Memo

To: Capitol and Policy Reporters, Editorial Board Members, Editors & Columnists
From: Sharon Ward, Director, Pennsylvania Budget and Policy Center
Date: April 10, 2013
Re: Pennsylvania House Finance Committee hearing on Governor's tax cut plan

Hidden deep within Governor Tom Corbett's proposed 2013-14 budget is a plan to enact a 30% cut in Pennsylvania's corporate net income tax rate over 10 years, along with a number of other tax policy changes, that when fully phased in will cost the commonwealth—conservatively—more than $800 million annually.

Media Contact

To set up an interview with Sharon Ward, please call Chris Lilienthal at 717-255-7156 or email him at lilienthal@pennbpc.org.

The new round of tax cuts come after two years of significant budget cuts and at a time when the commonwealth is having difficulty meeting its current obligations. It comes on top of 12 years of tax cuts whose value has reached more than $3 billion annually. This includes the final year of the capital stock and franchise tax phase out, which will drain more than $300 million in the current fiscal year.

State tax revenue for 2012-13 is not meeting expectations. The current year surplus that forms the foundation for next year's budget is dwindling, leaving a potential budget gap. Pension costs will rise over the next few years regardless of whether changes sought by the Corbett administration are enacted, putting added pressure on the budget. Long-delayed transportation infrastructure projects and public transit programs will vie for scarce dollars.

While state tax reform would be welcome, this plan falls far short of that goal. It makes modest changes to improve tax enforcement but avoids addressing corporate tax loopholes. Legislation that took steps to close the Delaware loophole passed the House last year, indicating growing support for leveling the playing field for Pennsylvania businesses.

Governor Corbett's tax cut proposal will cost hundreds of millions of dollars—shortchanging the schools, colleges, health care and infrastructure that are absolutely necessary for our economy to grow. Pennsylvania can ill afford a new round of corporate tax cuts.

The Governor's tax cut plan will be the subject of a Pennsylvania House Finance Committee hearing at 9:30 a.m. on Thursday, April 11 in Room G-50 of the Irvis Office Building, State Capitol Complex. In anticipation of that hearing, I would like to lay out some of the shortcomings of the Governor's plan and suggest a better course to achieve true tax reform that closes loopholes and improves accountability.

The Governor's Tax Plan

- Reduces the corporate net income tax rate from 9.99% to 6.99% by tax year 2025. The plan continues the increase in the Net Operating Loss carry-forward for a maximum of $5 million and 30% after tax year 2015. **A conservative estimate pegs the total cost of the proposal at $389 million by FY 2020-21 and $819 million when fully phased in.** It puts the vast majority of the cost onto a future administration, as the bulk of the rate cut occurs after 2018.
- Changes reporting requirements for pass-through entities, which includes partnerships, limited liability corporations (LLCs) and sub-chapter S corporations. With the phase-out of the capital stock and franchise tax, these corporate entities may not file a tax return with the state (partners and individual owners are required to file individual returns). This plan would make certain types of tax filing mandatory for these entities, and a $50 fine would be imposed for non-compliance.
- Ends a loophole in the realty transfer tax, through which large property holders are able to avoid state and local taxes.
- Eliminates unused tax credits, including the Call Center Tax Credit and the Coal Waste Removal Tax Credit.
- Provides for a $5,000 deduction for small business startups and conforms with IRS rules for like-kind exchanges for personal income taxpayers.
- Provides clarification for sourcing of sales of services and intangible assets, more important now that Pennsylvania has moved to basing its corporate income tax solely on sales.

A High Cost Plan That Creates Few Jobs

The Corbett administration projects that its tax cut plan will create 18,000 jobs in 2025. This amounts to 0.3% of total state employment and is less than that the 20,000 jobs in education that have been lost since 2010 due to state funding cuts. It is unclear if the administration's projections take into account job losses as a result of lost tax revenue and service cuts—which could make the net job gains even less than 18,000.

Tax cuts enacted over the past decade have not resulted in significant job growth. The phase-out of the capital stock and franchise tax is worth $2.5 billion in 2013 alone, but Pennsylvania's job creation record has actually worsened, falling from 27th nationally in 1999-2000 to 34th in 2011-12.

One reason that costly tax cuts produce few jobs is they offer little benefit to most companies. 80% of the tax cut benefits will go to the top 1% of corporate income tax filers in Pennsylvania — about 1,000 large multistate and multinational companies that may invest the state tax savings in Europe, Asia or other market.

Governor's Plan Does Not Close Loopholes

Last year, under the leadership of Republican Rep. Dave Reed, the Pennsylvania House adopted legislation that paired a cut to the state's corporate income tax rate with a modest step toward closing loopholes. The bill, while not perfect, was an important bipartisan acknowledgement that tax loopholes are a problem in Pennsylvania.

The Governor's tax plan ignores the issue of corporate tax loopholes in general. Instead it rewards businesses that hide income and avoid taxes with yet another tax break. It is entirely unfair for those Pennsylvania businesses that pay their taxes and will see little benefit from a new round of tax cuts for big corporations.

Most states have taken steps to close tax loopholes. Twenty-three states have adopted "combined reporting," which requires companies to file a single tax return for all related businesses like they do with the federal government. Thirteen additional states require companies to add back to their state returns income that is sheltered in other states (these are known as addback rules).

States with combined reporting have been able to raise an additional 9% to 13% in tax revenue, according to Pennsylvania's Independent Fiscal Office. That means Pennsylvania has lost between $900 million and $1.2 billion since 2008 by failing to enact combined reporting.

The proposal would close one specific loophole, the "89-11 loophole," where large property owners "break up" ownership transfer to 89% in the first year and 11% three years later to take advantage of a loophole in the law and avoid realty transfer tax at the state and local level. The General Assembly attempted to close this loophole in 2012.

Fact Checking Claims about Pennsylvania Business Taxes

Tax cut advocates have made several claims to justify their positions that don't stand up to scrutiny. The Tax Foundation Business Climate Index holds up certain states as tax "models." The top 10 states in its rankings are often states with mineral wealth. This is because the Tax Foundation doesn't count severance taxes as corporate taxes, which skews the ranking. The Tax Foundation index differs substantially from others, including the Council on State Taxation (COST) which looks at actual taxes paid by corporations. In the 2012 Index, COST ranked Pennsylvania in the middle of all states with taxes as a share of the economy (Gross State Product) at the national average. The Tax Foundation scores Wyoming as the best state for business taxes, even though it is home to not a single Fortune 500 company or a major airport. COST gave Wyoming a ranking of 45th of 50 states.

Pennsylvania's tax rate for small businesses, at 3.07%, is very low. There is no minimum corporate tax or pass-through entity tax in Pennsylvania, and taxation of tangible personal property is limited.

Many corporations subject to the corporate net income tax avoid the tax altogether using legal loopholes that allow them to shift income earned in Pennsylvania to tax-haven states like Delaware. Additionally, Pennsylvania corporate and personal income taxes are fully deductible from federal taxable income, reducing a corporation's overall taxes.

A Better Path Forward

Before making new tax cuts, Pennsylvania should get its fiscal house in order, addressing needed funding for schools, colleges, infrastructure, health care and increased pension costs. The commonwealth ranks among the worst states in per capita spending on public universities and has the second highest number of structurally deficit bridges in the nation. At the very least, tax reform should not deepen the state's fiscal problems, yet the Governor's proposal will do just that.

For true tax reform, the General Assembly should do the following:

- **Close loopholes.** Enact a strong addback bill, like New Jersey has, for 2014 and 2015 and then move to combined reporting in 2016. Any tax reform proposal must include real reform and close loopholes.
- **Do not tie the hands of future governors and legislators.** Tax cuts should be voted on every year as part of an overall spending plan, just as funding for schools and children's services are.
- **Enact more limited tax rate reduction.** With loopholes closed and real accountability in place, Pennsylvania can take steps to reduce the corporate net income tax rate; however, the goal should be more in line with a 2008 recommendation from CompetePA, a statewide coalition spearheaded by the Allegheny Conference, that called for a rate reduction to 8.5%.
- **Strengthen the Department of Revenue's tax enforcement capacity.** The Governor's proposal offers a number of steps to improve enforcement. They are a good first step. The Department of Revenue should be allocated additional resources for enforcement.

Business tax cuts have a poor track record when it comes to boosting the economy and creating jobs—raising between 25 cents and 30 cents for every dollar spent. Tax reductions that are accompanied by cuts in education, public safety, higher education, and infrastructure can impede rather than promote economic growth.

No longer should Pennsylvania be an outlier, looking the other way as companies funnel income earned here to tax-haven states. Tax reform that closes loopholes, improves accountability, achieves modest tax rate reduction and better supports public services critical to economic growth is the best path forward.

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