

Trends in California Corporation Tax Revenues

Allen Prohovsky, Ph.D.
California Franchise Tax Board

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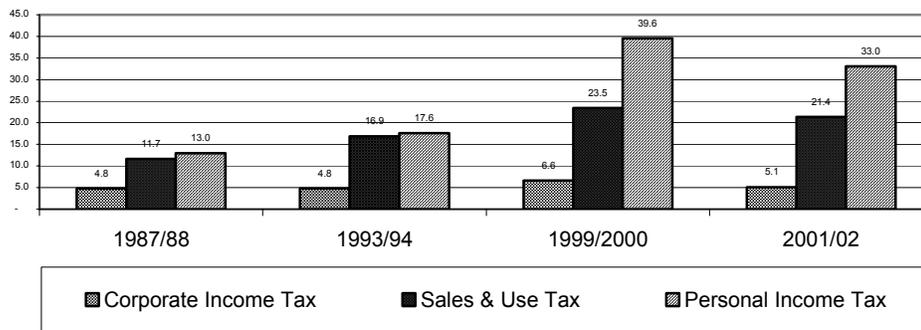
Abstract

Since 1988, California Corporation Tax revenues grew much more slowly than both the California economy and other major sources of California revenue. In fact, inflation adjusted Corporation Tax revenues actually declined during this period. This paper finds that much of the apparent weakness in the California Corporation Tax can be attributed to policy decisions. Estimates are presented of the revenue losses from: the creation and expansion of new forms of business organization, growth in the use of corporate tax credits (most prominently the Research and Development Credit and the Manufacturer's Investment Credit), increases in the use of Net Operating Losses, corporate tax rate reductions, and the water's-edge election.

Introduction

Corporation Tax revenues are the third largest source of revenue for the State of California.¹ In recent years, however, corporate income tax revenues have not kept pace with either the growth of other major sources of California revenue or with the growth of the California economy in general.² Corporate tax revenue increased only 6 percent between fiscal years (FY) 1987/88 and 2001/02 (see Figure 1).³ The two largest sources of California revenue, the Personal Income Tax and the Sales and Use Tax, grew much more rapidly during these years. Between FY1988/89 and FY2001/02, Personal Income taxes increased 245 percent, and Sales and Use taxes increased by 108 percent. California Gross State Product (GSP) grew by 98

**Figure 1
Major Sources of California Revenue Fiscal Years 1987/88-
2001/02
(\$ Billions)**



percent between 1988 and 2001. As a result, corporate tax liabilities as a percentage of GSP

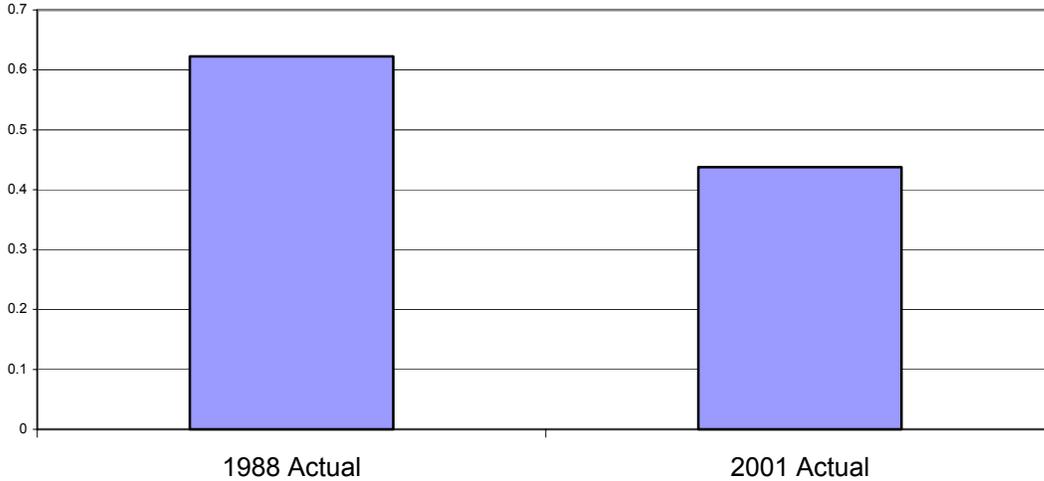
¹ Prior to 2000, the California Corporation Tax was called the California Bank and Corporation Tax.

² This phenomenon is not unique to California. For a national view of trends in state and local corporate income taxes see Steve Maguire, "Average Effective Corporate Tax Rates," Congressional Research Service report, February 29, 2000, or Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, 2001, vol. 40, no. 4, p. 27-43.

³ Admittedly, FY 2001/02 was a particularly bad year for corporate revenue. Growth in revenue from FY 1987/88 to FY 2000/01 was 37 percent, still well below the growth rate of the California economy and of other major revenue sources. Preliminary data suggest that corporate tax revenue for FY 2002/03 was almost the same as for FY2000/01. 1988 was chosen as the base year for this analysis because analysis of the immediately preceding years is complicated by the major federal tax reform of 1986 and subsequent California conformity legislation.

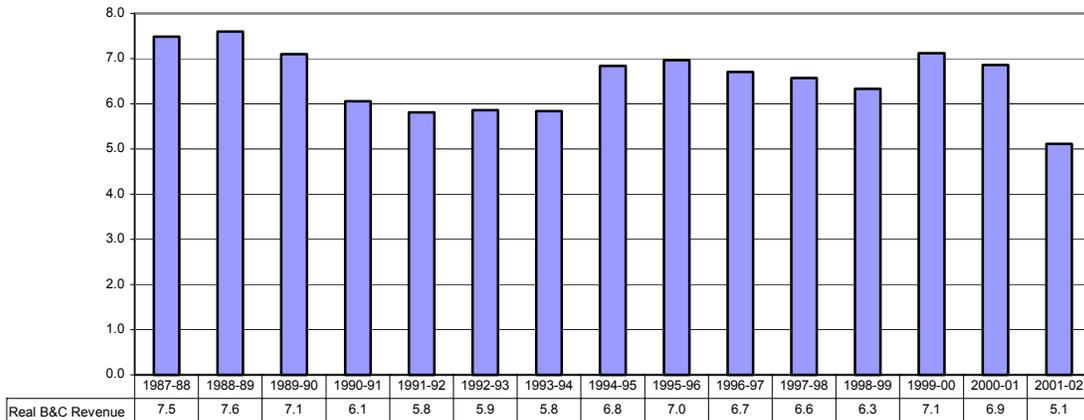
dropped from 0.62 percent in 1988 to 0.44 percent in 2001 (see Figure 2).⁴ After adjusting for

Figure 2
California Corporate Tax as a Percentage of GSP 1988 and 2001



inflation, real Corporation Tax revenues actually decreased by 10 percent from FY1988/89 to FY2000/01 and by 31 percent from FY1988/89 to FY2001/02 (see Figure 3).

Figure 3
Real Corporate Tax Revenue 1987-88 - 2001-02
(Billions of 2001 \$s)



⁴ Corporate tax liabilities are the amount of money corporations owe for a particular tax year. The fiscal year revenue numbers reported in Figures 1 and 3 are cash-flow numbers – i.e. the amount of money actually received from corporations in a fiscal year. These numbers will differ because they are based on slightly different time periods and because of fluctuations in the size of prepayments of estimated taxes,

The goal of this paper is to describe, and to evaluate the relative importance of, several factors contributing to the weakness of California Corporation Tax revenues. To facilitate the analysis, these factors will be divided into two general categories – factors that affect the amount of taxable corporate profits, and factors that affect the amount of tax paid on taxable profits. The discussion on the amount of taxable corporate profits, in the next section, touches on issues such as the performance of the corporate sector relative to the economy as a whole, the proportion of corporate profits attributable to California, and the distribution of profits across corporations. Unfortunately, one factor that we will not be able to address in this paper is tax shelter activity. This is because the major data series analyzed in this paper are all derived from corporate tax return data from which any changes in tax shelter activity will have been filtered out.

As described below, total State Net Income (SNI) of corporations with SNI greater than zero (i.e. with profits to tax) increased 112 percent from 1988 to 2000. Since taxable profits grew faster than GSP (94 percent) during this time period, most of the weakness in California Corporation Tax revenues (relative to GSP) must be due to changes in the tax on taxable profits.⁵ Positive SNI dropped 13 percent in 2001, contributing to the drop in revenues in 2001. The overall growth in positive SNI from 1988 to 2001 (84 percent), while somewhat below the growth in GSP (98 percent) is still well above the growth in corporate tax liabilities (40 percent) from 1988 to 2001.⁶ Section 2 of this paper examines the relationship between positive SNI and tax liabilities.

refunds issued for overpayments, and taxes collected for prior tax years through the Franchise Tax Board's enforcement programs.

⁵ Since most tax shelter activity would be not be included in either taxable profits or GSP, it is impossible from these two data items to determine anything about the extent of tax shelters

⁶ Note that the 40 percent growth in corporate tax liabilities from 1988 to 2001 is similar to the 37 percent growth in corporate tax revenues from FY 1987/88 – FY 2000/2001 (see footnotes 3 and 4 above). Corporate tax liabilities for the 2002 tax year are not available yet since many corporations report their liabilities on extended returns that will not be filed until October. Fiscal year revenues are used for comparisons between the Corporation Tax and other sources of California revenue. This is done because fiscal year data is the only convenient and meaningful way that data on all the California revenue sources is available. On the other hand, liability year data will be used below because actual data from corporate tax returns are only available on a liability year basis. Thus, in order to analyze items such as income, adjustments, apportionment factors, credits, and net operating losses (all of which can have an impact on corporate revenue trends) we must look at liability year numbers.

This paper identifies five factors that have contributed substantially to the weakness in Corporation Tax revenues. One of these five, adoption by California of elective water's-edge filing, affects the amount of positive SNI reported each year. The other four factors – recognition by California of the S-corporation structure, an increase in corporate tax credits, a reduction in California corporate tax rates, and the allowance by California of net operating loss carryforwards – affect the relationship between positive SNI and tax liabilities.

All five of these factors that have reduced California Corporation Tax revenues are directly attributable to policy decisions made by the California Legislature. There are, of course, a number of reasons that the Legislature adopted these policies. This paper will not attempt to evaluate the relative merits of these policies either individually or collectively; it will merely document that these policy decisions are largely responsible for the recent weakness in California Corporation Tax revenue.

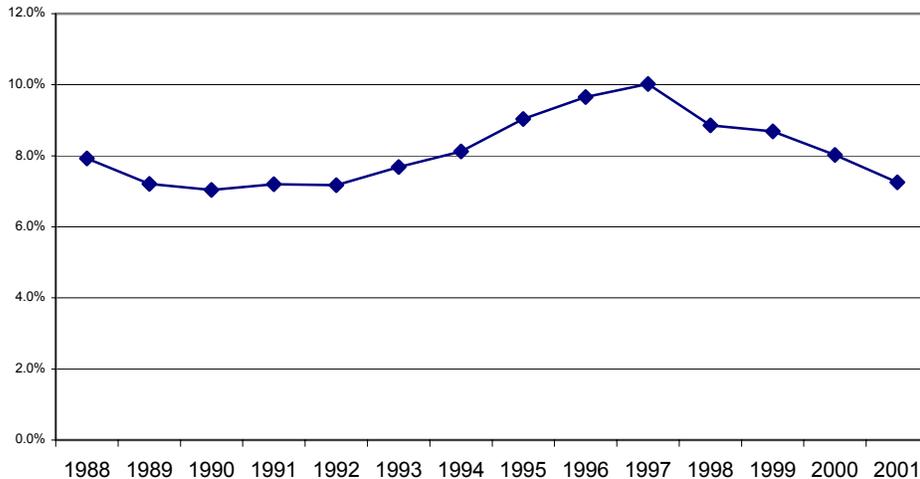
1. The Level of Taxable Corporate Profits.

The level of corporate profits nationally

It is possible that structural changes in the economy unrelated to tax law are reducing the relative importance of corporate profits in the economy. There are at least two ways in which such a structural change could occur. One is that sectors of the economy in which corporations are relatively important may be growing more slowly than sectors in which corporations are relatively less important. For example, if it were the case that all manufacturing were done by corporations while all services were performed by partnerships, then a shift in the composition of the economy from manufacturing to services would reduce corporate profits' share of the economy. The second possible structural change in the economy is a reorganization of business entities that does not affect production. For example, if a large number of corporations opted to reorganize themselves as Limited Liability Companies (LLCs), this would reduce corporate profits' share of the economy. A number of recent legislative changes, particularly in the area of LLCs, may have encouraged businesses to operate in a noncorporate form. If corporate production as

a percentage of economic activity is decreasing, we would expect corporate taxes as a percentage of economic activity to decline also.

Figure 4
Ratio of NIPA Corporate Profits to GDP



One view of the relationship between corporate economic activity and overall economic output (at the federal level) is presented in Figure 4. The measure of corporate activity presented in this figure is the series “Corporate Profits with Inventory Valuation and capital Consumption Adjustment” from Table 1.14 of the National Income Product Accounts. As shown in Figure 4, the ratio of corporate profits to Gross National Product (GNP) is cyclical. The ratio of corporate profits to GNP dropped 11 percent from 1988 to 1991, rose 42 percent from 1991 to 1997, and dropped 28 percent from 1997 to 2001. Overall, there was a slight decrease in this ratio from 1988 to 2001. Corporate profits grew only 81 percent during this time period, compared to 97 percent growth in GNP.⁷ Because of the volatility of the relationship between corporate profits and overall economic growth, it is difficult to assess whether or not there has been any shift of economic activity out of the corporate sector of the economy. It is clear, however, that the 81 percent increase in corporate profits is substantially greater than the growth of California corporate taxes over this time period, so there must be sources of weakness in California corporate taxes other than structural shifts in the economy. Another common measure of

⁷ Note that the 97 percent increase in GDP nationally was almost identical to the 98 percent growth in California GSP over the same period.

corporate profits, Corporate Receipts Less Deductions from the IRS's Statistics of Income (SOI), grew 125 percent from 1988 to 1999 (the latest year for which data are available). By this measure, corporate profits grew faster than the general economy over this time period.

Weakness in corporate profitability cannot, therefore, explain the weakness of Corporation Tax revenues.

A note on tax shelters

It has been suggested by various commentators that there has been an upsurge in recent years in tax shelter activity.⁸ If true, this would also reduce the level of profits reported from corporate activities and, in turn, reduce corporate tax revenues. Conceptually, tax shelter activity should affect the relationship between corporate profits and taxable corporate profits. However, in practice, tax shelter activity normally will instead reduce the measured level of corporate profits.⁹ This is because all of the data series on corporate profits are constructed from tax return data. The NIPA data make a number of adjustments to the tax return data in an attempt to measure "economic profit"; but the major adjustments, such as those for accelerated depreciation and the effects of inflation on inventory valuation, are not related to tax shelter activity. NIPA includes an adjustment for underreporting of income on tax returns, but this measure is based on historical audit experience and, therefore, is of little use in assessing recent changes in tax shelter activity. Therefore, the data in this paper cannot shed light on the tax shelter debate. Whatever the exact size of the tax shelter problem, there remains a substantial drop in corporate tax revenues relative to corporate profits that must be attributable to other factors. The discussion below explores several of these factors.

⁸ See, for example, Joseph Bankman, *The New Market in Corporate Tax Shelters*, **Tax Notes**, June 21, 1999 p. 1775-1795, or Michael M. Phillips, *Taking Shelter, As Congress Ponders New Tax Breaks, Firms Already Find Plenty*, **Wall Street Journal**, August 4, 1999, p. 1.

⁹This point was made by James B. Mackie III, *The Puzzling Comeback of the Corporate Income Tax*, Proceedings of the 92nd Conference on Taxation, National Tax Journal, Washington, DC, 2000.

Federal taxable corporate profits

There are several types of corporations whose profits are not taxable at the federal level. These include Regulated Investment Corporations (RICs), Real Estate Investment Trusts (REITs) and S-corporations. Both RICs and S-Corporations have grown substantially in importance during the 1990s.

RICs (mutual funds) and REITs are not taxed at the corporate level by either the federal or the California government. We would, therefore, expect corporate tax revenues not to keep pace with corporate profits if these sectors are responsible for the growth of corporate profits. Removing RICs and REITs from SOI Total Receipts Less Deductions lowers the growth rate for this series to 84 percent for the 1988 – 1998 period. This is slightly greater than the growth of GDP (82 percent) during these years.

The S-corporation was first introduced in 1958. At the federal level, S-corporations are taxed exclusively as pass-through entities; thus, they are not taxed at the corporate level at all. In California, S-corporations are taxed at the corporate level, but at a much lower rate than C-corporations. Several changes in the Tax Reform Act of 1986, including the repeal of the General Utilities Doctrine, spurred a rapid growth in the number of S-corporations. At the federal level, the number of S-corporations increased from 0.8 million in 1986 to more than 3 million in 2001. In 1999, S-corporations accounted for 15 percent of federal corporate Total Receipts Less Deductions (22 percent if we remove RICs and REITs from the denominator). The expansion of the S-corporation sector reduces the percentage of corporate profits that are taxable at the federal level.

The relationship between income subject to tax and liability at the federal level

Changes in the relationship between income subject to tax and liability at the federal level are primarily due to statutory changes, such as federal tax rates and federal treatment of net operating losses, that should not affect California revenues. Nonetheless, it is interesting to compare the relative growth of federal and state tax liabilities. Federal corporate tax liability

before credits increased 84 percent between 1988 and 1999. This is almost exactly the same rate as the growth in corporate income subject to tax (81 percent) during this period.

Regional differences in economic activity

The relationship between corporate income taxable by California and federal corporate income will reflect differences in economic performance between California and the rest of the nation. Federal income numbers include three types of firms: firms not conducting business in California, firms conducting some but not all of their business in California, and firms conducting business exclusively in California. California taxes none of the income from the first group, some of the income from the second, and all of the income from the third. Changes in the ratio of state to federal income may, therefore, reflect either changes in the relative importance of these three groups, or changes in the proportion of the income (known as apportionment factors) from the second group.

Figure 5
Ratio of Income for Corporations Taxable in California, Before State Adjustments and Apportionment to NIPA Corporate Profits With Inventory and Capital Consumption Adjustments

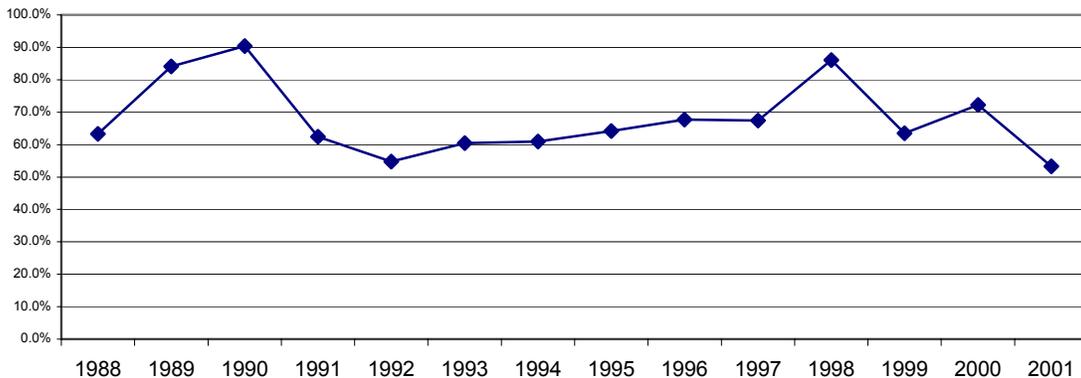


Figure 5 presents the ratio of net income for corporations taxable in California (before state adjustments and apportionment) to total federal corporate profits (from NIPA with inventory and capital consumption adjustments). The rise in this ratio in 1989 and 1990 suggests that California did not fall into the last recession as soon as did the rest of the country. This ratio bottomed out in 1992, when California was more deeply in recession than the rest of the country.

The ratio increased from 1992 to 1998, then dropped, erratically, from 1998 to 2001. Overall, this ratio increased from 1988 to 2000, suggesting that general weakness of the California economy relative to the national economy has not played a major role in the weakness of Corporation revenues. The sensitivity of this analysis to the exact choice of end point years, however, suggests that we should be cautious in assigning a firm quantitative weight to this factor.

State adjustments to income

Differences in corporate profits for state and federal purposes can be classified as resulting either from statutory differences in which profits are taxable or from differences in economic activity in different jurisdictions. Statutory differences arise from the fact that California has elected not to conform to the federal definition of income in several important areas. For example, differences in federal and state treatments of depreciation generate additions to income. On the other side, a number of types of dividends and certain capital gains may be subtracted from income under state law, but not under federal law.

Another potentially important recent change that may be reducing the ratio of state to federal net corporate income is the adoption by California of “water’s-edge” elections for tax years beginning on or after January 1, 1988. Previously, California considered total worldwide net income for all corporations. When corporations report on a worldwide basis, they begin with their federal profits, which are water’s-edge in nature. They then add in their income from outside the United States as an adjustment for California purposes. If the firms electing water’s-edge have profitable worldwide operations (which they should since water’s-edge is elective), then not requiring them to report their foreign profits as an adjustment will decrease income for state purposes relative to income for federal purposes. While water’s edge was adopted prior to 1988, the policy was relatively new, and the number of corporations opting for water’s edge was increasing rapidly during the years in question. The number of water’s edge electors increased from 406 in 1988 to 1,130 in 1989, 2,191 in 1992, and 5,714 in 2001. The expected reduction in net income reported by companies electing water’s-edge treatment will be partially offset by a

corresponding increase in apportionment factors.¹⁰ Firms will be more likely to elect water's edge, however, if doing so will reduce their tax liability. We estimate the 2001 revenue loss from allowing water's edge elections to be approximately \$360 million.

Figure 6
Ratio of California Corporate Net Income After and Before State Adjustments

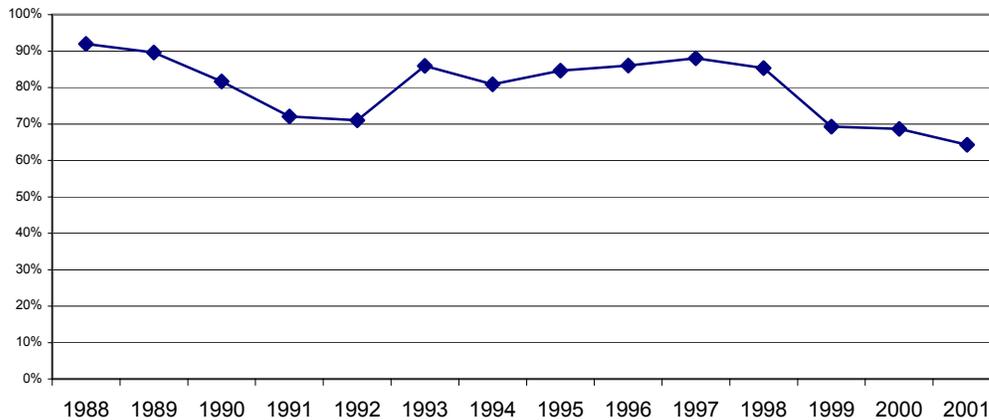


Figure 6 presents the ratio of net corporate income for California purposes after and before state adjustments for the years 1988 – 2001. This ratio has been quite volatile. The ratio of income after state adjustments to income before state adjustments decreased from 1988 to 1992 then rebounded to just below the 1988 level in 1993. This ratio was relatively stable from 1993 to 1998. The ratio dropped substantially in 1999 and dropped again in 2001. Overall, the ratio was 30 percent lower in 2001 than in 1988. Unfortunately, there is no data available for determining how much of this drop resulted from decreases in adjustments by firms electing water's-edge, and how much of the drop resulted from other changes in differences between federal and state law.

¹⁰ Apportionment factors measure the percentage of a corporation's business attributable to California. Corporations electing water's-edge will switch from using factors measuring the ratio of business conducted in California to business conducted worldwide to factors measuring the ratio of business conducted in California to business conducted in the United States. Since worldwide property, payroll, and sales must be greater than US property, payroll, and sales, the latter ratio must be greater than the first ratio. Thus, water's-edge election should raise apportionment factors.

Apportionment issues

As noted above, California does not tax all income of corporations conducting business in California. Rather it taxes only the portion of this income attributable to business activity taking place in California. This portion is determined by applying apportionment factors to a corporation's income. Several factors may have reduced average apportionment factors over the last decade and, in turn, contributed to the weakness in California corporate tax revenues. First, California emerged from the recession of the early 1990s later and more slowly than the rest of the United States. The proportion of national business activity attributed to California may, therefore, have decreased during the 1990s. By 2001, however, California's share of the national economy had rebounded (Personal Income in California was 13.2 percent of national Personal Income in 1988 and 13.0 percent in 2001), so California-specific macroeconomic weakness should not be contributing to the weakness in California corporate tax revenues.

Another possibility offered by some commentators is that there may have been an upswing in recent years in the resources devoted by corporations to state tax planning.¹¹ One area in which this trend may manifest itself is in organizing business operations to minimize apportionment factors in states that tax corporate income.

The aggregate ratio of post-apportionment to pre-apportionment income may also have shifted because of changes in the apportionment formula. California adopted a "double weighted sales factor" for most corporations in 1993.¹² An analysis of corporate tax return data suggests that this change reduced corporate tax revenue by approximately \$160 million in 2000 and \$110 million in 2001.

¹¹ See, for example, Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, **State Tax Notes**, March 22, 1999, p. 939-948.

¹² Previously, California used an equally weighted three-factor formula in which the portion of income attributed to California was equal to $[(\text{CA sales} / \text{total sales}) + (\text{CA payroll} / \text{total payroll}) + (\text{CA property} / \text{total property})] / 3$. The new factor is equal to $[2 * (\text{CA sales} / \text{total sales}) + (\text{CA payroll} / \text{total payroll}) + (\text{CA property} / \text{total property})] / 4$. For corporations whose sales factor is smaller than the other two factors, double-weighting the sales factor lowers the composite apportionment factor and lowers the ratio of State Net Income to pre-apportionment income. For corporations whose sales factor is larger than the other two, the effect is reversed. Agriculture and extractive industries were specifically exempted from this change.

Figure 7
Ratio of State Net Income to Pre-Apportionment Income

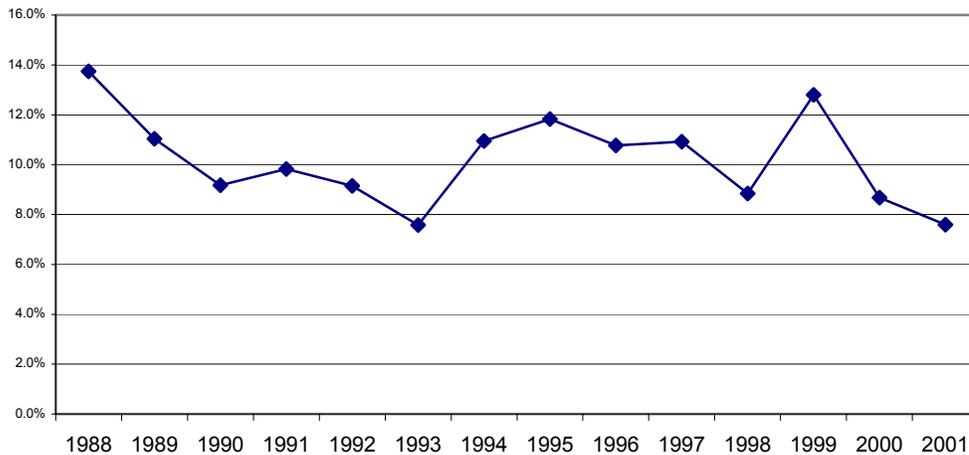


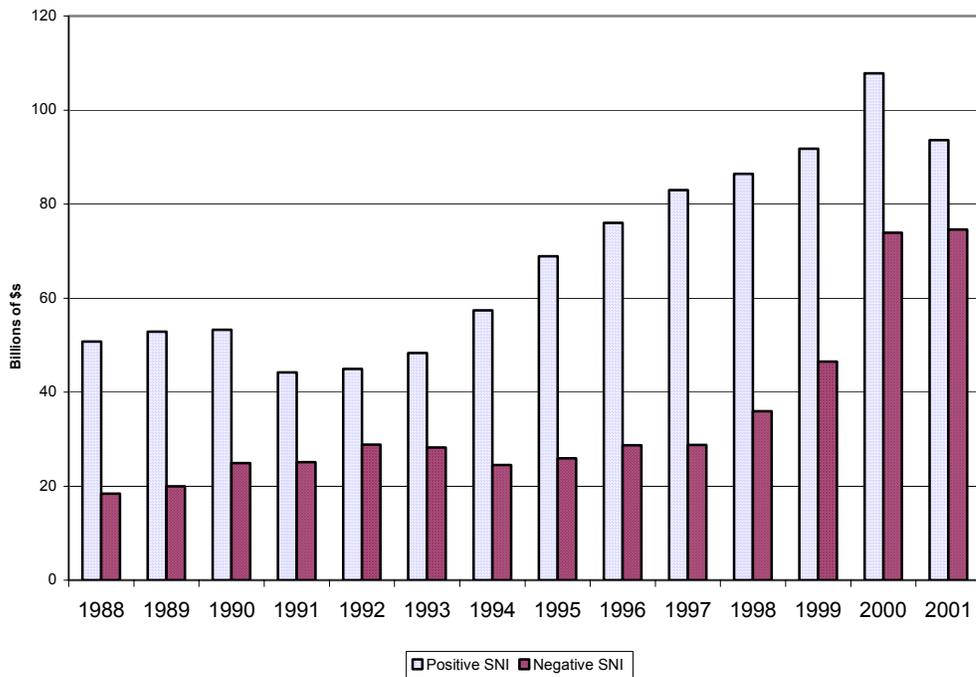
Figure 7 presents the ratio of net corporate income after state adjustments but before apportionment to State Net Income (SNI) after apportionment for the years 1988-2001. This ratio is quite volatile. The ratio of SNI to pre-apportionment income decreased significantly between 1988 and 1993. It then rebounded in 1994, dropped again in 1998, spiked up in 1999, and dropped in 2000 and 2001.¹³ Overall, the ratio of post- to pre-apportionment income decreased from 1988 to 2001 by 45 percent, despite the fact that, as described above, increases in water's-edge elections should have led to an increase in this ratio. The volatility of this ratio suggests caution in its interpretation, but changes in apportionment factors do appear to have played a role in the weakness of California corporate tax revenue.

¹³ It is interesting to note that the ratios presented in Figure 5 (State Profits Before Adjustments to Federal Profits) and Figure 7 (SNI to Pre-Apportionment Income) often (but not always) move in opposite directions. In some years this may result from corporate merger activity. For example, in a year in which many corporations not previously doing business in California merge with California corporations, all of the income of the non-California corporation gets added to SNI before apportionment, increasing the ratio of SNI before apportionment to federal corporate income. At the same time, the non-California corporation's property, payroll, and sales are added to the denominator, but not to the numerator, of the combined company's apportionment factors. This reduces the ratio of SNI to pre-apportionment SNI. When this occurs, these two effects should cancel and not affect the overall ratio of SNI to federal corporate profits or Corporation Tax revenues.

Profitable and Unprofitable Corporations

In the last several years, there has been substantial growth in the number of California corporations reporting losses and in the amount of losses reported. Figure 8 reports separately the SNI for corporations with positive SNI and those with negative SNI. Not surprisingly, the relationship between positive and negative SNI is cyclical. The ratio of positive SNI to negative SNI decreased from 1988 to 1992, increased from 1992 to 1997 then decreased again. As can be seen in Figure 8, negative SNI has grown more rapidly since 1997 than it did in the early 1990s. As a result, the weakness in net SNI is somewhat misleading. While net SNI decreased 41 percent from 1988 to 2001, positive SNI increased 84 percent. This growth is still less than the 98 percent growth in GSP during this time period, however.

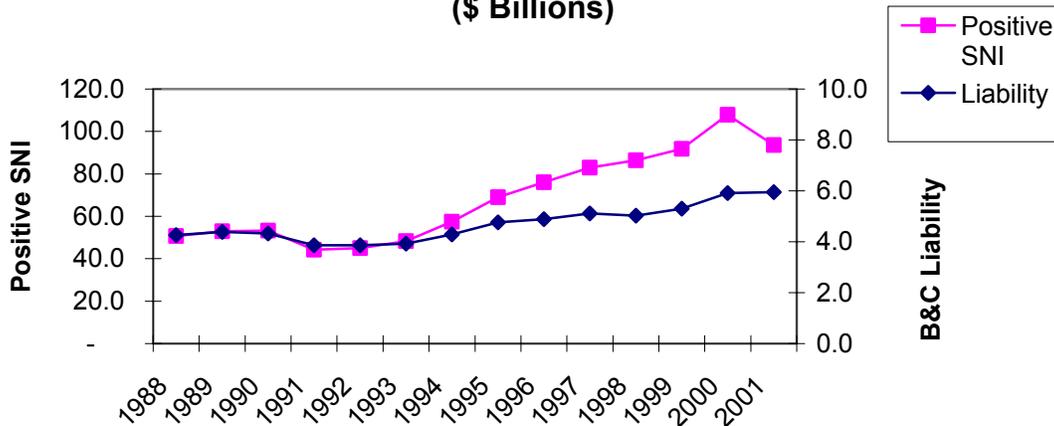
Figure 8
Positive and Negative SNI (\$ Billions)



2. The relationship between positive State Net Income and corporate tax revenues.

Since all corporate losses are taxed at a rate of zero, the rapid increase in negative SNI should have little affect on tax receipts. Instead, taxes ought to track positive SNI. As shown in Figure 9, positive SNI and tax liability tracked quite closely from 1988 until 1993. From 1993 to 2000, however, the growth in tax liability was substantially weaker than the growth in income of corporations reporting positive profits. In 2001, liability held steady while positive SNI dropped. Overall, the ratio of liabilities to positive corporate SNI dropped from 8.4 percent in 1988 to 6.4 percent in 2001. The remainder of this section discusses four factors that have contributed to this change.

Figure 9
Positive State Net Income and Corporate Tax Liability
(\$ Billions)



Net Operating Losses

One factor is the treatment of losses. Starting in 1987, California allowed corporations to subtract one half of all net operating losses (NOLs) generated in the previous five years from their SNI before calculating their taxes.¹⁴ The percentage of losses that could be deducted was increased to 55 percent in 2000, 60 percent in 2002, and will be increased to 100 percent in

2004. Beginning in 2000, the period in which the NOLs could be claimed was expanded from 5 years to 10 years. In response to budget crises, the deduction of NOLs was suspended for tax years beginning in 1991 and 1992, and again in 2003 and 2004. For NOLs that could otherwise have been applied during these suspensions, the time limit for applying the losses was extended by 2 years. California also allows corporations to deduct certain losses resulting from natural disasters. From 1988 to 2001, NOL usage increased 236 percent. Losses allowed California corporations to reduce their taxable income by \$6.5 billion in 2001. This reduced Corporation Tax revenues by about \$520 million in 2001. An increase in losses to offset income has, therefore, contributed to the sluggishness of Corporation Tax revenues during this period.

S-corporations

Another important factor is the recognition by California of the S-corporation. California first allowed S-corporations in 1987. S-corporations are taxed at a rate of 1.5 percent, rather than the 8.84 percent rate for C-corporations.¹⁵ Therefore, any shift of businesses from C-corporation to S-corporation status between 1988 and 2001 will have reduced the ratio of tax liability to SNI for California corporations. The number of S-corporations in California has grown from 50,964 in 1988 to 193,344 in 2001. As a result, by 2001, 38 percent of all corporations paying taxes in California were S-corporations. Positive SNI of S-corporations grew during these years from 12 percent to 31 percent of total positive SNI. The exact revenue impact of S-corporations depends on how many S-corporations would still have chosen to be corporations if the S-corporation option were not available (rather than becoming a partnership, a sole proprietorship or an LLC). If all S-corporations had been C-corporations, California corporate tax liabilities would have increased by about \$2.1 billion in 2001. Alternatively, if we assume that all S-corporations that had once been C-corporations had remained C-corporations in 2001, but that all other S-corporations would not have formed as corporations, 2001 corporate liability would have been just over \$1.0 billion greater. We estimate the actual effect of S-corporations on corporate liability to lie closer to the first of these two numbers, at slightly less than \$1.9 billion. This makes S-

¹⁴ The deduction of net operating losses was suspended for tax years beginning in 1991 and 1992.

corporations one of the most important sources of weakness in Corporation Tax revenue growth. Of course, since S-corporation income is passed through to shareholders, their personal income tax implications must also be considered in calculating the overall revenue impact to the state of S-corporations. We estimate the personal income tax revenue gain from S-corporations to be about \$1.2 billion for 2001, thus the net revenue loss from S-corporations is about \$800 million.¹⁶

Tax rates

A third factor lowering the ratio of liabilities to SNI is the recent reduction in California corporate tax rates. The rate for C-corporations was lowered from 9.3 percent to 8.84 percent in 1997. The rate for S-corporations was reduced from 2.5 percent to 1.5 percent in 1995. Had California collected tax on 2001 income at the 1988 rates, approximately \$590 million more would have been collected.

Tax Credits

Finally, there has been a dramatic increase in tax credits granted to California corporations since 1988. In 1988, California corporations claimed only \$64 million in tax credits. In 2001, they claimed \$938 million in tax credits, an increase of \$874 million, or 1,365 percent over 1988.¹⁷ The biggest credits claimed in 2001 were \$425 million for the research and development credit and \$320 million for the manufacturer's investment credit.¹⁸ Figure 10 presents the time trend in the ratio of credits to corporate tax liabilities. This ratio increased from 1.5 percent in 1988 to 16.7 percent in 2000, then receded to 13.6 percent in 2001. As a result, Corporation Tax liabilities increased only 40 percent from 1988 to 2001, compared to a 59 percent increase in Tax Before Credits.

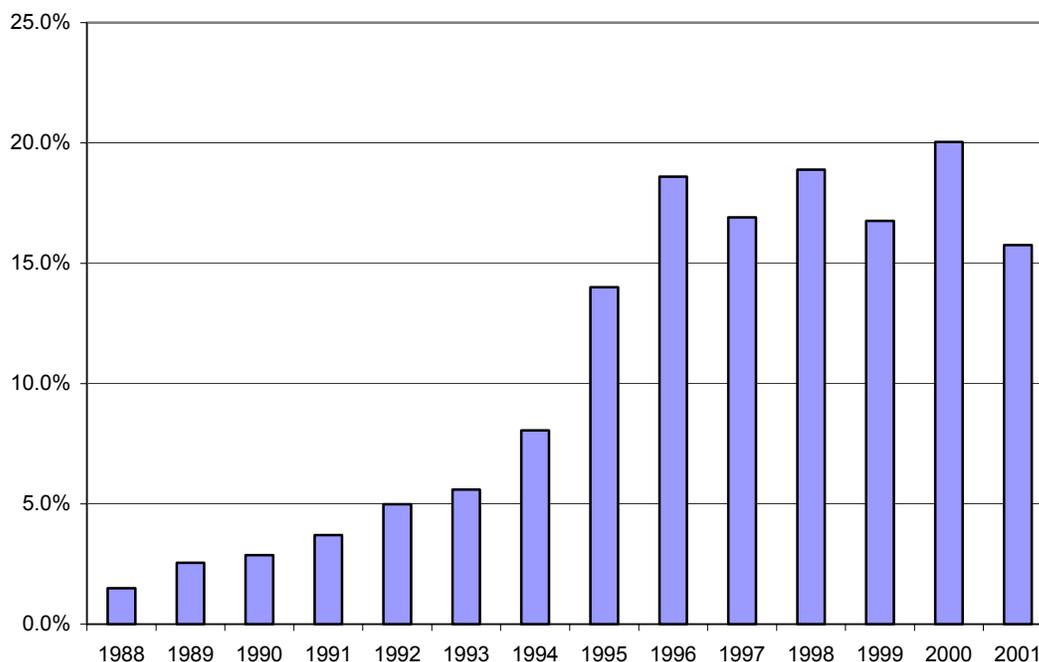
¹⁵ Prior to 1994, the S-corporations tax rate was 2.5 percent.

¹⁶ The net gain from S-corporations on the PIT side is smaller than the Corporation Tax loss primarily because flow-through losses may be used to offset other types of income and, hence, are more likely to reduce taxes than are losses that must be taken at the corporate level.

¹⁷ In 2000, corporations claimed \$1.185 billion in credits.

¹⁸ As of this writing, if no legislative action is taken to extend it, the MIC is scheduled to expire in 2004.

Figure 10
Credits as a Percentage of Corporate Tax Liability



3. Conclusion, The Cumulative Effect of Policy Changes

California Corporation Tax liability grew only 40 percent from 1988 to 2001. This is substantially less than the contemporaneous growth in other major sources of California revenue and in the California economy in general during this time period. A variety of factors contributing to the sluggishness of Corporation Tax revenue have been discussed above. Table 1 summarizes the impact on tax liability of the five important recent changes that we have been able to estimate: tax credits, tax rate changes, S-corporations, water's-edge elections, and carryover losses. The top row in the table shows actual California Corporation Tax liabilities in 1988 and 2001. The next five rows present estimates of what would have happened to liabilities had any one of these five items not been in place (keeping the other four changes). For example, the estimate in the first column of the second row shows what liabilities would have been in 1988

	Revenue (\$ Billions)		Percent Difference
	1988	2001	
Actual	4.26	5.95	40%
Eliminate All Credits	4.33	6.91	60%
1988 Tax Rates	4.26	6.54	53%
Disallow S-corporations	4.64	7.85	69%
Eliminate Carryover Losses	4.44	6.47	46%
Disallow Water's-Edge Elections	4.34	6.31	45%
Cumulative Effect	4.96	10.23	106%

had tax credits not been allowed in that year; and the estimate in the second column of the second row shows what 2001 liabilities would have been without tax credits. The last line of the table estimates the cumulative liability in these two years in the absence of all five factors.¹⁹ The last column of Table 1 reports the percentage growth of liabilities from 1988 to 2001 for each of these scenarios. We estimate that if California allowed no tax credits, S-corporations, water's-edge elections, or carryover losses in either year, and if 1988 tax rates applied in both years, corporate tax liability growth from 1988 to 2001 would have been 106 percent. Under this scenario, California Corporation Tax liabilities would have grown from 0.72 percent to 0.75 percent of California GSP between 1988 and 2001. The contrast between this result and the actual ratio of corporate tax liabilities in these two years (see Figure 2 above) is presented in Figure 11.

¹⁹ Note that the cumulative impact of two changes in tax law may not equal the sum of the isolated impact of each change. For example, if we revert to 1988 tax rates, the tax on S-corporations will increase by 1 percent of positive SNI (1.5 percent to 2.5 percent); however, if we first disallow S-corporations, the effect on of a rate change on these corporations will only be 0.46 percent of positive SNI (8.84 percent to 9.3 percent).

The discussion above does not present an exhaustive catalog of all the policy changes, economic trends, business cycle fluctuations, or corporate tax planning strategies that have affected Corporation Tax revenues since 1988. Particularly unfortunate is that the data used in this report are not suitable for testing recent reports that national and state tax shelters have had a significant impact on corporate tax revenue. Nonetheless, the quantitative examination presented here of the impact of several major policy changes indicates that policy decisions have played a significant role in the recent weakness of these revenues.

Figure 11
California Corporate Tax as a Percentage of GSP 1988 and 2001,
With and Without Five Policy Changes

