THE GOVERNOR'S CORPORATE TAX REDUCTION PROPOSAL

How Would the Governor's Proposed Tax Cut Affect Corporations, California's Business Climate and Overall Economy, and the State's Fiscal Condition?

Summary

The main feature of the Governor's 1997-98 tax reduction proposal is a 10 percent reduction in the bank and corporation tax rate, to be phased in evenly over a two-year period. This rate reduction proposal follows a 5 percent rate reduction that was enacted last year. The basic rationale for the proposal is to further improve California's business climate relative to competing states, thereby fostering continued corporate investment, job creation, and overall economic expansion. The proposal's net state revenue impact would be $90 million in 1997-98 (a partial-year effect), rising to $608 million in 2000-01 (when fully implemented). The tax reduction's benefits to corporations would be roughly proportional to their current-law share of tax liabilities. About 15 percent of businesses in California would have their taxes reduced in any given year.

Relative corporate tax burden comparisons between states are difficult to make. However, at present, California's corporate tax burden seems to be relatively high, although when all taxes affecting businesses are considered, its burden ranks in the middle and is not significantly out of line with comparable states. The state's relative tax rate ranking among western and industrial states would not change significantly if the Legislature adopted the proposal, although its position in terms of overall tax burden on businesses would improve somewhat.

The proposal would have a variety of offsetting effects which would have to be weighed against each other. It would tend to stimulate the private economy by decreasing the cost of "doing business" in California, thereby leading to increased investment and job creation. The magnitude of these impacts, however, would depend on a variety of difficult-to-predict behavioral and "dynamic feedback" effects. Offsetting factors would include out-of-state "leakages" of a portion of the tax reduction and the effects of reduced public-sector spending on the economy.

In examining the proposal, the Legislature will need to decide what its tax-policy and expenditure objectives are, and evaluate the proposal's fiscal and economic effects on taxpayers and the state generally.

INTRODUCTION

One of the key proposals in the *1997-98 Governor's Budget* is an income tax reduction for banks and corporations. The proposal's main provision calls for a 10 percent bank and corporation income tax rate reduction, phased in evenly over a two-year period beginning January 1, 1998. Last year, legislation was enacted that reduced the bank and corporation tax rate by 5 percent. This proposal would reduce the tax rate by an additional 10 percent, completing a total bank and corporation rate reduction of 15 percent, similar to that originally proposed by the Governor in both the 1995-96 and 1996-97 budgets. (These earlier proposals also included a personal income tax reduction.) In addition to the tax rate reduction, the budget also contains a proposal to partially conform state tax law to federal tax law involving Subchapter S corporations.

In this analysis, we first discuss the proposal's provisions, its fiscal effects, the Governor's basis for making the proposal, and some of the criteria that the Legislature might wish to consider in evaluating it. We then provide information on California's past and present corporate tax environment, and compare California's tax treatment of corporations to that of other states. Next, we discuss the proposal's economic effects. Lastly, we identify various alternative tax-change options that the Legislature might wish to consider—either in lieu of or in conjunction with the Governor's proposal—based on its underlying tax-policy and expenditure objectives.

WHAT IS THE GOVERNOR'S TAX REDUCTION PROPOSAL?

As noted above, the main feature of the Governor's 1997-98 tax reduction proposal is a 10 percent reduction in the state's bank and corporation tax rate, phased in over a two-year period. This rate reduction would apply to both the state's corporate franchise and income taxes.

The current tax rate of 8.84 percent would be reduced to 8.4 percent (a 5 percent reduction) effective January 1, 1998, for taxpayers with income years beginning on or after this date. A second 5 percent reduction would occur on January 1, 1999, reducing the bank and corporation tax rate to 7.96 percent, which would be 10 percent lower than its current level. The state's alternative minimum tax (AMT) for corporations would be similarly reduced.

Subchapter S Corporation Change. The budget also contains a proposal to partially conform state tax law to recent federal Subchapter S corporation tax law changes. Subchapter S corporations are closely-held corporations that enjoy certain special tax benefits. Specifically, for tax purposes, they are allowed to directly "pass through" their income to their shareholders where it is taxed, as opposed to having it first be subjected to regular corporate tax treatment. (At the federal level, no corporate tax rate is applied at the entity level, while in California, a reduced 1.5 percent special corporate tax rate is applied.) The reason why Subchapter S corporate status can be advantageous to taxpayers is that total tax liabilities associated with a corporation's income can be reduced, and net corporate *losses* can be directly deducted on the tax returns of its shareholders.

The Governor is proposing to increase the number of shareholders that a Subchapter S corporation can have from 35 to 75, which would conform to a recent federal law change. It should be noted that this federal change was accompanied by a variety of other changes in the tax treatment of Subchapter S corporations. The Governor, however, is not proposing to conform to these.

WHAT WOULD BE THE FISCAL EFFECTS OF THE PROPOSAL?

In considering the proposal's impact on California, two effects are of particular interest: (1) the *fiscal effects* on individual corporate taxpayers and on the state generally, and (2) the *economic effects* in terms of such factors as business location and retention, increased corporate investment, and job creation. In this section, we discuss the fiscal effects.

Of course, the proposal's fiscal and economic effects are not unrelated. In particular, to the extent that a tax reduction results in behavioral effects by businesses, such as new investment and growth in jobs, its fiscal impacts will be influenced accordingly. Similarly, if the tax cut resulted in reduced public expenditures on certain public services, this could affect its economic effects. These economic effects are discussed later.

Static Revenue Cost Would Be About $600 Million by 2000-01

Figure 1 (see next page) shows the Franchise Tax Board's (FTB) most recent projected fiscal impacts of the Governor's proposed tax reduction, along with the estimated effects of the tax rate reduction enacted last year. (These updated figures became available after the budget was released, and are somewhat lower than those released by the Governor.)

The figure indicates that this year's tax reduction proposal would reduce state revenues by $90 million in 1997-98 (a half-year impact), increasing to $608 million in 2000-01 (the first fiscal year that all taxable corporate net income would be taxed at the lower tax rate). These estimates include the Governor’s proposal to partially conform to recent federal Subchapter S changes. Including the tax rate reduction enacted last year, the estimated state revenue reduction in 1997-98 would be $320 million, rising to $928 million in 2000-01.

Figure 1

Effect of Corporate Tax Rate Reductions and Subchapter S Proposal[a]

(In Millions)

	State Revenue Reductions				
	1996-97	**1997-98**	**1998-99**	**1999-00**	**2000-01**
1996 Change					
Rate reduction effective beginning 1997 (5 percent)	-$85	-$230	-$290	-$300	-$320
Governor's 1997-98 Tax Reduction Proposal					
Rate reduction effective beginning 1998 (5 percent)	—	-$85	-$225	-$285	-$300
Rate reduction effective beginning 1999 (5 percent)	—	—	-85	-235	-300
Subchapter S conformity provision	—	-5	-7	-7	-8
Subtotals, 1997-98 proposal	(—)	(-$90)	(-$317)	(-$527)	(-$608)
Totals	**-$85**	**-$320**	**-$607**	**-$827**	**-$928**

[a] Estimates of the state revenue reduction were provided by the Franchise Tax Board. These numbers reflect revised estimates made after the *1997-98 Governor's Budget* was released on January 9, 1997.

The Governor’s current tax reduction proposal would automatically reduce the Proposition 98 minimum funding guarantee from what it otherwise would be. The amount of this reduction would be $58 million in 1997-98 and $158 million in 1998-99.

Corporate Tax Savings Would Be Partially Offset by Higher Federal Taxes. A portion of the state tax savings to corporations would be offset by higher federal income taxes. This occurs because corporate taxpayers are allowed to deduct state income tax liabilities (as an expense) when computing their federal taxable income. (If a corporation’s state income tax liabilities were reduced due to the proposal, then the amount it could claim as a business expense on its federal return would likewise be reduced. Consequently, its net income for federal tax purposes would rise.)

The amount of the federal offset for any one corporation would depend upon its federal marginal tax bracket. On average, however, FTB estimates that roughly 30 percent of the total state tax savings to corporations would be offset by higher federal tax liabilities.

Which Businesses Would Benefit?

The distribution between corporations of the dollar benefits from the proposed tax reduction would be roughly in proportion to their current share of taxes paid. That is, corporations who currently pay the most taxes would get the largest benefits, and vice versa for those who pay less.

According to FTB, there are over one million businesses filing tax returns in California. About 600,000 of these are partnerships and sole proprietors that file personal income taxes. Somewhat over 400,000 are corporate tax filers, and about one-fourth of these are Subchapter S corporations. Thus, about 30 percent of all businesses in California in a given year would have the potential of receiving tax reductions under the proposal. Of these, approximately half report net income subject to state taxation and the remainder report losses. Therefore, about 15 percent of businesses in California would have their tax burden reduced in any year.

Of those corporations that would receive tax savings, about 80 percent of the tax savings would go to large corporations with net taxable California income of over $1 million. These firms represent about 1.3 percent of all corporate tax returns filed annually.

Of course, given the volatile nature of corporate profits, the actual number of businesses reaping at least some benefit from the proposal would be considerably greater. This is because some companies that do not earn positive profits in one year (and thus do not benefit from a tax cut) will earn them in a subsequent year (when they will benefit).

The Parity Issue—Corporate Versus Noncorporate Businesses. As noted earlier, only corporate businesses would benefit from the proposal. In contrast, noncorporate businesses (such as partnerships and sole proprietorships) would continue to be subject to personal income tax rates of up to 9.3 percent. As a result, income of noncorporate businesses could be taxed at marginal rates as much as 15 percent higher than the rate on corporate income.

Distribution of Tax Savings by Industry. In the 1994 income year (the most recent complete year for which data are available), over half of corporate tax liabilities came from the manufacturing, finance, and finance-related industries. Because a flat tax rate is levied on corporations in California, the share of tax savings by industry would be proportional to the amount of tax liabilities paid. Thus, over half of the tax savings under the proposal would go to corporations in these industries. Corporations in the transportation, utilities, and trade sectors would receive about a third of the tax savings, again reflecting their share of taxes paid. The remaining 15 percent of tax savings would be mostly distributed among corporations in agriculture, mining, construction, and services.

WHAT IS THE BASIS FOR THE PROPOSED TAX REDUCTION?

Second Phase of Original Plan. As indicated above, the 10 percent corporate tax rate reduction proposed in this year's budget would complete the Governor's original objective with regard to corporations put forth in each of the past two years of an eventual 15 percent phased-in bank and corporation tax rate reduction.

Underlying Rationale—Stimulate the Economy. The Governor's stated objective for his proposal is to further stimulate economic growth in California and enhance its business climate, thereby creating more jobs and income for its citizens. As in his two prior tax-related budget proposals, the Governor's basic rationale for this proposal is three-fold:

- California's corporate tax rate still remains relatively high among states—the 14th highest in the nation.
- Further reduction in the corporation tax rate is needed to bring California's corporate tax burden into line with that of other states in order to improve our competitive position.
- By reducing corporate taxes, corporate investment and job creation will be stimulated in this state.

THE ROLE OF STATE TAXES IN BUSINESS DECISION MAKING

Before going further, it first is useful to briefly consider an important underlying question relating to the Governor's proposal—namely, to what extent do state taxes "matter" to businesses?

Many Factors Affect Business Decisions . . .

A state's tax structure is one of a number of key elements influencing the business climate. In fact, many studies have ranked other factors higher in terms of their influence on business locational and investment decisions (although taxes certainly appear on the list). The specific ranking of factors (including taxes) can vary depending upon the particular industry and business involved. Some of these other factors that businesses typically rank as important include access to markets, availability and costs of labor and other inputs, geographic characteristics, climate, infrastructure (such as transportation facilities), regulatory environment, quality of public services for employees and their families (such as schools), and housing prices.

. . . However, Taxes Do Matter

Despite the above, there is evidence that state tax policies can play an important role in business-related locational and investment decisions "at the margin"—that is, once a business' "highest priority" factors have been taken into account and it still finds itself trying to choose between competing locations. It also is important to note that state tax policy is an element of a state's business climate that can be changed in the near term, because it is under the direct control of policy makers. Sometimes, this can be especially important for businesses already located in a state but considering moving elsewhere.

Thus, the "bottom line" is that although various other factors are frequently more important than state taxes per se in business locational and investment decisions, state taxes can and do "matter."

CRITERIA TO CONSIDER IN EVALUATING THE PROPOSAL

In addition to its fiscal effects on the state, there are several other key criteria that the Legislature may wish to consider in its evaluation of the Governor's tax proposal. These include:

- *First*, how does California's current tax treatment of corporations compare with other states, and how would the Governor's proposal affect the state's relative comparability?

- *Second*, what would be the economic effects of the proposal, including its impact on business locational decisions, investment in California, new job creation, and the overall level of economic activity within the state?

- *Third,* how does the proposal "measure up" to the Legislature's own views regarding desirable tax policy, including the appropriate state tax burden for individual corporations to bear, and the right mix of the overall state tax burden between the different types of taxes the state levies?

HOW DOES CALIFORNIA COMPARE TO OTHER STATES?

Comparing the corporate tax structures between states can be a complicated undertaking. True, it is relatively simple to compare specific tax provisions themselves. However, developing meaningful interstate comparisons of the "overall" tax treatment of corporations is a different story. This is largely because tax structures—especially corporate tax structures—can have so many different elements, including rates, exclusions, exemptions, deductions, credits, and deferrals. And, even within these individual tax-structure elements, there can be complicated interstate differences, such as alternative rules for computing depreciation deductions and varying methodologies for calculating allowable amounts of specific types of tax credits.

No Measure Is Perfect. Given the above, a variety of approaches can be used for comparing the overall tax treatment of corporations. For example, at the most general level, one can make interstate comparisons of corporate tax revenues relative to total state tax revenues collected. Or, if one wants to focus on specific factors that may influence certain businesses decisions, then looking at key features of the tax structure such as tax rates or tax credits might be of interest. A more refined approach would be to calculate and compare tax liabilities in different states for firms with similar characteristics, such as industry type, internal structure, size, financial performance, and other key defining attributes.

Each of these and other approaches to making interstate corporate tax comparisons can be of use, depending on what one's primary focus is. However, they each also have their own limitations. Given that there is no "perfect" measure of interstate corporate tax treatment, we provide below several types of comparisons that will at least shed some light on this issue.

Comparison of Elements Of the Corporate Tax Structure

Corporate Tax Rates

California's Tax Rates Have Generally Declined in Recent Years. Figure 2 provides a history of California's bank and corporation tax rates

Figure 2

History of California Bank and Corporation Tax Rates

Income Year	General Tax Rate	Composite Tax Rate for Banks And Other Financials[a]	Subchapter S Corporation Tax Rate[b]	Minimum Franchise Tax	Alternative Minimum Tax Rate
1929-1932	2.00%	2.00%	—	$25	—
1933-1934	2.00	6.00	—	25	—
1935-1942	4.00	8.00	—	25	—
1943-1949	3.40[c]	7.40	—	25	—
1950-1958	4.00	8.00	—	25	—
1959-1966	5.50	11.00	—	100	—
1967-1971	7.00	11.00	—	100	—
1972	7.60[d]	11.60	—	200	—
1973	8.30	12.30	—	200	—
1974-1979	9.00	—[e]	—	200	—
1980-1981	9.60	11.60	—	200	—
1982-1986	9.60	—[e]	—	200	—
1987-1988	9.30	—[e]	2.50%	300	7.00%
1989	9.30	—[e]	2.50	600	7.00
1990-1993	9.30	—[e]	2.50	800	7.00
1994-1995	9.30	—[e]	1.50	800	7.00
1996	9.30	11.30	1.50	800	7.00
1997	8.84	10.84	1.50	800[f]	6.65

[a] Composite tax rate consists of the general tax rate plus an add-on tax rate that is paid in lieu of personal property taxes and local business taxes. Prior to January 1, 1996, the add-on tax rate was set annually by the Franchise Tax Board based on personal property and business taxes paid by nonfinancial corporations. This rate now is statutorily set at 2 percent.

[b] These corporations are subject to the minimum tax but not the alternative minimum tax.

[c] Tax rate reflects temporary reduction that was first enacted during World War II and subsequently renewed through income year 1949, after which the reduction was allowed to lapse and the rate returned to its previous level.

[d] Rate was increased beginning on July 1, 1973 on a monthly prorated basis until it reached 9 percent for income years ending on and after June 30, 1974.

[e] Add-on rates for these years dropped below the maximum 4 percent. The rate (in percent terms) was 3.707 in 1974, 3.978 in 1975, 3.772 in 1976, 3.425 in 1977, 2.73 in 1978, 1.633 in 1979, 1.307 in 1982 and 1983, 1.33 in 1984, 1.22 in 1985, 1.458 in 1986, 1.344 in 1987, 1.368 in 1988, 1.441 in 1989 through 1991, 1.707 in 1992, 1.807 in 1993, 2.17 in 1994, and 2.329 in 1995.

[f] New corporations with gross income under $1 million would be subject to a $600 minimum tax in their first year of incorporation. To qualify for this lower tax level, they may not be a subsidiary of an existing parent corporation.

Source: California Franchise Tax Board.

levied since the state tax was created in 1929. It shows that California's current general corporation tax rate is 8.84 percent. This is the lowest general corporation tax rate since 1973. Other state corporate-related tax rates, such as those for Subchapter S corporations, banks and financial corporations, and the corporate AMT, have also declined in recent years. However, the corporate minimum tax (which affects corporations whose tax liabilities are less than the minimum tax level) has remained at $800 for most corporations since 1990, except for being reduced beginning in 1997 for new corporations with gross income under $1 million for their first year of incorporation.

How California Compares. Figure 3 compares the general corporate tax rate, along with the number of corporate tax brackets and the bracket structure, for California versus other western and major industrial states. It indicates that among western states, California has one of the highest general tax rates. Only two states—Arizona and Alaska—levy a higher maximum corporate tax rate (although in the case of Alaska, it has a progressive tax rate structure and only its top two tax brackets levy a higher tax rate than California). Among major industrial states, California also ranks toward the upper end. The rates for Massachusetts, New York, and Pennsylvania, and the top rates for New Jersey and Ohio, are higher than in California. As can be seen from the figure, the Governor's proposal would reduce California's corporate tax rate but would not dramatically change its relative ranking among western and major industrial states.

The corporate tax rate by itself, however, provides only partial information on the tax burden facing a corporation. Without knowing the nature of the tax *base* to which a tax rate is applied, and tax credits that may affect final tax liabilities, one can arrive at erroneous conclusions about the relative tax burden in one state versus another. For example, Michigan has a very low corporate tax rate; however, its corporate tax is similar to a value-added tax (VAT) and has a very broad tax base. Thus, its 2.3 percent tax rate levied on its broad tax base actually may result in similar, or even higher, tax liabilities for a corporation than if it were located in a state with a higher tax rate but narrower tax base, due to extensive income exclusions, exemptions, and deductions.

Other Key Elements in State Tax Structures

Given the above, there are a variety of factors other than tax rates that need to be considered in making interstate corporate tax comparisons, In addition to those already mentioned—exclusions, exemptions, deductions, and credits—there is a wide variety of other features of corporate tax structures. These include the different types of filing statuses allowed,

Figure 3

State Corporate Income Tax Rates (As of January 1, 1997)

	Corporate Tax Rate	Number of Brackets	Net Income Level at Which Top Rate Begins
California	**8.84%**	**1**	**Flat Rate**
Other Western States			
Alaska	1% to 9.4%	10	$90,000
Arizona	9.0%	1	Flat Rate
Colorado	5.0%	1	Flat Rate
Hawaii	4.4% to 6.4% (income); 4% (capital gains)	3	$100,000
Idaho	8.0%	1	Flat Rate
New Mexico	4.8% to 7.6%	3	$1,000,000
Nevada	—	—	—
Oregon	6.6%	1	Flat Rate
Utah	5.0%	1	Flat Rate
Washington[a]	—	—	—
Other Major Industrial States			
Florida	5.5%	1	Flat Rate
Illinois	7.3%[b]	1	Flat Rate
Massachusetts	9.5%	1	Flat Rate
Michigan	2.3% single business tax[c]	1	Flat Rate
New Jersey	7.5% or 9.0%[d]	1	Flat Rate
New York	9.0%	1	Flat Rate
Ohio	5.1% to 8.9%	2	$50,000
Pennsylvania	9.99%[e]	1	Flat Rate
Texas	4.5% net taxable earned surplus[f]	1	Flat Rate

[a] Levies a business and occupations tax based on gross receipts (tax rate applied depends on industry classification).

[b] Includes a 2.5 percent personal property replacement tax.

[c] Similar to a value-added tax (VAT), and is based on the sum of federal taxable income, compensation paid to employees, dividends, interest, royalties paid, and other items.

[d] If entire net income is under $100,000, then corporation is taxed at 7 percent rate; otherwise, corporation is taxed at 9 percent rate.

[e] Includes a 0.49 percent surtax that will be phased out through 1997.

[f] Similar to a VAT, and is based on federal net taxable income plus compensation paid to officers.

Source: Federation of Tax Administrators.

special "add-on" taxes, rules for apportioning income for multi-state and multinational corporations, and the treatment of business losses. Below we discuss some of these other factors.

Alternative Filing Statuses. California gives qualifying corporations the option of selecting to be treated for tax purposes differently than under the general corporate tax structure. Specifically, California allows for:

- ***Subchapter S Corporations.*** These corporations are closely-held, domestic corporations that issue only one class of stock. As noted earlier, they are permitted for tax purposes to "pass through" their taxable income directly to shareholders. The corporations themselves generally are subject to either lower state tax rates or no entity-level income taxation at all. California currently levies a 1.5 percent tax rate on these corporations compared to the 8.84 percent levied on general corporations. All western states and major industrial states, with the exceptions of Nevada, Washington, Michigan, and Texas, allow corporations to elect Subchapter S corporate status. The specific tax provisions relating to them, however, do exhibit interstate variation.

- ***Limited Liability Companies (LLCs).*** This option also offers qualifying businesses favorable tax treatment. An LLC is a "hybrid" entity that combines various tax benefits of a corporation with the benefits of a partnership. It also is not as restrictive as Subchapter S corporate status in that it allows an unlimited number of shareholders and more than one type of stock to be issued. California and most western and major industrial states—with the exceptions of Alaska, Florida, and Texas—allow LLCs to qualify for tax treatment as a partnership. This enables the company to "pass through" taxable earnings to shareholders and avoid the general corporation entity-level tax.

Apportionment of Income. Multistate and multinational corporations "apportion" their income to states in which they are subject to corporate taxation. To accomplish this, states use a formula that takes into account any or all of three factors—their property, their payrolls, and their sales. Corporations then calculate the ratio of each of these factors within a state compared to the corporation as a whole, and then weight these ratios to arrive at a combined ratio. This combined weighted ratio is then applied as the share of a corporation's total income that is taxable to a particular state. Because the vast majority of corporate income in California is attributable to multistate and multinational corporations, the particulars of this formula and how it is applied are key determinants of the corporate tax base.

California has made some recent changes in its approach to apportionment which benefit businesses. One involves the way that the income of multinational corporations is treated. A second involves the way the apportionment formula is calculated. Specifically, California now "double weights" the sales factor in the formula. Most major industrial states and half of the western states (Arizona, Idaho, New Mexico and Oregon), follow this approach. The double weighting of sales in the apportionment formula—when compared with equal weighting of all three of the factors—provides a more favorable tax treatment for corporations that set up operations within a state, particularly for companies whose sales involve significant exports to other states and nations. Because California has many such corporations, its business community benefits from this change.

Deductions From Income. States allow various deductions that corporations may claim to reduce their taxable income, and thus, lower their income tax liabilities. Two particularly important deductions for which interstate variation exists are net operating losses and depreciation.

- ***Net Operating Losses (NOLs).*** Net operating losses occur when a corporation's deductible expenses exceed its gross income—that is, when it loses money. California as well as all western and major industrial states that impose corporate income taxes allow at least a portion of these losses to be "carried forward" to offset taxable income in future years. Some states, including New York, Illinois, Utah, Hawaii, and Idaho, also allow these losses to be "carried back" to offset income in past years. States have their own rules regarding such particulars as how long NOLs may be kept "on the books."

- ***Depreciation.*** Depreciation allows corporate taxpayers to "write off" the costs they incur for purchasing capital assets used in the operation of their businesses. These write-offs are generally required to be spread over time in recognition that the capital assets are "used up" over time (such as through wear and tear). The specific amount of depreciation allowable in any given year can differ significantly, however, depending on the depreciation method used.

  California's general corporations currently are subject to a depreciation method known as the Asset Depreciation Range (ADR) system, which was used by the federal government prior to 1981. In contrast, all other western states, most major industrial states, and California Subchapter S corporations conform to the current federal depreciation method known as the Modified Accelerated Cost Recovery (MACRS) System. (Michigan, New Jersey, New York, and Ohio have conformed to MACRS in limited areas.) The ADR system generally requires corporations to use longer lives and less-accelerated depreciation methods than the MACRS system. Thus, the annual deductions under ADR generally are smaller, but spread out over a longer time frame, than under MACRS. This means that the economic benefits to businesses under California's ADR system are less than they would be under MACRS. (It should be noted that California has conformed to MACRS depreciation under the personal income tax.)

Tax Credits Available to Corporations. Once a corporation's tax base has been determined, the state corporate tax rate is applied to it to determine the corporation's tax liability. The corporation may reduce or completely offset its state tax liability by claiming any state tax credits to which it is entitled. Figure 4 provides interstate comparisons of tax credits currently available to corporations in western and major industrial states.

The two largest tax credits claimed in California—the investment tax credit and the research and development tax credit—are offered in most other states. The scope of these credits vary considerably, and California's provisions are among the more generous. Another major tax credit available in most states, including California, is for investment and job creation within designated enterprise zones. Over half of western and industrial states, excluding California, also offer a credit for job creation or job training outside of enterprise zones. A limited number of states offer other types of credits, including credits for child care, environmental cleanup, and recycling of waste. Though not specified in detail on Figure 4, numerous states offer their own specific tax credits not common to other states.

Other Corporate Tax Levies. Another key element affecting corporate tax burdens are other tax levies in addition to the general corporate income tax. Two of these deserve special mention in discussing interstate tax burdens—the corporate AMT and the corporate minimum tax.

- ***The Corporate AMT.*** Corporate taxpayers that take sufficient advantage of certain tax provisions (such as deductions, exemptions, and credits), may be subject to an AMT or have their tax credits reduced or eliminated. The AMT basically limits the extent to which special tax provisions can reduce a taxpayer's liability. In most respects, California's AMT conforms to the federal AMT, although its AMT tax rate differs. California's AMT tax rate currently is 6.65 percent. Only a few states impose an AMT. Those that do include Alaska, Florida, and New York.

Figure 4

Interstate Comparisons of Corporate Tax Credits 1996 Income Year[a]

Allowable Credits by Purpose	Western and Major Industrial States[b]																			
	AK	AZ	CA	CO	FL	HI	ID	IL	MA	MI	NV	NJ	NM	NY	OH	OR	PA	TX	UT	WA
Specified Investments	■	■	■	■	□	□	■	■	■	■	□	■	■	■	■	■	■	□	□	□
Enterprise Zones	□	■	■	■	■	■	□	■	□	■	□	■	■	■	■	□	□	□	■	□
New Jobs/ Job Training	■	■	□	□	■	■	■	■	□	■	□	■	□	■	■	□	■	□	□	□
Research and Development	□	■	■	■	□	□	□	■	■	□	□	■	□	□	■	■	□	□	□	■
Recycling of Waste	□	■	□	■	□	□	■	□	□	□	□	■	□	□	■	■	□	□	■	□
Ridesharing/ Vanpools	□	□	■	□	□	□	□	□	■	□	□	■	□	□	□	□	□	□	□	■
Environmental Cleanup	□	■	□	□	■	□	□	□	□	□	□	□	□	□	■	■	□	□	□	■
Child Care	□	□	■	■	□	□	□	■	□	□	□	□	■	□	□	■	□	□	□	□
Historic Building Preservation	□	□	□	■	□	□	□	□	□	□	□	□	■	■	□	□	□	□	■	□
Small Business Activities	□	□	□	□	□	□	□	□	□	■	□	□	□	□	□	□	□	□	□	■
Coal-Related Usage and Equipment	□	□	□	■	□	□	□	■	□	□	□	□	□	□	□	□	□	□	■	□
Alternative Fuel/ Low-Emission Vehicles	□	■	□	■	■	□	□	□	□	□	□	□	□	□	□	□	□	□	■	□
Other[c]	□	□	■	■	■	■	■	■	■	■	□	□	□	■	■	■	□	□	■	■

[a] Symbols indicate whether credit is allowable in the state (■ Yes □ No).

[b] Abbreviations for states are as follows: AK: Alaska; AZ: Arizona; CA: California; CO: Colorado; FL: Florida; HI: Hawaii; ID: Idaho; IL: Illinois; MA: Massachusetts; MI: Michigan; NV: Nevada; NJ: New Jersey; NY: New York; OH: Ohio; OR: Oregon; PA: Pennsylvania; TX: Texas; UT: Utah; WA: Washington.

[c] These differ by state. Detail available from Legislative Analyst's Office.

- ***Corporate Minimum Tax.*** Corporate taxpayers that have no computed tax liabilities may still be subject to a state minimum tax. This tax generally may be viewed as a levy on corporations for the protection they receive under their limited liability status. California currently imposes an $800 minimum tax that applies to most corporations. Other states that impose a minimum tax include Arizona ($50), Colorado ($100), Idaho ($20), Oregon ($10), Utah ($100), Massachusetts ($456), New Jersey ($200), New York ($325 to $1500), and Ohio ($50). Thus, California's minimum tax is well above average. It also should be noted that the minimum tax affects the majority of California corporations, because their regular tax liabilities are less than the minimum tax level.

Effects of Recent Tax-Law Changes on California Corporations

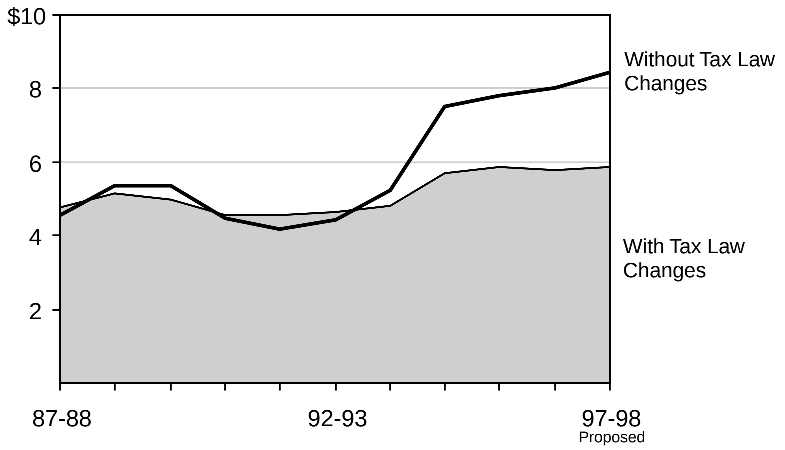
Within the context of reviewing California's corporate tax structure and how it compares to other states, it is useful to note the nature of the tax policy changes the state has adopted in recent years. Over the past decade, California has not fundamentally changed its approach to corporate taxation. However, it has enacted a variety of significant tax law changes. Some of these have been favorable to businesses, while others have been unfavorable. On balance, however, the net effect of these changes in terms of tax burden has been favorable to taxpayers.

Figure 5, for example, shows that bank and corporation tax revenues in recent years would have been significantly higher had none of the corporate tax law changes enacted since 1986 occurred.

Figure 5

The Impact of Recent Law Changes On California Corporate Tax Revenues

Corporate Tax Revenues (In Billions)



Some of the major corporate income tax legislation favorable to businesses enacted in the past decade are summarized in Figure 6.

Figure 6

Selected Major Income Tax Legislation Favorable to Businesses Over the Past Decade[a]

Year	Provisions
1986	Water's-Edge Election • Allows choice of alternative income apportionment formula for multinational corporations.
1987	Subchapter S Corporations • Allows closely-held corporations to enjoy tax advantages of partnerships while retaining limited-liability status of corporations. Corporation Rate Reduction from 9.6 Percent to 9.3 Percent Net Operating Losses (NOLs) • Allows businesses to carry forward tax losses to offset future tax liabilities. Research and Development (R&D) Tax Credit Low-Income Housing Tax Credit Enterprise Zone/Program Area Tax Credits
1988	Deduction for Employee Stock Option Plans (ESOPs) • Allows corporations to deduct dividends paid to employee ESOPs. Employer Credits for Child Care-Related Expenses
1989	Recycling Equipment Tax Credit Employer Rideshare Tax Credit
1990	Low-Emission Vehicle (LEV) Tax Credit
1992	Los Angeles Revitalization Zone (LARZ) Tax Credits
1993	Manufacturer's Investment Tax Credit (MIC) • Allows tax credit to businesses equal to 6 percent of the qualified costs of equipment purchased. Small Business Stock Capital Gains Exclusion
1994	Local Military Base Recovery Area (LAMBRA) Tax Credits Limited Liability Companies (LLCs) • Allows potentially favorable business organization form.
1996	Corporation Tax Rate Reduction from 9.3 Percent to 8.84 Percent Business Tax Incentives (SB 38) • Conforms state tax law to certain federal provisions; expands existing tax deductions and credits, such as increasing the R&D credit rates and the amount of small business expensing allowable; creates certain new provisions, such as the farmworker housing and rice straw tax credits.

[a] Some of the fiscal effects of these tax measures beneficial to businesses were offset by other provisions, including various changes in accounting procedures, base broadening, temporary suspension of NOL deductions, implementation of the AMT, and increases in the minimum tax.

What Is the "Bottom Line?"

As noted previously, arriving at a "bottom line" regarding California's corporate tax treatment relative to other states is not simple, given the many factors involved. Figure 7 indicates that California does rely rela-

Figure 7

1995 State Tax Collections by Source

Percentage of Total Collections

	Type of Tax			
State	**Corporate Income**	**Personal Income**	**General Sales and Use**	**Other**
California	**10.8%**	**34.4%**	**33.2%**	**21.6%**
Other Western States				
Alaska	27.5%	—	—	72.5%
Arizona	6.7	23.8%	44.5%	25.0
Colorado	4.2	46.4	27.2	22.2
Hawaii	1.6	32.2	47.4	18.8
Idaho	7.5	34.6	33.2	24.7
New Mexico	5.3	20.8	42.8	31.1
Nevada	—	—	53.3	46.7
Oregon	7.3	65.3	—	27.4
Utah	5.5	38.3	39.9	16.3
Washington[a]	—	—	59.3	40.7
Other Major Industrial States				
Florida	5.1%	—	57.3%	37.6%
Illinois	8.9	32.0%	29.9	29.2
Massachusetts	10.4	51.5	21.4	16.7
Michigan	12.0	30.9	33.1	24.0
New Jersey	7.6	33.4	30.4	28.6
New York	8.2	51.3	20.0	20.5
Ohio	4.7	36.6	31.3	27.4
Pennsylvania	9.8	27.0	30.4	32.8
Texas[a]	—	—	50.6	49.4

[a] State does not levy a corporate income tax; however, taxes are levied on specific corporate activities. These taxes would be recorded in the "Other" category on this table.

Source: United States Department of Commerce and Federation of Tax Administrators.

tively more on the corporate income tax as a share of total revenues—10.8 percent—than most other western and major industrial states. However, this factor alone does not necessarily tell the whole story about the tax burden, because this measure is influenced by a variety of factors other than the tax structure itself. These include the state's particular industry mix and productivity levels, as well as the state's reliance on other taxes that also affect corporations, including sales and use taxes. Given this, additional information is needed to get to the "bottom line."

What Does the Research Suggest?

Many different studies of interstate tax structures and their competitiveness have been conducted over the years. Often, these studies also have had difficulty arriving at "bottom lines," given the array of factors involved in state tax structures and the difficulty of weighting their relative importance. Two recent studies of interest (one completed by the Wisconsin Department of Revenue in 1996 and the other produced by KPMG Peat Marwick for the State of North Carolina in 1994) took a number of these tax-related factors into account when conducting interstate tax-burden comparisons on corporations across a variety of industries. California was included in these studies, along with most major industrial states. In addition to corporate income taxes, the studies included comparisons of other state taxes that contribute to the overall tax burden on corporations, including sales and use taxes, property taxes, and utility taxes.

The Results Vary. These two studies varied significantly in terms of their findings regarding California's *corporate tax* burden relative to other states, although neither ranked California low. The Wisconsin study ranked California's corporate tax burden as the fourth highest of 19 states, while the KPMG Peat Marwick study ranked California the eleventh highest of 21 states. However, when the *total* tax burden borne by corporations is considered (which includes all taxes that they pay), California fared better. Specifically, it ranked in the middle to lower half of states in both studies. While certain aspects of each state's tax structure have changed since these studies were completed, they still provide a general sense of where California stands compared to other states.

Conclusion. Given these and other research findings, along with the comparisons of individual components of the tax structure discussed above, it appears that California is relatively high in terms of its *corporate* income tax burden but about average in terms of its *total* tax burden on corporations.

WHAT WOULD BE THE PROPOSAL'S ECONOMIC EFFECTS?

There is little debate that the Governor's tax reduction proposal would lead to a variety of stimulative effects on the California economy, and that these effects would have certain positive impacts on revenues. These stimulative effects would be accompanied, however, by some offsetting negative economic impacts, such as occurs from reducing various types of public spending. There is considerable debate among economists regarding both *how much* of a direct beneficial effect on the economy tax changes like that proposed by the Governor have, and what their ultimate *net effect* on the economy and revenues are after taking account of the offsets.

Types of Economic Effects

The economic impacts from the proposal would include both *direct behavioral responses* and *dynamic feedback effects*. The former involve such decisions as locating or relocating in California, expanding business investment in the state, hiring more workers, and buying more supplies and other inputs in order to increase production activities in the state. The latter includes the so-called multiplier effect, whereby an initial increase in investment and production leads to additional spending, production, jobs, migration flows, and so forth.

All of these behavioral and dynamic feedback effects would stem from the reduction in the basic "costs of doing business" in California that results from a lowered corporate tax rate. Tracing these effects is complicated by the fact that the ultimate incidence of corporate taxes are distributed among several parties—owners of companies (through the prices of their stock shares and dividends they receive), employees (through the wages and benefits they receive and working conditions they face), and consumers and suppliers of inputs (through changes in prices). Given this, the benefits of a tax reduction also tend to be shared among these different parties.

Estimation of Behavioral and Dynamic Feedback Effects

The problem of estimating behavioral and dynamic feedback effects from state tax-law changes has been the subject of considerable interest and attention (as well as controversy) in recent years, both in California and various other states. In 1994, the Legislature enacted Chapter 393 (SB 1837, Campbell), requiring that such analyses be conducted for California, as specified.

The Department of Finance (DOF) Model. In conjunction with this requirement, the Legislature in 1995 provided DOF with funds to develop an appropriate model and staff to operate it. The department subsequently contracted with the University of California for the model's development and hired the necessary staff to conduct the actual dynamic analyses.

The DOF indicates that the model is in place and tax-change scenarios have been analyzed using it. The department also has testified at state fiscal hearings that the model has been used to scope out the effects of corporate tax changes. The DOF has indicated that its dynamic analyses of the Governor's current tax proposal will be made available when the proposal is evaluated in the appropriate legislative committees. As a result, in terms of analyzing the Governor's proposal, we have not yet had the opportunity to thoroughly examine the model's workings, or analyze the operational assumptions being used by the department.

Results Merit Careful Review. We suggest that when the Legislature receives the department's dynamic analysis of the Governor's proposal, its results be thoroughly reviewed, along with the assumptions underlying its estimates. This is particularly important because "tweaking" the assumptions incorporated into any dynamic model can significantly affect its outcomes. This review will ensure that the Legislature has the best, most reliable information available to it regarding economic and fiscal effects when considering the Governor's tax proposal. Among other things, this review should pay special attention to the model's assumptions regarding the proposal's effects on investment and locational decisions, estimation of "leakages" of tax-cut benefits out of California to other states and nations, impacts on labor supply and migration flows, and implications of reduced public spending associated with the tax reduction.

SHOULD OTHER ALTERNATIVES BE CONSIDERED?

The Governor's tax reduction proposal is but one approach for reducing the tax burden in California. Provided that the primary objective is to reduce the corporate tax burden, it has merit. Most notably, it is broad-based and scores high in terms of "tax neutrality," the term economists use for tax provisions that do not significantly distort decision making by taxpayers.

Depending on its specific tax policy objectives, however, the Legislature may wish to consider other tax-related changes in lieu of, or in addition to, the Governor's proposal. As with the Governor's plan, alternative options would have their own constellation of distributional, fiscal, and economic consequences. The alternative options might include:

- ***Other Types of Corporate Tax Changes.*** This involves whether alternative types of modifications to the corporate tax should be considered, such as modifying or eliminating the AMT or the minimum tax, as some have suggested. In the case of the AMT, the tax is very unpopular with many taxpayers (including personal income taxpayers) due to its complexity. It also poses various administrative compliance and enforcement problems.

- ***Increased Federal Conformity.*** There are several key areas where California does not fully conform to federal corporate tax law. These areas include depreciation rules, NOL provisions, small-business expensing amounts, and other Subchapter S provisions. Increasing federal conformity in these areas generally may be attractive to corporations by simplifying corporate record keeping and tax administration. Conformity to any one of these provisions would result in state revenue losses—for some provisions in the tens of millions of dollars. If the Legislature wishes to consider these options, it would be important to consider the rationale for conformity, in addition to its economic and fiscal implications.

There may be other tax-change alternatives as well that the Legislature might want to consider.

In evaluating the Governor's tax reduction proposal, or any alternatives including those noted above, the Legislature will first need to decide what its fundamental tax-policy objectives are, and then what changes, if any, would be appropriate to reach these objectives. Among other things, the distributional, fiscal, and economic effects of different options should be evaluated to ensure that they are consistent with the Legislature's objectives.