options to the staff recommendation:

1. Support AB 1313 without conditions.

Staff has recommended several amendments to AB 1313 to make mitigate impacts on local government financing. Council can support AB 1313 without these conditions.


2. Oppose AB 1313.

Council can direct staff to oppose AB 1313 - without working to amend the legislation to make it acceptable to local governments.

MBE/WBE

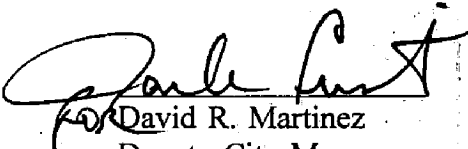
None.

Respectfully submitted,



Bill Farley
Sr. Management Analyst

Recommendation Approved:



David R. Martinez
Deputy City Manager

RESOLUTION NO.

ADOPTED BY THE SACRAMENTO CITY COUNCIL

ON DATE OF _____

RESOLUTION IN SUPPORT OF AB 1313

Be it hereby resolved by the City Council that:

1. Staff is directed to communicate the Council's support of AB 1313 with the following amendments:

- A. The range of equipment that can be exempted from the sales tax is be limited to \$750 million.
- B. The local portion of the sales tax be excluded from the exemption.
- C. Alternative revenue sources are adopted that offset losses from the sales tax exemption.

2. Staff is directed to work to amend AB 1313 in concert with other legislative initiatives by the City to protect the tax base of local governments.

MAYOR

ATTEST:

CITY CLERK

FOR CITY CLERK USE ONLY

RESOLUTION NO.: _____

DATE ADOPTED: _____

9

ASSEMBLY BILL

No. 1313

Introduced by Assembly Member Willie Brown

(Coauthors: Assembly Members Pringle, Aguiar, Andal, Caldera, Connolly, Conroy, Cortese, Costa, Epple, Ferguson, Haynes, Karnette, Lee, Martinez, Moore, O'Connell, Quackenbush, Rainey, Richter, and Solis)

(Coauthors: Senators Ayala, Deddeh, Hughes, Leonard, and Thompson)

March 3, 1993

An act to add Section 6377 to, and to add and repeal Section 6380 of, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

AB 1313, as amended, W. Brown. Sales and use taxes: exemptions: manufacturers.

The existing Sales and Use Tax Law imposes a tax on the gross receipts from the sale of, or the storage, use, or other consumption in this state of, tangible personal property and provides various exemptions from the taxes imposed by that law.

This bill would provide an exemption from those taxes for the gross receipts from the sale of, and the storage, use, or other consumption of, tangible personal property ~~primarily~~, as defined, used by a qualified person, as defined, primarily in any stage of manufacturing, processing, refining, ~~extracting~~, or fabricating of property, or producing in a cogeneration facility any electricity, steam, or fuel, as specified. The bill would also exempt the gross receipts from the sale of, and the storage, use, or other consumption of, tangible personal property primarily used ~~or consumed~~ in

research and development or used to maintain ~~or~~, repair, measure, or test any property exempted by this bill. The exemption would not apply to any tangible personal property that is used primarily in administration, general management, or marketing. The bill would require that the purchaser furnish the retailer with an exemption certificate, as specified.

This bill would also provide, until January 1, 2004, an exemption from those taxes for qualified property, as defined, for use in any space flight originating at Vandenberg Air Force Base.

This bill would make certain legislative findings and declarations as to the necessity of a special statute.

Counties and cities are authorized to impose local sales and use taxes in conformity with state sales and use taxes. Exemptions from state sales and use taxes enacted by the Legislature are incorporated into the local taxes.

Section 2230 of the Revenue and Taxation Code provides that the state will reimburse counties and cities for revenue losses caused by the enactment of sales and use tax exemptions.

This bill would provide that no appropriation is made and the state shall not reimburse local agencies for sales and use tax revenues lost by them pursuant to this bill.

This bill would take effect immediately as a tax levy, but its operative date would depend on its effective date.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: yes.

The people of the State of California do enact as follows:

- 1 SECTION 1. Section 6377 is added to the Revenue
- 2 and Taxation Code, to read:
- 3 6377. (a) There are exempted from the taxes
- 4 imposed by this part the gross receipts from the sale of,
- 5 or the storage, use, or other consumption in this state of,
- 6 all of the following:
- 7 (1) Tangible personal property ~~primarily used~~ used
- 8 by a qualified person ~~primarily~~ in any stage of the
- 9 manufacturing, processing, refining, ~~extracting~~, or
- 10 fabricating of property, or producing in a cogeneration

1 facility any electricity, steam, or fuel, beginning at the
 2 point any raw materials are received and ending at the
 3 point at which the manufacturing, processing, refining,
 4 ~~extracting~~, fabricating, or producing has altered property
 5 to its completed form, including packaging, if required.
 6 Any sales made to a contractor or subcontractor for use
 7 in the performance of a construction contract for a
 8 manufacturer To the extent that tangible personal
 9 property that would otherwise be exempt under this
 10 section is sold to or purchased by a contractor or
 11 subcontractor pursuant to a construction contract with a
 12 qualified person, the tangible personal property sold to
 13 the contractor or subcontractor shall be deemed to be
 14 made a sale to the manufacturer for purposes of this
 15 exemption.

16 (2) Tangible personal property primarily used or
 17 consumed in research and development.

18 (3) Tangible personal property primarily used to
 19 maintain or repair, repair, measure, or test any property
 20 described in paragraph (1) or (2).

21 This exemption shall not apply to any tangible personal
 22 property that is used primarily in administration, general
 23 management, or marketing.

24 (b) For purposes of this section:

25 ~~(1) "Extracting" means exploration for, or removal of,~~
 26 ~~a natural resource from its native environment.~~

27 ~~(2)~~

28 (1) "Fabricating" means to make, build, create,
 29 produce, or assemble components or property to work in
 30 a new or different manner.

31 ~~(3)~~

32 (2) "Manufacturing" means the activity of converting
 33 or conditioning property by changing the form,
 34 composition, quality, or character of the property for
 35 ultimate sale at retail or use in the manufacturing of a
 36 product to be ultimately sold at retail. Manufacturing
 37 includes any improvements to tangible personal property
 38 that result in a greater service life or greater functionality
 39 than that of the original property.

40 ~~(4) "Measuring or testing" includes both~~

1 nondestructive and destructive measuring or testing, and
 2 the alignment and calibration of machinery, equipment,
 3 and tools, in the furtherance of manufacturing,
 4 processing, refining, extracting, or fabricating of
 5 property or producing electricity, steam, or fuel.

6 ~~(5)~~

7 (3) "Processing" means the physical application of the
 8 materials and labor necessary to modify or change the
 9 characteristics of property.

10 ~~(6)~~

11 (4) "Qualified person" means any person engaged in
 12 those lines of business described in Codes 2000 to 3999,
 13 inclusive, of the Standard Industrial Classification Manual
 14 published by the United States Office of Management
 15 and Budget, 1987 edition.

16 (5) "Refining" means the process of converting a
 17 natural resource to an intermediate or finished product.

18 ~~(7)~~

19 (6) "Research and development" means basic and
 20 applied research and experimental activities in the
 21 sciences and engineering, and designing, developing, or
 22 testing prototypes, processes, or new products, including
 23 research and development of computer software that is
 24 embedded in, or an integral part of, the prototype or new
 25 product or that is required for property otherwise
 26 exempt under this section to function effectively.

27 (7) "Tangible personal property" does not include
 28 consumables with a normal useful life of less than one
 29 year, except as provided in subparagraph (F) of
 30 paragraph (8), and does not include inventory.

31 (8) "Tangible personal property" includes, but is not
 32 limited to, all of the following:

33 (A) Machinery and equipment, including component
 34 parts and contrivances such as belts, shafts, moving parts,
 35 and operating structures.

36 (B) All equipment or devices used or required to
 37 operate, control, regulate, or maintain the machinery,
 38 including, without limitation, computers, data processing
 39 equipment, and computer software, together with all
 40 repair and replacement parts thereof whether

1 purch. d separately or in conjunction with a complete
2 machine and regardless of whether the machine or
3 component parts are assembled by the taxpayer or
4 another party.

5 (C) Property used in pollution control.

6 (D) Other safety equipment related to any activity
7 exempt under this section.

8 (E) Special purpose buildings and foundations used to
9 house or support the exempt equipment.

10 ~~(F) Lubricants, hydraulic oil, coolants, chemicals,~~
11 ~~catalysts, fuels, and other property used or consumed in~~

12 (F) Fuels used or consumed in the manufacturing
13 process.

14 (c) No exemption shall be allowed under this section
15 unless the purchaser furnishes the retailer with an
16 exemption certificate, completed in accordance with any
17 instructions or regulations as the board may prescribe.

18 SEC. 2. Section 6380 is added to the Revenue and
19 Taxation Code, to read:

20 6380. (a) There are exempted from the taxes
21 imposed by this part the gross receipts from the sale of,
22 and the storage, use, or other consumption in this state of,
23 qualified property for use in space flight.

24 (b) For purposes of this section:

25 (1) "Qualified property" means any of the following:

26 (A) Tangible personal property that has space flight
27 capability, including, but not limited to, an orbital space
28 facility, space propulsion system, space vehicle, satellite,
29 or space station of any kind, and any component thereof.

30 (B) Tangible personal property to be placed or used
31 aboard any facility, system, vehicle, satellite, or station
32 described in subparagraph (A), regardless of whether
33 that property is to be ultimately returned to this state for
34 subsequent use, storage, or other consumption.

35 (C) Fuel of a quality that is not adaptable for use in
36 ordinary motor vehicles, but is produced, sold, and used
37 exclusively for space flight.

38 (2) "Space flight" means any flight designed for
39 suborbital, orbital, or interplanetary travel by a space
40 vehicle, satellite, space facility, or space station of any

1 kind, and originating at Vandenberg Air Force Base.

2 (c) The exemption established by this section shall not
3 be denied by reason of a failure, postponement, or
4 cancellation of a launch of a space vehicle, satellite, space
5 facility, or space station of any kind, or the destruction of
6 any launch vehicle or any component thereof, but shall
7 not apply to any material that is not intended to be
8 launched into space.

9 (d) This section shall remain in effect until January 1,
10 2004, and as of that date is repealed, unless a later enacted
11 statute, that is enacted before January 1, 2004, deletes or
12 extends that date.

13 SEC. 3. The Legislature finds and declares that a
14 special law is necessary and that a general law cannot be
15 made applicable within the meaning of Section 16 of
16 Article IV of the California Constitution because of the
17 unique location, facilities, and resources of Vandenberg
18 Air Force Base, all of which establish that Vandenberg
19 Air Force Base is uniquely suited for commercial space
20 activities.

21 SEC. 4. Notwithstanding Section 2230 of the Revenue
22 and Taxation Code, no appropriation is made by this act
23 and the state shall not reimburse any local agency for any
24 sales and use tax revenues lost by it under this act.

25 SEC. 3.

26 SEC. 5. This act provides for a tax levy within the
27 meaning of Article IV of the Constitution and shall go into
28 immediate effect. However, the provisions of this act
29 shall become operative on the first day of the first
30 calendar quarter commencing more than 90 days after
31 the effective date of this act.

O