

Competitiveness and Pennsylvania's Business Tax Structure

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Hearing on Assessing Pennsylvania's Business Tax Climate

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Mr. Chairman and Members of the Committee:

The recent recession and the slow recovery have been difficult for states. Jobs and economic growth are desperately needed now more than ever, and policymakers are searching for any way to give their states an edge. At the same time states have to balance these needs against the need for revenue, which plunged during the recession. Some states have been able to maintain their business tax competitiveness in this challenging environment while others are finding that their lack of competitiveness may be holding them back now more than ever. Pennsylvania should use this challenging time as an opportunity for productive tax reform.

Pennsylvania's tax system is a mix of good and bad. Your personal income tax compares favorably to your neighbors and nationally, ranking 14th in the Tax Foundation's 2011 State Business Tax Climate Index. But the state is weighed down in part by a poor ranking in the corporate portion of the study, where you rank 38th. Taking into account all the major taxes that affect business, Pennsylvania ranks 26th nationally.ⁱ

It is not difficult to tell why Pennsylvania's corporate taxes rank poorly. The state's 9.99% corporate income tax rate is second only to Iowa's 12% rate. Combined with the US's top corporate income tax rate, Pennsylvania actually has one of the highest corporate income tax rates in the world.ⁱⁱ While the top corporate tax rate is not the only thing that matters to business competitiveness, it certainly does not help the state.

Other areas of Pennsylvania's corporate tax code are in need of improvement as well. With a cap of \$3 million, Pennsylvania is one of only two states to limit net operating loss carry-forwards. Pennsylvania also disallows carry-backs altogether, a policy that is somewhat more common, though probably not

desirable. Allowing corporations more leeway to deduct their losses will help them cope with the business cycle and will help put Pennsylvania on a level playing field with other states.

Pennsylvania also has a capital stock tax. While this tax is scheduled to be phased out, it currently counts against the state because it is still being levied through 2013. You should absolutely follow through with the phase-out of this outdated and unjustified tax, and consider speeding up its elimination.

Pennsylvania also has several specialized tax credits available to corporations. Many of these credits benefit businesses that create or retain jobs or invest in the state. There is even a tax credit for movie production companies that film in the state. These types of tax breaks are attractive because they offer the hope of improving the state's economic and job outlook. However their benefits are often exaggerated while their unseen costs are ignored. Much of the revenue is lost to economic activity that would have occurred regardless of the incentives. Even the very idea that policymakers can "create" jobs in the state is highly suspect. Many of the jobs "created" are really just transplanted from somewhere else – either a different industry within the state or from another state.

Ultimately, the economic literature is not kind to economic development and job creation tax incentives. At best their economic impact is minimal, at worst it is zero and sometimes negative. With a \$200 million price tag in Pennsylvania for the 2012 fiscal year, these types of incentives are ultimately not a sustainable or cost-effective approach to economic development.ⁱⁱⁱ

The state needs to also consider the opportunity costs of tax incentives. Even if they are successful, the revenue that is lost to these incentives might be put to better use elsewhere, and these uses need to be considered as well. For instance, Pennsylvania needs to ask the question of whether the public would be better served by eliminating targeted business tax breaks and using the revenue for essential services or to fund broad-based tax cuts.

Such tax giveaways have unintended consequences as well. First, they come with significant compliance costs for businesses, enforcement costs for the state, and the potential for significant abuse.^{iv} Furthermore, the more tax exemptions, deductions and credits that are embedded in the tax code, the higher tax rates have to be in order to raise sufficient revenue. These higher rates reduce the reward from economic activity on the margin and amplify the hidden, non-revenue, costs of taxation – what economists call the dead weight loss.

This is not to say that any provision in the tax code that reduces corporate tax revenue is a bad policy. Deductions for net operating losses were mentioned above as one desirable aspect of a corporate income tax. Likewise, some form of depreciation or expensing is necessary for business investments. While the ideal way to structure these provisions is debatable, they should not be viewed as giveaways to corporations. Rather, these and other provisions serve to correctly define the tax base.

However, there are many tax breaks, like those tax credits mentioned above, that are not essential to a properly functioning corporate income tax and serve only to redistribute the tax burden between businesses. The state needs to take a serious look at reforming these provisions. What Pennsylvania has now is a corporate income tax with a high statutory tax rate and a tax base that leaves out significant

amounts of income. You could greatly improve the state's tax code by broadening the tax base – eliminating non-essential tax credits, deductions and exemptions – and reducing the tax rate.

In the very least, the state needs to closely study and monitor these tax incentives and tax breaks. Comprehensive studies that include both the costs and benefits of tax incentives are essential. Those incentives that are failing to live up to their promises or have outlived their usefulness should be eliminated, and the opportunity costs must never be ignored.

In the current economic climate Pennsylvania cannot afford to leave its corporate tax code unchanged. A number of reforms can help make the state's tax code simpler, more neutral, and more competitive. Reducing the tax rate and broadening the tax base would go a long way towards achieving these goals. In addition, Pennsylvania should consider speeding up its elimination of the capital stock tax. While these reforms could be designed as revenue neutral tax reforms, reducing the overall tax burden on business would be beneficial as well.

Thank you.

ⁱ Kail Padgitt, *2011 State Business Tax Climate Index*, Tax Foundation Background Paper No. 60, Oct 26, 2010, <http://taxfoundation.org/publications/show/22658.html>

ⁱⁱ Scott A. Hodge, *Illinois Corporate Tax Hike Inches U.S. Closer to #1 Ranking Globally*, Tax Foundation Fiscal Fact No. 257, Jan 14, 2011, <http://www.taxfoundation.org/research/show/26974.html>

ⁱⁱⁱ Governor's 2011-2012 Executive Budget

^{iv} Mark Robyn, *Iowa Auditor Issues Report on Film Tax Credit Scandal, New Zealand Shells Out for The Hobbit*, Tax Foundation Tax Policy Blog, Oct 27, 2010, <http://www.taxfoundation.org/blog/show/26808.html>