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AN ANALYSIS OF REDUCING THE CORPORATE INCOME TAX RATE¹

Georgia's corporate income tax generated \$670.4 million in revenue in FY 2011, accounting for 4.3 percent of Georgia's total state tax revenue.² Over the years there have been calls in Georgia, as well as in other states, to reduce the corporate tax rate. One option would be to reduce the corporate income tax rate to zero; that is, eliminate the corporate income tax entirely. We are unaware of any state that has ceased taxing corporations, but in the past few years two states have replaced their corporation income tax with a gross receipts tax that is levied on all businesses. There have been suggestions that states impose a value added tax on businesses, including non-corporate firms, as a replacement for the corporation income tax.³

In its final report, the Special Council on Tax Reform and Fairness for Georgians (2011) proposed that Georgia reduce its corporate income tax rate from the current 6 percent to 4 percent. The Tax Reform Council tied this rate reduction to its proposal to decrease the top marginal personal income tax rate from 6 percent to 4 percent. However, there is no inherent reason why the state's corporate income tax rate has to be equal to the top marginal personal income tax rate. In fact, for many years these two rates were not equal in Georgia, nor are they equal at the federal level.

In this policy brief we focus on the proposal to reduce the corporate income tax rate, not eliminating the tax. In particular we discuss the effect on incentives and revenue from reducing the corporation income tax rate from 6 percent to 4 percent. We also suggest two alternatives to an across the board reduction in the corporate tax rate.

Incentive Effects

We first discuss the effect of reducing the corporate tax rate on economic incentives for the firm. While reducing the Georgia tax rate from 6 percent to 4 percent is a decrease of 2 percentage points, to determine the economic incentive effect it is necessary to also consider the federal corporate income tax and the role of the apportionment formula (see Box 1 for an explanation of the apportionment formula).

Other than small corporations, C-corporations pay, at the margin, a federal corporate income tax rate of 35 percent.⁴ A firm can deduct Georgia's corporate income taxes in calculating its federal income tax liability.⁵ Thus, if a firm's Georgia taxable corporate income increased by \$100, at current tax rates the firm would pay an additional \$38.90 in federal and Georgia corporation income taxes.⁶ If Georgia reduced its corporate income tax rate to 4 percent, the firm would pay \$37.60 in total corporation

BOX 1 APPORTIONMENT OF PROFITS OF MULTI-STATE FIRMS

Rather than requiring firms that operate in multiple states to maintain separate financial records for their operations in each state, as is done for multi-national firms, states require firms to calculate an apportionment ratio using the state's apportionment formula. This apportionment ratio is used to determine the amount of the firm's operating income that is taxed in a particular state. States use three factors, either alone or in combination, in the apportionment formula, namely, sales (gross receipts), payroll, and property. In all cases, a firm calculates the ratio of, say, sales in the state to its sales throughout the entire U.S.

Most states use what is known as the three-factor formula. In this formula, the ratios for sales, payroll, and property are added and divided by three. Several states have, over the past several years, adopted alternative formulas, generally increasing the importance of sales in determining the apportionment ratio. Several states now double weight the sales factor, that is, the sales factor is counted twice, and thus, the total of 2 times the share of sales plus the share of the other two factors is then divided by 4. Georgia and nine other states have adopted an apportionment formula that uses only the sales factor. Imposing an apportionment formula based only on the sales factor is seen by many as having a positive effect on economic development within a state. Under the traditional three-factor apportionment formula, firms that increase their physical property or employment within a state face a higher apportionment rate which may lead to an increased tax liability. Using just the sales factor in the formula means that increases in employment or physical investment do not result in increases in the firm's tax liability.

For some industries a different method is used to apportion taxable income. For corporations whose income comes mainly from transporting passengers and cargo by air, the apportionment is based on the Georgia share of the firm's air miles, tons of cargo handled, and originating miles, with the weights on the first two factors being 0.25 and the weight on the third factor being 0.5. Special provisions are also made for apportioning profits of credit cards firms, public service corporations, pipeline firms, and railroads.

Georgia's current apportionment formula was fully adopted in 2008.

income taxes on the additional \$100 income. This amounts to a reduction in the total tax rate of 1.3 percentage points, or a 3.3 percent reduction in federal plus Georgia corporate income taxes.

Georgia's apportionment formula also plays an important role in determining the incentive effects of the corporate income tax. In Georgia, a firm's profit is apportioned based on the ratio of the firm's sales in Georgia to its total U.S. sales. The effect on a firm's effective tax rate from a reduction in Georgia's corporate income tax rate depends on the firm's apportionment ratio. Consider a multistate firm that invests in Georgia and earns a return of \$100 million before income taxes. Assume that the distribution of the firm's sales across states does not change as a result of the investment and that the firm's apportionment ratio is 25 percent. Thus, the income tax liability (federal and Georgia) on the \$100 million of income would be \$35.98 million, which is an effective tax rate on the investment of 35.98 percent.⁷ If Georgia reduces its corporate income tax rate to 4 percent, the firm would pay \$35.65 million in combined income taxes, which is an effective tax rate on the investment of 35.65 percent. This amounts to a decrease in the effective tax rate on the investment of 0.33 percentage points, which is a reduction of 0.92 percent in its combined

Georgia and federal income tax liability. The smaller the apportionment ratio, the smaller will be the reduction in the firm's effective tax rate due to the reduction in Georgia's corporate income tax rate.

The reduction in the firm's effective tax rate provides an incentive for the firm to increase its investment or economic activity in Georgia. But we are also interested in determining whether the reduction in Georgia's corporate income tax rate provides an incentive for a firm to invest in Georgia rather than in another state.

For corporations that already have nexus⁸ in Georgia, a reduction in the corporate income tax rate may cause no change in the incentive for the firm to locate new investment in Georgia. The fact that Georgia uses an apportionment formula that relies entirely on sales influences the effect of a reduction in the corporate income tax rate on the incentives for investing in Georgia. To see this, consider the following simple example. Consider a firm that has nexus in Georgia and is deciding whether to locate a new plant either in Georgia or some other state, State A, which uses a three-factor apportionment formula. Because the firm's Georgia apportionment ratio is based only on sales rather than payroll or property, we can generally assume

that the location of the new plant will not change the firm's Georgia apportionment ratio.

Suppose further that the plant generates taxable income of \$100 million regardless of which state it locates the plant and that the firm would pay \$2 million in taxes to State A if the plant was located in State A, but would pay no taxes to State A if the plant was located in Georgia. Assuming that the firm has nexus in Georgia and has a Georgia apportionment ratio of 50 percent, the firm would pay taxes to Georgia of \$3 million (= \$100 million \times 50% \times 6%) regardless of whether the plant was located in Georgia or in State A.⁹

If the plant was located in State A, the firm's tax would be \$5 million (\$3 million to Georgia and \$2 million to State A), which is \$2 million less than if they located in State A. Therefore, the firm would be better off locating the plant in Georgia. Now consider what happens if Georgia reduced its corporate tax rate to 4 percent. The firm would pay \$2 million in Georgia income tax (= \$100 million \times 50% \times 4%) but would pay \$4 million in taxes if it located the plant in State A (\$2 million to Georgia and \$2 million to State A). The tax difference is still \$2 million. Thus, the reduction in Georgia's tax rate does not change the size of the incentive (a saving of \$2 million) to locate the plant in Georgia. While the reduction in Georgia's corporate income tax rate provides no additional incentive for this firm to locate the new investment in Georgia, the rate reduction does reduce taxes paid by \$1 million which may lead to new investment, but not necessarily in Georgia.

This result holds for any corporation that currently has nexus in Georgia. However, for firms that do not currently have nexus in Georgia, locating a plant in Georgia would result in the firm paying Georgia income tax only if the plant was located in Georgia (which gives the firm nexus in Georgia) and had sales in Georgia. In this case, the firm would pay \$3 million in taxes if its located in Georgia and \$2 million in taxes if it's located in State A, assuming 6 percent corporate tax rate. Lowering the Georgia corporate tax rate to 4 percent, reduces the tax liability to \$2 million if the firm were to locate in Georgia.

Using corporate income tax returns for 2008 Table 1 shows the distribution of the number and size of C-corporations in Georgia by the value of the apportionment ratio.¹⁰ We measure size by federal taxable income. 64 percent of firms have apportionment ratios greater than 80 percent. However, 46 percent of Georgia taxable income is earned by firms with apportionment ratios of less than 50 percent. Table 2 shows the average apportionment ratio by federal taxable income

categories. Note that the ratio falls with increasing federal taxable income. The average apportionment ratio across firms is 66 percent, while the average weighted by Georgia taxable income is 49 percent. This suggests that the change in the effective tax rate from reducing the Georgia tax rate from 6 percent to 4 percent would be rather small for a substantial percentage of economic activity in Georgia.

Reducing Georgia's corporate income tax rate would mean an increase in the return on an investment, which would be expected to increase economic activity. While the literature implies that corporations would respond to a change in the tax rate, the estimates of the magnitude of the resulting change in economic activity vary widely.

We are reluctant to use these published estimates to forecast the effect of changing the Georgia corporate income tax rate given that the studies do not use a consistent measure of the tax rates and to the uncertainty of the timing of any response by corporation to a tax change. However, Chirinko and Wilson (2010) do present evidence as to the effect on investment in equipment and structures from a reduction in corporate tax rates. For Georgia, they estimate that a one percentage point reduction in the corporate income tax rate would increase investment in structures and equipment by 0.86 percent in the long run. Chirinko and Wilson's finding thus suggests that investment in Georgia in the long run would increase by 1.72 percent by corporations as a result of reducing the corporate tax rate by two percentage points. Chirinko and Wilson account for the effect of federal deductibility of Georgia's taxes, but not apportionment. Given the weighted average apportionment ratio of 49 percent, Chirinko and Wilson's results imply that the two percentage point reduction in Georgia's statutory tax rate would increase investment in Georgia by corporations in the long run by 0.84 percent.

Finally, it is possible that if Georgia reduced its corporate income tax, other states would follow suit if they thought Georgia's action would result in a loss of industry from their state. Such a reaction would reduce the magnitude of the incentive effect of a reduction in Georgia's corporate income tax rate.

Effects on Tax Revenue

While cutting the tax rate to 4 percent is a reduction in the tax rate of one-third, the percentage reduction in revenue will be somewhat larger because of tax credits¹¹ Using the corporation income tax returns for 2008, the estimated reduction in tax liability for tax year 2008 of reducing the tax rate to 4 percent would have been \$181 million, which is 35 percent of the \$514

TABLE 1. DISTRIBUTION OF C-CORPORATIONS BY THEIR GEORGIA APPORTIONMENT FACTOR, 2008.

	Percent of Federal Taxable Income	Percent of Corporations
Apportionment Rate=0 percent (100 percent out of state)	11.3 percent	7.9 percent
0<Apportionment Rate<=25 percent	86.1 percent	25.5 percent
25 percent<Apportionment Rate<=50 percent	0.5 percent	1.5 percent
50 percent<Apportionment Rate<=75 percent	0.1 percent	0.9 percent
75 percent<Apportionment Rate<100 percent	0.4 percent	1.3 percent
Apportionment Rate=100 percent (100 percent in state)	1.5 percent	62.9 percent

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

TABLE 2. AVERAGE APPORTIONMENT RATIO OF C-CORPORATIONS BY FEDERAL TAXABLE INCOME, 2008

	Average Apportionment Ratio
Federal Taxable Income<=\$0	0.73
\$0<Federal Taxable Income<=\$100,000	0.84
\$100,000<Federal Taxable Income<=\$500,000	0.40
\$500,000<Federal Taxable Income<=\$1,000,000	0.22
\$1,000,000<Federal Taxable Income<=\$10,000,000	0.13
\$10,000,000<Federal Taxable Income	0.05

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

TABLE 3. REVENUE EFFECTS OF REFORM OPTIONS

	-----Average Tax Savings-----	
	Reduce Rate to 4 Percent	Implement 2 Percent Bracket
Federal Taxable Income<=\$0	\$114	\$80
\$0<Federal Taxable Income<=\$100,000	\$198	\$366
\$100,000<Federal Taxable Income<=\$500,000	\$909	\$1,316
\$500,000<Federal Taxable Income<=\$1,000,000	\$1,416	\$1,230
\$1,000,000<Federal Taxable Income<=\$10,000,000	\$2,832	\$1,166
\$10,000,000<Federal Taxable Income	\$49,416	\$1,761

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

million tax liability reported on the tax returns.¹² This number is a static estimate in that it does not account for any behavioral response to the tax rate cut.

A reduction in the tax rate will likely increase economic activity in the state, although as suggested above, this effect is unlikely to be large. In addition, it will take time for any impact to be felt. With the reduced tax rate, firms may engage in tax planning to shift income to Georgia, which would offset the reduction in tax revenues. Furthermore, a reduction in the corporate income tax relative to the personal income tax has been shown to affect the choice of operating as a C-corporation rather than as a S-corporation or as a limited liability corporation (LLC). To the extent that some firms

convert to C-corporations, tax revenue will increase, although with a corresponding decrease in personal income tax revenue.

Alternatives

As noted above it is unlikely that cutting corporate tax revenue by 35 percent will have much effect on the level of economic activity in the state, particularly in the short run. Thus, the state might want to consider an alternative that would provide a larger increase in economic activity.

One alternative would be to impose a two-rate system. There are 13 states that have a multi-rate corporate income tax system. For example, Georgia could impose a 2 percent rate on taxable income of, say, \$250,000 or less and a 6 percent rate on

taxable income above \$250,000. This option would provide a substantial percentage reduction in taxes for smaller firms and a smaller reduction for larger firms.¹³ Smaller firms are less likely to be multi-state firms, and thus the effect of the tax rate reduction will be larger. However, large multi-state firms might have small Georgia taxable income. Using the corporate income tax returns for 2008, we estimated the revenue loss for tax year 2008 from this option to be \$24 million, which is a 5 percent reduction in corporate tax revenues. This is a static estimate; behavioral changes would affect the revenue estimate.

Table 3 shows the average reduction in tax liability by corporation size, as measured by federal taxable income, for both tax rate reduction options.

A second alternative would be to change the apportionment formula so that it would be smaller for corporations that have a large physical presence in Georgia. For example, consider the following apportionment formula:

$$(\text{Sales factor}) - 1/3 \times (\text{property factor}),$$

where the sales factor is the current apportionment ratio and the property factor is the ratio of the firm's property in Georgia divided by its total property. This would be the property factor that was used when Georgia had a three-factor apportionment formula. Of course, the property term in the above expression could be replaced by the average of the firm's property and employment shares in Georgia.

This formula would reduce the apportionment ratio, and thus the effective tax rate, for corporations that have investments in Georgia. Consider a firm whose sales and property are entirely in Georgia. Under the current corporate income tax the apportionment ratio is 1, and thus its corporate income tax liability would be its net income times 6 percent. With the alternative formula, the apportionment ratio would be 0.67 ($= 1 - 1/3 \times 1$), and thus its corporate income tax liability would be its net income times 4 percent ($= 0.67 \times 6\%$). In other words, this firm would have a reduction in its effective tax rate of 2 percent points. It would be the same as if the statutory tax rate was reduced to 4 percent, but the relief is targeted to those corporations with property in Georgia.

On the other hand, firms that have relatively little physical presence in Georgia would experience a small reduction in their effective tax rate. For example, consider a firm that has sales in Georgia but essentially no property. Suppose its sales factor was 0.5 and its property factor was 0.01. This firm's current effective tax rate is 3 percent ($= 0.5 \times 6\%$). Under the revised formula the firm's effective tax rate would be 2.97 percent, and thus the reduction in this firm's effective tax rate would be 0.03 percentage points.

As noted above, for this firm a reduction in the statutory tax rate would provide no additional incentive to invest in Georgia. However, the revised apportionment formula provides an incentive for the firm to investment in Georgia rather than in another state. Investing in Georgia would increase the last term in the proposed formula, and thus reduce its effective tax rate.

Using the corporate income tax returns that were provided by the Department of Revenue, we estimated that if the state had implemented this apportionment formula for tax year 2007, the reduction in 2007 corporate tax liability would have been 31.4 percent.¹⁴ Multiplying the 2008 corporate tax liability by this percentage yields an estimated reduction in tax liability of \$161 million. This compares to the estimated reduction in 2008 tax liability of \$181 million from reducing the tax rate from 6 percent to 4 percent.

NOTES

¹This Policy Brief is drawn from Sjoquist, Wheeler, and Almada (2012).

²For a description of Georgia's corporate income tax and review of the issues associated with the corporation income tax, see Grace (1998 and 2002) and Sjoquist and Wheeler (2012). The reported revenue includes revenue from the net worth tax.

³For a discussion of gross receipt taxes and value added taxes see Wheeler and Sennoga (2007), Martinez-Vazquez, et al. (2007), Bird (2007), Wheeler and Monkam (2007).

⁴C-corporations are what one normally considers to be corporation. S-corporations are firms with a small number of owners and for which profits are passed through to the owners and taxed as personal income.

⁵The firm can also deduct the Georgia income tax in calculating its Georgia's corporate income tax liability for the following year. We ignore this. Georgia is the only state that allows a deduction of its own income tax in calculating Georgia tax liability.

⁶This was calculated as the combination of the following two expressions: federal tax = $(100 - \text{Ga Tax}) \times 35\%$ and Ga Tax = $100 \times 6\%$.

⁷The firm's Georgia income tax would be $\$100,000,000 \times 0.25 \times 0.06$. The firm's federal income tax would be $(\$100,000,000 - \text{GA tax}) \times 0.35$.

⁸Nexus refers to a level of economic presence in a state. Once a firm is deemed by state law to have nexus in that state, it is obliged to pay state tax on income earned in that state.

⁹It is important to understand that because the apportionment ratio is based only on sales, the location of a plant in Georgia will not affect its apportionment ratio or its tax liability to the state.

¹⁰We obtained the individual corporate income tax returns, stripped of firm identification, for 2008 from the Department of Revenue. We use these data to make several calculations.

¹¹To illustrate, consider the formula for determining tax liability: (income*tax rate – credits). For income of \$1,000 and credits of \$10, the tax liability would be \$50 with a tax rate of 6 percent, and \$30 with a tax rate of 4 percent. The reduction in tax liability in this case is 40 percent, not 33.3 percent.

¹²Tax liability is not the same as tax revenue since the payment of the tax liability will occur over time as corporations make estimated payments and obtain refunds.

¹³Large firms will have a reduction in their taxes since all firms would be taxed at only 2 percent on the first \$250,000.

¹⁴We used 2007 tax returns since that was the last year for which the value of the property factor was reported.

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