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TRENDS IN CORPORATE INCOME TAX RECEIPTS

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Trends in Corporate Income Tax

Receipts

Executive Summary

Corporate income tax receipts have been an important source of tax revenue since the tax was officially created in 1909. Corporate taxes accounted for almost 12 percent of federal revenues in 1998 and 6.4 percent of state tax revenues in the same year. In Georgia, corporate income tax revenues are 6.4 percent of total net revenue in 1998--on par with the average state in the U.S. Corporate income tax revenues pall in comparison with personal income and sales tax revenues in the state. As a comparison, the Georgia personal income tax accounted for 48 percent of total net revenue in 1998 and the general sales and use tax was 36 percent of net total revenue collections.

Over the past two decades, the growth in Georgia state corporate tax receipts relative to other state revenue sources has faltered. With the exception of a slight rebound in 1993-95, the corporate tax as a percent of individual income tax receipts in Georgia declined from a high of 24.2 percent in 1985 to 14 percent in 1998. Compared to all state tax revenue, the corporate income tax has fallen from 9.5 percent in 1985 to the current level of 6.4 percent. The majority of the decline in importance as a state revenue source occurred from 1983-91. Since pulling out of the 1990-92 recession, state corporate tax revenues as a percent of total state taxes have stabilized at a rate between 6 and 7 percent. Relative to other states, Georgia's corporate income tax grew more slowly than the average state until the post-recession years.

Some might view these revenue patterns as significant--others may not be particularly concerned over these patterns. After all, the tax generates only about 6.4 percent of total revenue in the state -- about one third more than the revenue loss due to the exemption of food from the sales tax base and less than the equivalent of a one cent increase in the sales tax. However, the tax is the third most important single revenue source in the state. Also, the corporate income tax does not simply play a revenue

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generating role. As a “tax on business” it is perceived to be a tax which is progressive in nature. In fact, whether the tax is progressive in nature or not is an open question.¹

So long as the corporate tax exists, the question of why corporate tax receipts have slowed relative to other revenue sources is important. The state government needs to know whether the pattern of corporate receipts is due to natural changes in the economy or due to federal and state policies. Such information will give the state more information for forecasting receipts as well as shed some light on the impact (cost) of federal and state policies such as tax rate changes and increased exemptions.

This report examines the trends in state corporate tax receipts and possible explanations for these trends. We might think of the possible explanations as falling into three categories: legal tax avoidance (tax reforms and changes in laws governing incorporation and their impacts), economic changes, and other tax policy changes (tax credits and incentives).² What we find is that the changes in the economic base of Georgia are the most likely reason that state corporate tax receipts have declined in importance. Georgia’s industry concentration is growing in sectors which do not pay an increasing share of federal corporate income taxes. This is due to the growth coming in industries which report smaller increases in taxable profits.

There are some other possible reasons for the trend in corporate tax revenue in the state including:

- ! A change in the form of incorporation by businesses (“disincorporation”). This means that due to tax policy and law changes, business entities can by-pass the corporate tax structure by passing income through to owners, shareholders, and partners who pay tax via the personal income tax structure.

¹In addition to its distribution and revenue roles, there are other reasons to levy a corporate income tax. These include the exportability of the tax (which lowers the tax burden of state residents) and the use of a tax as payment for services received by corporations. According to the benefits principle of taxation, taxes are payments for goods and services produced by the public sector. Businesses are consumers of roads, police protection, educational services and the like and as such businesses should pay for some part of these public goods.

²In this report we do not investigate tax evasion.

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! There have been some tax law changes which may contribute to the loss in corporate tax revenue in the state. In particular, the BEST legislation of 1994 and its expansion in 2000 offer a host of tax credits to corporations in the quest for economic development. Through 1997 the usage of these credits appears small, but anecdotal evidence suggests that firms are paying more attention to the credits and their usage may be on the rise.

! There are some other specific tax policy issues which plague the corporate income tax. The use of separate accounting encourages tax planning such that companies report as few taxable profits in Georgia as possible. A tax amnesty in late 1992 may have affected the growth of corporate tax revenues post recession and an expanded depreciation allowance in 1990-91 may have contributed to the same.

Many of the remaining questions--the extent of tax planning, the impact of differential tax rates among states, the effect of expanded credits, and the disincorporation hypothesis, can be more fully investigated with a panel of corporate taxpayers. Such analysis is necessary to quantify these potential changes so that we better understand what has happened to the corporate income tax in the state and what might happen in the future. Quantifying the costs of such avoidance behavior and the tax expenditures of the state government are important inputs in the development of a rational, long-term corporate income tax policy.

Introduction

Throughout the 1980s and 1990s, federal and state policy makers have been concerned over the performance of federal and state corporate income taxes. While corporate income tax revenues have always been susceptible to swings in the business cycle, it was the tax policy changes of the 1980s and 1990s (including the massive tax reform in 1986 and the tax rate increase of the 1990s) that created a new set of incentives for businesses to operate as other than traditional, corporate tax paying C-corporations. With those new policies came expectations of changes in the growth of corporate and individual income tax revenue. In this report we investigate the pattern of growth of Georgia state corporate tax receipts over the last two decades. The purpose of this study is to identify trends in collections and to offer some possible reasons for these trends. Comparisons will be made with national trends, although the emphasis in this report is not on explaining what is happening nationally but rather what may be affecting corporate tax collections in Georgia.

Over the last two decades, a number of tax policy changes at the federal level have been enacted which many believe should have impacted the growth of corporate tax revenues. For example, the Tax Reform Act of 1986 (TRA86) made numerous changes to the tax code. The TRA86 created a rate structure where the corporate tax rate exceeded the individual income tax rate for the first time in the modern history of both income taxes. This immediately created an incentive for businesses to find a way to distribute income such that the income could be taxed at the lower individual income tax rate. This could be accomplished if the business income were flowed through to individuals via partnerships, S-corps or limited liability corporations. If this change occurred, the number of corporate income tax returns and corporate tax liabilities could fall as businesses "disincorporated." During much of this period, the state of Georgia witnessed rates of economic growth greater than the national average. Because of this growth, one might assume that Georgia would be insulated from any policy shocks. As discussed later, this is not necessarily the case due to the nature of the economic growth in the state.

In fact, since TRA86, we have witnessed some change in the growth of corporate income tax revenues, although the change has not been necessarily consistent with pre-TRA86 expectations. Figure 1 demonstrates these trends. As seen there, corporate tax receipts were relatively stagnant from 1985-86 (as expected) but have shown moderate growth in the past 15 years, with the exception of the recessionary period of 1990-1992. In fact, as a share of all federal receipts, corporate receipts have grown since the mid-1980s, after decades of declining importance (see Figure 2). Most recently (1997-98), we see a slight decline once again, although these two data points alone do not constitute a new trend. As a comparison, the federal personal income tax continues to be a strong revenue producer for the federal government and its growth has outpaced that of the corporate income tax.

The State of Georgia has also witnessed some changes in the pattern of corporate income tax revenues over the past two decades. Figure 3 shows the growth in Georgia's state corporate and individual income tax receipts from 1985-1999. The growth in corporate income tax revenue has been relatively steady except for a significant decline in the 1990-1993 period. However, compared to overall tax revenues and individual income tax revenues specifically, the corporate tax has declined in importance since

1985. With the exception of a slight rebound in 1993-95, the corporate tax as a percent of individual income tax receipts in Georgia declined from a high of 24.2 percent in 1985 to 14 percent in 1998 (see Figure 4). Compared to all state tax revenue, the corporate income tax has fallen from 9.5 percent in 1985 to the current level of 6.4 percent (see Figure 5). Over the period studied, most of the decline occurred from 1983-91. Since pulling out of the 1990-91 recession, state corporate tax revenues as a percent of total state taxes have stabilized at a rate between 6 and 7 percent.

FIGURE 1. FEDERAL TAX REVENUES

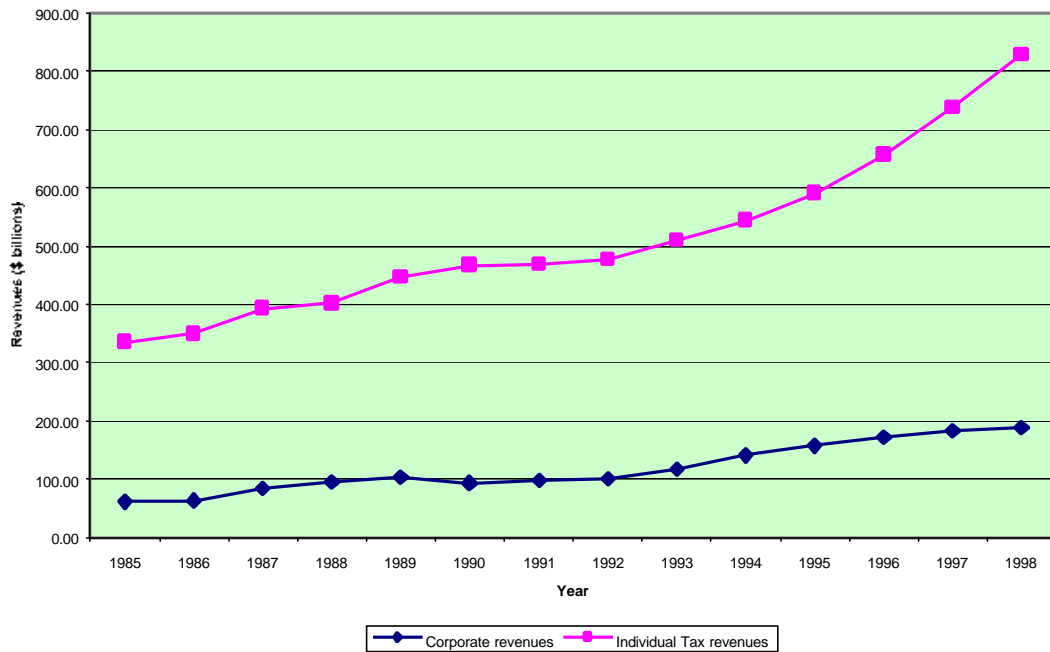


FIGURE 2. US CORPORATE TAX RECEIPTS/TOTAL US RECEIPTS

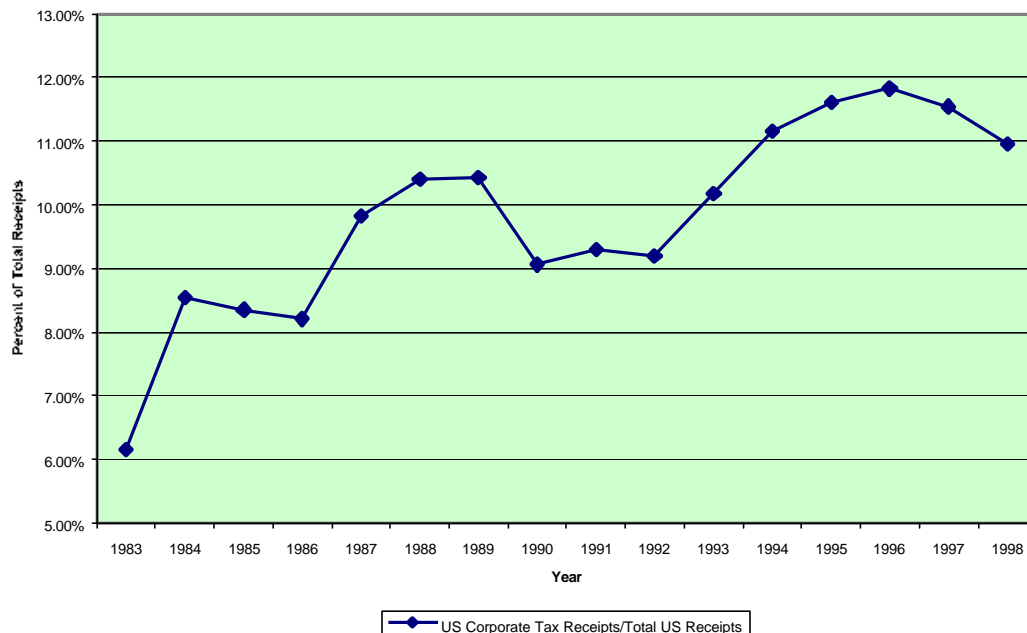


FIGURE 3. GEORGIA TAX RECEIPTS

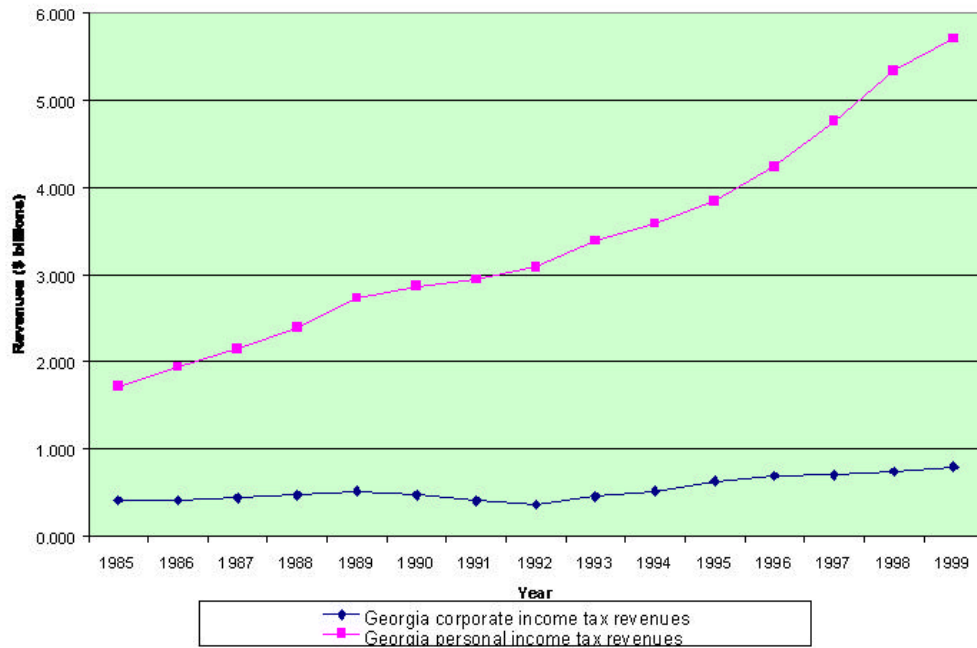
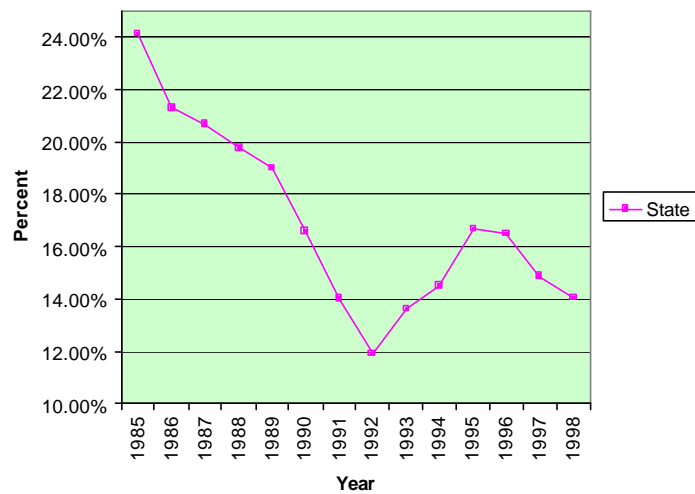


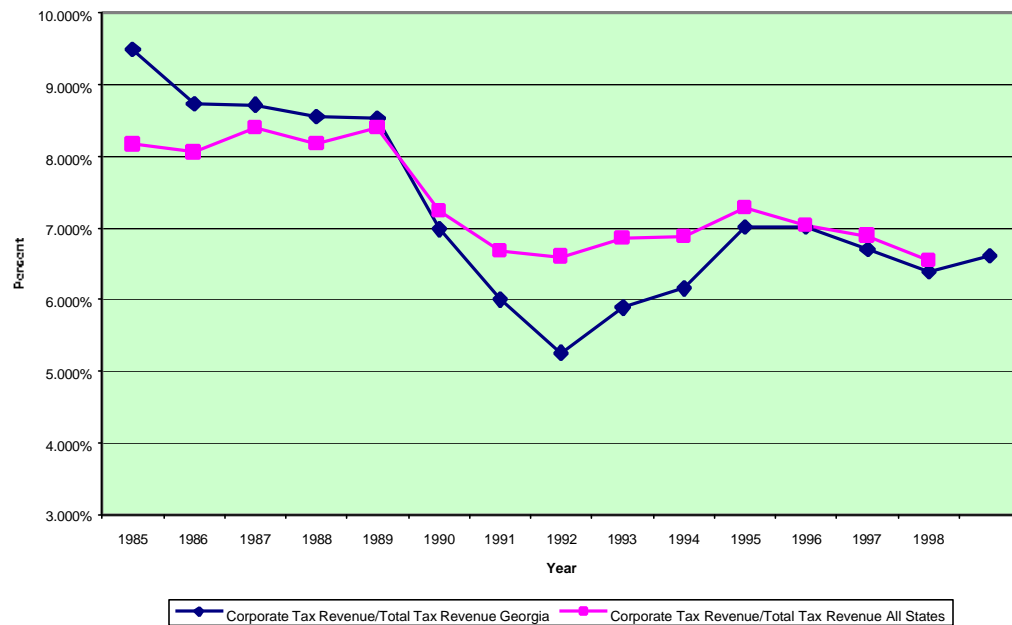
Figure 4. Corporate/Individual Tax Revenues



Simply looking at revenue statistics does not shed much light on the reasons for the decreases or increases in the growth of corporate tax revenues. At first blush, it looks like federal corporate revenues are growing relatively smoothly, especially considering

the volatile tax base of the corporate tax. However, corporate revenues may not have kept up with overall economic growth. At the state level, there is a bit more mystery over the continued declining trend of state corporate tax revenue as a percent of total state revenue. In the midst of a robust economy, the state corporate tax revenue has lost ground. Perhaps corporate profits have not grown as fast as other tax bases (such as personal income); perhaps the state has afforded corporations deductions worth an increasing share of profits. A more detailed analysis which focuses on the trends in business entity formation (by type of entity), aggregate statistics of growth of output from business entities, changes in tax law (including tax incentives), and general economic growth is needed to understand why corporate tax revenue growth in the state of Georgia has been rather erratic over the past two decades. The remainder of this report is dedicated to such analysis.

FIGURE 5. CORPORATE TAX AS A PERCENT OF ALL TAX REVENUE



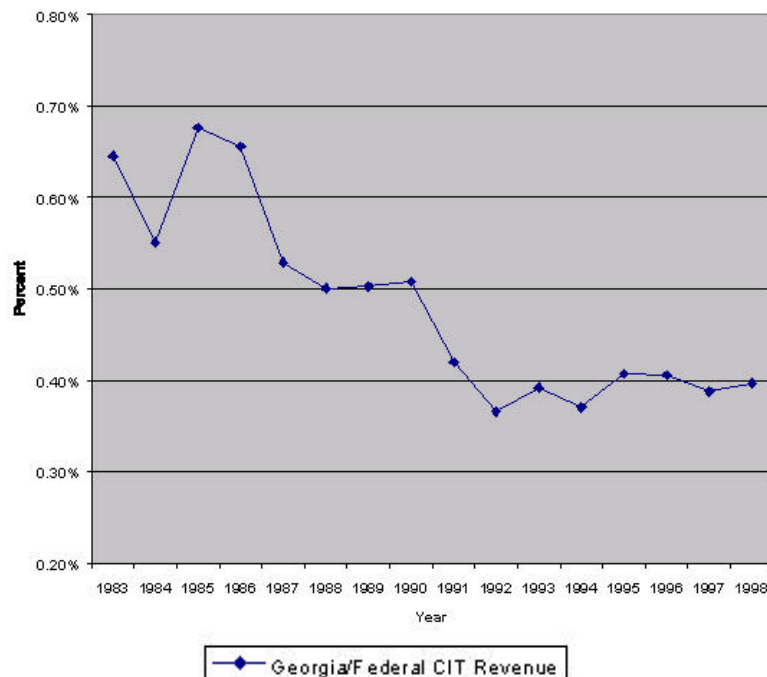
Patterns in Revenues

Based on general growth patterns, the federal corporate income tax seems to have stabilized its growth, while the Georgia corporate income tax has lost ground relative to other tax sources in the state. Figure 5 demonstrates this point more directly as it shows a general downward trend of state corporate income tax revenues to total tax revenues in the state. There was some rebound in 1999, but the growth pattern for 2000 may be down slightly again, according to the most current collections. Figure 5 also shows that Georgia's corporate tax take relative to total state tax revenues has been more cyclical than the average of all US states. During the 1990-91 recession, corporate receipts dipped further in Georgia than in the average US state. It also took us longer to recover post-recession than states on average. The underlying structure of the Georgia economy is likely to blame for these patterns. This will be discussed in detail later in this report.

Since 1994, the pattern of corporate tax to total tax revenue growth in Georgia is very similar to that of all states--in most all states, corporate tax revenues have lost some additional ground to overall tax revenues.

Another interesting look at revenue growth can be found in Figure 6. There we see the Georgia corporate tax revenue as a percent of Federal corporate income tax revenue. If the federal and state corporate receipts were similarly affected by the economy, tax policy and the like, this ratio should be fairly constant. Instead we see a huge drop in Georgia corporate revenues relative to federal corporate revenues from 1983 to 1991, with a stabilization in the rate post-recession. Again, there appears to be some type of structural break during the recessionary period, as if Georgia's tax base did not recover as quickly or as much as that of the federal government. A more positive spin on these statistics is that Georgia may have attracted more start-up companies post-recession--companies with years of losses ahead of them. Yet another explanation is that the disincorporation related to changes in corporate and individual tax structure is more pronounced in Georgia than at the federal level due to the mixture of industries in the state (some industries are more able to make the switch than others). Finally, the growth of state tax incentives may provide an explanation of the trend in corporate tax receipts (in Georgia as well as other states).

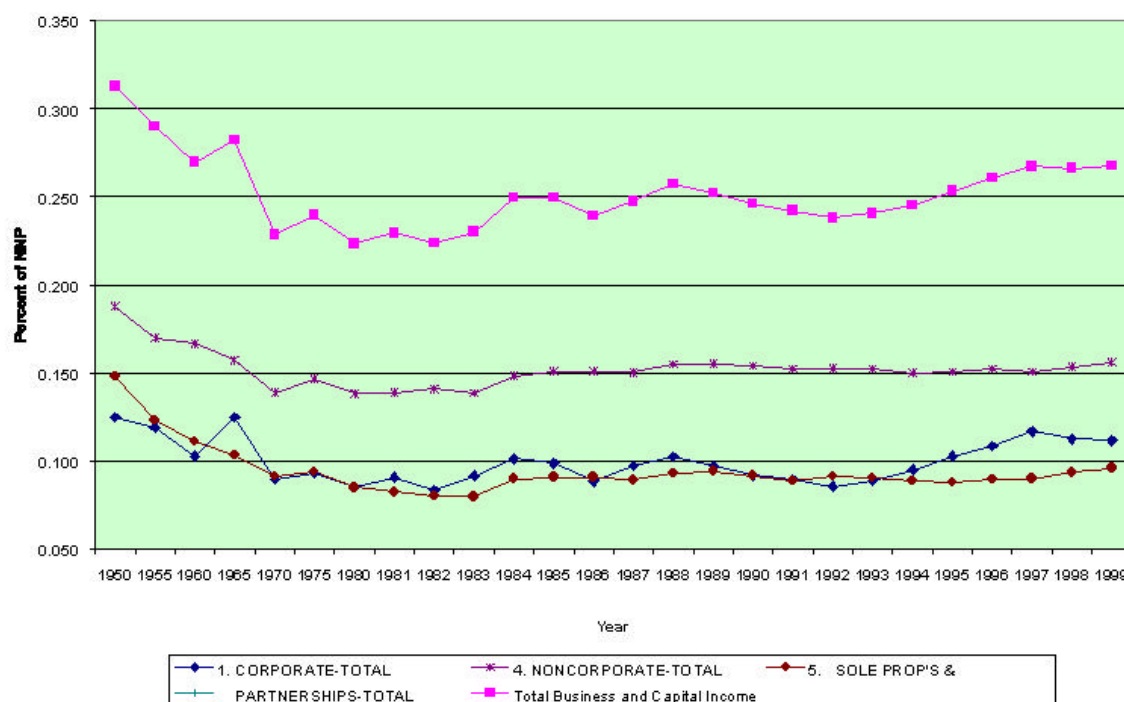
Figure 6. GEORGIA/FEDERAL CIT REVENUE



There are many alternative hypotheses for these patterns of corporate income tax growth.

The next sections of the report will provide some background on the tax and a list of potential explanations for these trends. It also provides analysis which may help sort out the importance of these alternative explanations. In most cases, a significant amount of additional research, with some very specific data, needs to be done to begin to estimate the impact of each possible explanation. We might think of the possible explanations as falling into three categories: due to legal tax avoidance (tax reforms and changes in laws governing incorporation and their impacts), economic changes, and other tax policy changes (tax credits and incentives). We do not specifically address tax evasion in this report, but given the number of policy changes to the corporate tax and its administration, there may very well be some changes to overall compliance with the federal and state corporate income taxes. There are certainly more categories worthy of investigation, but we stick to these as they are likely to be the most important ones.

Figure 7. BUSINESS AND CAPITAL INCOME AS A PERCENT OF NNP



Background

Corporate income tax receipts have been an important source of federal tax revenue since the tax was officially created in 1909. The tax is a less important state revenue source and an even smaller local government revenue source. Corporate taxes accounted for almost 12 percent of federal revenues in 1998 and 6.4 percent of state tax revenues in the same year. In Georgia, corporate income tax revenues are 6.4 percent of total net revenue in 1998--on par with the average state in the U.S. Corporate income tax revenues fall in comparison with personal income and sales tax revenues in the state. The Georgia personal income tax accounted for 48 percent of total net revenue in 1998 and the general sales and use tax was 36 percent of net total revenue collections.

Why have a corporate income tax? The corporate income tax does not simply play a revenue generating role. In fact, it plays a very small revenue generation role. As a "tax

on business" it is perceived to be a tax which is progressive in nature; that is many individuals, including policy makers, feel that the largest portion of the burden of the tax is on the wealthy. For many people, a tax on business equates to a tax on the wealthy. However, like all taxes, the corporate income tax is paid by individuals--holders of corporate stocks (including pension funds), consumers of goods produced by corporations, labor, and holders of most forms of capital. How progressive such a tax is depends on whether a tax on corporations can be passed forward into higher prices for a corporation's output, or "backward" to reduce corporate profits or wages. If the tax burden is born by capital owners it is more progressive; if born by labor and/or consumers the tax is likely to be relatively less progressive.

In addition to its distribution and revenue roles, there are other reasons to levy a corporate income tax. These include the exportability of the tax (which lowers the tax burden of state residents) and the use of a tax as payment for services received by corporations. According to the benefits principle of taxation, taxes are payments for goods and services produced by the public sector. Businesses are consumers of roads, police protection, educational services and the like and as such businesses should pay for some part of these public goods. These issues are covered in more detail in Grace, 1998.

To understand the factors affecting corporate tax receipts, it is important to have some idea of what the tax is. Fortunately, the structure of Georgia's corporate income tax is relatively simple. The tax is coupled to the federal corporate income tax. This means that many of the calculations used for deriving the federal corporate income tax base (taxable income) are used for Georgia's income tax base as well.

The first line on the Georgia form is federal taxable income. From that starting point, Georgia allows some adjustments. By law, these adjustments have changed over the period studied in this report and the following are the current major adjustments:

- Additions to federal taxable income: state and municipal bond interest (other than of Georgia jurisdictions), net operating loss, accelerated depreciation deducted on the federal return for electing corporations, net income or profits taxes imposed by taxing jurisdictions other than Georgia;
- Subtractions from federal taxable income: interest on obligations of the U.S., allowable depreciation, Georgia net operating loss deduction, and up to 10 percent of qualified payments to minority firms for a corporation which is party to a state contract.

Taxable income is then apportioned by a three factor formula (payroll, property, and gross receipts), with a double weight applied to the receipts factor (sales). Prior to 1995, the three factors were equally weighted in the apportionment of income. The portion of income allocated to Georgia is finally taxed at a flat 6 percent rate. The corporate income tax schedule allows for certain credits to be taken from Georgia corporate tax liability including: job tax credit, investment tax credit, child care credit, and retraining tax credit. The job tax credit was instituted in 1990 and has had limited takers (Faulk et. al. 2000). This is discussed in detail later in the report. Many credits were instituted by the BEST legislation--Georgia's Business Expansion Support Act of 1994 which was expanded in the past legislative session (2000).

Since the taxable income base includes dividends, the Georgia corporate income tax applies double taxation of dividends just as the federal corporate tax system does. Corporations pay dividends from after tax dollars and then the dividends are also taxed at individual income tax rates (at a state individual income tax rate of 6 percent for most taxpayers in Georgia).

Not all businesses are subject to the corporate income tax--federal or state. For tax purposes, there are various legal forms of businesses--some of which are taxed under the corporate income tax structure and some of which are effectively taxed under the individual income tax structure (via pass-through of earnings to individual partners, shareholders, etc.). In most states, if a business entity is subject to the federal corporate income tax, it is subject to the state corporate income tax (a piggy-back of sorts on the tax status of the entity).

The C-corporation is the most traditional form of business and c-corps are taxed under the corporate income tax. C-corps are largely distinguished from other business entities by the number of employees, shareholders, and rules governing their sale. Business income in general can also be taxed via "pass through" entities such as partnerships, S-corporations (defined in part by the number of shareholders), and limited liability corporations (among others). If a business entity forms as a partnership or limited liability corporation, it can pay out income directly to individuals involved in the activity, thus by-passing the corporate tax structure. Earnings from an s-corporation are also subjected to the individual income tax and not the corporate income tax system. Sole proprietorships (single owner-employee businesses) are a traditional form of business which is taxed under the individual income tax structure.

While there are costs involved in switching the form of business from a c-corporation to another form and there are costs and benefits to forming as a c-corporation, s-corporation, partnership, etc. All else held equal, changes in the corporate and individual tax rates can affect the declared form of business. Tax planners will seek out the formation which minimizes tax liability of the business entity. As the federal corporate tax liability is significantly larger than state corporate tax liabilities, changes in federal tax policy lead the charge for this tax planning. The Tax Reform Act of 1986 was one such policy change that may have given rise to an increase in business formation under tax statuses other than the C-corporation.

Form of Incorporation Hypothesis

The federal Tax Reform Act of 1986 significantly changed the income tax playing field. For the first time in modern tax history, corporate tax rates would be higher than individual income tax rates (see Table 1). In the early days of TRA86, there was much concern over the effect of the change in tax rates on forms of incorporation and ultimately corporate income tax receipts. Both the federal as well as many state governments expected to see reductions in the growth of corporate income tax receipts as business entities shifted from traditional C-corps to other forms of business enterprises which would be taxed under the personal income tax schedule.

While statutory rate changes associated with TRA86 are obvious, the net changes in effective tax rates facing capital income, interest, dividends, and capital gains are fairly complicated. Nelson (1988) summarizes some of the changes and their impacts on the after-tax return to capital income. For example, while TRA86 raised the top corporate

tax rate above the top individual income tax rate, the overall difference between the two sets of rates fell. This might make it less worthwhile to do significant tax planning. The effective tax rate on equity (dividends and capital gains) changed relative to that on debt (interest). So, depending on the type of financing used by a corporation, TRA86 changes may or may not have influenced a switch from a corporate to a non-corporate status for tax purposes. There were many provisions in TRA86 which had competing effects and therefore make it difficult to discern the impact of TRA86 on corporate tax receipts. Subsequent tax policy changes are similar in their overall complexity.

Table 1. Comparison of Top Individual Income Tax Rates and Top Corporate Tax Rates

Year	Fed PIT top rate	Fed CIT top rate	GA PIT top rate	GA CIT top rate
1980	70	46	6	6
1985	50	46	6	6
1986	50	46	6	6
1987	38.5	40 (transition rate)	6	6
1988	28	34	6	6
1989	28	34	6	6
1990	28	34	6	6
1991	31	34	6	6
1992	31	34	6	6
1993	39.6	34	6	6
1994	39.6	35	6	6
1995	39.6	35	6	6
1996	39.6	35	6	6
1997	39.6	35	6	6
1998	39.6	35	6	6
1999	39.6	35	6	6

Sources: Pechman (1987), Georgia Department of Revenue (various years), CCH Master Tax Guide (various years). Rates ignore bubbles and phase-outs.

Nelson also examines the growth in income for tax purposes through 1985. She compares reported net income, losses and deficits for corporations, s-corporations, partnerships and sole proprietorships to determine whether there was disincorporation for tax purposes. She concludes that the evidence through 1985 is mixed; corporate and non-corporate net income less deficit both grew, but the corporate income grew at a declining rate. We extended this analysis through 1997 and found more evidence of potential disincorporation for tax purposes. From 1990-1997, net income less deficit for s-corps and partnerships grew at a rate more than double that of corporate net income less deficit.

This was a period of changing tax laws and regulations for these types of business entities as well as the start-up of the "dot-com" phenomenon. These tax-based statistics give some credibility to the notion of disincorporation for tax purposes, and seem much more pronounced than the pre-TRA86 patterns of income growth for s-corps and partnerships. It is important to note that the growth in the number of these entities is strong, but not nearly as strong as the growth in net income reported for tax purposes.

Nelson expands her analysis of the movement of income among types of business forms by comparing the level of income reported on the business tax returns and that reported as the flow-through on individual income tax returns. One might expect a close correlation between these two reported income measures. However, she finds that much less than 100 percent of business reported s-corp income and partnership income shows up on individual income tax returns. This pattern has continued, although the percent of business income showing up on individual income tax returns has stabilized compared to the pre-1986 period. Why doesn't all of the flow-through income show up on individual income tax returns? Recall that differences in tax rates is expected to lead to more or less use of these pass-throughs as business entities seek the lowest tax liabilities. However, the pass-through can be to individuals, estates, trusts, and non-profits as well as other corporations (in some cases). As it is nearly impossible to account for 100 percent of the pass-through income, it is very difficult to determine the behavior induced by the tax changes.

From this analysis, can we assume that Georgia has also seen an increase in s-corp and partnership income growth for tax purposes? We currently do not have the distribution of net income for partnerships and s-corporations in Georgia, although these entities file specific tax forms in Georgia (form 700 for partnerships and 600s for s-corporations). In the absence of specific tabulations of reported income by type of business entity, one might simply assume that Georgia has changed as the nation has and as such Georgia has seen similar disincorporation. We might be able to do a little better than that overriding assumption by looking at growth by industry. At the federal level, we have statistics on the growth in net income less deficit for tax purposes for s-corps and partnerships by industry. We also have output growth statistics by industry for the state of Georgia. If industries in Georgia act as those nationally in terms of tax planning, we can impute the national trends in s-corp and partnership growth to Georgia, by industry. This might give us some idea of the effect of potential disincorporation on the overall corporate tax base in Georgia. For example, strong gross state product growth occurs in Georgia in industries in which we see evidence of strong s-corp or partnership growth, this would increase the non-corporate share of Georgia's tax base. If on the other hand, Georgia's industrial output growth comes in industries for which there is evidence of a lower level of growth in non-corporate entity reporting, there will be less effect on the corporate tax base. This is a very simplified analysis, but it may shed some light on what is occurring in Georgia relative to the US.

What we find is a mixed answer. The financial, service, and construction industries have seen rapid growth in s-corp net income less deficit figures at the federal level. In Georgia, the financial and service sectors have posted strong growth during the period analyzed. The financial, manufacturing, and mining sectors have posted the strongest partnership net income growth in the 1990s. While the financial sector also posted a relatively high level of output growth in Georgia over that period, the other two sectors

posted less than average (for Georgia) growth. The net impact on the tax base is therefore mixed. The same is true with s-corp growth: nationally the growth came in the financial, services, and construction sector while Georgia's output growth for the construction industry was less than average for all industry growth in Georgia. A tabulation of the actual tax returns in Georgia would help to clarify the potential non-corporate versus corporate tax base growth in Georgia.

All of these statistics and trends point out the possibility that disincorporation, shifting between the corporate sector to the non-corporate sector for tax purposes, may be occurring in the US and in Georgia. The entire disincorporation hypothesis deserves much more attention and research. To do an accurate job investigating the possibility of this phenomenon and its tax receipts impacts, we would need a panel of corporate, s-corp and partnership tax returns. This would enable us to investigate whether C-corps "die" for tax purposes and are born as s-corps (discontinue to file federal form 1120 and move to 1120S; for Georgia it would be a move between the form 600 to 600s or 700). This is a tricky analysis as it would be very difficult to link what is actually the same firm under two different tax specifications. Partnership and s-corp returns could be analyzed over time to look for births in particular industries as well as the use of deductions and exemptions. Finally, corporate returns could be studied to determine the use of deductions and tax shelters (which would affect the wedge between NIPA reported income and income reported for tax purposes). Depreciation is one deduction which needs to be studied very carefully. For example, the CBO (2000) analyzes a particular trend--recent increases in investment in assets with short depreciable lives--and suggests that the revenue cost of this deduction is growing.

Is It The Economy?

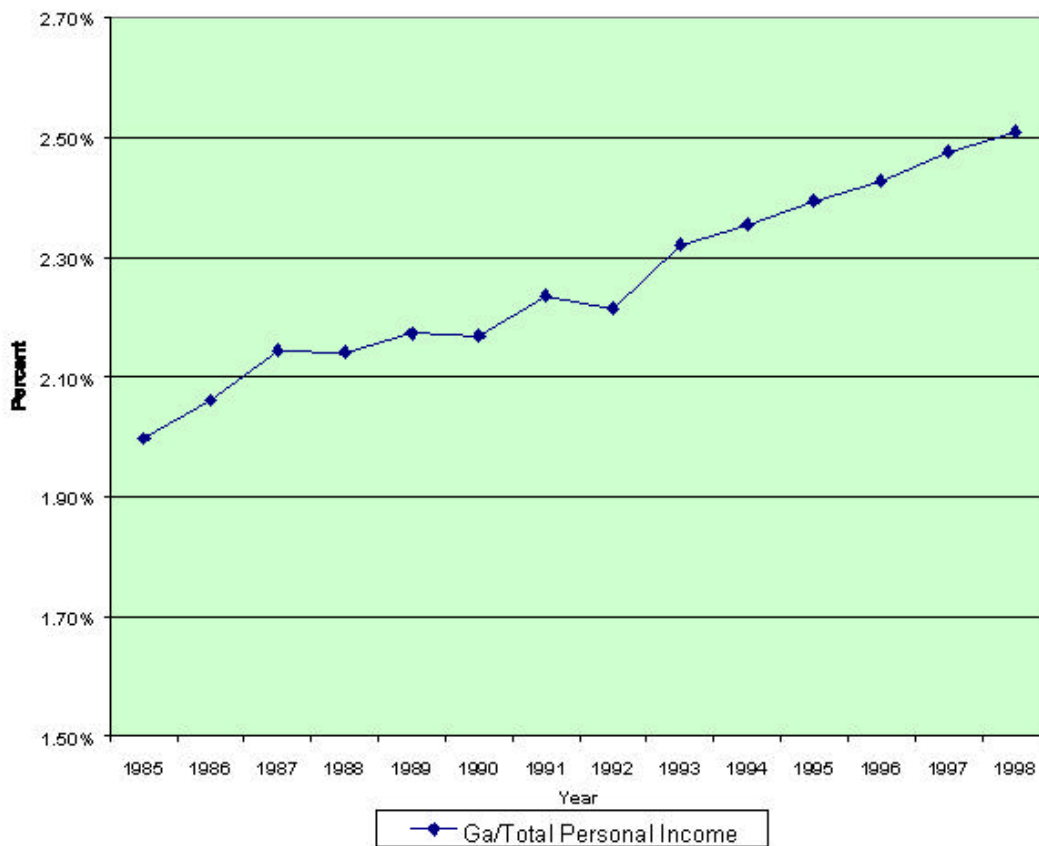
We presented some evidence above which suggests that the underlying base of the corporate income tax is growing smoothly at the federal level. This squares with the finding that federal corporate tax revenue growth is at least keeping up with overall tax receipt growth at the federal level. However, Georgia's corporate tax take relative to that of the federal government fell from 1985-1990. Is it that the taxable income for each is growing differently or that the tax structures have made different adjustments to increase the wedge between receipts federal versus state corporate income taxes? We can start that investigation by comparing economic activity in general (measured as GDP and GSP for the federal and state levels respectively) and then moving on to a discussion of the change in corporate profits. As noted earlier, we can not easily distinguish profits from "Georgia firms" versus profits in general. This is due to the nature of businesses--they operate in various states and they apportion income to the states in which they do business. Since the apportionment formulas vary from state to state there is no consistent way to measure profits allocated to each state. In fact, we are not sure that corporate profits are taxed at 100 percent, less or more on a national basis.

The issue we are investigating here is whether there is evidence that the corporate tax base in Georgia has grown faster or slower than that of the US. One way to look at this issue is to compare a general measure of the corporate tax base Georgia (before any tax treatment) through gross state product as a measure of overall economic activity in the state. A similar measure at the federal level is gross domestic product. Both statistics measure overall economic activity and therefore include income that will show up in the

corporate and individual income tax bases. Comparing these will in any case give us some idea of where to turn next--if Georgia GSP is growing more slowly than national GDP, a case can be made that we expect Georgia's corporate revenues to grow more slowly than federal corporate revenues. If Georgia is growing more quickly, we need to investigate the distribution of GSP for more clues.

The information in Figure 8 shows very clearly that Georgia's GSP has grown more quickly than GDP of the nation, except for the recessionary period of 1990-91. The general trend in the ratio of Georgia GSP to national GDP is upward for the period studied, ranging from a low of 2.19 percent in 1983 to 2.77 in 1997. If corporate profits tracked this general measure of growth, we should expect the state corporate income tax revenues to grow at least as quickly as the federal tax revenues if tax policy changes did not occur. So, what has happened?

FIGURE 8. GEORGIA/US TOTAL PERSONAL INCOME



The next step would be to move a little closer to an analysis of the relative changes in corporate profits (again, we do not have statistics on such for states). To do this, we can compare corporate profits by industry at the national level and compare growth by industry to GSP growth by industry for the state of Georgia. The idea is to analyze whether Georgia's output growth has come in sectors which are more or less profitable, measured in a variety of ways. If the state's growth has come in industries which are profitable on a national basis, and we assume the same profitability of those industries in

Georgia, we should expect the tax base in Georgia to grow somewhat similarly to that of the nation. If the opposite is true--that Georgia's growth has come in less profitable industries, then we might have another piece of the puzzle answered.

We look at the following data for 1980-97 by industry: NIPA corporate profits before tax (which is a more expansive tax base than that measured by tax data), SOI net income less deficit (a tax base measure which includes federal deductions), and SOI tax liability (the corporate tax liability figures for the federal corporate income tax). We compare the growth of these indicators with the growth in Georgia's GSP by industry. We examine these statistics for two sets of years, 1980-1990 and 1995-1997. Since the data seem to show some significant adjustment pre and post recession, these years will allow us to investigate what may have happened in the underlying structure of the corporate income tax for Georgia (recall again that the apportionment factor changed in 1995 and may be a factor in explaining the more recent stability of corporate income tax growth in the state).

Since Georgia's overall economic growth has been so strong, it is difficult to piece together the analysis of whether growth for certain industries has resulted in a tax base that grows less than the national average. If the industries that are growing fastest in Georgia are those with less growth in pre-or post tax income, Georgia's tax base and receipts may be dampened. We'll take it one step at a time.

Comparing NIPA pre-tax growth by industry to Georgia's GSP growth by industry, we notice a couple of trends. NIPA pre-tax growth (profits growth that does not include many of the tax allowances) is strongest in the FIRE (finance, insurance and real estate), transportation/communications, construction, agriculture and services industries. Georgia's GSP growth mirrors this very closely although the magnitude of relative growth of each sector is somewhat different--the growth industries in Georgia are services, FIRE, agriculture, construction and transportation/communications. If we decompose this analysis further and look at the change in concentration by industry, we get a slightly different picture of what is going on. The changes are really quite subtle and can not necessarily be picked up by simply looking at aggregate data. What we find is that while FIRE and services as a percent of all output has increased in Georgia, it has increased even more in the US as a whole. This is important because the net effect on the growth of corporate tax receipts is affected by the relative weight of each industry and the change in this weight over time.

Moving to the tax related-definitions of income and to tax liability, we see similar trends for the US as seen for the NIPA pre-tax profits. Tax reported net income less deficit has grown most for the FIRE and transportation/communications industries. Growth was negative for agriculture, mining, and wholesale-retail trade. SOI tax liability (federal corporate tax liability) posted the strongest growth in the FIRE, transportation/communication, and services industries. Simply analyzing the pattern of these data, one is hard pressed to conclude that growth industries in Georgia are similar to industries with growth in corporate profits liability at the federal level. The changes are too many and too varied. Also, since the overall tax base must be considered, we should be investigating changes relative to the average for Georgia and for the US. There is a more direct way to do this.

If we define the industry weighted share of the federal corporate tax receipts as t_i (where t is the share of corporate tax liability of industry i and s is the share of industry i

in total output) , we can decompose the weighted effect of changes in tax receipts as follows:

$$\Delta(t_i \cdot s_i) = s_i \cdot \Delta t_i + t_i \cdot \Delta s_i + \Delta t_i \cdot \Delta s_i$$

What this decomposition does is allow us to determine the impact of increased (or decreased) concentration of particular types of industries in the tax take (the t_i) and at the same time weigh these changes by changes in the economic base (the s_i). If tax liability is growing most for industries which are losing their share of the economic pie in Georgia but gaining nationally, then we would expect tax receipts in Georgia to grow more slowly on than the national average. This is not about a reduction in economic growth, rather it is about a shift in the composition of the economic base and the effect of that shift in the growth of tax receipts.

We find some interesting results. First, if we apply the change in the concentration of federal tax liability from 1980-1990 to the 1990 distribution of industries (one industry as a percent of all industries) in Georgia and the US, we find that the sum of the weighted change in tax receipts is greater for the US than for Georgia. This means that Georgia's economic base structure in 1990 was not weighted as heavily toward the industries which increased their share of tax liability from 1980-1990. For example, FIRE posted the largest growth in the concentration of tax liability and while Georgia's concentration of FIRE is high, it is not as large a component of Georgia's base as it is of the US average. Therefore, the "pop" or growth in federal tax receipts will be greater than the growth in state tax receipts all else held constant. Summing industry by industry, we find that there is more growth in tax-paying industries in the US than in Georgia.

In the second part of the analysis we calculate the change in the concentration of industries to determine whether not Georgia's economic growth has come in industries which shoulder a higher percentage of the federal corporate tax burden. From this part we see that manufacturing (which shoulders a large share of the total tax burden) declined in importance in Georgia's base. Although it declined for the US as well, it decreased less at the national level so the weighted tax effect gave the US tax receipts more growth relative to Georgia. Similar trends for other industries results in a situation where the tax liability weighted by the relative industrial growth in Georgia is slightly less than for the US as a whole.

Combining these effects gives an exciting result--the difference in weighted growth of tax liabilities in Georgia is about 28 percent less than that of the US over the period 1980-1990. At the end of the period in which Georgia's corporate income tax revenues fell as a percent of federal revenue, Georgia's share had fallen by about 32 percent. The divergence of the economic base changes relative to the tax-related profits changes (measured as federal corporate tax receipts) seems to answer much of the question regarding Georgia's corporate tax growth for the 1980-1990 period. This could be due to a natural attrition of firms or the attraction of profitable firms to states with lower (or no) corporate tax liability, or a variety of other reasons.

Expanding the analysis for more recent years, we find that from 1995-1997, the net effect of changes in the concentration of tax liability coupled with changes in concentration of industries indicates that the federal corporate tax receipts could be expected to grow 4 percent faster than Georgia's receipts. The most recent years have seen some fluctuation in the revenue pattern of the state relative to the nation, but from

1995 to 1997 we did see a loss of the state relative to the federal receipts of about 4.5 percent. This is very close to the estimated impact of the industry concentration analysis and we therefore conclude that the industrial make-up of the state continues to be an important determinant of the growth in receipts, past and present.

It is interesting to note that growth in profits (by NIPA definition) are strongest in transportation/communications, FIRE, construction, and services, while the tax liability growth (federal level) is strongest for FIRE, transportation/communications, and services. This suggests a wedge is driven between profits more generally defined and taxable income, and that the wedge differs by industry although there is some similarity in the general growth rates by industry.

This analysis has been quite helpful in analyzing the declining growth in the state corporate income tax in Georgia, especially relative to the nation. While there are other competing changes which are yet to be examined, the changes to the economic base seem to be a major culprit in explaining the trend of a relative decline in state corporate income tax receipts. In the 1980-1990 period, Georgia was less and less concentrated in industries in which a higher concentration of tax liability was found. At the same time, the concentration of industry in Georgia grew more for industries which had a smaller share of tax liability, on average. The net effect is that due to the changing composition of the economic base, we would expect a significant drop in state tax receipts in Georgia relative to federal tax receipts (assuming that the close correspondence between the two taxes holds). For the more recent period, we see much less difference between the expected growth rates of Georgia income taxes and federal by the changing industry hypothesis is very credible even in the more stable time period.

Another piece of the puzzle to explain corporate tax revenue growth in Georgia deals with tax competition--that combination of tax policy changes and the resulting impacts on tax bases. As an economic development tool, some states have taken to reducing effective corporate tax rates to attract new businesses. This is done with changes in tax rates, changes in apportionment formulas, and changes in deductions and credits. States hope to attract businesses to their location--new companies as well as relocations of old companies. If this is a successful endeavor, we should expect to see larger growth in the tax base (this may or may not translate into increased growth of tax revenues as it depends on the relative tax rate decrease and the base increase).

It is very difficult to tabulate the change in effective tax rate by state for a number of years. As a proxy, we will use Oslund's (1999) classification of rate changes for 1982-1995. Using data on tax structures from the Advisory Commission on Intergovernmental Fiscal Relations, she calculates the change in the top statutory tax rate between two periods: 1982-88 and 1989-1995. A "-" or "+" means that states decreased/increased their rates, a "--" or "--" means that states decreased/increased their rate by at least 0.5 percentage points. The following reproduces her analysis:

State	Director of Change
California	-
Colorado	-

Florida	+
Iowa	+
Illinois	++
Kansas	+
Minnesota	–
Missouri	++
Nebraska	++
New Jersey	+
New York	–
Ohio	–
Oklahoma	++
Pennsylvania	++

Evidence of tax rate effects? A guarded yes might be an answer. Here we are looking at statutory tax rates only so the effect of other incentives is not measured. We are also comparing tax increase to tax rate decrease states and the difference in GSP growth pre-recession is 1.1 percentage points per year. Georgia was not a tax increase state during that period of time, so it is very difficult to conclude that the effects of tax competition explain the loss of corporate tax growth pre-recession using the statutory rate as an indicator of reduced effective tax rates. Georgia's statutory tax rate is slightly higher than the average in the Southeast. A more detailed analysis which measures effective rates should be conducted to investigate the effect of tax policy on the attraction of business. To date, there has been mixed evidence on the effect of these and other incentives on economic development. The corporate income tax is a stranger animal because firms can work to apportion their receipts, property and payroll in a way to minimize tax liability. This is different than investigating a property tax relief program, for example. In that case, we have only one component of business to investigate (property holdings). In the case of the corporate income tax, a business can do business in a state but pay relatively little tax if it is successful in seeking out the lowest tax rate for each taxable component.

To date, the literature suggests that in the short-run, the impact of double weighted receipts formula is small in the short-run (Edmiston, 2000). Over the longer-run, the economic development incentives may be more significant. There are potential revenue consequences however, and these depend on the mix of industry in a state.

Effects of Tax Policy Changes

Many of the changes in the federal and state corporate income taxes over the past two decades have contributed to changes in tax receipts. The whole form of incorporation issue is a function of tax policy changes (changing the statutory tax rates facing business entities). In addition, there are tax policy changes which more directly alter the tax base: exemptions, credits, changes to depreciation rules, etc. In some cases, business entities can respond by changing their investments, mix of capital and labor, and research and

development. In other cases, the taxpayer just goes along with the policy changes and their effect on increasing or decreasing the tax base.

Since Georgia's corporate income tax is closely coupled to the federal corporate income tax, policy changes at the federal level affect the base and receipts at the state level. Over the past two decades, the changes at the federal level have been many. We've already mentioned the TRA86 and its far-reaching affects on many aspects of businesses (depreciation, debt-equity mix, incorporation). The Economic Tax Recovery Act of 1981 (phased in through 1983) changed the relative individual and corporate tax rates, accelerated business depreciation and allowed an easier transfer of losses. There have also been changes to the investment tax credit and research and development credits over this period of time. All of these changes have had some impact on federal and therefore state corporate tax bases and receipts.

The literature is full of estimates of the effects of these changes on reported corporate receipts, income, deductions, and credits. Unfortunately, there is little consensus as to the magnitude of these behavioral responses, and less information on responses by industry. The impacts of all of these changes on Georgia's corporate tax base is beyond the scope of this study. For now, we will concentrate on trying to explain the divergence of Georgia's corporate income tax growth from that of the federal corporate income tax. We may simply assume that the effects of the federal tax policy changes on the federal and state tax base are similar. This may or may not be true--it depends on the use of various credits, deductions, and profit structure by industry. In fact, there is evidence presented below that Georgia's industry make-up is different from that of the US. This would suggest that federal tax policy changes have had a differential impact on Georgia's corporate tax base. This issue is left for future research.

Another way to reduce tax revenue is to reduce the corporate tax rate. This has not happened in Georgia, although it has occurred in other states and may add to the explanation of falling state corporate tax revenues at large (Oslund, 1999). Georgia did conduct a tax amnesty in the fall of 1992, which may have helped to bring the receipts out of the recession slump. Still, Georgia's receipts growth was less than states overall during that period, so the amnesty is not a strong explanation of the patterns of growth witnessed during this period.

Over the past two decades, especially over the last decade, Georgia has implemented some potentially important tax incentives for businesses. The jobs tax credit of 1990 and the BEST legislation of 1994 could be factors in reducing the tax base of the corporate income tax in Georgia. Faulk, et. al. (2000) present a detailed analysis of Georgia's economic development incentives. Based on a detailed investigation of corporate tax returns, they estimate that very few eligible firms take the jobs tax credit. In 1996, the total of credits awarded firms based on five of the BEST credits was about \$33 million or approximately 4.5 percent of net corporate tax revenues in that year. The following year it was about \$20 million or 3 percent of net corporate tax revenues for 1997.

The effect of these tax expenditures could explain the difference between the importance of the corporate income tax in Georgia versus other states, but other states have developed their own incentives. Oslund (1999) reports that in 1996, 44 states offered job credits and 39 offered investment credits (up from 12 for each in 1980). Estimates for the state of Kansas are that corporate tax incentives cost 2.6 percent of

corporate revenue in 1996. At this point, we do not have estimates of the costs of each states corporate tax incentives so a direct comparison is difficult.

Since the state tax incentives stand separate from the changes at the federal level, we can estimate how much Georgia's tax credits explain the relative loss in corporate revenue growth for the state relative to the federal government. In 1996, the cost of the credits explains about 11 percent of the difference in the post-TRA86 gap that opened between federal and state corporate tax revenues. Although tax expenditure estimates are not available for other credits and adjustments to the corporate tax base and revenues for Georgia, it is unlikely that these are more than a few percentage points of the tax base. The "credit story" does help explain some of the differential growth in revenues in Georgia post-TRA86, but leaves a lot of the difference still without answer. Once again, a panel of tax returns would be invaluable to estimating costs and the long-run usage of various credits, deductions and adjustments. Also, given the recent expansion in BEST legislation, we may be seeing only the beginning of the effect of these incentives on the corporate income tax. Anecdotal evidence from the Georgia Department of Revenue and a handful of tax advisors suggest that firms are trying to expand their use of the credits.

One more specific policy issue is worthy of investigation. Georgia went to a double-weighted sales apportionment formula in 1995. Previously, receipts, payroll, and property were each weighted equally when apportioning reported income to Georgia. Corporations now must weight receipts by 50 percent, property by 25 percent and payroll by 25 percent. The expectation of such a change is that firms with more investment in Georgia (measured as property and payroll) would see a slight reduction in state corporate tax liability relative to those companies that have little property and payroll in the state. We do witness an increased growth in corporate tax revenues in 1995. Whether this is due to the change in apportionment and an increase in corporate tax liabilities is not obvious. First, note that from 1991 on, the corporate tax receipts grew in Georgia as a result of the recovery from the recession so 1995 might be considered part of the recovery. Growth between 1994 and 1995 was 22.88 percent; from 1992-93 it was over 25 percent; from 1993-94 it was 13 percent.

On the other hand, in 1995, Georgia corporate receipts as a percent of federal receipts recovered about 0.02 percentage points--equal to about 45 million dollars of state corporate tax receipts (7 percent of corporate tax revenue in 1995). It is probably unrealistic to assume more than 25 percent of that growth comes from the apportionment change. However, timing of payments is an issue here. When a major change in tax policy occurs, it is not unusual for the timing of payments to change. In some cases, firms may not have been fully informed of the effective date of the apportionment formula change and could have made estimated payments according to the old rules or pre-payments to avoid penalties. In any case, the timing effects will wash out over a year or two. Like a broken record, we point out that a better estimate of the effect of the apportionment change could be made with a panel of tax returns.

This section points out that policy changes may be a partial answer to some of the differential growth in the federal versus state corporate tax receipts. Note, however, that all of these policies relate to events post-1990-91 recession. Remember that the biggest drop-off in state corporate tax receipts took place from 1983-1991. These policy changes therefore may help explain the smaller difference between overall tax growth in Georgia and corporate tax growth post-1994.

Where Are We?

We have examined trends in the growth of the federal and state corporate income tax over the last two decades. The following trends and explanations appear to be the strongest:

- Federal corporate tax receipts have increased as a share of total federal receipts in the last two decades. The pattern is not smooth, but the trend is slightly up. It is still possible that corporate receipts could have been higher in the absence of tax policy changes which may have increased disincorporation and induced other behavioral changes. The federal corporate income tax has not grown as fast as the personal income tax.
- Georgia's corporate tax receipts have declined as a percentage of total state tax collections, as is true of states in general. The state's corporate tax receipts have also declined as a percent of federal tax receipts. Over the period studied, most of that decline was from 1983 to 1991. Since 1995, the pattern of growth has leveled off compared to other states and federal corporate revenue growth. The level of corporate tax revenue in Georgia compared to all tax revenue in Georgia never quite recovered after the recession, but the pattern seems to have stabilized. Georgia's corporate tax receipts took a bigger hit during the recessionary period of 1990-91 than the average state.
- One explanation for lower federal and state corporate tax receipts is the disincorporation hypothesis. This means that due to tax policy and law changes, business entities can by-pass the corporate tax structure by passing income through to owners, shareholders, and partners. There is some evidence of this at the federal level. If Georgia's form of incorporation structure is similar to that of the nation, it is one explanation for somewhat weaker than possible corporate tax receipts but it does not add to the explanation of why Georgia's receipts have grown more slowly than the federal receipts. If however, disincorporation has occurred to a greater extent than the national average, then it does count as a potential explanation. A panel of corporate tax returns would be useful in investigating this hypothesis further. If this is an issue, there is really little the state could do unless it wished to de-couple from the federal rules governing the tax treatment of various forms of businesses. This would be a costly administrative change.
- The mix of industries in Georgia seems to be the most likely candidate for explaining the reduction in state corporate tax receipts to federal receipts, especially over the 1980-1990 period. Georgia's economic expansion was concentrated in industries which paid a smaller share of corporate income tax either because of their profitability or specific treatment of certain expenses and losses in the tax code. It is not possible at this time to determine whether this shift in industry has occurred as a result of the tax system.
- The changing mix of industry in Georgia could be accompanied by increases in expenses due to above average expansions and possibly higher debt to equity ratios for such expansions. These expansions could be investigated with a panel of tax returns.

- There have been some tax law changes which may contribute to the loss in corporate tax revenue in the state. In particular, the BEST legislation of 1994 and its expansion in 2000 offer a host of tax credits to corporations in the quest for economic development. Through 1997 the usage of these credits appears small, but anecdotal evidence suggests that firms are paying more attention to the credits and their usage may be on the rise.
- There are some other specific tax policy issues which plague the corporate income tax. The use of separate accounting encourages tax planning such that companies report as few taxable profits in Georgia as possible. A tax amnesty in late 1992 may have affected the growth of corporate tax revenues post recession and an expanded depreciation allowance in 1990-91 may have contributed to the same.

Many of the remaining questions--the extent of tax planning, the impact of differential tax rates among states, the effect of expanded credits, and the disincorporation hypothesis can be more fully investigated with a panel of corporate taxpayers. Such analysis is necessary to quantify these potential changes so that we better understand what has happened to the corporate income tax in the state and what might happen in the future. Quantifying the costs of such evasion behavior and the tax expenditures of the state government are important inputs in the development of a rational, long-term corporate income tax policy.

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Table 1. Comparison of Top Individual Income Tax Rates and Top Corporate Tax Rates

Year	Fed PIT top rate	Fed CIT top rate	GA PIT top rate	GA CIT top rate
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