FAST FACTS
House Appropriations Committee (D)

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General Fund Tax Expenditures and Revenue Options

This is a basic overview of the most-asked 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 average annual NYMEX price of natural gas less than or equal to $3.00.

Corporation 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, more than 20 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.

Gov. Rendell proposed combined reporting as part of the 2010/11 budget, and Gov. Wolf asked for it in the 2015/16, 2017/18 and 2018/19 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.

Sales and Use Tax

Sales and Use Tax Exclusions

Currently, 69 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 tax expenditures are for food and clothing, worth about $1.4 billion and $629 million, respectively. Exclusions for items commonly considered to be necessities -- such as food, clothing and hygiene products -- alleviate the regressive nature of the sales tax. Therefore, if the legislature were to remove such exclusions, it would hurt low-income individuals more than anyone else.

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 though 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 expenditures should be carefully studied. The list of tax expenditures is annually updated in the governor's executive budget. For 2018/19, the sales and use tax section begins on Page D46; see "What is a Tax Expenditure" on Page 3 of this document.

Incremental Revenue Estimates

The table on page 4 shows how state revenue would be affected by an increase or decrease in the tax rate. The revenue change for each hypothetical rate represents the estimated amount of revenue that could be gained or lost as compared to the revenue estimates from the 2018/19 Executive Budget.

The estimates shown in the table (pg. 4) can generally be extrapolated to calculate other tax rate scenarios by multiplying the estimate. For example, a change in the personal income tax rate of 0.2 percent (to 3.27 percent or 2.87 percent) would result in an increase or decrease of about $963.3 million in 2019/20 ($481.6 million multiplied by two).

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 educating taxpayers. Therefore, the full amount of estimated revenue for the first year might not be achievable for certain tax types if legislation is passed 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. Beauty is in the eye of the beholder, but no matter the opinion, 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. Most states have followed suit and today most report tax expenditures.

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 Thousands)				
Tax Type	**Tax Rate Increment**	**2018/19**	**2019/20**	**2020/21**
Sales and Use Tax (Current rate = 6.0%)	1%	$ 1,792,100	$ 1,822,650	$ 1,860,517
Personal Income Tax (Current rate = 3.07%)	0.1%	$ 461,697	$ 481,635	$ 505,726
Corporate Net Income Tax (Current rate = 9.99%)	1%	$ 292,293	$ 401,171	$ 429,409
Realty Transfer Tax (Current rate = 1%)	1%	$ 561,200	$ 584,900	$ 606,500
Liquor Tax (Current rate = 18%)	1%	$ 21,461	$ 22,506	$ 23,444
Malt Beverage Tax (Current rate = $2.48/barrel)	1 cent/barrel	$ 97	$ 99	$ 99
Cigarette Tax (Current rate = $1.60/pack)	10 cents/pack	$ 70,769	$ 71,444	$ 69,088
Other Tobacco Products (30% of wholesale price)	1%	$ 4,030	$ 4,153	$ 4,193

This table is a guide, not an endorsement of any particular policy, nor is it an endorsement of any general policy to increase taxes.

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