General Fund Tax Expenditures and Revenue Options

This is a basic overview of the most asked about options for raising revenue. Policymakers may consider the following sources as "replacement revenue" to offset other tax reductions, to improve equitable treatment of taxpayers, to pay for proposed initiatives, or to balance the state budget. Some of the outlined revenue options would only require minor changes in current tax laws to be implemented.

Policymakers often need revenue options for a variety of reasons and circumstances. For example, revenue may be needed to address the impact of shifts in taxpayer behavior, such as the growth of online shopping or changes in how businesses choose their corporate structure. Long-term trends in the economy can erode tax bases and reduce revenue, as is the case for the sales tax and the cigarette tax. Or, Pennsylvanians might desire to make fundamental changes to how we pay for government services, as is the case in the recurring discussion about lowering local property taxes and replacing them with other revenue sources.

This document contains an overview of the revenue foregone from providing preferential tax treatment, often referred to as a tax expenditure, and a discussion outlining the amount that is generated from each unit of the rate levied under the most common state taxes.

Severance Tax

Natural Gas Severance Tax

Pennsylvania is the only major natural gas producing state without a severance tax. Act 13 of 2012 imposed an unconventional gas well fee, or impact fee; however, drillers are paying much less under the fee as compared to a reasonable severance tax.

According to an Independent Fiscal Office estimate, a severance tax could have generated $210 million, had it been enacted in 2018/19, and $277 million in 2019/20 at an effective tax rate (ETR) of 4 percent (consisting of an impact fee ETR of 1.6 percent and a severance tax ETR of 2.4 percent). Severance tax estimates are based on the average annual NYMEX price of natural gas less than or equal to $3.00.

Corporate Taxes

Combined Reporting

Current corporate tax law only allows for separate accounting, which means the profits of subsidiaries are not reported or taxed in Pennsylvania. As a result, companies have an incentive to avoid paying state taxes by establishing subsidiary operations out-of-state and moving parts of the business to that subsidiary - a practice commonly called the "Delaware loophole." Combined reporting would require multi-state corporations to add together the profits of all their associated subsidiaries and parent corporations before calculating the amount of income apportioned to Pennsylvania. Currently, 28 states and the District of Columbia use combined reporting to calculate corporate taxes.

Revenue estimates for combined reporting vary because it is not known to what extent corporate profits are shifted to out-of-state subsidiaries or parent companies. We do know that new revenue generated by switching to combined reporting would take several years before it would be fully phased in. In its first year, Pennsylvania could realize $100 million to $200 million in new revenue. After four years, when fully phased in, combined reporting could generate more than $600 million annually. The Department of Revenue estimates possible revenue of almost $1.0 billion at the full rate.

Gov. Rendell proposed combined reporting as part of the 2010/11 budget, and Gov. Wolf asked for it in six of the last seven budgets. Each of Gov. Wolf's budgets that proposed to implement combined reporting also proposed to decrease the corporate net income tax rate. The proposals received minimal consideration and often faced significant opposition from large corporations. Even with significant rate reductions, many large, multi-state corporations would realize a higher tax liability. Smaller corporations that only have a presence in Pennsylvania would benefit from a rate reduction and would be unaffected by combined reporting requirements.

Add-back Rules

A majority of states either require combined reporting or have add-back provisions that require certain income or transactions (usually related to intangible property or royalties) to be added back to the tax liability. Pennsylvania enacted an add-back rule in 2013 (Act 52) that requires corporations to add back any portion of income that was intentionally not included for the specific purpose of avoiding tax payments. Pennsylvania's rule is considered weak because it only catches transactions that were intended for tax avoidance. It is self-reported, so the Department of Revenue is not able to determine if there are other payments that go unnoticed.

There is room for improvement for Pennsylvania to strengthen the add-back rules, similar to other states such as North Carolina, Tennessee and Virginia, to provide the Department of Revenue with information on transactions between affiliated entities. For example, North Carolina gives the Department of Revenue the ability to request separate filing by corporations and affiliated entities to review transactions if it has reason to belief the transactions lack economic substance or are not at fair market value. Tennessee strengthened its add-back rules by expanding the definition of intangible expenses to include the interest related to intangible expenses. Similarly, Virginia narrowed its definition of exceptions to allow for more transactions to be added back to taxable income.

Sales and Use Tax

Sales and Use Tax Exclusions

Currently, 75 items (tangible personal property or circumstantial transactions of such sales in the tax code) are specifically excluded from the sales tax base. Each item comes at a cost to the commonwealth and is considered to be a tax expenditure. Therefore, removal of any such exclusion would result in new revenue to the state.

The two largest sales tax exclusions are for food and clothing, worth about $1.5 billion and $680 million, respectively. Exclusions for items commonly considered to be necessities -- such as food, clothing and hygiene products – are intended to alleviate the regressive nature of the sales tax. Only five other states with a sales tax exempt clothing, and 38 states have a full or partial exemption for groceries.

Services are exempt from Pennsylvania's sales tax (except for a few that are specifically enumerated). Therefore, most services are also considered to be tax expenditures. Adding specific services to the tax base would result in new revenue but policymakers should carefully weigh the benefit in conjunction with an analysis of other taxes that businesses pay.

While each exemption has a cost, they are supported by stakeholders that strongly defend the exclusion.

The effect of removing any given exclusion is not evenly distributed across the state and can have a significant impact on people in certain locations. Some exclusions exist for practical purposes (such as the sales-for-resale and manufacturing exemptions) to avoid the pyramiding of taxes through various product production phases.

Other exclusions exist because it is administratively impractical to collect the tax (for example, infrequent yard sales). Therefore, removal of exclusions like this would not realistically result in increased revenue.

Any proposal to eliminate sales and use tax exclusions should be carefully studied. The list of tax exclusions is annually updated in the governor's executive budget.

Incremental Revenue Estimates

The nearby table shows how state revenue would be affected by an increase or decrease in the tax rate. The revenue change for each hypothetical rate represents a general approximation estimated of revenue that could be gained or lost and is based on an average of recent collections and estimates.

The estimates shown in the table can generally be extrapolated to calculate other tax rate scenarios by multiplying the estimate.

Changes to tax law take time to implement before the full revenue effect is realized. It could take several months for the Department of Revenue to make changes to regulations, forms, instructions and computer systems, as well as educate taxpayers. Therefore, the full amount of estimated revenue for the first year might not be achievable for certain tax types if legislation is enacted close to the beginning of the fiscal year or after the fiscal year begins.

What is a Tax Expenditure?

Governments spend money in several ways. Most spending is accomplished through a direct expense, often identified as an appropriation, but it can also take more indirect forms. Preferential tax treatment can resemble spending that benefits certain individuals, businesses, or transactions. Transparency demands that governments report revenue foregone by special tax treatment just as they provide detailed budgetary spending reports. Both are forms of government spending and policy makers need to be able to analyze and weigh their value.

The federal Treasury Department began reporting tax expenditures in 1972 and included a definition of them in the Congressional Budget Act of 1974 and all states now report them as well.

The inclusion of a tax expenditure analysis in the governor's budget submission to the General Assembly was first required in statute by Act 180 of 1992 as an amendment to Article VI of the Administrative Code (Act 175 of 1929). According to Section 624 of the Administrative Code, a tax expenditure is "a reduction in revenue that would otherwise be collected by the commonwealth as the result of an exemption, reduction, deduction, limitation, exclusion, tax deferral, discount, refund, commission, credit, special rate, or special treatment."

The Department of Revenue uses the following criteria to further clarify the statutory definition of a tax expenditure:

- Reduces state revenues.
- Confers special treatment.
- Is included (specifically detailed) in the defined tax base.
- Is not subjected to equivalent alternative taxation.
- Can be altered by a change in state law.
- Is not an appropriation.

The budget book details all tax expenditures (Section D), beginning with tax credits followed by subsections for each major tax type. A brief description of each expenditure is accompanied by a general revenue estimate, as well as an estimate of beneficiaries of each expenditure.

Revenue estimates are general and do not align with any specific piece of proposed legislation. Therefore, tax expenditure estimates are helpful for understanding the scope of foregone revenue, but are not meant to be the sole basis for revenue estimates when considering new legislation.

Incremental Revenue Estimate Table			
Revenue Impact of Incremental Changes in Tax Rates ($ amounts in millions)			
Tax Type	**Current Rate**	**Tax Rate Increment**	**Revenue**
Sales and Use Tax	6%	1%	$ 2,100
Personal Income Tax	3.07%	1%	$ 5,100
Corporate Net Income Tax	10%	1%	$ 378
Realty Transfer Tax	1%	1%	$ 683
Liquor Tax	18%	1%	$ 24
Malt Beverage Tax	$2.48/barrel	1 cent/barrel	$ 0.1
Cigarette Tax	$1.60/pack	10 cents/pack	$ 56
Other Tobacco Products	30% of wholesale	1%	$ 5

The table above is a guide, not an endorsement of any particular policy, nor is it an endorsement of any general policy to increase or decrease taxes.