



Cost Cuts Proposed by California Budget Watchdog Angers State's Life Science Leaders

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Groups representing California's life-sciences employers are vowing to fight recent proposals by the state's budget watchdog that would end up cutting several state economic-development subsidies, including credits on research and development and net operating losses.

The proposals by the state's Legislative Analyst's Office seek to balance California's budget through 2012-13 and generate nearly \$1 billion in annual tax revenues over the next four years. They were part of a package of tax increases and spending cuts proposed late last month by LAO head Elizabeth Hill.

As part of that strategy, disclosed Feb. 20, the LAO would roll back \$2.7 billion in economic-development subsidies, and institute new fees. Among the changes:

- **R&D Credits** — Hill called for limiting to two-thirds of a taxpayer's liability the amount that can be claimed in any one year. Current law limits liability to 15 percent for R&D activity funded by businesses, and 24 percent if that activity is undertaken by universities or charitable institutions. Unused credits could still be carried over to future years, as current law allows. The LAO projected the cutback would raise for the state \$355 million in the fiscal year that begins July 1, and \$290 million in FY 2009.
- **Net Operating Loss Deductions** — Hill proposed limiting them to 50 percent of a taxpayer's net income in a given year; there is no limit at present. The reduction is projected to generate \$330 million for the state in FY 2008-09 and \$410 million in the following fiscal year.
- **Capital gains** — Hill would eliminate the 50-percent exclusion of capital gains on small business stock. This measure would generate \$55 million in each of the two next fiscal years.
- **Enterprise Zones** — Hill would phase out the program that gives tax breaks to companies that locate in depressed areas designated for reinvestment by the state. That would save California \$100 million in FY 2008-09 and \$120 million in FY 2009-10.
- **Custom computer programs** — Hill would eliminate the state's tax exemption for custom computer programs and in the process raise \$53 million next fiscal year and \$48 million in 2009-10.
- **Industry-Specific Equipment** — Hill would end the tax exemption for farm equipment and machinery used in some agribiotech operations, a move her office said would save the state \$120 million in 2008-09 and \$123 million in 2009-10.

The LAO claims the plan would give California a \$1.3 billion surplus by the end of fiscal 2008, about half the \$2.7 billion surplus estimate projected by Gov. Arnold Schwarzenegger under his own stimulus strategy. The LAO says California faces a \$16 billion deficit if current spending continues, while the governor pegged that number at \$14.5 billion.

“We believe that to successfully address a budget problem of the magnitude the state now faces, it is important to cast the net broadly for solutions,” Hill’s office concluded in a 176-page report submitted Feb. 20 to the 16-member Joint Legislative Budget Committee.

Life-science leaders in the state immediately shot back. “I don’t know what would make an economic downturn worse, faster, than cutting out incentives for companies to buy capital and equipment, or canceling research and development tax credits,” Matthew Gardner, president of **BayBio**, the life sciences group for the San Francisco Bay Area and northern California, told *BRN*. “You talk about putting the clamps on an economy and any kind of [tech] spending? It’s crazy.”

Gino DiCaro, a spokesman for the California Manufacturers and Technology Association, a statewide manufacturers’ group whose 800 members include life sciences companies, said R&D credits and NOL deductions “are two of the very few offsets that manufacturers have in California to reduce their costs,” and if enacted the plan would compel biotech, pharmaceutical, and medical-device companies to think twice about doing more business in California.

“You would lose all sorts of dynamic economic activity five to 10 years after those [rollbacks] are actually implemented or taken away,” he added. “There’s a very, very, very narrow path to staying competitive with facilities in other states.”

According to the LAO report, *The 2008-09 Budget: Perspectives and Issues*, which can be read [here](#), the group targeted for reduction economic development programs “that are not achieving their stated purposes or are of a lower priority” than those spared.

Mac Taylor, deputy legislative analyst, told *BioRegion News* the LAO proposed rolling back the R&D and NOL credits because “we thought it would have less effect than, say, an increase in the overall corporate tax rate.

“If you’re going to restrict the ability to use R&D credits, a company that’s going to have a good year, they’re going to have to pay more taxes than they otherwise would,” Taylor said. “Is that going to affect other decisions they make regarding their R&D or other investment decisions? Well, it might, or might not.”

“We still would acknowledge that they could have some effect on business decisions,” Taylor added. “We just thought it would be much less than a bump in the top marginal rates.”

For their part, leaders from both parties in the state government last month united quickly to pass \$1 billion in cuts to the current state budget, but they remain divided on the LAO’s alternative budget. Outgoing Assembly Speaker Fabian Nunez — soon to be succeeded by another Los Angeles Democrat, Karen Bass — welcomed the package as “a balanced approach that includes eliminating tax loopholes and raising revenues so we will not have to close parks, lay off teachers, and put our state’s most vulnerable citizens at risk.”

But Republican legislative leaders criticized the plan for its tax increases: “It is careless to burden struggling families with increased taxes because the Legislature, despite repeated warnings and multiple opportunities, has continually failed to be fiscally responsible,” Senate minority leader Dick Ackerman (R-Irvine) said in a statement.

In another report, the LAO acknowledged that its rollbacks would raise less revenue for the state than raising the state sales tax by a quarter percentage point or raising the corporation tax rate by 1 percent, each of which could generate \$1.5 billion in additional revenue for the state Treasury.

“Increasing tax rates, however, can negatively affect taxpayer work and investment decisions at the margin,” therefore negating at least some of the revenue gains the taxes would create, concluded the report, called [An Overview of California’s Research and Development Credit](#).

The report continues LAO’s campaign against several economic-development incentives targeted to the life sciences and other tech industries. Back in 2003, the office published a report recommending that the state Legislature either reduce the R&D credit or phase it out over time, citing the tight state budget of that year — a key factor in that year’s gubernatorial recall election, which saw Democrat Gray Davis replaced with Schwarzenegger.

In 2002 and 2003, budget squeezes prompted California to suspend its NOL carryover deduction on all but disaster-related losses, though NOLs generated during those years continued to be computed and carried over when the deduction got reinstated in 2004.

Taylor said his office would go along with a similar temporary suspension of NOL, R&D credits, or other economic development subsidies for next year’s budget if lawmakers preferred it. “We didn’t talk about that because we were trying to get ongoing savings. But certainly as the Legislature considers these things, that would be an option available to them.”

‘Absolutely Crazy’

BayBio’s Gardner last week said that cutting state R&D and NOL credits would discourage industry investment in California, and pointed out that the proposed cuts fly in the face of the professed support for the life sciences and other high-tech industries long shown by state officials.

“To think that an economic downturn that led to a tightening of capital gains revenues for the state would lead them to think that tightening further and clamping down on business would actually have an upside?” he said. “It’s absolutely crazy. This is a really, really unhealthy discussion.”

Gardner said his group will draw public attention to the issue, through a newspaper op-ed column it had begun working to publish last week.

Long-Term Stopgaps?

The NOL proposal comes a year after California’s Assembly passed a bill —sought by BayBio and other life sciences groups — that would double, from 10 to 20 years, the amount of time that biotech companies can carry forward tax deductions on their net operating losses. The bill, [AB 1370](#), is pending in the Senate’s revenue and taxation committee.

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California requires businesses to use their oldest NOL credits first where state taxes are concerned. Federal tax law allows companies to carry NOLs forward 20 years, as well as back two years.

In January, Assemblyman Gene Mullin (D-South San Francisco), who chairs the education committee and select subcommittee on biotechnology in California's lower house, told *BRN* that the state's budget situation made further legislative action unlikely on the NOL bill or other new economic incentives for the life sciences or other industries [[BioRegion News, Jan. 21](#)].

BIOCOM, the San Diego region's life sciences industry group, asked its public-policy staffers last week to begin asking employers to gauge the impact of the proposed cuts on their businesses, Jimmy Jackson, the group's vice president of public policy and communications, told *BioRegion News*.

Jackson said rolling back the R&D and NOL tax credits would make life sciences and other companies think twice about expanding in California, causing reduced state revenue that would extend well beyond the coming fiscal year.

"They are important enough to the state in the long-term that they should not be used as stopgaps to try and close this budget deficit," Jackson said in an interview. "When the economy recovers, all of a sudden, you don't have that group of companies contributing to that recovery. It would be a short-term fix for a problem that would have incredible long-term implications."

He added that "the great unknown is how many companies would use that as a factor in considering whether they move to California or stay in California. That's something that's very difficult, if not impossible, to accurately quantify."

The reason, Jackson said, is because several other states are aggressively pursuing new life sciences companies. He cited efforts by Florida, North Carolina, Iowa, and especially Massachusetts, where officials are close to approving a 10-year, \$1 billion set of subsidies intended to stem erosion of the state's industry leadership in recent years [[BioRegion News, Feb. 19](#)].

"When your main competitor" — Massachusetts — "is doing something like that, that's not the time when you want to be making your state less attractive to companies," Jackson said. "There are any number of states that have very aggressive attraction or retention programs. It's hard to estimate what the competition is going to look like 12 months or 24 months from now."

San Diego's cluster of some 500 life-sciences employers is gearing up to host this year's 2008 Biotechnology Industry Organization Global Convention, to be held June 17-20 at the San Diego Convention Center. Keynote speaker for the four-day conference will be Schwarzenegger, who has sought to convey support for the life sciences industry.

On Feb. 11, Schwarzenegger toured the Carlsbad, Calif., headquarters of Invitrogen [[BioRegion News, Feb. 19](#)] during a intended to convey the state's support for the industry: "What this is all about is ... job creation. We as the state, Sacramento is responsible to make lives better for people in California, to put people to work, and to create employment, and that's what we're doing. And that's why we're all here."

Nine days later, Schwarzenegger trumpeted how the state won a \$5.6 million US Department of Labor grant toward retraining laid-off mortgage-industry workers for new careers in the life sciences [[BioRegion News, Feb. 25](#)].

The state's Democratic lieutenant governor, John Garamendi, has also embraced California's life sciences industry. In July 2007, he announced the state's creation of a new advisory committee of biotech industry professionals, with the goal of developing programs to help California maintain its biotech leadership.

Garamendi told *BRN* in an interview that the state must spend money to develop a biofuels specialty as well as improve training programs for the life sciences cluster [[BioRegion News, Aug. 6, 2007](#)].

The CMTA's DiCaro said the tax credit rollbacks compound a climate that manufacturers in the life sciences and other industries consider increasingly hostile. He cited the state's decision in 2004 to remove the 6-percent manufacturers investment credit due to a reduction in manufacturing jobs, which DiCaro said cost the state well above the projected loss of about \$450 million in activity.

CMTA has called for exempting manufacturers from the state sales tax on new equipment, a policy argument it has made in part through a Milken Institute report it commissioned. The report concluded that California would gain \$114 million in net revenue over five years and an average 50,000 new jobs per year, 14,000 of them in the manufacturing sector, if it fully repealed its 5-percent sales tax on manufacturing equipment. If lowered to 2 percent, those numbers would dip to \$66 million in new revenues and 32,000 new jobs a year, 8,000 of them in manufacturing.

CMTA's report, *The Economic Impact of a Sales Tax Reduction on Manufacturing Equipment*, is available [here](#).

According to the agency, it costs manufacturers 23 percent more than the national average to do business in California. The loss of the investment credit is a factor, as well as the state's higher-than-average energy and labor costs. CMTA says those factors explain why the state has lost more than 400,000 manufacturing jobs over the last seven years.

As of January 2008, the most recent month figures were available, California recorded just over 1.45 million manufacturing jobs, down 23,600 jobs or 1.6 percent from the nearly 1.48 million jobs recorded in January 2007, according to figures from the California Employment Development Department. Click [here](#) for the full January 2008 report.

Back in January 2001, California recorded nearly 1.88 million manufacturing jobs, according to [historical data](#) from the department — 426,700 more than in January 2008.