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INTERPRETING FEDERAL REVENUE ESTIMATES: CORPORATE RECEIPTS AFTER THE TAX REFORM ACT OF 1986

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I. Overview

Distinguishing itself from other tax legislation of the 1980s, the Tax Reform Act of 1986 (TRA86) altered the basic structure of the U.S. tax system. A particularly important feature of TRA86 was the shifting of the collection of approximately $120 billion in revenue from individuals to corporations for fiscal years 1987–1991 in order to maintain the "revenue-neutrality" of the package. Halfway through this period, the magnitude of the increased corporate liability remains in question. This question has most recently been of concern to several states (as well as to a number of commentators) which had expected to see state tax receipts rise as a result of federal base broadening.

While this paper will touch upon several aspects of recent corporate tax law changes its primary purpose is to outline some of the methodological issues in using federal corporate revenue forecasts as an input to state revenue forecasts. These forecasts include both the semiannual budget forecasts and the estimates of the revenue effects of proposed and enacted legislation. In addition, this paper examines federal corporate receipts since 1985 in an attempt to quantify the extent that federal corporate receipts may have been increased as a result of TRA86.

In the next section of this paper the use of semiannual federal budget forecasts for state revenue forecasting purposes is addressed. The third section contains a discussion of the use of federal revenue estimates of proposed and newly enacted legislation. The fourth section examines recent federal collections history and is followed by the conclusion.

II. Budget Forecasts

At the federal level, budget forecasts are produced twice a year. In January, the President (through the Office of Management and Budget, OMB) submits to Congress a proposed Budget for the upcoming fiscal year containing a detailed listing of proposed outlays and estimated receipts along with any tax proposals. In August, these estimates are revised to incorporate recent legislative and administrative actions as well as changes in the economic forecast. The revised estimates are released as the *Mid-Session Review of the Budget*.

The federal receipts estimates are produced for OMB by the Office of Tax Analysis (OTA) of the Department of the Treasury. Paralleling the work of the executive branch, the Tax Analysis Division of the Congressional Budget Office (CBO) produces a similar set of estimates for Congressional use based upon a separate macroeconomic forecast.

To properly use federal forecasting information for state revenue forecasting three principal issues need to be addressed. These issues concern the level of aggregation, the nature of what is being estimated at the federal level, and, most important, the underlying economic assumptions. Most of these issues have been the subject of general discussion for a number of years and will only be briefly reviewed here.

a. Aggregation

The most obvious issue states must address when using federal forecasts is the need to disaggregate. By its nature, the federal forecast is an aggregate forecast of income from all states and therefore not directly usable by any given state in estimating their own receipts. Unlike their federal counterparts, state forecasters need to be much more attentive not only to the state's industry mix but also to the relative profitability of the state's industries.

While the need to disaggregate the federal forecast is obvious, the information necessary to adequately accomplish it many not be readily available. Corporate activity within a state may be concentrated within specific industries or be dominated by a small number of firms. In these cases, the federal forecast may yield very little information of use to forecasters.

b. Definition of the Receipts Baseline

The President's budget contains two sets of receipts projections derived from a single set of macroeconomic assumptions. The most useful for state estimating purposes, current services, presents a forecast of receipts and outlays under the assumption that the current level of government activity will continue. The second set of projections, proposed law, are estimates of the level of receipts and outlays that would be realized if all of the President's budget proposals were adopted—to the exclusion of all others. Since neither of these options are likely to occur, the forecast levels of receipts must be viewed with caution. Except for periods of unusual legislative activity, the current service estimates more closely resemble a standard forecast, at least in the short-run. Beyond two years, however, the forecast quality of the estimates deteriorates as it becomes a projection of the potential direction the economy could follow if all of the President's proposals are adopted.[1]

c. Assumptions

The most important issue to be addressed by those who would use the federal receipts forecast is the accuracy of the underlying macroeconomic forecast. While the movement of the state's economy relative to the national economy is critical to obtaining an accurate state forecast, the accuracy of the federal macroeconomic forecast may have greater quantitative significance. In addition, the federal macroeconomic forecast will be one of the greatest determinants of the estimated effects of recently enacted legislation—an issue which will be dealt with separately in the next section.

The accuracy of federal macroeconomic and receipt forecasts has been the subject of recent inquiry.[2] However, regardless of the accuracy of the published aggregate variables, the importance of the accuracy of sub-components of the forecast should not be overlooked. In the pre-TRA86 world, corporate profits may have been the primary determinant of gross corporate tax liability, but the investment assumptions would have determined the amount of investment tax credits available to reduce liability. Unfortunately, very little detailed information from the macroeconomic forecast is released to the public.

One potential check on the reasonableness of the administration's forecast is the forecast produced for Congress by CBO. The CBO receipts forecast is based upon a separate set of macroeconomic assumptions and can be used to highlight the sensitivity of corporate collections to corporate profits levels. Whether CBO or OMB produces the more accurate corporate receipts forecast is an unanswered question. The aggregate forecasts of these two agencies have not appeared to be very different.[3]

The importance of the various unpublished components of the macroeconomic assumptions are highlighted when there are changes in the tax law. After a legislated change in the law, estimators are not able to use recent history as a guide for projecting future revenue. Since many years may pass between the enactment of a new law and the availability of data,[4] forecasts of receipt levels as they would have been in the absence of change are used as a base, with estimates of the marginal effects of the new law added as a final adjustment. Questions regarding the interpretation of federal estimates to determine the appropriate adjustments to TRA86's corporate provisions are addressed next.

III. Enacted Legislation

As with the state use of federal forecasts, most of the important issues regarding the interpretation and use of federal estimates of newly enacted legislation have been discussed by others.[5] This section will merely try to highlight some of the major issues and more fully examine issues which may have received insufficient attention earlier.

a. Aggregation

In the case of enacted legislation it may be easier for state forecasters to disentangle the effects of numerous tax provisions on their states receipts than it is to utilize the federal receipts forecast. Unlike federal revenue forecasts, enacted legislation tables (such as those regularly produced by the Joint Committee on Taxation (JCT), or occasionally released by the Department of the Treasury) display the effects of a new tax law provision-by-provision. As a result, if a state has within it's borders a large share of the country's companies likely to be affected by a provision[6]—defense contractors, insurance companies, or timber, for example—the state can use this data to infer the law's effects on state revenue. Likewise, any state having a very small number of firms in a particular industry, or no firms, can discount the effect that the particular provision will have on state revenue. For rate changes and general base-broadeners, which would affect all firms, the task is more difficult and more closely resembles the methodology used to disaggregate federal budget receipts forecasts.

Even after determining the share of national economic activity within a state, the tax condition of

those companies—as opposed to their general business condition—will also affect the amount of state revenue. In particular, if companies within a state are relatively less profitable, or are currently profitable but have net operating loss carryforwards, the net effect of a revenue increasing provision can be substantially reduced, or completely offset, at least in the short-run.

Transition rules are generally included in new legislation to reduce the burden on corporations which had made business decisions on the basis of prior law. For example, in TRA86, companies with binding contracts prior to a specified date for investment in capital goods were given relief from some of the changes in the capital cost recovery rules. "Rifle-shots" provide relief from changes in law to particular companies or projects. In either case, the effect of both of these types of provisions are to reduce the amount of tax to be paid by corporations. If large companies within a state are recipients of substantial transition relief, it will reduce the amount of additional revenue flowing to the state.

Finally, the "stacking order" of the various provisions will affect the amount of revenues a state gains or loses from a law change. "Stacking order" refers to the sequence in which provisions were estimated.[7] For example, the federal estimates of corporate provisions in TRA86 stacked the rate reductions first, followed by the repeal of the investment tax credit, other capital cost provisions, and finally the remaining changes. The estimates of the rate reductions were therefore based upon the level of taxable income that would have existed under prior law. It is easy to see that if the rate reductions were stacked last, after the effects of the base-broadeners had been estimated *at the old rates,* the estimates of *all* corporate provisions would have been different than those reported by the JCT and Treasury.

Stacking order decisions also affect the amount of interaction different provisions will have with each other. For example, if the particular circumstances of companies within a state meant that they would be affected by only two of three interrelated provisions, the published data would be of little use to state analysts unless the provision which did not affect their state was stacked last. Otherwise, it would be difficult, perhaps impossible, to quantify the impact of only two of the three provisions.

b. Assumptions

The level and composition of projected macroeconomic activity is perhaps the most significant quantitative issue to be dealt with when using federal enacted legislation tables. Although briefly touched upon in the earlier discussion of receipts, knowing the detailed assumptions affecting each tax provision is essential to using the information for state, or any other, forecasting purpose.

In the case of aggregate assumptions published as part of the Budget process, attention to the forecast levels, and comparison to the macroeconomic assumptions used by the state, will provide some insight about the magnitude of any necessary adjustments. Retrospective examination of forecasts is also important in determining the causes of potential errors.

By way of example, the Mid-Session Review of the 1987 Budget, released August 6, 1986, presented the macroeconomic assumptions used to estimate the effects of TRA86 at the time of its enactment. At that time, corporate profits were estimated to reach $356 billion in 1988—$49 billion higher than recently reported by the Department of Commerce.[8] Unless individual incomes were underestimated by an offsetting amount, the objective of shifting revenue collections from individuals to corporations in a "revenue-neutral" manner would clearly seem to have failed.

Components of the macroeconomic forecast which are not published have an equally significant effect on the revenue expected to be generated by TRA86. The most obvious example is the repeal of the investment tax credit and other capital cost provisions. If investment was substantially lower than projected in 1986, those provisions will have generated far less revenue than forecast.

Just as comparisons of CBO and OMB receipt forecasts can be used as a guide to the reasonableness of each others budget forecasts, comparisons of published estimates from the JCT and OTA can be used when examining estimates of proposed and enacted legislation. While the JCT and OTA may strive for a consensus on their estimates of proposed changes, their estimates will always differ due to the different set of macroeconomic assumptions underlying their work. Differences beyond that will be due to technical differences in the interpretation of the proposal or its economic effects. Unfortunately, this type of comparison can only be made for TRA86 at one point in time since the JCT does not regularly update their estimates of enacted legislation. Each group does, however, annually prepare tax expenditure estimates which can be used, with caution, as a guide to the revenue effects of particular provisions of current law.[9]

c. Timing Changes

The final issue regarding the interpretation of federal tax law changes is the need to identify pure timing changes or other collection speed-ups. A number of provisions in recent tax bills—the best ex-

ample being the changes made to corporate estimated payment rules in 1987 and 1988—may have increased federal collections, but have had no effect on the underlying liability of corporations. In these instances, the effect of the law is merely to require payment of a liability earlier than otherwise would have occurred. There is no reason to believe that changes of this type would have any effect on state collections.

IV. Corporate Receipts Since 1985

In this section I address the question of how much additional federal revenue was generated by the TRA86. While the exact revenue effect of the corporate changes of TRA86 will never be known, an estimate of the approximate magnitude can be inferred by examining published data for the past several years.[10]

Column (a) of Table 1 lists actual corporate receipts for each fiscal year from 1984 to 1989. Column (b) lists the level of receipts forecast in August 1986 under the Administration's assumptions, not including the effects of TRA86. Column (c) contains the estimated corporate receipt effect of TRA86 as reported by Nester [1987]. The fourth column, (d), represents the implied corporate receipts forecast at that time, and is obtained by adding columns (b) and (c). As can be seen in columns (e) and (f) this implied forecast overstated the annual level of receipts through 1988 by more than 20 percent. While this error is severe, it is not an indictment of the TRA86 estimates themselves, since the baseline forecast could contain a substantial amount of error. As discussed in III.b., above, the August 1986 estimate of corporate profits before tax was $49 billion higher than actually achieved.

In column (g), the estimated effect of TRA86 for each year is subtracted from the actual level of corporate collections. If the TRA86 estimates were correct, this column would provide the best estimate of what receipts would have been in the absence of the change in the law. The pattern in column (g) suggests corporate receipts would have declined between 1986 and 1987 even though corporate profits rose. This pattern seems unlikely. Accepting for the moment the possibility that receipts would have remained constant between 1986 and 1987 (at $63.1 billion) the maximum amount of additional corporate revenue generated from TRA86 would have been $20.8 billion (83.9–63.1), far less than the $28.3 billion reported at the time.

In Table 2, corporate receipts for fiscal year 1984 through 1988 are presented along with BEA estimates of the levels of GNP and NIA corporate profits. Examining the ratio of corporate net receipts

Table 1

Year	Corp. Actual (a)	Corp. Forecast Aug '86 (b)	effect of TRA86 (c)	forecast + TRA86 (d)	Error (e)	Percent Error (f)	Actual-TRA86 est (g)
1984	56.9	56.9	--	56.9	--	--	--
1985	61.3	61.3	--	61.3	--	--	--
1986	63.1	61.6	--	61.6	+1.5	--	--
1987	83.9	75.0	28.3	103.3	-19.3	-23.03	55.7
1988	94.5	92.6	25.2	117.8	-23.2	-24.60	69.4
1989	107.0	104.9	23.4	128.3	-21.3	-19.91	83.6

Table 2

Year	Corp. Net Receipts (a)	CY GNP (b)	Receipts / GNP (c)	CY NIA Profits (d)	Receipts / Profits (e)
1984	56.9	3772.2	.0151	266.9	.213
1985	61.3	4014.9	.0153	282.3	.217
1986	63.1	4231.6	.0149	282.1	.224
1987	83.9	4524.3	.0186	298.7	.281
1988	107.0*	4880.6	.0194	328.6	.288

*estimate.

Note: Receipt data is for fiscal years.

to either series shows that collections increased following 1986. Corporate receipts as a share of GNP rose from a 1984–1986 average of .0151 to .0190, an implied increase in collections of $19.03 billion in 1988. A similar calculation using NIA profits suggests a 1988 revenue gain of $21.8 billion. These gains are substantial—the $19.03 billion estimate represents 20.14 percent of total corporate receipts for 1988.

A final issue to address concerns other adjustments that corporations might have made to mitigate the effects of the corporate income tax generally, and TRA86 in particular. Since any attempt to minimize corporate tax liability at the federal level will clearly reduce tax collections by the states, these issues should also be of interest to state forecasters.[11] In particular, I will briefly examine two: the substitution of debt for equity, and the use of S-corporations.

The substitution of debt for equity has received considerable attention over the past few years in both the mass media and in professional journals. While corporations can reduce their taxable income, and hence their tax liability, by substituting debt for equity,[12] it is not clear that the provisions of TRA86 caused an additional increase in the desired level of corporate debt. By itself, the decline in the top corporate rate should have decreased the tax benefit of additional interest, however this effect is generally offset by the general increase in liability, which increases the likelihood that a tax benefit can be used. Until post-TRA86 data becomes available, it is not possible to determine which of these effects will dominate.

One reaction to TRA86 that could be having a significant impact on both federal and state revenues is the election of eligible corporations to be taxed as S-corporations, and therefore no longer subject to the corporate income tax. During the first half of 1987 more than 370,000 corporations requested permission to convert to S-corporations—nearly 30,000 more than had requested the treatment for all of 1986. While much of this is a one-time shift in response to TRA86, the incentive for firms to want to operate as S-corporations has clearly increased. The revenue effects of a large number of corporations electing S could be substantial. By way of example, in 1986 corporations with $100,000 or less of assets were responsible for $12.37 billion of income subject to tax, and $4.07 billion in tax before credits. The respective figures for corporations with assets of $1 million or less were $31.92 billion and $8.45. By way of comparison, income subject to tax for all corporations in 1986 was $276.2 billion, and total tax before credits was $111.1 billion.

V. Conclusions

At this point in time it is still difficult to determine all of the effects of the changes brought about by Tax Reform Act of 1986. What is known, however, is that the amount of additional revenue that was estimated would flow to the federal, and perhaps state, government have not appeared.

State forecasters, who must rely on federal data sources, face a difficult task in isolating the effects of federal tax changes on businesses within their state. While no other source of data is available, federal estimates of receipts and newly enacted tax legislation must be used with caution. A better understanding of the methodology employed by federal agencies, and the framework in which federal forecasts were constructed, can only increase the usefulness of such data.

Endnotes

[1]See Reischauer [1983] for a discussion. This point is also made in the annual Budget document.

[2]Kamlet et. al. [1987] have reviewed the accuracy of selected macroeconomic variables. Budget aggregates have been examined by Plesko [1988].

[3]Plesko [1988].

[4]For corporations, data for 1986 tax returns were released in August 1989. See U.S. Department of the Treasury, Internal Revenue Service [1989].

[5]Nester [1987], and particularly Nester and Joulfaian [1988].

[6]This discussion ignores the problems caused by consolidated returns and apportionment.

[7]A numerical example can be found in Nester and Joulfaian [1988].

[8]U.S. Department of Commerce [1989].

[9]The Administration's estimates of tax expenditures are published in Special Analysis G of the Budget. The JCT releases a pamphlet each year containing their estimates. Important to note is that each tax expenditures estimate is stacked last.

[10]Data for Table 1 and Table 2 were obtained as follows: GNP and corporate profits from the *Economic Report of the President* [1989] and the *Survey of Current Business* [1989]; receipts data from the *Budget;* the 1986 economic assumptions from the "Mid-Session Review"; and the estimates of TRA86 from Nester [1987].

[11]Aten and Gold [1989] address a number of possible explanations for the apparent lack of a revenue "windfall" at the state level. It is worth noting that Strauss [1987], after a review of the major features of TRA86 and the potential interactions with state tax laws, predicted that any state windfall would be "modest."

[12]Shoven [1987] has suggested that share acquisitions could have reduced 1985 liabilities by as much as $27 billion.

[13]A discussion of the eligibility requirements and the effect of TRA86 on the decision to elect Subchapter S, along with the data cited in this section, can be found in Plesko [1988b].

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FEAST OR FAMINE: FEDERAL TAX POLICY AND CALIFORNIA PERSONAL INCOME TAXES

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I. Introduction

Federal tax policy has had a dramatic effect on California personal income tax receipts during the past three years, and the current proposal before Congress to reduce the effective rates on capital gains will, if adopted, result in further revenue swings in the future. This paper discusses (1) California's