Breaking Ground

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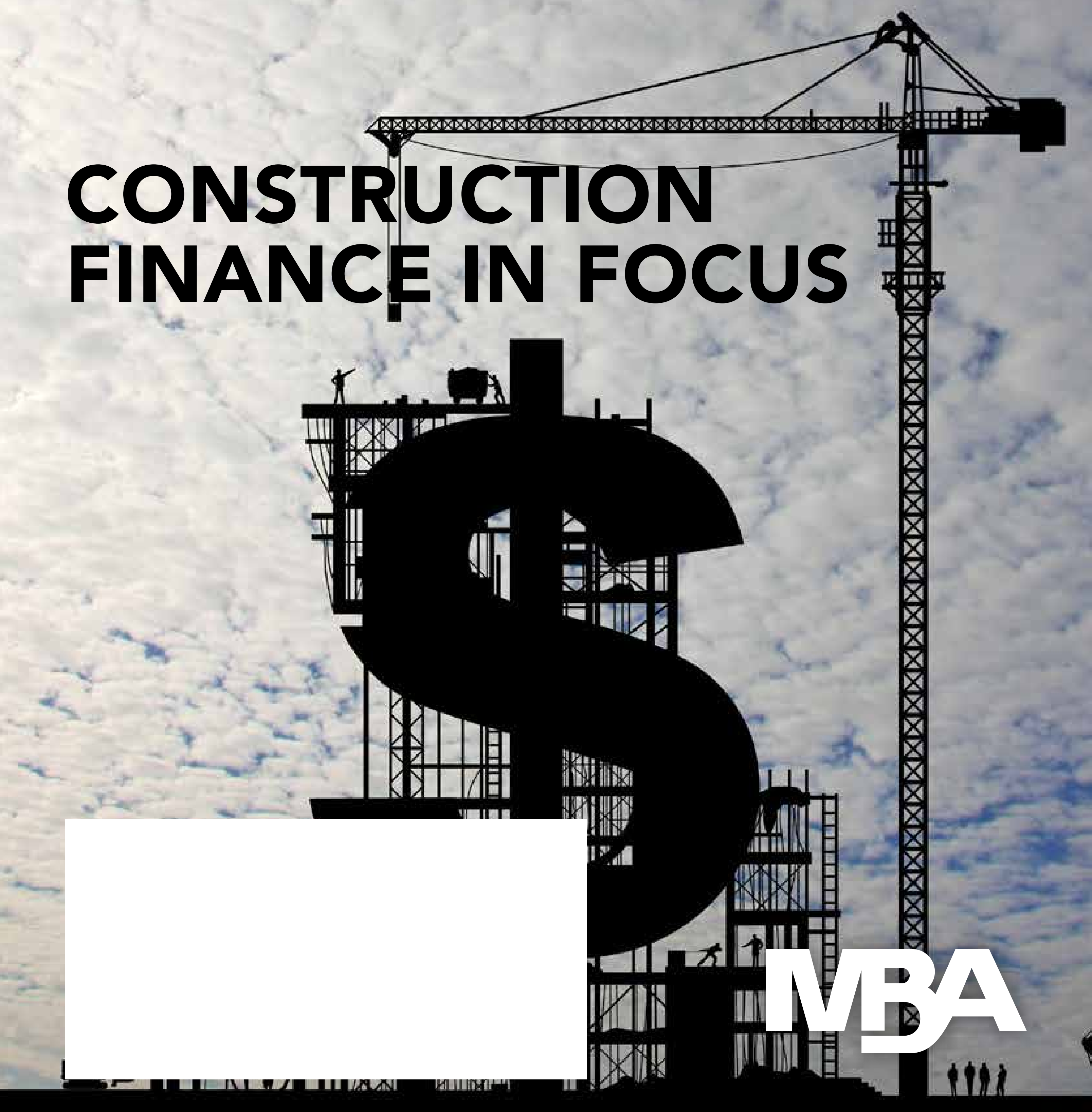
CONSTRUCTION FINANCE IN FOCUS



MBA

FINANCIAL PERSPECTIVE

A REDUCTION IN PA'S CORPORATE TAX HAS A CHANCE TO PASS IN 2022

A reduction in the commonwealth's Corporate Net Income (CNI) tax has been the top of the wish list for business attraction and economic development professionals for years. State legislators and governors from both sides of the aisle have been in favor of a reduction – with varying levels of enthusiasm and at different times – but attempts to reduce CNI have repeatedly fallen short of the finish line. Failure is, of course, still an option with the current legislature and administration, but there is unusual optimism that Pennsylvania's CNI rate, which has been 9.99 percent since 1965, could be lower beginning next year.

On April 13, Senate Bill 771 (SB 771) was approved by the Senate Finance Committee. The measure, introduced by Senator Ryan Aument (R-Lancaster) would bring the CNI from its current 9.99 percent to 6.99 percent by 2024. The legislation, as written, is performance-based, with the extent of further cuts dependent upon Pennsylvania's tax revenues being equal to the revenue projections for 2024 at the 9.99 percent rate.

The average state CNI is 6.0 percent. Pennsylvania currently has the third highest CNI in the U.S. The good news: our neighbor to the east, New Jersey, is slightly higher at 10.05 percent. The bad news: every other state bordering Pennsylvania is 6.5 percent or lower. Ohio, with its aggressive track record of incentive offerings, is one of six states with no corporate net income tax.

The bill calls for reductions that are similar to the ones proposed by Governor Wolf when he announced his 2022-2023 budget in February. The governor called for a two-point reduction in 2023, followed by a drop to 6.99 percent in 2026 and to 5.99 percent in 2027.

Two weeks later the Pennsylvania House of Representatives passed HB 1960, written by Rep. Josh Kail (R-Beaver), which would reduce the CNI rate by one percent in 2023, but only to 7.99 percent by 2025. HB 1960 will be reviewed in the Senate.

Matt Smith, president of the Greater Pittsburgh Chamber of Commerce and a former state representative, has seen numerous attempts at reducing the CNI fail because of concerns about the lost revenues. The Chamber is part of a coalition proposing an immediate two-point reduction. Smith cites the January announcement by Intel Corp. of a $20 billion investment in a chip manufacturing campus in Columbus, OH as a potential turning point in the debate.

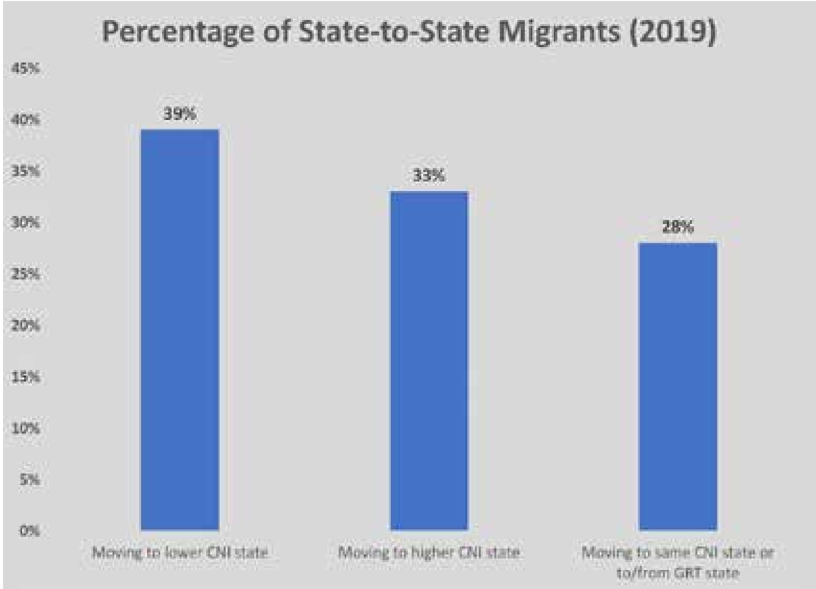
"What has changed now is that other states are moving in this direction, making themselves more attractive to business investment, so there are competitive pressures coming from the outside," Smith says. "The other thing that makes it different now, particularly for Western Pennsylvania, is the competition with Ohio and West Virginia. Ohio has no corporate income tax. They have other business taxes, but they market quite heavily the zero corporate net income tax across the U.S. and into Southwestern Pennsylvania. Intel's investment of billions in Columbus and Nucor's big investment in West Virginia are real wake up calls for Pennsylvania to get its business tax house in order."

Smith notes that proponents of the tax cut are looking beyond the benefits to Pennsylvania's businesses and corporations. In promoting SB 771, Sen. Aument has touted research that shows that states with lower – or the lowest – CNI rates outperform those with the highest rates in several key metrics. Among those metrics are perennial sore spots for Pennsylvania, like population growth, home price appreciation, and government revenues.

According to the research Aument compiled from 17 individual academic and private papers, states with the lowest CNI rates saw state tax revenues growth 103 percent from 2000 to 2022, while states with the highest rates experienced 92 percent growth. Homeowners in the half of the states that had the lowest CNI rates saw their property values increase 36 percent versus 27 percent for homeowners in the highest half of the states from 2010 to 2020. Aument also cited research that a decrease in CNI of one percentage point boosted worker's wages by $223.35.

There is, unfortunately, no research that shows a cause-and-effect relationship between the lower CNI rate and the better financial outcomes. Given the fact that most of the states with the lowest CNI rates are also attractive places to live and work for other reasons (better weather, lower overall taxes, fewer business regulations, etc.), it is possible that the higher state revenues or better home price appreciation are coincidental to the lower CNI.

More intriguing was the positive correlation between lower CNI rates and in-migration of population. While the coincidental factors mentioned above can obviously be driving migration, there is a direct relationship between population growth and job creation. For a state like Pennsylvania, which has been losing population and employment slowly and steadily for decades, a strategy that looks to reverse that trend is attractive.



Source: Corporate Net Income Tax Policy Analysis

Cade Hepner is the research analyst for the PA Senate who assembled and conducted the research supporting Aument's bill. The methodology for the population research was a regression analysis that compared population growth in the 23 states with the highest CNI to the 23 with the lowest. States with no CNI and no tax receipts were excluded (that included Ohio.) Hepner acknowledges that it is not possible to draw cause and effect conclusions between the lower tax rates and the gains in metrics. He points out two statistical probability factors that impressed him about the research on population growth. One, the coefficient of determination (R2), measures how changes in one variable – in this case population growth – can be explained by changes in another variable. The other (P-value) measures the likelihood that changes in the variables are unrelated.

"For this study, the R2 was 13.6, so we could expect the 13.6 percent of the change in population of a state could be correlated to the corporate income tax rate in any given year. That's a pretty good fit for a model that measures the effect of government policy," Hepner explains. "The P-value, the probability that these variables weren't related at all, was 3.9 to the negative 17th power. That's a likelihood of about four in one trillion."

Hepner notes that it is not possible to isolate any one state and judge the impact of a single variable, like the state's CNI rate, on other variables. He is more confident about the conclusions that can be drawn about the overall environment of low-tax rate states.

"I'm a person who doesn't like to say anything is certain, but it's a fairly easy conclusion that these tax rates exist in a pro-business environment," Hepner says. "Alison Felix is an economist from the Federal Reserve Bank of Kansas City who did research on this topic for the National Bureau of Economic Research. Her research found that CNI rates are generally carried down to employees. Based upon the conclusion Felix makes, you could conclude that wages are more attractive in those states because employers don't have the extra burden of the corporate income tax. The evidence supports that argument."

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The high CNI rate is one more obstacle for business attraction in Pennsylvania. Relative to the southern and southwestern states where new business has been flocking since 1980, Pennsylvania has poorer weather, an older declining population, poor infrastructure, challenging topography, and a regulatory environment that is less business friendly. Many of the faster-growing states, like Texas, Florida, and Colorado, also have low (or no) personal income tax rates. That makes talent attraction that much easier. Lowering one major obstacle to corporate location will not eliminate all the challenges of attracting business to Pennsylvania, but it makes sense given some of the state's current strengths.

In Pittsburgh, the pace of development of emerging technologies is quickening. Hundreds of millions have been invested to scale that development from viability to manufacturing. During this decade, many of the emerging companies will mature into high-volume manufacturers. The talent that these companies want is here. The best outcome will be that some of these companies will build plants in Western PA. But when they reach the point of needing those facilities, there will be a long line of smiling faces (with sweet incentives) from other regions. It will be easier to make a case for locating in Pennsylvania if regional leaders do not have to start the conversation by apologizing for the commonwealth's CNI rate, but it will likely not overshadow other key factors in site selection.

"My gut tells me that a lower rate will have less impact in Pittsburgh. The main factor determining these multi-market searches is availability of labor. As long as our population is stagnant and we don't have great labor numbers, Pittsburgh will be overlooked," says Tobiah Bilski, research manager for JLL Pittsburgh. Bilski expresses frustration at the "chicken or egg" dilemma of population and employment gains. "How do you shift that mindset? You need jobs to attract people. If companies are not coming here to provide those jobs, how do you attract people?"

One potential solution to the population dilemma is to retain a higher share of the students graduating from Pennsylvania's colleges and universities, many of which have strong reputations in technology and manufacturing. Roughly half of Pittsburgh's 20,000 graduates leave the area each year. Senator Ament argues that a deeper bench of employers would keep young Pennsylvania residents from relocating to find career opportunities.

The extent to which a reduced CNI rate will benefit business attraction is an open and unanswerable question. What proponents hope for is that the lower rate will reduce the number of opportunities lost because the commonwealth's corporate rate eliminates Pennsylvania before the merits of locating there are presented.

"CNI is a first cut thing. But if a company is looking at the Tri-State area or the Ohio Valley – sites that matter to Beaver County – it can make a difference when compared to the corporate rates in Ohio or West Virginia," says Lew Villotti, president of Beaver County Corporation for Economic Development.

Smith again points to the multi-market Intel site search as an example of the problem the high CNI rate causes.

"What we've been told by various site selectors was that Pennsylvania was never in the hunt for that Intel investment. It's not just that we're not in the game; we're not in the stadium competing for these kinds of investments," he says. "We can make an argument for our sites, our great workforce, and the great universities we know exist here, but we couldn't even make that argument because of impediments that we put in place as a state."

Pressed to estimate how many opportunities are lost because of the high CNI rate, Villotti replies with what is a regular refrain from economic development professionals.

"I don't know the answer to that," he says. "Those opportunities never make it to my front door."

Proponents of SB 771 hope to see it passed by both legislative houses and on the governor's desk for signature by the time the budget is approved in June. Even if the legislation passes with the most aggressive reduction, it will still be several years before Pennsylvania has a CNI rate that is equivalent to its neighbors and competitors. Smith believes that getting on the path to a competitive corporate rate would be an effective tool for the Department of Community and Economic Development (DCED) and its allies.

"Being at 7.9 percent doesn't get us to the place to be competitive but it does enable DCED and economic development organizations throughout the state to market Pennsylvania in a way that is much different from what we've done over the last 30 years," Smith suggests. "We will be able to say Pennsylvania is getting its business tax house in order. It shows we would be serious about making it a priority, which sends the market a signal in an impactful way."