COMPARATIVE ANALYSIS OF THE TAXATION OF THE P&C INSURANCE INDUSTRY IN FLORIDA

Prepared for the

American Insurance Association

by

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EXECUTIVE SUMMARY

This study is designed to compare the state tax burden on the property and casualty (P&C) insurance industry with the state tax burden on a representative set of industries that were subject to Florida general business taxes during the five-year period from 1985 to 1989. The study was commissioned by the American Insurance Association (AIA). AIA is a national trade association, headquartered in Washington, D.C., representing 240 major companies which provide all lines of P&C insurance throughout the United States.

Key Findings

- The P&C industry was subject to an effective tax rate of 33.5 percent in Florida over the five-year period from 1985 to 1989, (using the statutory income measure which is applied for the purpose of insurance regulation). The effective tax rates for the comparison industries in the manufacturing, retail trade and banking sectors ranged from 5.6 to 9.9 percent over the same period.

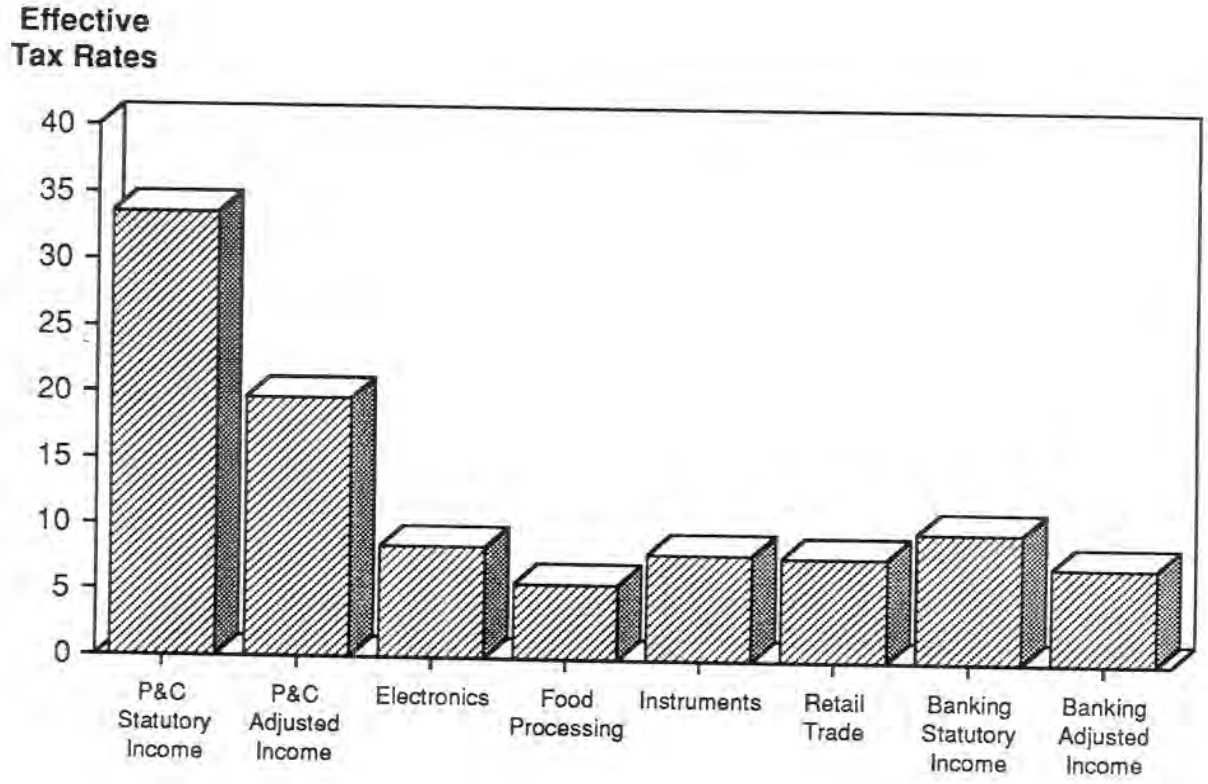
- Even using a broad measure of pre-tax income, the P&C industry was subject to an effective tax rate of 19.6 percent over the five-year period from 1985 to 1989.

- In 1985, companies with 36 percent of Florida P&C premiums were unprofitable yet they paid Florida premium taxes.

- The financial burden on the P&C industry is even higher when guaranty fund assessments are considered. The five-year average burden was 39.3 percent, measured against statutory income, and 22.9 percent, using the broad measure of pre-tax income.

Chart 1 displays five-year average effective tax rates for the P&C industry and each of the comparison industries.

Chart 1
Comparison of Effective Tax Rates
(5-Year Average for 1985 - 1989)



I. OVERVIEW OF STUDY

Corporate Taxation In Florida

Florida corporate tax policy is similar to that of other states in that different types of taxation are applied to insurance and non-insurance corporations. The corporate income tax is the general business tax applied to corporations in Florida. During the timeframe of this study, the income tax was imposed at a statutory rate of 5.5 percent from 1985 to 1989. During this period, an emergency excise tax was also imposed to offset the potential state revenue loss resulting from state conformity with the federal accelerated depreciation provisions applicable to property placed in service from 1981 to 1986. Businesses are also subject to an intangibles tax on personal property with a situs in Florida. Intangibles (other than debt instruments related to real property) were taxed at a rate of 1 mill per dollar of value during the 1985-1989 period. Mortgages and deeds were subject to a one-time tax at a rate of 2 mills per dollar of value.

P&C insurance companies in Florida are subject to a tax on premiums as well as the corporate income, emergency excise and intangibles taxes. The premium tax base for P&C insurers is gross premium revenue excluding refunds, returned premiums and assumed reinsurance. The premium tax base does not allow subtractions for operating expenses or payments to cover losses by insured parties. The premium tax does not vary with changes in the profitability of the taxpayer. Premium tax revenue increases or decreases to the extent that premium volume increases or decreases from year to year. The tax rate on P&C insurance premiums was 2 percent from 1985 to 1988 and 1.75 percent for 1989. Before 1987, domestic insurance companies were exempt from the premium tax.

Foreign insurers (that is, companies that are chartered in other states) also face retaliatory taxation in Florida. The retaliatory tax is designed to promote the interstate business of domestic insurers. It is imposed when a foreign insurer's state of domicile imposes higher taxes on Florida insurers doing business in that state than Florida would otherwise impose on that state's insurers doing business in Florida.

Premium and retaliatory taxes are the primary taxes that are imposed on P&C companies in Florida, in addition to general business taxes. (Credits are provided against the premium tax for income, emergency excise tax and intangible taxes paid.) Additionally, P&C insurers are subject to a number of special assessments, taxes and fees. For example, assessments are paid into insurance guaranty funds by solvent companies in order to cover losses incurred by insolvent companies. Taxes and assessments based upon premiums are also earmarked to finance municipal police and firefighter pensions as well as the operations of the state fire marshall and workers' compensation programs.

Methodology For Tax Comparisons

In order to compare Florida tax burdens on the P&C insurance industry with industries that are subject to the franchise tax, it is necessary to convert these burdens into comparable effective tax rates.

Comparison Industries - Five industries were selected as comparison industries reflecting a range of profitability during the study period. The four nonfinancial industries are food processing, electronics, instruments, and retail trade. For example, the five-year return on equity in food processing was above the average for all manufacturing industries while returns were below average for electronics. The average return on equity for these four industries as a composite approximates the average return on equity for all manufacturing and retail trade firms during the 1985 to 1989 period. The use in this manner of return on equity as the selection criterion avoids bias in choosing comparison industries. The fifth comparison industry is commercial banking, which is a financial services industry that is subject to a franchise tax measured by net income, as well as the intangibles and emergency excise taxes.

Concept of Effective Tax Rates - Comparable effective tax rates have been calculated for the P&C industry and the comparison industries. For the P&C industry, the effective tax rate is a fraction the numerator of which is premium, retaliatory, corporate

income, emergency excise and intangibles taxes paid and the denominator of which is "pre-tax income". For the comparison industries, the numerator is corporate income, emergency excise and intangibles taxes paid and the denominator is "pre-tax income".

Definition of Pre-tax Income - Effective tax rate studies often use a different concept of income than taxable income for two reasons. First, the definition of taxable income includes numerous exclusions and deductions which have differential impacts across industries. Second, statutorily-defined taxable income changes over time so that the measure of income can be inconsistent from year to year. For example, the federal Tax Reform Act of 1986 had a major impact on the definition of taxable income at both the federal and state level over three of the five years analyzed in this study.

In order to achieve comparability, consistent measures of pre-tax income have been constructed for the P&C industry and comparison industries. For P&C companies, the measure of pre-tax income starts with pre-tax statutory net income, as reported on the annual statement blank filed with the National Association of Insurance Commissioners.

Two alternative income measures for the P&C industry are presented. One measure is statutory net income without adjustment. A second, broader measure is statutory net income with four adjustments. These adjustments were for loss reserve discounting and deferred acquisition costs, both of which were mandated for federal income tax purposes under the Tax Reform Act of 1986, as well as state and local income taxes and the lower yield on tax-exempt bonds.

Comparable pre-tax income measures were developed for the comparison industries. The measure for the manufacturing and retail trade industries is book income as defined by financial statements. The measure for the banking industry is book income as reported to regulatory authorities, with and without certain adjustments. These income measures can be expected to be more consistent than taxable income across the six industries and over the five-year period.

Data Sources and Effective Tax Rate Calculation Methods - The tax and financial data that were used to calculate effective tax rates for the P&C industry were obtained through a voluntary survey of AIA member companies. Survey responses were obtained from 162 P&C companies that accounted for 27 percent of total Florida P&C premium volume in 1988. Actual taxes were divided by pre-tax income apportioned to Florida based upon Florida premiums as a percent of total U.S. premiums for each company in the sample.

Price Waterhouse developed a model to estimate effective tax rates for the comparison industries. A modeling approach was used because aggregate information on income, emergency excise and intangible tax liability and corporate income, by industry, was not available. The data used to estimate pre-tax financial income and tax liability were obtained from the Quarterly Financial Reports published by the U.S. Bureau of the Census and the Standard and Poor's Compustat data base (in the case of manufacturing and retail trade) and Federal Deposit Insurance Corporation reports (in the case of banking). The Model methodology is described in detail in Chapter IV of this report.

A supplementary financial burden measure for the P&C industry was also calculated to reflect the effects of guaranty fund assessments. While not part of the effective tax rate comparison, these additional state obligations are unique to the insurance industry and impose an additional burden on that industry.

Economic Impacts of Insurance Taxation

The P&C insurance industry plays an important role in the Florida economy. In 1988, P&C companies provided 19,404 jobs in Florida. (This job total reflects direct P&C employment and does not include agents and brokers.) Furthermore the P&C industry is a major source of investment in Florida assets. P&C companies doing business in Florida held $17.3 billion of Florida assets in 1988. Public sector bonds accounted for two-thirds

of the Florida investments of P&C insurers. Thus, the P&C insurance industry is a major source of capital for financing public facilities in the state.

Higher insurance company taxes would have an adverse impact on economic activity in Florida to the extent that such higher taxes resulted in a reduction in the amount of purchased insurance. In addition to potential adverse employment and investment impacts, higher insurance company taxes can have significant negative impacts by encouraging inappropriate use of self-insurance. Florida does apply a premium tax to commercial and other self-insurance funds but at lower rates than are applied to P&C insurers. Some self-insured businesses may not have the financial resources to meet all claims. Furthermore, as lower-risk individuals and businesses self-insure, "marginal" risks such as young automobile drivers, inner-city homeowners and small businesses will remain in the purchased insurance pool and be faced with higher prices.

II. HISTORICAL DEVELOPMENT OF THE STATE TAXATION OF P&C COMPANIES IN FLORIDA

P&C insurance companies in Florida are subject to general state corporate taxes as well as the insurance premium tax. In this regard, the structure of Florida insurance taxation is different from many states which impose a premium tax in lieu of the corporate income or franchise tax. Thus the history of Florida taxation of P&C insurance companies involves the development of the corporate income tax as well the premium tax.

Florida first imposed a tax of two percent on the gross receipts of premiums from companies engaged in the business of sick and funeral benefit insurance in 1907. Over the years, the tax base was broadened to include premiums from all lines of P&C and life insurance business.

In 1943, domestic companies were exempted from the insurance premium tax. In 1953, foreign insurance companies maintaining regional home offices in Florida were granted a credit equal to 50 percent of premium tax liability and a credit was also provided for local property tax payments.

Florida established its corporate income tax in 1971 and amended the insurance premium tax as well. The corporate income tax was initially imposed at a flat rate of 5 percent. Insurance companies were provided a credit against premium tax liability for corporate income taxes paid. In addition, the local property tax credit for regional home offices was repealed. In 1984, the corporate income tax rate was increased from 5 to 5.5 percent.

In 1982, an emergency excise tax was enacted as an additional tax on corporations, including P&C insurers. This tax was intended to offset the potential state tax reduction resulting from state conformity with the federal Accelerated Cost Recovery System (ACRS) for property placed in service from 1981 to 1986. The Florida corporate income tax uses federal taxable income as the starting point in calculating state tax liability. Several states

chose not to conform to the federal depreciation changes in order to avoid state revenue losses. Florida's response was to impose the emergency excise tax as an offset to general conformity with ACRS in the definition of state taxable income. A credit for emergency excise tax paid against the insurance premium tax was also provided in 1982.

A series of legislative changes to insurance taxation were enacted in Florida during the 1987-1990 period. The 1987 legislature increased the premium tax rate from 2 to 2.25 percent, effective July 1, 1988. Statutory rate distinctions between domestic, regional home office and foreign insurance companies were eliminated. A new credit was provided equal to 10 percent of salaries paid to non-licensed employees in Florida. The salary tax credit and the corporate income tax credit were subject to a maximum credit of 50 percent of premium tax liability.

During the 1988 legislative session, the scheduled changes were substantially amended prior to the July 1, 1988 effective date. The premium tax rate was changed back to 2 percent, the salary tax credit was increased from 10 to 15 percent, and the combined cap on the credit for corporate income taxes and the salary credit was increased from 50 to 75 percent.

Another round of changes was made during the 1989 legislative session. The combined cap on the corporate and salary credits was reduced from 75 to 65 percent; the premium tax rate was reduced from 2 to 1.75 percent; the 100 percent exclusion of the salary tax credit in calculating retaliatory taxes was reduced to 80 percent; and credits for guaranty fund assessments were reduced.

Credits are a significant feature of the Florida premium tax. Of the dozen credits that are currently allowed, the most important in terms of dollar amounts are the:

- Workers' compensation administrative expense credit;
- Municipal firefighters' pension trust fund credit;
- Municipal police officers' pension trust fund credit;
- Corporate income and emergency excise tax credit; and
- Salary tax credit.

Credits are also authorized for certain guaranty fund assessments, including the Florida Insurance Guaranty Association which covers P&C insurers. However, the rate at which the credits are allowed has been reduced to the point where they are no longer significant. Initially, the assessments were recovered over a five-year period at the rate of 20 percent per year. Beginning on July 1, 1990, these credits are limited to 0.1% each year.

Insurance companies are also subject to the intangible personal property tax. Intangible property such as stocks, bonds and account receivables are currently subject to an annual tax at a rate of 1.5 mills per dollar of value. The annual tax rate was 1 mill of value from 1985 to 1989. A one-time nonrecurring tax is also imposed on mortgages, deeds and other liens on real property located in Florida at a rate of 2 mills per dollar of value.

Table 2.1 describes the current structure of Florida insurance taxes.

TABLE 2.1
Florida Insurance Taxes on P&C Companies

State Premium Tax

Tax Base: Gross premiums less returned premiums and reinsurance assumed

Tax Rate:

1985-1988	*1989*
2%	1.75%

Major Credits Subject to Limitation:

Corporate Income Tax/Emergency Excise Tax Credit

Salary Tax Credit

- Combined cap of 75 percent (1988) and 65 percent (1989) of premium tax liabiltiy

Other Major Credits

Workers' Compensation Administrative Expense Credit

Intangibles Tax Credit

Other Taxes and Assessments

Corporate Income and Emergency Excise Tax

- 5.5 percent of net income

Intangibles Personal Property Tax

- 1 mill per dollar of value (1985-89); 1.5 mills (thereafter)

Florida Insurance Guaranty Association Assessment

- Maximum assessment up to 2% of premiums, as needed

State Fire Marshall Regulatory Assessment Tax

- up to 0.625% of fire and property premiums (1985-90); increased to 1% for 1991

Workers' Compensation Administrative Expense Assessment

- Specific amount or percentage of net premiums.

III. AN OVERVIEW OF THE P&C INSURANCE INDUSTRY

Through its investments and employment, the P&C insurance industry plays an important role in the Florida and the U.S. economies. The P&C industry also provides protection and financial security to businesses and individuals against almost every kind of peril. In 1989, this industry paid over $143 billion to policyholders in the U.S. who had suffered losses. These payments contribute to the stability and security of the overall economy.

Property and Casualty Insurance Companies

In 1989, there were 3,900 P&C insurance companies in the U.S., an 12 percent increase from the 3,461 companies in existence in 1985. (See Table 3.1). There were 94 P&C companies headquartered in Florida in 1989. This was an increase of 34 percent from 1985. In 1989, Florida P&C insurance companies accounted for 2.4 percent of the total number of P&C companies in the U.S.

Employment in the Property and Casualty Insurance Industry

In 1988, the U.S. P&C insurance industry directly employed 528,493 full and part-time employees. Table 3.2 presents the number of P&C industry employees in the U.S. and Florida from 1985 to 1989. Since 1985, U.S. employment in the P&C insurance industry has increased by approximately 66,000 employees or over 12 percent. P&C employment in Florida also increased by over 28 percent to a total of 19,404 employees from 1985 to 1988.

U.S. Premium Income

Net premiums written by the P&C industry in the U.S. totalled $215.5 billion in 1989, up 4 percent from the 1988 level of $205.7 billion. The average annual increase from 1985 to 1989 was 9 percent.

TABLE 3.1

Number of P&C Companies, United States and Florida: 1985-1989

Year	*U.S.*	*Florida*	*Florida as % of U.S.*
1985	3,461	70	2.0
1986	3,555	80	2.3
1987	3,799	80	2.1
1988	3,849	79	2.1
1989	3,900	94	2.4

Source: Insurance Information Institute.

TABLE 3.2

Employment in P&C Industry United States and Florida: 1985-1989

Year	*U.S.*	*Florida*	*Florida as % of U.S.*
1985	462,512	15,087	3.3
1986	483,208	14,933	3.1
1987	504,191	17,187	3.4
1988	528,493	19,404	3.7

Source: County Business Patterns. Compiled by Price Waterhouse.

The P&C industry writes many different types of insurance. The percentage breakdowns of total U.S. premiums, by line of business, are presented in Table 3.3. Chart 3.1 compares actual U.S. premiums written by the major lines of business from 1985 to 1989.

Automobile Insurance. Automobile insurance is the largest line of P&C insurance in terms of amount of premiums written. In 1989, automobile insurance totalled $94.4 billion for private passengers and commercial combined, accounting for 43.8 percent of total premium income. The 1989 level was 5.7 percent above the 1988 level and nearly 50 percent higher than the 1985 level. Automobile insurance includes both liability and physical damage protection. Auto liability insurance has become a necessity both for financial security and because of state laws requiring minimum amounts of coverage.

Workers' Compensation Insurance. The second largest line in terms of premiums written is workers' compensation insurance. Workers' compensation insurance is designed to cover the lost wages and medical and rehabilitation costs for workers injured in job-related accidents. It also covers death benefits for dependents of persons killed in work-related accidents. In 1989, workers' compensation premiums totalled $31.9 billion and comprised 14.8 percent of total property and casualty premiums. During the 1985 to 1989 period, workers' compensation insurance has been one of the fastest growing types of P&C insurance.

Homeowner and Commercial Multiple Peril Insurance. Two other major types of insurance are homeowners and commercial multiple peril. These types of insurance provide coverage for a variety of perils such as fire, liability, windstorm, and burglary and theft. In 1989, premiums for homeowner insurance totalled $18.1 billion, up by 4 percent from 1988 and by 25.7 percent from 1985. Commercial multiple peril insurance premiums were $18.9 billion in 1989, down by 1 percent from 1988, but up by 36 percent from 1985.

TABLE 3.3

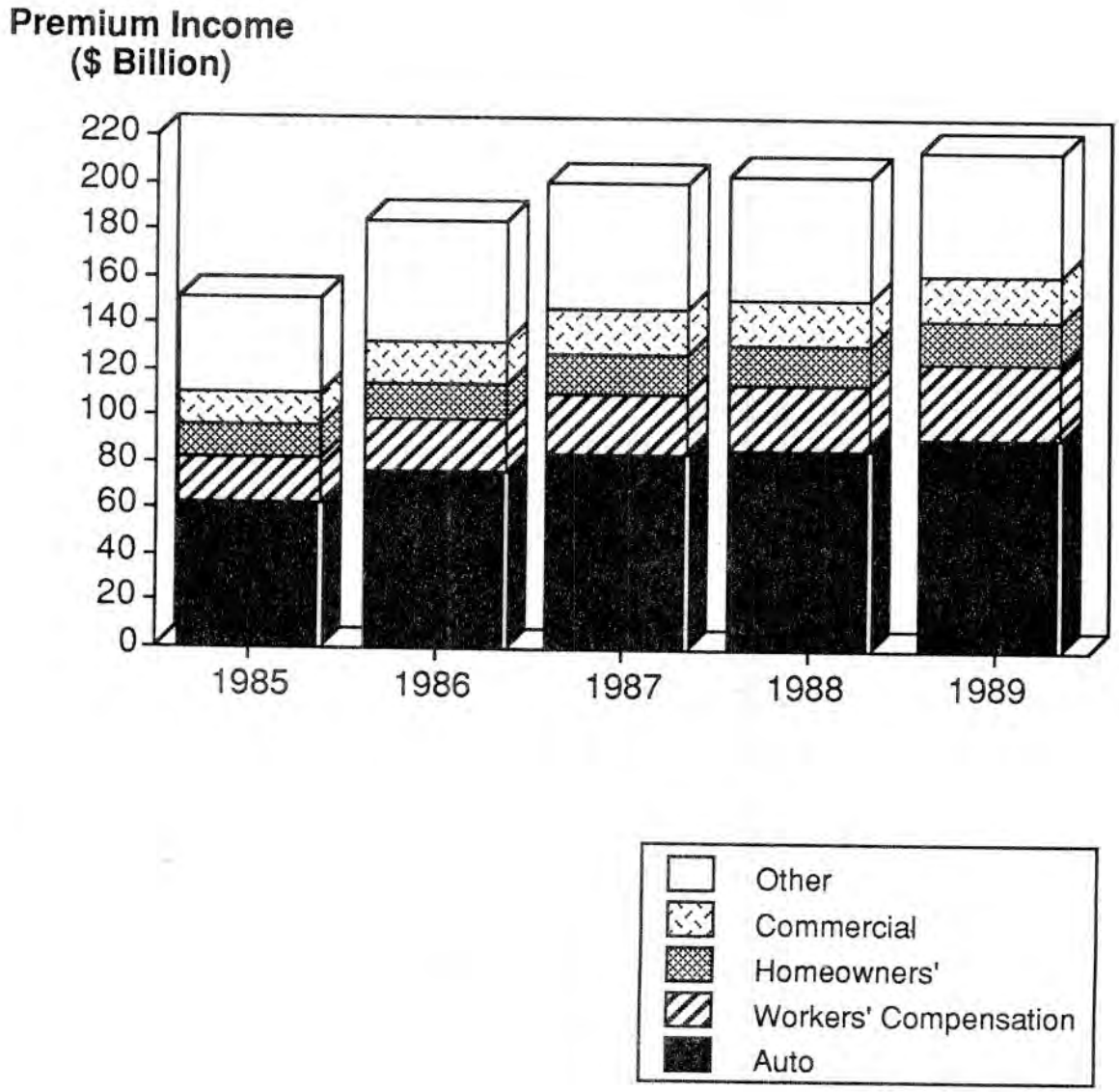
Major Lines of P&C Insurance Purchased by Individuals and Businesses in The United States: 1989

[dollars in billions]

	$	Percent of Total
INDIVIDUALS		
Homeowner's Multiperil	$18.07	8.4
Automobile	76.09	35.3
Individual Subtotal	$94.16	43.7
BUSINESS		
Commercial Multiperil	$18.86	8.7
General Liability	22.39	10.4
Automobile	18.33	8.5
Workers' Compensation	31.85	14.8
Other	29.94	13.9
Business Subtotal	121.37	56.3
TOTAL PROPERTY & CASUALTY PREMIUMS	$215.53	100.00

Source: Insurance Information Institute. Compiled by Price Waterhouse.

Chart 3.1
U.S. Premium Income for Major Types of Property and Casualty Insurance
1985 - 1989



Source: Insurance Information Institute. Compiled by Price Waterhouse.

Purchasers of P&C insurance can be broken down into two broad categories: individuals and commercial. In 1989, premiums paid by individuals accounted for 44 percent of the total, while business accounted for 56 percent. The breakdown between personal and business premium volume is presented in Table 3.3. Auto insurance was the primary type of insurance purchased by individuals. Insurance purchased by businesses tends to be more evenly distributed between various lines of insurance. In 1988, the major types of insurance purchased by businesses were workers' compensation, general liability, commercial multiple peril, and auto.

Florida Premium Income

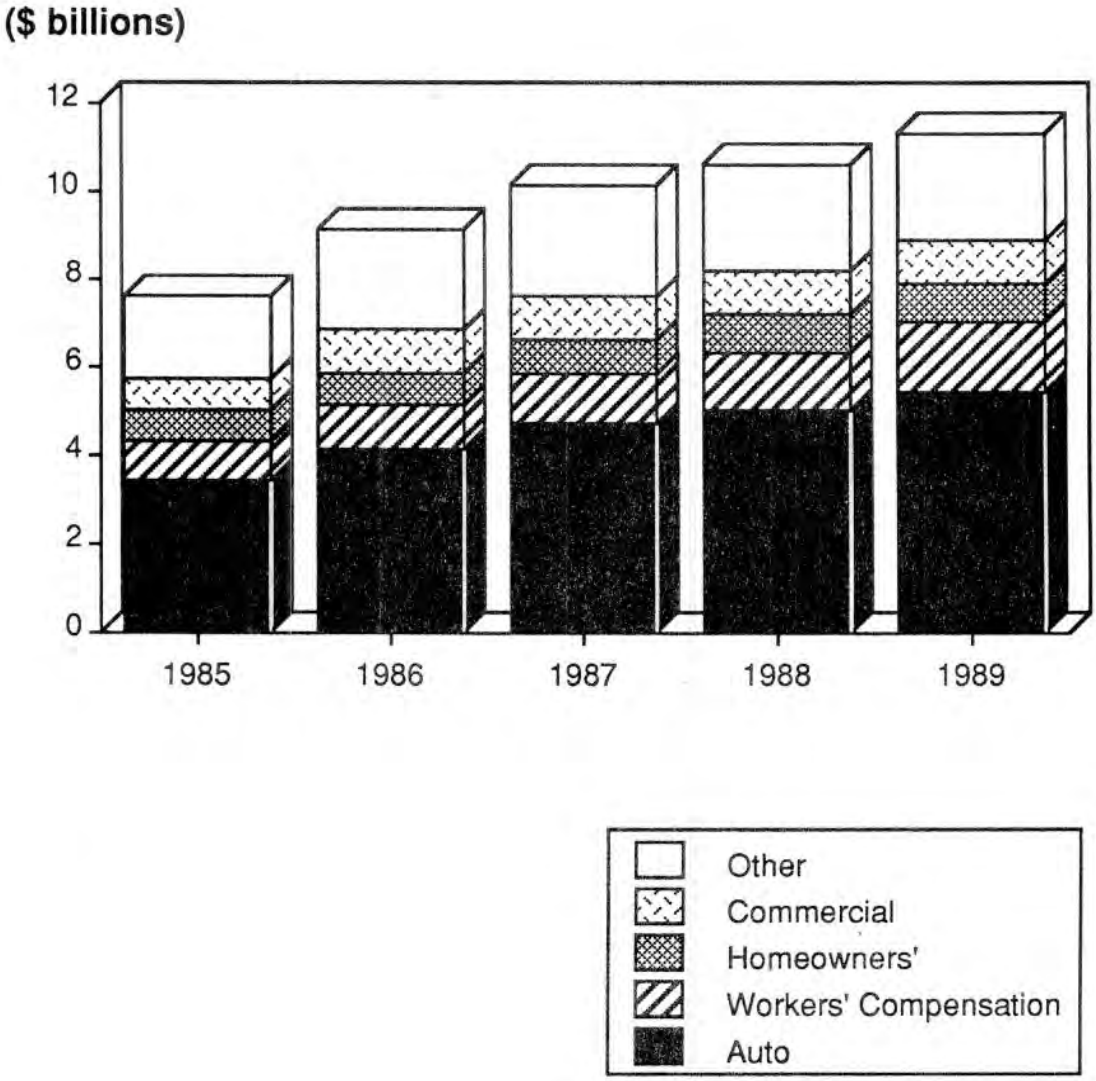
As shown in Chart 3.2, net premiums written in Florida had a value of $11.2 billion in 1989. In 1989, Florida accounted for 5.2 percent of total U.S. P&C premiums written in the U.S. Florida's share of total U.S. premiums written has been stable over the 1985 to 1989 period.

Table 3.4 shows the breakdown between individual and business P&C insurance for Florida in 1989. Businesses accounted for 52.5 percent of total premium volume. The mix of P&C business in Florida is similar to the national mix. Auto insurance (private passenger and commercial combined) accounts for 48 percent of total P&C premium volume in the state.

P&C Insurance Losses

Direct losses incurred by P&C companies indicate the benefits claimed by policyholders. Chart 3.3 illustrates the trend in losses for the U.S. P&C industry. In 1986, direct losses increased 13.6 percent to $116.9 billion. In 1987, losses increased 7.7 percent to $125.9 billion and then increased 5.5 percent to $132.8 billion in 1988. In 1989, U.S. direct losses increased 7.8 percent to $143.1 billion.

Chart 3.2
Florida Premium Income for Major Types of Property and Casualty Insurance 1985 - 1989



Source: Insurance Information Institute. Compiled by Price Waterhouse.

TABLE 3.4

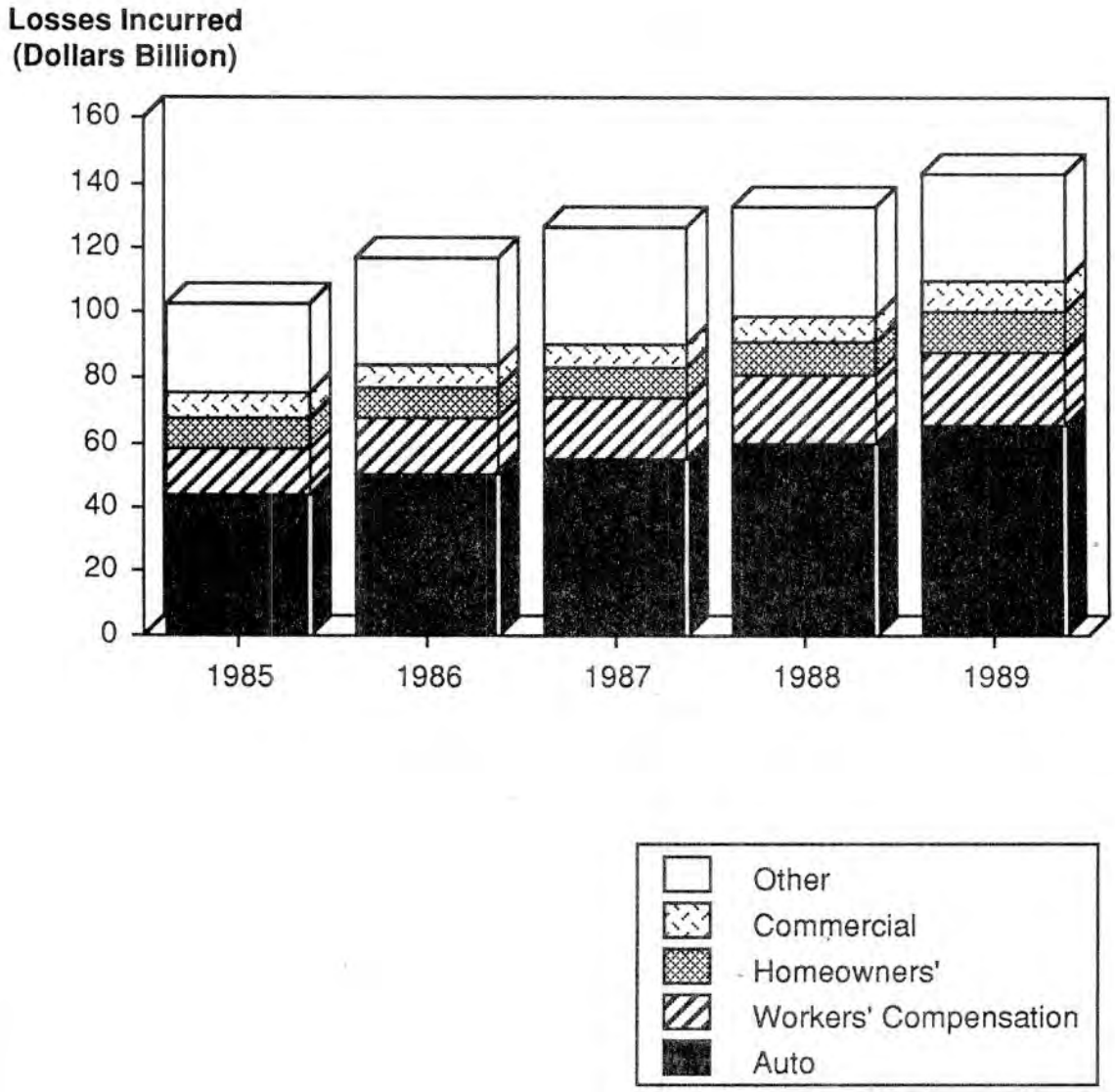
Major Lines of P&C Insurance Purchased by Individuals and Businesses in Florida: 1989

[dollars in billions]

	$	Percent of Total
INDIVIDUALS		
Homeowner's Multiperil	$0.94	8.4
Automobile	4.39	39.1
Individual Subtotal	$5.32	47.5
BUSINESS		
Commercial Multiperil	$0.98	8.8
General Liability	0.89	7.9
Automobile	0.99	8.8
Workers' Compensation	1.56	13.9
Other	1.47	13.1
Business Subtotal	5.88	52.5
TOTAL PROPERTY & CASUALTY PREMIUMS	$11.21	100.0

Source: Insurance Information Institute. Compiled by Price Waterhouse.

Chart 3.3
U.S. Property and Casualty Losses by Type of Insurance 1985 - 1989



Source: A.M. Best, Aggregates and Averages, Property and Casualty, 1986-1990. Compiled by Price Waterhouse.

Losses incurred in Florida are portrayed on Chart 3.4.

Investments of P&C Insurers

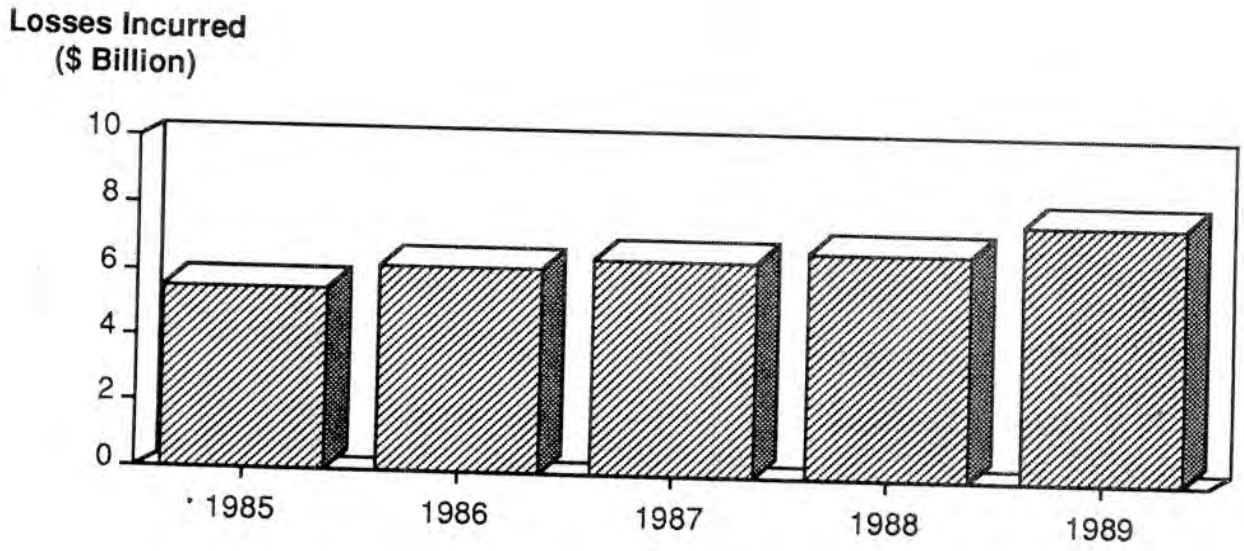
In 1988, P&C industry investments in the U.S. totalled $362.9 billion. As shown in Table 3.5, these investments are primarily held in stocks and bonds. P&C companies generally invest in relatively liquid assets, such as stocks and bonds, rather than longer-term investments such as real estate. A highly liquid portfolio is essential for funds to be available to pay claims related to unexpected events.

Table 3.6 presents data on P&C insurance company investments and deposits in Florida in 1988. P&C investments and deposits in Florida totalled $17.2 billion. The market value of Florida public sector bonds amounted to $11.5 billion or 67 percent of total P&C investments. Thus P&C insurers are a major source of capital for financing public facilities in the State of Florida.

State and Local Taxes and Fees Paid By P&C Insurers In the U.S.

Chart 3.5 shows total state and local insurance taxes and fees paid by P&C insurers in the U.S. Total taxes have increased by 47 percent from $3.5 billion in 1985 to $5.2 billion in 1989. These figures include state premium and income taxes and insurance department fees, but exclude real estate taxes.

Chart 3.4
Florida Property and Casualty Losses
1985 - 1989



Source: Insurance Information Institute. Compiled by Price Waterhouse.

TABLE 3.5

Investments of Property and Casualty Insurance Companies (percent of total investments)

Type of Investment	*1978*	*1983*	*1988*
BONDS	79.07	71.38	77.65
U.S. Government	12.12	14.70	19.44
States and Municipals	16.46	13.92	13.04
Special Revenue	33.43	31.46	27.78
Other	17.06	11.30	17.39
COMMON STOCK	16.68	21.51	16.90
Parent, Affiliates	4.26	6.03	5.60
Bank/Insurance	1.36	1.87	1.36
Utility	1.60	1.66	1.22
Other	9.46	11.95	8.72
PREFERRED STOCK	3.60	5.05	2.78
OTHER	0.65	2.07	2.66
Mortgages	0.31	1.21	1.54
Miscellaneous	0.34	0.86	1.12
TOTAL INVESTMENTS	100.00	100.00	100.00

Source: Insurance Information Institute.

TABLE 3.6

P&C Insurance Company Investments and Deposits in Florida [dollar amounts in millions]

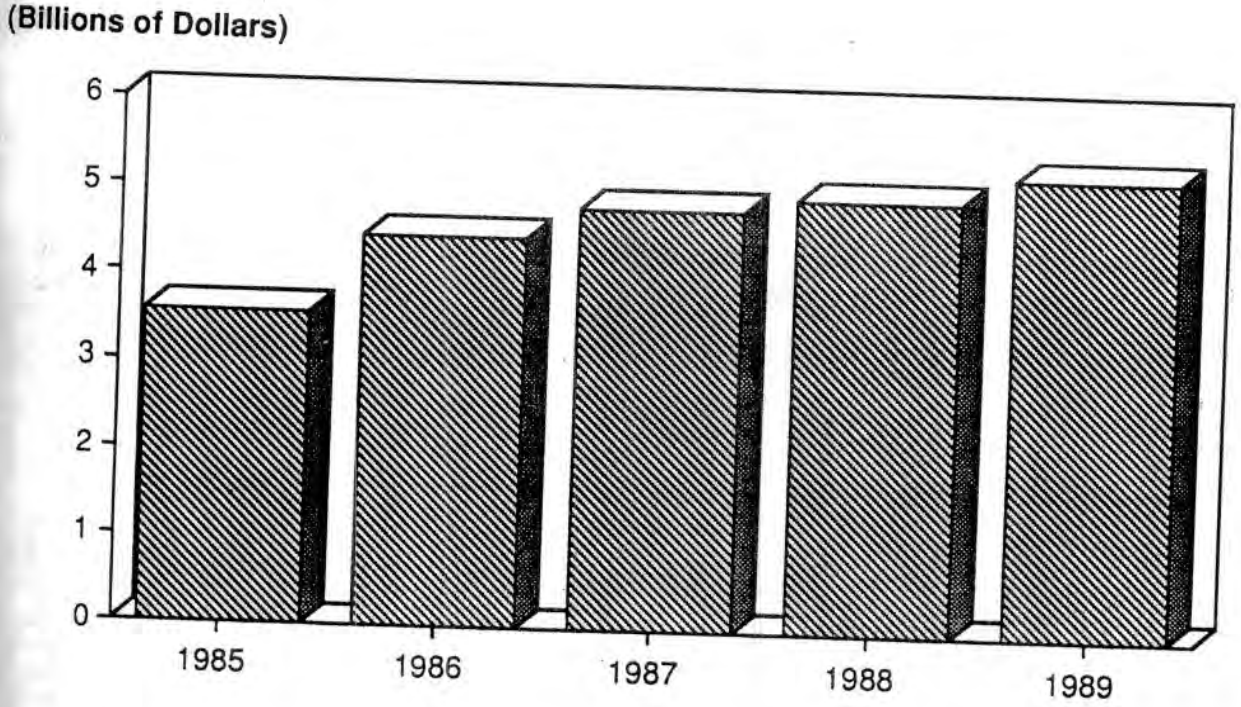
TYPE OF INVESTMENT	$		*Percent of Total*
Public Sector Bonds	11,471.9	/1	66.6
Private Sector Bonds	1,685.7	/1	9.8
Mortgages	1,368.4	/2	7.9
Real Estate	346.0	/1	2.0
Stocks	1,070.0	/1	6.2
Deposits & Short Term Investments	545.4	/2	3.2
Other	744.8	/2	4.3
TOTAL	17,232.1		100.0

/1 Market Value

/2 Book Value

Source: Florida Department of Insurance. Compiled by Price Waterhouse.

Chart 3.5
State and Local Taxes and Fees Paid by P&C Companies, U.S. Total



Source: A.M. Best, Aggregate and Averages, P&C 1986-1990. Compiled by Price Waterhouse.

IV. COMPARISON OF FLORIDA TAX BURDENS ON THE P&C INSURANCE AND OTHER INDUSTRIES

Noninsurance corporations doing business in Florida are generally subject to the Florida corporate income tax and intangibles tax. Insurance companies, including P&C insurers, are subject to a premium tax as well as the corporate income and intangibles taxes.

A common measure of effective tax rates must be developed in order to accurately compare premium, income and intangibles tax burdens for different industries. This chapter describes the methodology that has been used to measure effective tax rates and presents the comparative burden analysis.

The analysis covers a multi-year period from 1985 to 1989. A multi-year study time frame is of special importance because tax liabilities and corporate profits fluctuate from year to year. The 1985-1989 period includes both high and low profit years during the recent P&C insurance underwriting cycle. This time period also reflects variation of profits of manufacturing, retail trade, and banking industries during years of relatively slow growth, such as 1985, and relatively rapid growth, such as 1987.

The common measure of tax burden is tax liability stated as a percent of pre-tax income. For P&C companies, premium, retaliatory, corporate income, and intangible personal property taxes form the numerator of the effective tax rate calculation. Pre-tax income is the denominator.

The use of a consistent pre-tax income concept is a critical feature of the burden analysis. Industry tax burden studies typically use a pre-tax financial income concept in the denominator of the tax rate calculation. The pre-tax income measure used in this study provides a consistent measure of ability-to-pay across industries and over time. Taxable income is not used because it includes tax incentive or preference features that may distort the measurement of economic profits. In particular, this is a problem when the definition

of taxable income changes significantly during the study timeframe, as is the case with the fundamental federal income tax law changes, affecting P&C companies and other industries, that were contained in the Tax Reform Act of 1986. The use of a uniform and consistent income concept helps to eliminate industry-specific preferences in an inter-industry comparison.

Effective Tax Rates on the P&C Insurance Industry

The P&C industry effective tax rates that are presented in this report were developed from a sample comprised of AIA member companies doing business in Florida. Price Waterhouse designed the survey form and administered the survey. The survey form was designed to obtain detailed confidential income data as well as information on Florida and U.S. premium volume and Florida premium taxes, fees and assessments. Price Waterhouse performed checks to identify and correct reporting errors to assure the accuracy of the survey data.

Responses to the survey were received from 162 companies, accounting for 27 percent of premium volume in Florida in 1988.

The survey companies closely resemble the population of all P&C companies doing business in Florida with respect to profitability. Statutory net income as a percentage of total premiums was 8.7 percent for the companies in the sample and was 9.2 percent for all P&C insurers doing business in Florida in 1988, based upon A.M. Best data.

Description of Pre-tax Income Measure

Different measures of income of P&C insurance companies are used for regulatory, federal tax and financial reporting purposes. For purposes of this study, two alternative pre-tax income measures were used. Both measures have been applied consistently throughout the

five-year study period. One measure is statutory net income without adjustment. A second, broader measure is statutory net income with four adjustments.

A. Statutory Net Income

The first measure of pre-tax income is statutory net income before income taxes. Statutory income includes both underwriting income and investment income.

Annual statutory income for the companies in the sample increased from -$510 million in 1985 to $3.4 billion in 1986. It was $4.4 billion in 1987 and then declined to $4.1 billion in 1988 and to $3.7 billion in 1989. This pattern is similar to the industry's total nationwide net income which increased from -$0.1 billion in 1985, to $12.2 billion in 1986, $17.1 billion in 1987, $18.6 billion in 1988, and then declined to $15.0 billion in 1989.

B. Adjusted Pre-tax Income

Four adjustments are made to statutory net income to calculate the alternative, broader measure of pre-tax income.

Adjustment for loss reserve discounting. The largest adjustment is for the discounting of loss reserves. The Federal tax definition of discounted losses under Section 846 of the Internal Revenue Code of 1986 was used. The adjustment for discounted loss reserves was calculated by taking the companies' change in total unpaid losses and loss adjustment expenses from the annual statement and subtracting the change in total unpaid losses (discounted) reported on the tax return (Form 1120PC after 1986). For growing companies, the discounting of loss reserves results in a positive adjustment to net statutory income.

Because there was no discounting of loss reserves for federal tax purposes prior to 1987 (the first year that the Tax Reform Act of 1986 was effective), an adjustment for discounted loss reserves for 1985 and 1986 was estimated for purposes of this study. The estimate was based on the difference between the discounted tax and undiscounted statutory reserve changes in 1987-1989 as a percentage of total losses incurred on insurance contracts reported on the tax return.

The adjustment for loss reserve discounting for the sample of P&C companies ranged from $1.0 billion in 1985 to $1.8 billion in 1988.

Adjustment for deferred acquisition costs. Under the Tax Reform Act of 1986, 20 percent of the increase in the unearned premium reserve is no longer deductible for Federal income tax purposes. This amount is intended to serve as a rough proxy for deferred acquisition expenses. This change was made because Congress concluded that it was necessary to provide a better matching of income and expense by, in effect, denying current deductibility for a portion of premium acquisition expenses.

The adjustment for purposes of this study follows the Federal tax rule, but is based on the average industry relationship between increases in unearned premium reserves and total premiums written for each year during the period 1985 to 1989. The adjustment for deferred acquisition costs for the sample of P&C companies ranges from $0.1 billion in 1989 to $0.5 billion in 1985.

Adjustment for state and local income taxes. A third adjustment was made for state and local taxes imposed on or measured by net income and deducted for Federal income tax purposes. The income measure is pre-income taxes, so state and local income taxes are added to statutory net income. The adjustment for state income taxes for the sample of P&C companies adds approximately $0.1 billion annually.

Adjustment for lower yield on tax-exempt bonds. Finally, an adjustment was made for the reduced yield on state and local government bonds that are exempt from Federal income tax. Tax-exempt bonds generally yield 15-46 percent less than comparable Treasury bonds, depending on the maturity of the bond and Federal statutory tax rates. The adjustment adds an estimate of the amount of pre-tax interest income that P&C insurance companies could have earned if they had invested their tax-exempt bonds in fully-taxable securities. A company typically invests in tax-exempt bonds despite the lower yield because they provide a higher after-tax return.

The estimate of the additional income had the P&C industry invested in taxable instead of tax-exempt bonds is based on the ratio of the average industry yield from U.S. government securities to the average industry yield from state and local government obligations in each of the years. The adjustment for the sample of P&C companies adds approximately $0.2 billion annually.

The calculations of pre-tax income from adjusted statutory net income for years 1985-1989 are shown in Table 4.1.

The adjustments add $1.7 billion to $2.4 billion annually to statutory income, over the five-year period. Except in the trough year of 1985, adjusted pre-tax income for the companies in the survey sample ranges from $5.5 billion to 6.4 billion annually.

Apportionment of Pre-tax Income to Florida

States levying insurance premium taxes collect taxes on policies written to cover risks located in the state. For purposes of calculating the effective tax rate, pre-tax income was apportioned to Florida on the basis of the percentage of Florida premiums to total U.S. premiums for the sample companies.

TABLE 4.1

Adjusted Pretax Income of the P&C Insurance Companies in the Sample Calculated from Annual Statutory Income, 1985-89 ($millions)

ADJUSTED PRETAX INCOME	*YEAR*				
	1985	*1986*	*1987*	*1988*	*1989*
Annual statutory income	$-510	$3,408	$4,364	$4,075	$3,714
+ Adjustment for loss reserve discounting	1031	1254	1320	1791	1237
+ Adjustment to unearned premium reserve for deferred acquisition costs	493	450	227	189	130
+ Adjustment for state income tax	83	108	150	141	137
+ Adjustment for gross up of tax exempt income	234	305	310	250	235
= Adjusted Pretax income	1330	5526	6371	6447	5453
Difference between statutory and adjusted pretax income	1840	2118	2007	2372	1739
Ratio of adjusted pretax to statutory income	*	162.1%	146.0%	158.2%	146.8%

* The ratio in 1985 would be negative due to the negative statutory income that year.

Source: Price Waterhouse.

The industry-wide percentage of premiums written in Florida was 4.9 percent over the 1985-1989 period, according to A.M. Best reports. This percentage for the sample companies averaged 4.6 percent over the same period. In calculating pre-tax income apportioned to Florida, the percentage of total premiums written in Florida for each individual company was used.

P&C Industry Effective Tax Rates

Table 4.2 shows the calculation of effective tax rates for P&C insurers in the sample over the period 1985 to 1989. Florida taxes were divided by the apportioned Florida pre-tax income, using the two alternative measures of income.

The corporate income tax liability in Table 4.2 includes related income tax provisions such as the emergency excise tax and the alternative minimum tax. The accounting for the premium tax reflects the unique structure of the Florida tax which makes extensive use of earmarking of premium-based taxes and assessments as well as an extensive system of credits against premium tax due. The treatment of premium taxes in the effective tax rate calculation avoids double-counting.

The item "premium tax (general fund)" is the state premium tax after subtraction of all allowable credits. This item also includes the wet marine and transportation tax on underwriting profits.

The item "premium tax (earmarked)" includes four premium-based taxes and assessments that are credited against the state premium tax. The four components of this item are the municipal firefighters' relief pension fund tax, the municipal police officers' relief pension fund tax, the state fire marshall regulatory assessment, and the workers' compensation administrative assessment. Each of these taxes and assessments are credited against the state premium tax. The net result is that a portion of the state premium tax is earmarked for these purposes.

TABLE 4.2

Calculation of Effective Tax Rates of P&C Insurance Companies in the Sample, 1985-1989 ($ millions)

	1985	*1986*	*1987*	*1988*	*1989*	*1985-1989*
Statutory Income Calculation						
Statutory income	-510	3408	4364	4075	3714	$15,051
Apportionment factor	0.084	0.045	0.050	0.048	0.046	0.046
Apportioned Florida statutory income	-43	153	216	196	172	694
Corporate income and intangibles taxes 1/	1	3	12	10	8	32
Premium tax (general fund) 2/	19	23	24	16	12	94
Premium tax (earmarked) 3/	15	21	22	20	21	98
Retaliatory taxes	1	*	*	*	6	7
Total taxes 4/	36	47	58	46	46	233
Effective tax rate 5/	NI	30.7%	26.7%	23.2%	27.0%	33.5%
Adjusted Pretax Income Calculation						
Pretax income	$1,330	$5,526	$6,371	$6,447	$5,653	$25,327
Apportioned Florida pretax income	53	261	314	308	254	1189
Effective tax rate 5/	68.0%	17.9%	18.4%	14.8%	18.3%	19.6%

1/ Corporate income tax includes emergency excise tax.
2/ Premium tax (general fund) is after credits.
3/ Premium tax (earmarked) includes municipal police and firefighters pension taxes and state fire marshall and workers compensation administrative assessments.
4/ Total taxes are the sum of corporate income, intangibles, premium and retaliatory taxes.
5/ The effective tax rate is total taxes divided by apportioned income.

NI refers to negative income. Effective tax rate cannot be calculated because pre-tax income was negative.
* Less than $1 million
Detail may not add due to rounding.

Source: Price Waterhouse.

The increase in the retaliatory tax in 1989 reflects the legislative change that allows only 80 percent (rather than the previous 100 percent) of the benefit of the salary tax credit to accrue to foreign P&C insurers.

Using statutory net income, effective tax rates range from a high of 30.7 percent in 1986 to a low of 23.2 percent in 1988 during the years in which income is positive. In 1985, the industry was in a loss position using the statutory net income measure. (Annual effective tax rates cannot be calculated when income is negative.) Over the five-year period, the average effective tax rate using this income measure was 33.5 percent. (The average effective tax rate is calculated by dividing tax liability for the five year period by income for the five-year period. The five-year average rate thus includes the year with negative income and is greater than the year with the highest annual rate).

Using the broader, adjusted income measure, effective tax rates range from a high of 68.0 percent in 1985 to a low of 14.8 percent in 1988. Over the five-year period, the average effective tax rate using this income measure was 19.6 percent.

The effective tax rate for a P&C insurer will vary greatly across firms, depending on their profitability relative to their taxable premiums. An unprofitable firm will still be required to pay premium taxes. A firm with marginal profitability will have a relatively high effective tax rate. Alternatively, a highly profitable firm with relatively low taxable premiums could have a low effective tax rate.

Tables 4.3 and 4.4 show the distribution of effective tax rates across firms as weighted by Florida premiums using the alternative income measures. Several facts are important to highlight:

- Even in the 1988 peak period of the P&C insurance underwriting cycle, over 80 percent of Florida premiums were written by firms with effective tax rates in excess of 10 percent.

TABLE 4.3
Distribution of Florida Premiums by Effective Tax Rate
(Statutory Net Income)

Effective Tax Rates	*YEAR*					
	1985	*1986*	*1987*	*1988*	*1989*	*1985-1989*
Less than 5%	7.7%	0.0%	0.0%	0.0%	0.0%	1.3%
5.1% - 10%	0.0%	0.2%	1.1%	2.4%	6.3%	2.1%
10.1% - 15%	14.8%	4.7%	3.7%	13.7%	7.7%	8.6%
15.1 - 20%	0.2%	21.8%	9.0%	22.3%	34.2%	18.1%
20.1% - 25%	7.0%	25.2%	22.2%	15.0%	0.6%	14.3%
Greater than 25%	31.7%	42.6%	60.6%	39.8%	37.5%	43.1%
Not calculated because economic income is negative	38.5%	5.5%	3.4%	6.8%	13.8%	12.5%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Price Waterhouse.

TABLE 4.4
Distribution of Florida Premiums by Effective Tax Rate
(Adjusted Pre-Tax Income)

Effective Tax Rates	*YEAR*					
	1985	*1986*	*1987*	*1988*	*1989*	*1985-1989*
Less than 5%	9.8%	2.3%	0.0%	0.0%	0.0%	2.1%
5.1% - 10%	14.9%	4.0%	2.4%	15.8%	14.0%	9.9%
10.1% - 15%	0.6%	33.4%	26.6%	37.7%	29.4%	26.5%
15.1 - 20%	9.4%	22.2%	35.0%	27.1%	7.6%	20.8%
20.1% - 25%	1.8%	3.7%	11.9%	0.7%	9.8%	5.9%
Greater than 25%	27.6%	28.4%	23.8%	15.1%	30.9%	25.1%
Not calculated because economic income is negative	35.9%	6.0%	0.2%	3.6%	8.4%	9.7%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Price Waterhouse.

- During the five-year period, over 30 percent of the Florida premiums were written by firms with effective tax rates in excess of 20 percent.

- In 1985, firms with 36 percent of Florida premiums were unprofitable yet they paid Florida premium taxes.

Effective Tax Rates for Comparison Industries Subject to the Florida Corporate Taxes

The general business taxes that are included in the numerator of the effective tax rate for the comparison industries are the corporate income and emergency excise tax and the intangibles personal property tax. The corporate income tax is the primary general business tax for the manufacturing and retail trade industries.

Five industries that are subject to the income tax were selected for comparison with the P&C industry. The five industries are food processing, electronics, scientific instruments, retail trade and banking. These industries were selected in order to reflect a wide range of profitability. The average return on equity for the four nonfinancial industries as a composite approximates the average return on equity for all manufacturing and retail trade firms during the 1985 to 1989 period.

Ideally, the measurement of tax burdens for the comparison industries would be based upon actual data on income and intangibles tax liability and corporate income, by industry, for firms doing business in Florida during the 1985 to 1989 period. However, this approach is not feasible because Florida did not report income and tax liability data by industry for all years during this period. Thus, estimates of effective tax rates for the comparison industries were developed through use of the Price Waterhouse Business Tax Model. This Model is an analytical tool that has been used in a number of state projects to analyze state tax burdens on new investment. The Model was specially adapted for this project.

The steps involved in using the model to calculate effective tax rates for the comparison industries are straight-forward. The following step-by-step presentation applies to the four nonfinancial industries. An example of this procedure is set forth in the Appendix.

Step One: Actual data is used to develop financial profiles for representative firms in each comparison industry. The primary data source is the Bureau of Census, Quarterly Financial Reports (QFR). The QFR provides balance sheet and income statement data for a sample of over 7,000 manufacturing firms and approximately 700 retail trade firms from 1985 to 1989. The financial statements of the representative firms in each industry provide the average financial ratios for the firms included in the QFR sample.

Step Two: Pre-tax income is taken directly from the income statement of each representative firm. The income concept from the financial statement is generally a better approximation of pre-tax income than is taxable income and is consistent across the five-years.

Step Three: Pre-tax income for each representative firm is apportioned based upon the Florida share of sales and payroll, for each industry, consistent with the Florida three factor apportionment formula with sales double-weighted. Because data on property by state is unavailable, payroll is used as a proxy for that factor.

Step Four: Taxable income is calculated by analyzing book-tax income ratios for a set of firms within each of the comparison industries. This analysis uses tax expense information from the Standard and Poor's Compustat data base. For example, the difference between book income and taxable income takes account of differences between accelerated depreciation for tax purposes and slower depreciation for financial accounting purposes.

The relationship between book and taxable income varies across industry and from year-to-year reflecting the impact of corporate tax laws. After the Tax Reform Act of 1986,

federal and Florida tax law accelerated taxable income relative to financial statement income and recaptured previously deferred income on certain types of transactions, such as installment loans and long-term contracts. In these cases, effective tax rates can be higher than the statutory tax rate.

Step Five: Annual corporate income tax liability is calculated for the representative firms by applying the statutory income tax rate to apportioned taxable income. Emergency excise tax liability is calculated by estimating depreciation deductions under the Accelerated Cost Recovery System.

Step Six: Intangibles tax liability is calculated by applying the statutory rate to the intangibles tax base. The intangibles tax base is comprised of notes and accounts receivables, and stocks and bonds for businesses that have a Florida domicile. Out-of-state businesses are subject to tax on receivables generated by business tax activities in Florida.

Step Seven: Annual tax liabilities are divided by apportioned pre-tax income to calculate effective tax rates.

The procedure for calculating effective tax rates for the banking industry is similar with the following differences. First, the data source is special tabulations from the Federal Deposit Insurance Corporation, Call Reports. These data are broken out so that banking activity in Florida is shown separately for banks domiciled in Florida.

Second, two measures of pre-tax income for banks have been constructed. One measure is pre-tax net income as reported for regulatory purposes, without adjustments. The alternative measure reflects three adjustments: (1) the lower yield earned on tax-exempt bonds; (2) the difference between the provision for bad debts and actual net charge-offs on bad loans; and (3) the estimated income tax liability.

Table 4.5 presents effective tax rates for the representative firms in the comparison industries for each year.

Comparison of Effective Tax Rates

Table 4.6 presents the effective tax rates for the P&C insurance industry and the five comparison industries. As shown, the average effective tax rate for the P&C industry is higher than the average effective tax rates for all five of the comparison industries. The P&C effective tax rates are higher using the broad, adjusted income measure as well as the statutory net income measure.

Overall Taxes, Fees and Assessments Imposed on the Insurance Industry in Florida

The effective tax rate comparison presented above reflects, for P&C companies, only premium, retaliatory, income, emergency excise and intangible taxes paid. It is important to note that a number of additional fees and assessments are imposed on the insurance industry in Florida. Certain of these items, such as annual filing fees, are similar to fees that are imposed on corporations generally. Thus it would not be appropriate to include these fees in a burden measure for the P&C insurance industry while excluding comparable fees for the comparison industries.

TABLE 4.5
Effective Tax Rates for Comparison Industries: 1985-1989
(per $100 million of U.S. Assets)

ELECTRONICS

Year	Florida Pretax Income (000)	Florida Corporate Income Tax (000)	Florida Intangibles Tax (000)	Total Tax Liability (000)	Effective Tax Rate
1985	$149	11.00	1.04	$12.04	8.1%
1986	206	17.38	0.73	18.10	8.8
1987	243	21.85	0.81	22.66	9.3
1988	324	25.77	0.81	26.57	8.2
1989	248	18.44	0.85	19.30	7.8
5-Year Average:	234	18.89	0.85	19.73	8.4

FOOD PROCESSING

Year	Florida Pretax Income (000)	Florida Corporate Income Tax (000)	Florida Intangibles Tax (000)	Total Tax Liability (000)	Effective Tax Rate
1985	$320	16.57	0.49	$17.06	5.3%
1986	440	26.36	0.57	26.93	6.1
1987	468	25.70	0.56	26.26	5.6
1988	628	34.56	0.63	35.19	5.6
1989	501	25.60	0.64	26.24	5.2
5-Year Average:	471	25.76	0.58	26.34	5.6

RETAIL TRADE

Year	Florida Pretax Income (000)	Florida Corporate Income Tax (000)	Florida Intangibles Tax (000)	Total Tax Liability (000)	Effective Tax Rate
1985	$436	31.75	0.77	$32.52	7.5%
1986	490	37.29	0.86	38.15	7.8
1987	472	38.61	0.88	39.49	8.4
1988	394	31.35	0.95	32.30	8.2
1989	445	34.36	0.99	35.35	7.9
5-Year Average:	447	34.67	0.89	35.56	7.9

TABLE 4.5 (Continued)
Effective Tax Rates for Comparison Industries: 1985-1989
(per $100 million of U.S. Assets)

INSTRUMENTS

Year	Florida Pretax Income (000)	Florida Corporate Income Tax (000)	Florida Intangibles Tax (000)	Total Tax Liability (000)	Effective Tax Rate
1985	$190	19.57	0.53	20.10	10.6%
1986	(9)	0.00	0.51	0.51	NI
1987	242	15.44	0.56	16.01	6.6
1988	301	22.04	0.74	22.79	7.6
1989	247	20.06	0.83	20.89	8.4
5-Year Average:	194	15.42	0.64	16.06	8.3

BANKING (Statutory Pretax Income)

Year	Florida Pretax Income (000)	Florida Franchise Tax (000)	Florida Intangibles Tax (000)	Total Tax Liability (000)	Effective Tax Rate
1985	$995	34.00	56.00	$90.00	9.1%
1986	855	29.00	58.00	87.00	10.2
1987	916	36.00	56.00	92.00	10.1
1988	960	35.00	55.00	90.00	9.4
1989	783	34.00	55.00	89.00	11.4
5-Year Average:	902	33.60	56.00	89.60	9.9

BANKING (Adjusted Pretax Income)

Year	Florida Pretax Income (000)	Florida Franchise Tax (000)	Florida Intangibles Tax (000)	Tax Liability (000)	Effective Tax Rate
1985	$1,378	34.00	56.00	$90.00	6.6%
1986	1,177	29.00	58.00	87.00	7.4
1987	1,295	36.00	56.00	92.00	7.1
1988	1,244	35.00	55.00	90.00	7.2
1989	1,153	34.00	55.00	89.00	7.7
5-Year Average:	1,249	33.60	56.00	89.60	7.2

1. NI refers to negative income. Effective tax rate cannot be calculated because pre-tax income was negative.
2. Effective tax rate is franchise tax liability divided by Florida pre-tax income.
3. Corporate income tax includes Emergency Excise Tax.
Source: Price Waterhouse.

TABLE 4.6

Comparison of Effective Tax Rates

	Property & Casualty Insurance						*Banking*	
YEAR	*Statutory Income*	*Adjusted Income*	*Electronics*	*Food Processing*	*Instruments*	*Retail Trade*	*Statutory Income*	*Adjusted Income*
1985	NI	68.0	8.1	5.3	10.6	7.5	9.1	6.6
1986	30.7	17.9	8.8	6.1	NI	7.8	10.2	7.4
1987	26.7	18.4	9.3	5.6	6.6	8.4	10.1	7.1
1988	23.2	14.8	8.2	5.6	7.6	8.2	9.4	7.2
1989	27.0	18.3	7.8	5.2	8.4	7.9	11.4	7.7
5-Year Average:	33.5	19.6	8.4	5.6	8.3	7.9	9.9	7.2

NI refers to negative income. Effective tax rate cannot be calculated because pre-tax income was negative.

Source: Price Waterhouse.

P&C insurers doing business in Florida face other obligations, however, that impose special and additional burdens on the P&C industry. In particular, substantial assessments are imposed in order to finance the Florida Insurance Guaranty Association Fund to deal with insurer insolvencies. These state assessments are unique to the insurance industry. (It should be noted that banks do make payments to the Federal Deposit Insurance Corporation to deal with financial institution insolvencies). Payments to the Florida Insurance Guaranty Association have fluctuated depending upon need. Assessments have ranged from $24.1 million in 1989 to $107.0 million in 1987. Table 4.7 presents an alternate burden calculation when the Guaranty Fund assessments are added to the premium tax and retaliatory tax amounts used to calculate the effective tax rate measure presented in Table 4.6. The total burden, including Guaranty Fund assessments, equals 22.9 percent, over the five-year period, using the adjusted income measure, and 39.3 percent, using statutory net income.

It should be noted that this financial burden measure does not "double count" the Guaranty Fund assessments since the premium tax credit that was provided to recover the assessment is subtracted in calculating premium tax burden. As noted, this credit was virtually eliminated after 1989.

Table 4.8 presents the amount of Florida premium and retaliatory taxes collected from P&C and life insurance companies operating in Florida for fiscal years 1985 to 1989 as well as additional P&C assessments. In 1989, insurance companies (both life and non-life) paid $240 million in premium taxes in Florida. Compared to total payments in 1985, the 1989 level was up 54 percent. In addition to the items included in Table 4.8, P&C insurers paid corporate income and intangibles taxes, for which data was not available.

TABLE 4.7

P&C Burdens Including Guaranty Fund Assessments: 1985-1989

	Effective Tax Rate: Premium and Retaliatory Taxes		*Burden with Guaranty Fund Assessments*	
YEAR	*Statutory Income*	*Adjusted Income*	*Statutory Income*	*Adjusted Income*
1985	NI	69.0	NI	72.4
1986	30.7	18.0	36.0	21.1
1987	26.8	18.5	33.9	23.4
1988	23.3	14.9	26.4	16.8
1989	27.1	18.4	31.7	21.5
5-Year Average:	33.6	19.6	39.3	22.9

NI refers to negative income. Effective tax rate cannot be calculated because pre-tax income was negative.

Source: Price Waterhouse

TABLE 4.8
Florida Insurance Taxes, Fees, and Special Assessments: FY1985 - FY1989
(thousands)

	1985	1986	1987	1988	1989
P&C AND LIFE					
Premium Taxes: P&C and Life 1/	$156,088.8	$186,882.8	$218,619.1	$295,634.3	$240,324.7
P&C ONLY					
Florida Insurance Guaranty Association Assessments	$ 33,506.1	$ 55,512.1	$ 106,972.1	$ 36,643.7	$ 24,147.7
Workers' Compensation Administration Assessment	40,874.0	42,303.8	43,300.0	33,407.0	33,794.0
Additional P&C Assessments	$ 74,380.1	$ 97,815.9	$ 150,272.1	$ 70,050.7	$ 57,941.7

1/ Premium tax includes net premium tax (after credits) allocated to the state general fund plus retaliatory tax, municipal firefighters' and police officers' pension fund taxes and state fire marshall assessment

Source: Florida Insurance Guaranty Association
Florida Department of Labor and Employment Security
Florida Department of Revenue

V. THE ECONOMICS OF STATE TAXATION OF P&C INSURANCE COMPANIES

State tax policymakers examine a number of criteria when evaluating alternative revenue sources. Issues of equity involve the impact of tax policy options on the progressivity or regressivity of the state tax system. States are also increasingly sensitive to the volatility of tax revenue sources. Revenue sources which do not fluctuate greatly from year-to-year are desirable because they contribute to the stability and predictability of the overall revenue structure.

Two additional tax policy evaluation criteria, which are the focus of this chapter, involve economic efficiency and development. Economic efficiency refers to the principle that taxes should be designed to minimize interference with resource allocation decisions in otherwise efficient markets. The economic development criterion focuses upon the role of tax policy in creating incentives or disincentives to investment and job creation in the state.

Two key points are presented here in applying these criteria to state taxation of P&C insurance companies. First, high taxes on P&C insurers can have an adverse effect on economic development by increasing the cost of doing business in the state. Second, high P&C insurance taxes have negative social as well as economic impacts by interfering with efficient choices about whether to purchase insurance or self-insure.

Effect on State Economic Development

P&C insurance taxes can have an adverse effect on economic development in relation to purchases of insurance by businesses. As noted in Chapter III, in Florida, over 52 percent of total P&C insurance (by premium volume) is sold to businesses. The incidence or ultimate burden of the premium tax on business purchases is likely to depend upon the characteristics of particular business customers. If the firm sells its product in in-state markets, the premium tax will tend to be treated as a cost passed through in the price of

the final product. This is the case because a tax can more readily be passed through if it is a cost that is incurred uniformly by all sellers in a localized market.

The incidence of the premium tax is not as clear in the case of purchases of insurance by businesses that sell their products in national or global markets. Florida businesses, such as manufacturing or business service industries with export characteristics, compete with companies that operate in other states. The prices of the final products sold by such firms are set in national markets. Export-oriented firms may not be able to pass, the entire state tax costs on to final consumers through prices increases without losing market share.

If these export-oriented firms selling their products in national markets cannot pass the premium tax to consumers then, in the short run, the firm would absorb the cost of the premium tax. However, this behavior would result in a lower after-tax return on investment. Because capital is mobile, investment by firms operating in national markets would shift to jurisdictions with lower tax costs over the long run. This would reduce investment and employment in Florida.

In summary, state premium taxes related to P&C insurance sold to Florida business customers who sell their products in national markets can have various effects. If the business customer attempts to pass the premium tax cost through to consumers of its final products, the firm will lose market share and Florida employment will be adversely affected. If the business customer absorbs the premium tax costs, the after-tax return on investment in Florida will be lower and, in the long run, mobile capital will be shifted to states with lower premium taxes.

Additionally, it should be noted that a higher premium tax rate would also increase the amount of retaliatory taxes paid by Florida insurers to other states. Higher retaliatory tax costs, to the extent that they are reflected in prices, may then reduce the market share of Florida insurers in those states.

Effect on Economic Efficiency

Insurance customers may also respond to premium taxes in a manner which conflicts with the criterion of economic efficiency by choosing to self-insure rather than purchase insurance. Individuals and businesses will have an incentive to self-insure if they conclude that their risks are less than the average risk embedded in the cost of purchased insurance. The decision to self insure may be a rational decision in an efficient market. However, premium taxes can distort efficient market decisions by encouraging self-insurance when it is inappropriate. Premium taxes are an additional cost of purchased insurance. Self-insurers were made subject to premium taxes in Florida in 1988 but at a lower rate than are P&C insurance companies. Thus self-insurance has a cost advantage relative to purchased insurance because of state tax policy.

There are two ways in which this state tax incentive to use self-insurance can have adverse social and economic consequences. First, some self-insured businesses may not have the financial resources to meet all liabilities and could file for bankruptcy without compensating deserving claimants. By contrast, state regulation and state guaranty funds provide a system for ensuring that companies selling purchased insurance will meet claim liabilities. If self-insurance becomes less expensive than comparable purchased insurance because of differential taxation and government mandates, then large costs may be inflicted on individuals without compensation from the self-insured.

Second, the price of purchased insurance will be pushed up as lower-risk businesses self-insure, leaving a greater proportion of higher-risks remaining in the purchased insurance pool with a commensurate increase in the necessary premium for purchased insurance. The resulting price increase would have a disproportionate impact on individuals and businesses that are "marginal" risks -- young automobile drivers, inner-city homeowners, and small businesses or businesses with high risk activities. These "marginal" risks would experience the largest increase in premiums as a fraction of their income.

APPENDIX

EXAMPLE OF EFFECTIVE TAX RATE CALCULATION FOR REPRESENTATIVE FIRMS IN COMPARISON INDUSTRIES

The following example provides an illustration of how effective tax rates have been calculated for each of the nonfinancial comparison industries. This example is the representative firm in the electronics industry. The representative firm is assumed to have $100 million of total assets in 1985. The calculations are shown for 1985 and 1986.

		(Thousands of Dollars) 1985	1986
1.	Total U.S. assets are assumed to be $100 million in 1985. Growth in assets to 1986 is based upon actual data from the Quarterly Financial Reports (QFR).	100,000	105,993
2.	The ratio of U.S. pre-tax net income to total assets is taken directly from the QFR income statement.	3,859	5,329
3.	U.S. pre-tax income is apportioned to Florida using the Florida share of U.S. sales and payroll, for each industry, consistent with the Florida apportionment formula. Because property by state is unavailable, payroll is used as a proxy for that factor.	149	206
4.	Florida taxable income is calculated by applying the ratio of book-to-tax income to the pre-tax income amount from Step 3. The source of the book-tax income ratio is the Standard and Poor's Compustat data base for each comparison industry.	145	231

		(Thousands of Dollars) 1985	1986
5.	The statutory income tax rate of 5.5 percent is applied to the amount from Step 4 to calculate income tax liability.	8.0	12.7
6.	The emergency excise tax liability (EET) is calculated by multiplying the EET tax base by the statutory rate.	3.0	4.7
7.	The intangibles tax is calculated by multiplying the Florida share of accounts receivables by 0.1 percent.	1.0	0.7
8.	Effective tax rates are calculated by dividing corporate income, EET and intangibles tax liability (Steps 5, 6 and 7) by Florida pre-tax income (Step 3).	8.1%	8.8%

Estimation of Emergency Excise Tax Liability

Beginning in 1981, Florida imposed an additional corporate tax called the emergency excise tax (EET). The purpose of the EET is to offset the potential state revenue loss from conformity with federal accelerated depreciation rules under the Accelerated Cost Recovery System (ACRS). The EET is applied to property placed in service from 1981 to 1986. The EET does not apply to investments after 1986 when slower federal and state depreciation rules were in effect. However, because the tax applies over the life of investments made during the 1981-86 period, EET liability was imposed on corporations doing business in Florida throughout the 1985-89 period of this study. It is important to include this item in an effective tax rate analysis since, in some study years, EET liability was equal to 25 percent or more of net corporate income tax liability.

The EET provides for the taxation of 40 percent of the depreciation deductions allowed under the Accelerated Cost Recovery System (ACRS). The ACRS depreciation amounts for each industry were computed applying the appropriate depreciation schedules to the amount of investment in each industry, in each year, over the 1981 to 1986 period.

The investment amounts for each industry were divided among four different classes of assets: automobiles and light trucks, computers, other equipment, and buildings and structures. Under ACRS, automobiles and light trucks were treated as 3-year property; other equipment and computers were treated a 5-year property; and buildings and structures were treated as 15-year property (rising to 19 years by 1985). The amount of investment in each industry for each type of asset was obtained from the Department of Commerce, Bureau of Economic Analysis (BEA). The total depreciation deduction under ACRS was computed by applying the ACRS depreciation schedule to each year's investment, and summing across the four types of assets. In this way, the total depreciation (under ACRS) was computed for current year investment, plus deductions attributable to prior year investment.

For years after 1986, the ACRS depreciation deductions continue to accrue to assets placed in service prior to that time. The ACRS deductions tend to trail off over time, as older assets become fully depreciated and as the schedules "slow" down. No further investment is subject to ACRS and additional deductions for new investment do not arise. Thus, eventually, the deductions under ACRS will reach zero. The consequence of this pattern is a declining EET tax liability over the time span covered by this report.