

Governor Corbett's Tax Reform Proposal

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Members of the Committee:

I appreciate the opportunity to testify today on Governor Corbett's tax reform proposal. In the 76 years since our founding, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

The State Business Tax Climate Index

Each year we produce the *State Business Tax Climate Index*. This widely-cited report evaluates state tax structures to see how well a state tax system comports with the principles of good tax policy: the idea that taxes should be, as much as possible, simple, neutral, transparent, and stable. Over 100 variables from all areas of taxation – income, business, sales, property, and unemployment tax – are included, incorporating the latest academic evidence about the impact of tax policy on economic growth.

In our most recent *Index*, using state laws as they stood on July 1, 2012, Pennsylvania ranked 19th best out of the 50 states. While middle-of-the-pack nationally, the rank compares favorably with neighboring states: Delaware is slightly better at 14th best, Virginia slightly worse at 27th best, and other states much lower (Ohio at 39th, Maryland at 41st, New Jersey at 49th, and New York at 50th.) The state's lowest-in-the-country individual income tax and moderate sales tax are key positive attributes.

However, two components of the Pennsylvania tax system compare unfavorably to her fellow states: business taxes (46th best) and property and wealth taxes (42nd best).

Under this phasedown, the Pennsylvania rate would begin falling below neighboring states in 2019, and the ultimate 2025 rate would be roughly in the middle of rates compared to the rest of the country.

Capital Stock Tax

Additionally, while the capital stock tax is being phased out, this damaging and outdated tax continues to negatively affect business investment and capital accumulation until then. Of the 20 states retaining such a tax, Pennsylvania's is in the upper half in terms of the burden it imposes on business activity. The tax is scheduled to end in 2014.

Net Operating Loss Carrybacks and Carryforwards

It is for convenience reasons that we tax income on an annual basis. However, that arbitrary time choice can be problematic for corporations with cyclical income, seeing high profits one year but losses the next. The federal government and most states allow corporations to deduct losses from previous years to offset current taxes owed. These Net Operating Loss (NOL) "carrybacks" and "carryforwards" smooth out tax obligations over time. This policy is valuable because it assures that industries with cyclical income are not set at a competitive disadvantage against industries with more stable revenue.

Twenty-six states and the District of Columbia (including Pennsylvania) allow businesses to use past losses to offset current tax obligations for up to 20 years; however, Pennsylvania is one of only four states that cap the total carryforwards. All other states, including all of Pennsylvania's neighbors, allow unlimited dollar amounts of carryforwards. Fifteen states allow businesses to carry back losses against past taxes for 2 or 3 years; Pennsylvania does not allow any loss carrybacks.

Governor Corbett's proposal would increase the cap on carryforwards from \$3 million to \$5 million. While a better alternative would be eliminating this arbitrary cap entirely, raising the cap is a good second best.

Business Tax Costs: *Location Matters*

In addition to the *State Business Tax Climate Index*, in 2012 we conducted another study that may be of interest to you. Our economists designed seven model firms to compare tax costs: a capital-intensive manufacturer, a labor-intensive manufacturer, a call center, a distribution center, a corporate headquarters, a research & development facility, and a big-box retailer. Each firm had certain characteristics (so many employees, so many sales, so many square footage, etc.), drawn from statistics from comparable enterprises.

We then worked with the respected accounting firm KPMG to calculate each model firm's tax bill in each of the 50 states. And each calculation was done twice: once for mature businesses, generally not eligible for targeted tax incentive programs, and once for a new business that could access such programs.

Pennsylvania fared quite poorly in this comparison. The state had the highest tax costs for corporate headquarters and R&D facilities, both new and mature. Mature retailers faced the highest tax costs; new retailers, the third-highest. The state tax system also imposes the second-highest tax costs for mature distribution centers (third-highest for new); and the third-highest tax costs for call centers. Manufacturing facilities fared better: 5th lowest tax costs for capital-intensive and 15th lowest for labor-intensive.

Contributing factors to these high tax costs are the state's high corporate tax rate, the capital stock tax, local income taxes, and high tax burdens.

Conclusion

Pennsylvania's business tax system is behind its regional and national competitors. Reforms that reduce the corporate tax rate, remove restrictions on net operating losses, and eliminate the capital stock tax will improve the state's tax system, its score on the *State Business Tax Climate Index*, and its attractiveness to economic growth.

ABOUT THE TAX FOUNDATION

One of America's most established and relied-upon think tanks, the Tax Foundation has since 1937 worked for simple, sensible tax policy at the federal, state, and local levels. We do this by informing Americans about the size of tax burdens and providing economically principled analysis of tax policy issues.

ABOUT THE CENTER FOR STATE TAX POLICY AT THE TAX FOUNDATION

The Tax Foundation's Center for State Tax Policy produces and markets timely and high-quality data, research, and analysis on state fiscal issues that influences the debate toward economically principled tax policies. Our experts are routinely relied upon for presentations, testimony, and media appearances on state tax and fiscal policy, and our website is a comprehensive resource for information on tax and spending policy in each U.S. state.